Revenue recognition

Handbook

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Contents

New revenue challenges

The application of Topic 606 is not a simple exercise – it requires significant judgment, estimation and disclosures. Changes in business practices and the economic environment continue to create new challenges to the accounting for revenue.

In response to these challenges, companies evaluate and may need to revisit a number of estimates and judgments to account for their revenue arrangements and related costs. Companies may also apply certain aspects of the guidance that they had not, or had less frequently, applied in the past.

In this publication, we focus on the accounting and disclosure aspects of Topic 606. Questions continue to arise as companies enter into new or modified revenue arrangements, or respond to a changing economic environment. The interpretation of the principles in Topic 606 continues to be informed by evolving practice issues and regulator views.

Our purpose in this updated publication is to assist you in gaining an in-depth understanding of the five-step revenue model by answering the questions that we are encountering in practice and providing examples to explain key concepts.

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About this publication

The purpose of this Handbook is to assist you in understanding the revenue standard, Topic 606. In addition, this Handbook includes contract costs guidance under Subtopic 340-40 and guidance on the derecognition of nonfinancial assets under Subtopic 610-20.

Organization of the text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we are encountering in practice and includes examples to explain key concepts.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples:

— 606-10-25-16 is paragraph 25-16 of ASC Subtopic 606-10.

— ASU 2014-09.BC87 is paragraph 87 of the basis for conclusions to Accounting Standards Update No. 2014-09.

— TRG 01-15.16 is agenda paper no. 16 from the meeting of the International Accounting Standards Board (IASB) and the FASB's Joint Transition Resource Group for Revenue Recognition (TRG) held in January 2015.

— S-X Rule 5-02 is Rule 5-02 of SEC Regulation S-X.

— SAB Topic 11.M is SEC Staff Accounting Bulletin Topic 11.M.

— FRM 1500 is paragraph 1500 of the Financial Reporting Manual of the SEC's Division of Corporation Finance

— Regs Comm 03/2018 is a meeting of the SEC Regulations Committee in March 2018.

— 2007 AICPA Conf is the 2007 AICPA National Conference on Current SEC and PCAOB Developments. These references are hyperlinked to the source material on the SEC's website.

Pending content

This Handbook incorporates a number of Codification amendments in Accounting Standards Updates that are not yet effective for all entities. For example, the amendments to the Codification made by ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326) are reflected in this Handbook as pending content.

When an excerpt from the Codification is affected by this pending content:

— the specific sentences that have been superseded are underlined; and
— the amended sentences are included at the end of the excerpt, marked as pending content.

The transition dates for pending content are shown based on their general applicability to public entities (P) and nonpublic entities (N). See the relevant Topic to determine the specific transition requirements.

March 2024 edition

This version of our Handbook includes new and updated interpretations based on our experiences with companies applying Topic 606, as well as discussions with the FASB and SEC staffs.

Chapter 16 has been removed as the revenue standard is effective for all entities.

The following symbols are used throughout this Handbook to indicate the types of revisions made in this edition for sections, Questions, Examples and other items.

**	new item
#	significant updates or revisions to the item
●	item moved

Questions and Examples included in previous editions (regardless of when added or updated) that have not been significantly updated or moved in this edition are not marked.

Abbreviations

We use the following abbreviations in this Handbook:

IP	Intellectual property
MSA	Master services agreement
PCS	Post-contract support
R&D	Research and development
SaaS	Software-as-a-service
TRG	The IASB's and the FASB's Joint Transition Resource Group for Revenue Recognition

1. Executive summary

Scope

The guidance applies to all contracts with customers unless the customer contract is specifically in the scope of other guidance – e.g. Topic 944 (insurance), Topic 460 (guarantees).

Topic 606 applies to contracts to deliver goods or services to a customer. A 'customer' is 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.

Topic 606 is applied to part of a contract when only some elements are in the scope of other guidance.

Read more: chapter 2

Step 1: Identify the contract

Contracts can be written, oral or implied by an entity's customary business practices, but must be enforceable by law.

This may require legal analysis on a jurisdictional level to determine when a contract exists and the terms of that contract's enforceability.

A contract with a customer is accounted for under the revenue model when the contract is legally enforceable and all of the following criteria are met:

- the contract has commercial substance;
- rights to goods or services can be identified;
- payment terms can be identified;
- the consideration the entity expects to be entitled to is probable of collection; and
- the contract is approved and the parties are committed to their obligations.

If the criteria are not met, any consideration received from the customer is generally recognized as a deposit (liability).

Read more: chapter 3

Step 2: Identify the performance obligations

Performance obligations do not have to be legally enforceable; they

Performance obligations are the unit of account under Topic 606 and generally represent the distinct goods or services that are promised to the customer.

exist if the customer has a reasonable expectation that the good or service will be provided.

Promises to the customer are separated into performance obligations, and are accounted for separately if they are both (1) capable of being distinct and (2) distinct in the context of the contract.

A promise can be implied by customary business practices, policies or statements.

If the distinct goods or services are substantially the same and have the same pattern of transfer to the customer over time, they are combined into a single performance obligation (a 'series').

Read more: chapter 4

Step 3: Determine the transaction price

Estimating variable consideration is a significant judgment for many entities.

When determining the transaction price, an entity uses the legally enforceable contract term. It does not take into consideration the possibility of a contract being cancelled, renewed or modified.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. some sales taxes. This consideration can include fixed and variable amounts.

The transaction price determination also considers:

— **Variable consideration**, which is estimated at contract inception and is updated at each reporting date for any changes in circumstances. The amount of estimated variable consideration included in the transaction price is the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.

— **Noncash consideration** received from a customer, which is measured at fair value at contract inception.

— **Consideration payable to a customer**, which represents a reduction of the transaction price unless it is a payment for distinct goods or services the entity receives from the customer.

— **Significant financing component**, which may exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.

Read more: chapter 5

Step 4: Allocate the transaction price

A contractually stated price or list price is not presumed to be the stand-alone selling price of that good or service.

The transaction price is allocated at contract inception to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. Observable stand-alone prices are used when they are available. If not available, an entity is required to estimate the price using other techniques that maximize the use of observable inputs – even if the entity never sells the promised good or service separately.

Read more: chapter 6

Step 5: Recognize revenue

An entity first determines whether a performance obligation meets the criteria to recognize revenue over time.

If none of the over-time criteria are met, revenue for the performance obligation is recognized at the point in time that the customer obtains control of the goods or services.

An entity recognizes revenue when it satisfies its obligation by transferring control of the good or service to the customer.

A performance obligation is satisfied **over time** if one of the following criteria are met:

— the customer simultaneously receives and consumes the benefits as the entity performs;

— the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or

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

If control transfers **over time**, an entity selects a method to measure progress that is consistent with the objective of depicting its performance.

Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods or services – or prevent others from doing so.

If control transfers at a **point in time**, the following are some indicators that an entity considers to determine when the customer obtains control. The customer has:

— a present obligation to pay;
— physical possession;
— legal title;
— the risks and rewards of ownership; and
— accepted the asset.

Read more: chapter 7

Customer options

A customer option is accounted for as a performance obligation only if it grants the customer a material right.

Revenue is allocated to a customer option to acquire additional goods or services, and is deferred until (1) those future goods or services are transferred or (2) the option expires when it represents a material right.

A material right exists if the customer is only able to obtain the option by entering into the sale agreement and the option provides the customer with the ability to obtain the additional goods or services at a discount that is incremental to a discount typically given to that class of customer.

If the option is not a material right, it is considered a marketing offer that is accounted for separately.

Read more: chapter 8

Warranties

Warranties do not have to be separately priced to be accounted for as performance obligations.

Assurance-type warranties are generally accounted for under Topic 460 (guarantees).

A warranty is accounted for as a performance obligation if it includes a service beyond assuring that the good complies with agreed-upon specifications. This could require some warranties to be separated between a service element (deferral of revenue which is then recognized as the services are provided) and an assurance element (cost accrual at the time the good is transferred).

Read more: section 4.5

Principal vs. agent

Determining whether an entity is the principal or an agent in a transaction involving another party providing a good or service focuses on whether the entity has control of the good or service before it is transferred to the customer.

An entity identifies each specified good or service to be transferred to the customer, and determines whether it is acting as a principal or agent for each one. In a contract to transfer multiple goods or services, an entity may be a principal for some goods and services and an agent for others.

An entity is a principal if it controls the specified good or service that is promised to the customer before the good or service is transferred to the customer.

Indicators that an entity has obtained control of a good or service before it is transferred to the customer are:

— having primary responsibility to provide the specified goods or services;
— assuming inventory risk; and
— having discretion to establish prices for the specified goods or services.

Read more: chapter 9

Licensing of intellectual property

Topic 606 includes a framework for determining whether there is a license of IP, and the category into which it falls.

As a result, the pattern of revenue recognition for licenses could be point in time or over time depending on the nature of the license.

How an entity recognizes license revenue depends on the nature of the license. Topic 606 has two categories of licenses of IP:

— **Functional IP.** IP is functional if the customer derives a substantial portion of the overall benefit from the IP's stand-alone functionality – e.g. software, biological compounds, films and television shows. Revenue is generally recognized at the point in time that control of the license transfers to the customer.

— **Symbolic IP.** IP is symbolic if it does not have significant stand-alone functionality, and substantially all of the customer's benefit is derived from its association with the licensor's ongoing activities – e.g. brands, trade names and franchise rights. Revenue is generally recognized over the license period using a measure of progress that reflects the licensor's progress toward completion of its performance obligation.

There is an exception to the general revenue model on variable consideration for sales- or usage-based royalties attributable to licenses of IP. A sales- or usage-based royalty is recognized as revenue at the later of:

— when the sales or usage occurs; and

— the satisfaction or partial satisfaction of the performance obligation to which the royalty has been allocated.

Read more: chapter 10

Contract modifications

Topic 606 has a general framework to account for contract modifications either on a cumulative catch-up basis or a prospective basis.

When the parties approve a change in the scope or price of a contract, Topic 606 requires an entity to account for approved modifications either on a:

— **cumulative catch-up basis**, when the additional goods or services are not distinct; or
— **prospective basis**, when the additional goods or services are distinct.

If any additional distinct goods or services are not priced at their stand-alone selling prices, the remaining transaction price is required to be reallocated to all unsatisfied performance obligations, including those from the original contract.

Read more: chapter 11

Contract costs

Subtopic 340-40 provides guidance on costs to obtain and fulfill a contract in the scope of Topic 606.

Subtopic 340-40 provides guidance on the following costs related to a contract with a customer in the scope of Topic 606:

— incremental costs to obtain a contract; and
— costs incurred in fulfilling a contract that are not in the scope of other guidance.

Capitalization is required when specified criteria are met.

Incremental costs to obtain a contract with a customer (e.g. sales commissions) are required to be capitalized if an entity expects to recover those costs – unless the amortization period, which may include anticipated contracts or renewals, is less than 12 months.

The fulfillment cost guidance only applies when the costs are not in the scope of other guidance.

Fulfillment costs that are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant, and equipment – are capitalized if they:

- relate directly to an existing contract or specific anticipated contract;
- generate or enhance resources that will be used to satisfy performance obligations in the future; and
- are expected to be recovered.

Capitalized contract costs are subject to an impairment analysis.

An entity amortizes the assets recognized for the costs to obtain and fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the assets relate.

Read more: chapter 12

Presentation and disclosure

The disclosure requirements are designed to provide financial statement users with sufficient information to understand the nature, amount, timing and uncertainty of revenue, certain costs and cash flows arising from contracts with customers.

For each contract with a customer, an entity presents a contract asset, contract liability and/or a receivable on the balance sheet, if applicable.

Topic 606 contains both qualitative and quantitative disclosure requirements for annual and interim periods.

There are specific disclosure requirements for:

- disaggregation of revenue;
- contract balances, including changes during the period;
- performance obligations;
- remaining transaction price;
- significant judgments; and
- assets recognized to obtain or fulfill a contract, including changes during the period.

Reduced disclosures are available for many nonpublic entities.

Read more:

- chapter 14 (presentation)
- chapter 15 (disclosure)

Derecognition of nonfinancial assets

Subtopic 610-20 uses the principles in Topic 606 to account for certain transfers to noncustomer counterparties.

Gains and losses may arise from the derecognition of nonfinancial assets and in substance nonfinancial assets transferred to counterparties that are not customers. The revenue recognition principles in Topic 606 are applied to such contracts when the transferring entity does not retain a controlling financial interest.

Partial sales of nonfinancial assets are in the scope of Subtopic 610-20.

Entities recognize any retained interest in a derecognized nonfinancial asset (e.g. an equity method investment) at fair value in a partial sale when the derecognition criteria are met.

Read more: chapter 17

2. Scope

Detailed contents

2.1 How the standard works

Topic 606 applies to contracts with customers. To be in the scope of Topic 606, the goods or services provided to a customer need to be outputs of the entity's ordinary business activities.

The standard provides a single revenue recognition model regardless of the industry in which an entity operates, and replaced much (but not all) of the industry-specific revenue guidance under legacy US GAAP. If a contract with a customer remains in the scope of another Topic, it is not in the scope of Topic 606. As a result, the following are not in the scope of Topic 606:

- lease contracts in the scope of Topic 842;
- guarantees (other than product or service warranties) in the scope of Topic 460;
- financial instruments and contracts for the sale or transfer of financial instruments that are in the scope of other guidance;
- contracts in the scope of Topic 944 for insurance entities; and
- nonmonetary exchanges between entities in the same line of business to facilitate sales to (potential) customers.

A contract may comprise elements that are in the scope of other guidance, and residual elements that are in the scope of Topic 606.

Subtopic 340-40 applies to certain costs associated with contracts with customers that are in the scope of Topic 606. Section 12.2 discusses the scope of Subtopic 340-40.

2.2 Scope of Topic 606

Excerpt from ASC 606-10

> Entities

15-1 The guidance in this Subtopic applies to all entities.

> Transactions

15-2 An entity shall apply the guidance in this Topic to all **contracts** with **customers**, except the following:

a. Lease contracts within the scope of Topic 842, Leases.
b. Contracts within the scope of Topic 944, Financial Services—Insurance.
c. Financial instruments and other contractual rights or obligations within the scope of the following Topics:
   1. Topic 310, Receivables
   2. Topic 320, Investments—Debt Securities
   2a. Topic 321, Investments—Equity Securities
   3. Topic 323, Investments—Equity Method and Joint Ventures
   4. Topic 325, Investments—Other
   5. Topic 405, Liabilities
   6. Topic 470, Debt
   7. Topic 815, Derivatives and Hedging
   8. Topic 825, Financial Instruments
   9. Topic 860, Transfers and Servicing.
d. Guarantees (other than product or service warranties) within the scope of Topic 460, Guarantees.
e. Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Topic would not apply to a contract between two oil companies that agree to an exchange of oil to fulfill demand from their customers in different specified locations on a timely basis. Topic 845 on nonmonetary transactions may apply to nonmonetary exchanges that are not within the scope of this Topic.

15-2A An entity shall consider the guidance in Subtopic 958-605 on not-for-profit entities—revenue recognition—contributions when determining whether a transaction is a contribution within the scope of Subtopic 958-605 or a transaction is within the scope of this Topic.

15-3 An entity shall apply the guidance in this Topic to a contract (other than a contract listed in paragraph 606-10-15-2) only if the counterparty to the contract is a customer. A customer is 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.

20 Glossary

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

Customer

A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

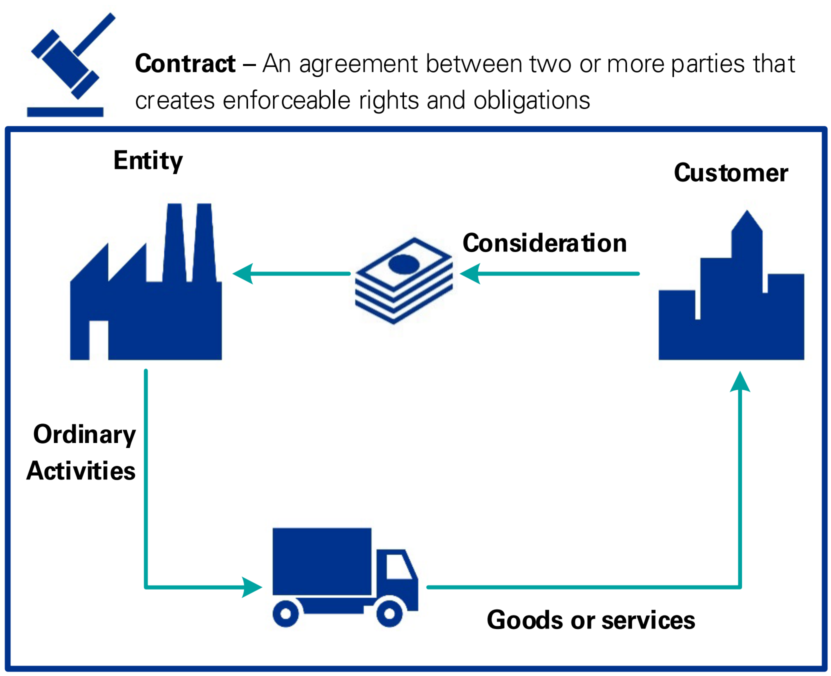
Revenue

Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Topic 606 applies to contracts with customers. Therefore, the Topic applies if there is (1) a contract and (2) a customer. The scope section of Topic 606 generally focuses on whether an arrangement is with a customer.

A customer is defined 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." As a result, the scope of Topic 606 generally depends on whether the goods or services an entity provides under an arrangement are outputs from its ordinary business activities. [606-10 Glossary]

If the arrangement is in the scope of Topic 606, then Step 1 is applied to the arrangement to determine when a contract exists for accounting purposes (see chapter 3).



Even if a contract is with a customer, it may fall into one of the scope exceptions to Topic 606. The scope exceptions are discussed in section 2.3. In addition, by definition, contracts with noncustomers are not in the scope of Topic 606. Subtopic 610-20 applies to the sale of a nonfinancial asset to a noncustomer. [606-10-15-3, 610-20-15]

Accounting for the sale of a nonfinancial asset to a noncustomer under Subtopic 610-20 is nonetheless similar to the accounting for a sale of nonfinancial assets to a customer under Topic 606. Subtopic 610-20 applies Topic 606's principles to determine how to measure the gain or loss and when to derecognize a nonfinancial asset. The main differences relate to presentation of the sale on the income statement and disclosure. Specifically, under Topic 606, a sale affects the revenue and cost of sales accounts on the income statement, while a sale under Subtopic 610-20 affects the gain or loss accounts. See section 17 for further discussion of derecognition of nonfinancial assets. [610-20-25-5, 25-6, 32-6]

For a discussion of when sales of real estate and in-substance real estate are in the scope of Topic 606, see KPMG publication, Revenue: Real Estate.

2.2.10 Ordinary activities

The counterparty in an arrangement is considered a customer under Topic 606 only if it is acquiring goods or services that are an output of the entity's ordinary activities. [606-10 Glossary]

Question 2.2.10
What are ordinary activities?

Interpretive response: The FASB chose not to define ordinary activities. Instead, it stated in the basis for conclusions to ASU 2014-09 that the definition of ordinary activities is derived from the definition of revenue. Topic 606's definition of revenue refers to an entity's 'ongoing major or central operations'. The concept of ongoing major or central operations refers to how an entity attempts to fulfill its basic function in the economy of producing and distributing goods or services at prices that enable it to pay for the goods and services it uses and to provide a return to its owners. [ASU 2014-09.BC53, 606-10 Glossary]

How an entity has classified a nonfinancial item on its balance sheet that it sells or transfers is an important factor in determining whether the sale or transfer is in the entity's ordinary activities. Typically, the sale or transfer of an item that is classified as property, plant and equipment is not in an entity's ordinary activities, while the sale or transfer of inventory is in an entity's ordinary activities. However, judgment may be necessary to determine what constitutes an ordinary activity of the entity because other factors could be relevant in any given situation.

Example 2.2.10
Identifying ordinary activities

Real Estate Co. is in the business of developing and selling retail land. Its sale of a property to Purchaser is in the scope of Topic 606, because Purchaser has entered into a contract to purchase an output of Real Estate's ordinary activities and is therefore considered a customer of Real Estate.

Conversely, Manufacturer is selling its corporate headquarters to Purchaser. The transaction is not a contract with a customer because selling real estate is not an ordinary activity of Manufacturer. As a result, this transaction is not in the scope of Topic 606; it falls into the scope of Subtopic 610-20 because it is a sale of a nonfinancial asset to a noncustomer, and will be presented as other income. [610-20-15]

Example 2.2.11
Identifying ordinary activities – other real estate owned by a bank

Bank provides financing to third parties for the purchase of real estate. When a borrower defaults on a loan, Bank forecloses on the real estate and re-sells it to recoup the portion of the loan outstanding. The resale typically occurs within a short period and may involve the provision of financing.

A seller-financed sale of real estate that is not considered a business would involve a product (a loan) that is part of Bank's ordinary activities. However, Bank does not ordinarily invest in nonfinancial assets and the other good that is being obtained by the buyer (the property) is generally not an output of Bank's ordinary activities. Therefore, Bank's sale of the foreclosed real estate is not in the scope of Topic 606; it falls into the scope of Subtopic 610-20, because it is a sale of a nonfinancial asset to a noncustomer. [AICPA AAG-REV 12.7.01, 610-20-15]

Example 2.2.12
Identifying ordinary activities – credit card arrangements

Retailer provides Bank with marketing services and a license to use its brand to market a co-branded credit card. Bank pays royalties to Retailer based on cardholder spending and card acquisition fees for each new co-branded card account.

Retailer's primary operations are to procure goods for sale and distribution to its retail customers. Although the consideration in the co-brand card agreements is received from Bank and not retail customers, the arrangement is common in the industry. Co-brand card arrangements are used as a vehicle by retailers to increase customer spending in their stores.

Therefore, Retailer's marketing and license of its brand in the co-brand arrangement is considered part of its ongoing major or central activities and results in revenue in the scope of Topic 606 from Bank (the customer in the arrangement).

Question 2.2.20

Are proceeds received from the settlement of a patent infringement with another party in the scope of Topic 606?

Interpretive response: We believe it depends on whether the proceeds constitute revenue. Revenue is defined in Topic 606 and the ASC Master Glossary as 'Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations'.

We observe that this approach to the evaluation is consistent with that taken under pre-Topic 606 legacy US GAAP, which, in the absence of a codified definition of revenue, looked to the conceptual framework for determining classification of the settlement amount. The current Topic 606 and ASC Master Glossary definition of 'revenue' is unchanged from the legacy Conceptual Framework definition of revenue in CON 6. Therefore, we believe the analysis regarding the income statement classification of settlement proceeds in these scenarios did not change upon adopting Topic 606. [606-10 Glossary, ASC Master Glossary]

The classification of settlement proceeds depends on the facts and circumstances. The settlement of a patent infringement should be distinguished from a settlement of past due fees from contracts in the scope of Topic 606. When a portion of the settlement relates to past due fees, an entity allocates the settlement amount between past due license fees and settlement gain. Generally, this is a residual allocation, with the license receiving an allocation equal to its stand-alone selling price and any remaining amount being characterized as a settlement gain. The settlement proceeds in this example are partially characterized as revenue from contracts with customers because the entity's ordinary activities included licensing IP.

In contrast, if a settlement does not relate to an entity's ordinary activities, then no part of the settlement is characterized as revenue. For example, assume Company B has patented internal-use software and Company A has infringed upon Company B's patent by developing a similar internal-use software product. Because licensing is not part of Company B's ongoing major or central operations (i.e. ordinary activities), no part of the settlement is characterized as license revenue from contracts with customers.

We believe that the considerations outlined in an SEC staff speech are still relevant in analyzing the substance of these arrangements. The speech discussed matters such as potential elements of the arrangement, allocation of consideration, classification of the settlement (including treatment of payment to customers) and consideration received by a customer as a result of a settlement. It was noted that accounting for litigation settlements requires judgment in determining the elements in the arrangement, when to recognize those elements and the value to allocate to them. [2007 AICPA Conf]

Question 2.2.25

Are sales of byproducts from a manufacturing process in the scope of Topic 606?

Interpretive response: It depends. Income earned on sales of byproducts from a manufacturing or production process are in the scope of Topic 606 and presented as revenue if the byproduct is an output of the entity's ordinary activities and is not specifically in the scope of other guidance. See Question 2.2.10.

As a result of its manufacturing process, an entity may produce byproducts that are often sold to third parties who may use it to develop their product or sell it to others in a secondary market. Entities evaluate the specific facts of their arrangements to determine the appropriate guidance to apply.

When these byproducts are routine outputs of the primary manufacturing process and their sales are also part of recurring (ongoing) operations, the transaction likely is in the scope of Topic 606. In that case, the sale will be accounted for and presented as revenue in the income statement.

Entities evaluate the specific facts of these arrangements to determine the appropriate guidance to apply as not all byproducts represent revenue under Topic 606. For example, an entity may have a nonrecurring sale of scrap or byproduct that are not outputs of its primary manufacturing process. In these cases, it may be appropriate for the sale to be accounted for under Subtopic 610-20 and presented as other income.

Generally, it is not appropriate for an entity to record the income related to the sale of byproducts to third parties as a reduction of costs to produce the core product. However, it is important to differentiate byproducts or scrap that are sold to third parties from a scenario in which the manufacturer returns raw materials or a product to the supplier, or disposes of raw materials because they do not pass inspection before the manufacturing process commences. For a return of raw materials or inputs to manufacturing before the process commences, it may be appropriate to record the income on return as a reduction of costs. See Example 2.2.15.

Example 2.2.15

Byproduct sales

Producer manufactures and sells ethanol to oil refiners throughout North America. Producer purchases its raw materials (primarily corn) to process into the final product (ethanol) from farmers located near its production facilities. Processing the corn into ethanol also yields byproducts of distillers' grain and corn oil. Producer sells the distillers' grain to regional dairies and feedlots and in the commodities market, and the corn oil to food companies.

Even though Producer does not dedicate significant resources to its byproduct sales, the distillers' grain and corn oil are routine outputs of its primary manufacturing process and part of its recurring (ongoing) operations. As such, the byproduct sales represent part of Producer's ongoing or major central operations and are in the scope of Topic 606; accordingly, they should be presented as revenue in the income statement.

It would not be appropriate for Producer to record this income as a reduction of costs to produce what it believes is its core product.

2.2.20 Customer

A customer is 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. However, a counterparty to a contract is not a customer if it participates in the entity's ordinary activities that produce the contract's goods or services or otherwise share in the risk or benefits of those ordinary activities. [606-10-15-3]

Question 2.2.30
Can an entity have more than one customer for a transaction?

Interpretive response: Yes. A revenue transaction may have multiple counterparties that meet the definition of a customer. Identifying all of an entity's customers is important because, for example, the determination of whether a counterparty is a customer affects the accounting for any consideration payable to that counterparty.

For example, Marketing (agent) markets and incentivizes the purchase of Merchant's (principal) products by providing coupons to Merchant's end customer. Marketing might view both Merchant and Merchant's end customer as its customers. In that case, Marketing evaluates consideration payable to Merchant's end customer to determine whether it is consideration payable to a customer. If it is, then Marketing accounts for that payment as a reduction of revenue rather than as an expense. See section 5.7 for discussion of consideration payable to a customer.

See Question 2.2.70 for the customer in a service concession arrangement that is not in the scope of Topic 853.

Collaborative arrangements

Excerpt from ASC 808-10

• > Other Considerations

15-5A A collaborative arrangement within the scope of this Topic may be partially within the scope of other topics, including, but not limited to, Topic 606 on revenue from contracts with customers.

15-5B A collaborative arrangement is partially in scope of Topic 606, if a unit of account, identified as a promised good or service (or bundle of goods or services) that is distinct within the collaborative arrangement using the guidance in paragraphs 606-10-15-4 and 606-10-25-19 through 25-22, is with a **customer**. An entity shall apply the guidance in Topic 606 to a unit of account that is within the scope of that Topic, including the recognition, measurement, presentation, and disclosure requirements. If a portion of a distinct bundle of goods or services is not with a customer, the unit of account is not within the scope of Topic 606.

• > Joint Operating Activity

15-7 The joint operating activities of a collaborative arrangement might involve joint development and commercialization of intellectual property, a drug candidate, software, computer hardware, or a motion picture. For example, a joint operating activity involving a drug candidate may include research and development, marketing (including promotional activities and physician detailing), general and administrative activities, manufacturing, and distribution. However, there may also be collaborative arrangements that do not relate to intellectual property. For example, the activities of a collaborative arrangement may involve joint operation of a facility, such as a hospital. A collaborative arrangement may provide that one participant has sole or primary responsibility for certain activities or that two or more participants have shared responsibility for certain activities. For example, the arrangement may provide for one participant to have primary responsibility for research and development and another participant to have primary responsibility for commercialization of the final product or service.

• > Active Participation

15-8 Whether the parties in a collaborative arrangement are active participants will depend on the facts and circumstances specific to the arrangement. Examples of situations that may evidence active participation of the parties in a collaborative arrangement include, but are not limited to, the following:

a. Directing and carrying out the activities of the joint operating activity
b. Participating on a steering committee or other oversight or governance mechanism
c. Holding a contractual or other legal right to the underlying intellectual property.

15-9 An entity that solely provides financial resources to an endeavor is generally not an active participant in a collaborative arrangement within the scope of this Topic.

• > Significant Risks and Rewards

15-10 Whether the participants in a collaborative arrangement are exposed to significant risks and rewards dependent on the commercial success of the joint operating activity depends on the facts and circumstances specific to the arrangement, including, but not limited to, the terms and conditions of the arrangement.

15-11 The terms and conditions of the arrangement might indicate that participants are not exposed to significant risks and rewards if, for example:

a. Services are performed in exchange for fees paid at market rates.
b. A participant is able to exit the arrangement without cause and recover all (or a significant portion) of its cumulative economic participation to date.
c. Initial profits are allocated to only one participant.
d. There is a limit on the reward that accrues to a participant.

15-12 Other factors that shall be considered in evaluating risks and rewards include:

a. The stage of the endeavor's life cycle
b. The expected duration or extent of the participants' financial participation in the arrangement in relation to the endeavor's total expected life or total expected value.

15-13 Many collaborative arrangements involve licenses of intellectual property, and the participants may exchange consideration related to the license at the inception of the arrangement. Such an exchange does not necessarily indicate that the participants are not exposed to significant risks and rewards dependent on the ultimate commercial success of the endeavor. An entity shall use judgment in determining whether its participation in an arrangement subjects it to significant risks and rewards.

20 Glossary

Collaborative Arrangement

A contractual arrangement that involves a joint operating activity (see paragraph 808-10-15-7). These arrangements involve two (or more) parties that meet both of the following requirements:

a. They are active participants in the activity (see paragraphs 808-10-15-8 through 15-9).
b. They are exposed to significant risks and rewards dependent on the commercial success of the activity (see paragraphs 808-10-15-10 through 15-13).

Topic 606 excludes from its scope contracts with a collaborator or a partner that has contracted with the entity to share in the risks and benefits that result from the collaborative activity or process. Arrangements described by the parties as collaborative are common in certain industries, such as software or biotechnology. Such arrangements are accounted for under Topic 808.

The basis for conclusions to ASU 2014-09 further provides some examples of arrangements for which the facts and circumstances affect whether they are collaborations (but does not conclude as to whether or not they are):

— collaborative R&D efforts between biotechnology and pharmaceutical entities or similar arrangements in the aerospace and defense, technology, and healthcare industries, or in higher education;

— arrangements in the oil and gas industry in which partners in an offshore oil and gas field may make payments to each other to settle any differences between their proportionate entitlements to production volumes from the field during a reporting period; and

— arrangements in the not-for-profit industry in which an entity receives grants and sponsorship for research activity and the grantor or sponsor specifies how any output from the research activity will be used. [ASU 2014-09.BC54]

See Question 2.4.30 for further discussion of collaborative arrangements that are partially in the scope of Topic 808 and partially in the scope of Topic 606.

Question 2.2.40

Can a collaboration partner be a customer?

Interpretive response: Yes. Topic 808 states that certain transactions between collaborative partners are accounted for as revenue under Topic 606 when the collaborative partner is a customer. If a collaborative arrangement's activities are the ordinary activities of one of the parties, then the other party may be that party's customer. In this instance, the party with the customer applies Topic 606 to its revenue from the arrangement and the other party (the customer) applies Topic 808 to its revenue and costs associated with the arrangement. If neither party is considered the other's customer, then both parties apply Topic 808.

Topic 808 also specifies that the determination of whether there is a customer relationship is made in the context of a unit of account (i.e. a distinct good or service). Topic 606 guidance (including recognition, measurement, presentation and disclosure requirements) is applied to the unit of account when the collaboration partner is a customer. When a portion of a bundled unit of account (i.e. a bundle that includes multiple promises that are not individually distinct) is not with a customer, the entire unit of account is not in the scope of Topic 606.

Topic 808 does not address the recognition and measurement of collaborative arrangements. However, its presentation requirements offer the following methodology for determining how to classify and report payments between collaborators:

— if the collaborative arrangement is in the scope of other authoritative literature, apply that literature;

— if the collaborative arrangement is not in the scope of other authoritative literature, apply other authoritative literature by analogy; and

— if there is no appropriate analogy, apply a reasonable and rational accounting policy (and do so consistently). [808-10-45-3]

Therefore, it is important for an entity to determine both:

— whether an arrangement is a collaborative arrangement; and

— whether a collaborator or a partner is a customer for any portion of the arrangement. Even if the arrangement is a collaborative arrangement, if the collaborator is a customer for a distinct good or service or all of the contract, the entity's activities related to transferring goods or services that are an output of its ordinary activities are revenue-generating and in the scope of Topic 606.

For those collaboration arrangements or aspects of the arrangement that are in the scope of Topic 808 but are not in the scope of Topic 606, an entity may (but is not required to) analogize to the recognition and measurement guidance in Topic 606 for some or all of the collaboration. If an entity analogizes to Topic 606, it should not present the related revenue together with revenues from contracts with customers that are directly in scope of Topic 606. [808-10-45-3]

Example 2.2.20

Collaborative arrangement that is in the scope of Topic 606 for one party but not the other party

Software Developer and Equipment Manufacturer enter into an arrangement to jointly develop software to power a new class of consumer product that Equipment Manufacturer will then produce and sell to customers.

The entities will both actively participate in the development of the software – e.g. both participate on a joint development committee that is responsible for outlining required specifications for the software and in testing the software in various prototypes of the new consumer product. They also will jointly share in the R&D costs of the new software, and, if successful, share in the profits from sales of the new consumer product that uses the software.

Software Developer will own the software, and have the right to license it to other customers for applications that do not compete with Equipment Manufacturer's product. Equipment Manufacturer will obtain a perpetual license to the software.

Based on these facts and circumstances, both entities conclude that the arrangement is a collaborative arrangement. However, the two entities reach different conclusions about whether the arrangement is in the scope of Topic 606:

— **Software Developer's** ordinary activities include developing and licensing software. Therefore, Equipment Manufacturer, in contracting to obtain a perpetual license to Software Developer's software, is contracting to obtain an output of Software Developer's ordinary activities. In this scenario, Equipment Manufacturer is Software Developer's customer and the software development and licensing aspects of this contract are in the scope of Topic 606 for Software Developer. Software entities receiving funding in these types of arrangements should analyze the guidance related to funded software development arrangements as discussed in Question 2.2.50.

— **Equipment Manufacturer** will participate in the development of software that Software Developer will own at the conclusion of the collaboration. Equipment Manufacturer does not, as part of its ordinary activities, engage in software development or sell software (or other IP) to other parties. Consequently, Equipment Manufacturer concludes that its services as part of the collaboration to assist Software Developer in developing the software are not in the scope of Topic 606. However, once the product is developed, Equipment Manufacturer's sales of equipment will be in the scope of Topic 606.

Example 2.2.25
Collaborative agreement

Biotech has an arrangement with Pharma to research, develop and commercialize a drug candidate. Biotech transfers a license of IP to Pharma and is responsible for the R&D activities, while Pharma is responsible for the commercialization of the drug candidate. Both Biotech and Pharma agree to participate equally in the results of the R&D and commercialization activities.

Because the parties are active participants and share in the risks and rewards of the end product (the drug), this is a collaborative arrangement. However, there may be a revenue contract within the overall collaborative arrangement.

Pharma determines that the guidance in Topic 606 would not apply to its arrangement with Biotech as Pharma's contracts with customers are with third parties and not Biotech. However, Biotech concludes that providing a license and R&D services are outputs of its ordinary activities and that Pharma is a customer. As a result, Biotech accounts for the contract entirely under Topic 606.

The guidance in Topic 808 does not address the recognition and measurement of collaborative arrangements. In addition, the Topic 808 guidance on presentation refers to other authoritative literature or, if there is no appropriate analogy, suggests that entities apply a reasonable, rational and consistently applied accounting policy election. Therefore, in some cases it might be appropriate to apply the principles of Topic 606 to some transactions with collaborators or partners. [ASU 2014-09.BC56]

R&D funding arrangements

R&D funding arrangements are used to finance the R&D of a variety of new products. They can take different forms; however, many are limited partnerships, with the entity conducting the R&D having a general partnership interest and the entities funding those activities having limited partnership interests. [730-20-05-1 – 05-2]

Question 2.2.50

Are R&D funding arrangements in the scope of Topic 606?

Interpretive response: It depends. The entity first evaluates whether other GAAP applies – e.g. Topic 815 (derivatives), Topic 470 (sales of future revenues), Subtopic 985-20 (certain funded software arrangements) or Subtopic 912-730 (if the funding party is the federal government). See Question 3.3.10 of the KPMG Handbook, Research and development, for further discussion.

If other GAAP does not apply, then the entity analyzes the funding arrangement under Subtopic 730-20. Under that Subtopic, all or portions of the funding proceeds are considered to be either: [730-20-25-3, 25-8]

- an obligation to repay others (i.e. a borrowing); or
- an obligation to perform contractual services.

See section 3.4.10 of KPMG Handbook, Research and development, for further discussion to make this determination.

If the entity's obligation under the arrangement is to perform R&D services, then Topic 606 applies if the funding party meets the definition of a customer. If the funding party is not a customer, the entity considers whether other GAAP applies. See Question 3.4.80 in KPMG Handbook, Research and development, for further discussion of the accounting when the funding party is not a customer.

Example 2.2.30

Funding arrangement with a customer

Developer receives funding from ERP Corp. to develop a software application to map the locations of oil and natural gas deposits. ERP will obtain a nonexclusive, perpetual license to the software and intends to embed that software as a module into its enterprise resource planning (ERP) software for sale to oil and gas producing entities. In addition to the research funding that it does not have to repay, Developer will receive future royalties on ERP's sales of ERP software that includes Developer's module.

The arrangement is not in the scope of Subtopic 730-20 because Developer is not required to repay the funding from ERP. In addition, because Developer is in the business of developing and licensing software to third parties, ERP is contracting to obtain software and services that are an output of Developer's ordinary activities and therefore is a customer. Accordingly, Developer accounts for this funded software development arrangement under Topic 606. [730-20-25-3 – 25-8, 606-10 Glossary]

We believe this is the appropriate conclusion even if Developer doesn't normally develop mapping software or develop software for oil and gas entities. We believe ordinary activities applies to the broader consideration that Developer is in business as a software developer that licenses software to third parties.

Example 2.2.40
Funding arrangement with a noncustomer

ABC Corp. receives partial funding from Funder to develop a software application to be used in semiconductor research. ABC does not have to repay the funding as long as it puts forth 'best efforts' in the R&D.

ABC will own the developed software, while Funder will receive a perpetual license to that software. Both parties intend to use the developed software to increase their research efficiency. ABC is not a software developer, nor has it licensed software previously. However, both parties have agreed that, subject to their joint approval, they would license this software to another party if it would not negatively affect their use of the software. In such case, they would split any license fees earned on a 50/50 basis.

Funder is a collaboration partner, rather than a customer, because ABC's ordinary activities do not include the development and licensing of software. We believe this would be the appropriate conclusion even if ABC had entered into a similar transaction in the past; engaging in an activity on more than one occasion does not by itself create a presumption that an activity is ordinary for that entity. We believe a *pattern* of such transactions or an intention for similar future transactions could call into question whether Funder is a customer even if ABC's primary activities are semiconductor R&D and licensing the results of those efforts. [606-10 Glossary]

If ABC had a pattern of such transactions, then Funder is a customer and ABC follows the guidance of Topic 606. If Funder is determined to be a partner in the collaborative arrangement, it follows Topic 808, which provides income statement presentation guidance. However, because Topic 808 does not provide recognition and measurement guidance for collaborative arrangements, Funder will have to apply a reasonable, rational and consistent accounting policy for such arrangements which may include analogizing to Topic 606 (see Question 2.2.40). [808-10-45-3 – 45-4]

Service concessions and similar arrangements

Service concession arrangements in the scope of Topic 853 are arrangements between a grantor (a government or public sector entity) and an operating entity. In these arrangements, the operating entity typically operates and maintains the grantor's infrastructure (e.g. airports, roads, bridges, tunnels, prisons or hospitals) for a specified period. Additionally, the operating entity may be required to construct or provide periodic capital-intensive maintenance (major maintenance) of the infrastructure. In exchange for these services, the operating entity may receive payments from the grantor, or may be given the right to charge the public (third-party users) for using the infrastructure. [853-10-05-1 – 05-2]

Although Topic 853 defines a service concession arrangement, an operating entity accounts for its related revenue and costs under other Topics, such as Topic 606. [853-10-25-1]

For an in-depth analysis of the accounting for service concession arrangements, see KPMG Handbook, Service concession arrangements.

Question 2.2.60

Who is the customer in a service concession arrangement?

Interpretive response: Because in a service concession arrangement the operating entity could receive payments for its services either from the grantor or from third-party users, an issue arises as to who the operating entity's customer is in these arrangements.

The *grantor* in a service concession arrangement in the scope of Topic 853 is the operating entity's customer for operating services, which includes maintenance services. The grantor is also the customer (and therefore in the scope of Topic 606) for other aspects of the service concession arrangement, such as construction and upgrade services.

Question 2.2.70

When an entity operates another entity's assets under a contract outside the scope of Topic 853, who is the entity's customer?

Interpretive response: Some entities enter into arrangements that are similar to service concession arrangements but are not with a public sector entity and therefore do not meet the definition of a service concession arrangement in the scope of Topic 853. For example, an entity may operate a hotel or a food establishment for a private property owner.

Topic 606 applies to these types of arrangements, so the operating entity determines whether the property owner, the end consumer or both are its customers.

Example 2.2.50

Customer of an operating entity

Management Co. enters into a contract with Property Owner to provide hotel management services to Property Owner. Management Co. will provide reservations, hotel staffing, cleaning services, security, food and beverage services, and similar services, and it will collect rental fees from hotel guests.

The specific rights and obligations under the contract are as follows.

— Management Co. provides a license to use its hotel brand name and related marks over the agreement term. It also provides access to its proprietary hotel system IP, which includes the reservation system, mobile applications and property management software over the agreement term.

— Management Co. manages the hotel operations on behalf of the Property Owner based on the terms of the Management Agreement.

- Management Co. executes all contracts in the name of and on behalf of Property Owner.
- Property Owner selects the brand name under which the hotel will be operated.
- Property Owner provides the pre-opening funds and all working capital.
- Property Owner has budget approval rights over the operating and capital budget rights.
- Property Owner pays Management Co. a royalty fee based on sales, an incentive fee based on hotel performance and reimbursement of direct labor costs incurred.

Although fees are collected from hotel guests, Management Co. determines that Property Owner is the customer in this contract because the obligation is to provide services to Property Owner.

2.3 Scope exceptions

2.3.10 Overview

Topic 606 is often referred to as a residual topic because it applies to a contract with a customer only if that contract is not in the scope of another Topic. For example, if a contract with a customer is a lease (or contains a lease), part or all of it may fall into the scope of Topic 842. Any portion of such a contract that is not in the scope of the leasing Topic is analyzed under Topic 606. [ASU 2014-16.BC61]

Section 606-10-15 lists several specific types of arrangements that are accounted for under other Topics – e.g. leases, certain types of guarantees, financial instruments, insurance contracts and nonmonetary exchanges.

Leases

Lease contracts in the scope of Topic 842 are specifically excluded from the scope of Topic 606. [606-10-15-2(a)]

See Question 2.4.10 for discussion of contracts that include lease and non-lease components.

For an in depth analysis of the accounting for leases under the leases standard, Topic 842, see KPMG Handbook, Leases.

Guarantees

Guarantees in the scope of Topic 460 are specifically excluded from the scope of Topic 606. [606-10-15-2(d)]

Question 2.3.10

Are guarantees of an entity's own future performance in the scope of Topic 606?

Interpretive response: It depends. Topic 460 does not apply to a guarantee or an indemnification of an entity's own future performance – e.g. a guarantee that the guarantor will not take a certain future action. [460-10-15-7(i)]

Although a performance guarantee is outside the scope of Topic 460, it might be a derivative in the scope of Topic 815 (see KPMG Handbook, Derivatives and hedging). If the performance guarantee does not qualify as a derivative under Topic 815, it is in the scope of Topic 606 and usually gives rise to variable consideration (see section 5.3) in the arrangement.

For example, an entity may provide maintenance services and guarantee that it will respond within 12 hours of each request or pay a penalty. Because the entity is guaranteeing its own performance, that provision is not in the scope of Topic 460 and gives rise to variable consideration in the scope of Topic 606. See Question 5.3.80 for further discussion of service level guarantees/ arrangements. [606-10-15-2]

Conversely, assume an entity serves only as an agent to coordinate maintenance services, but also guarantees to its new customers the quality of the third-party maintenance service provider's work. For example, if the entity guarantees that the maintenance will last for at least 90 days or it will pay a penalty, the entity is not guaranteeing its own performance. This guarantee is not in the scope of Topic 606 because the entity is providing a guarantee related to a third-party's performance over which it does not have control as a principal in the transaction. Instead, this guarantee is in the scope of Topic 460.

Question 2.3.20

Are contracts that include a profit margin guarantee in the scope of Topic 606?

Interpretive response: It depends. The entity needs to first consider whether the guarantee is in the scope of Topic 460 (guarantees).

The scope of Topic 460 includes contracts that contingently require a guarantor to make payments to a guaranteed party based on changes in an underlying that is related to an asset, a liability or an equity security of the guaranteed party. However, Topic 460 also lists certain exclusions, including a contract that provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party. [460-10-15-4(a), 15-7(e)]

Therefore, when an entity provides a profit margin guarantee that is based on the customer's sales (revenue or volume) of the entity's products, the guarantee is not in the scope of Topic 460. Provided that the guarantee does not qualify as a derivative or is not accounted for under another Topic, a profit margin guarantee based on the customer's sales of the entity's products is in the scope of Topic 606. An example is a clothing manufacturer's contract with a retail store that obligates it to refund the retailer if the retailer does not meet a minimum sales margin on its sales of the manufacturer's product; this is because the refund is based on the sales of the product.

In contrast, a market value guarantee on a nonfinancial asset owned by the guaranteed party is in the scope of Topic 460. Therefore, we believe seller guarantees of a return on investment for real estate, similar to market value guarantees, generally fall into the scope of Topic 460. [460-10-15-4(a), 55-2(b)]

When a contract with a customer contains elements addressed by different Topics, if the other Topics specify how to separate and/or initially measure one or more parts of the contract, an entity first applies those separation and/or initial measurement requirements. Therefore, the separation and measurement guidance in Topic 460 applies to the guarantee. [606-10-15-4]

Under this guidance, the guarantee is separated from the sale transaction and initially measured at fair value. The seller allocates the remainder of the contract consideration to the sale of the real estate, which is subject to Topic 606's guidance on determining the transaction price.

Example 2.3.10
Profit margin guarantee

Manufacturer enters into a contract to sell 1,000 dresses to Retailer for $20 per dress. The contract states that Manufacturer will refund up to 20% of the sales price after 90 days if Retailer has not met a minimum sales margin (i.e. a profit margin guarantee).

Manufacturer determines that the guarantee is not in the scope of Topic 460 because the payment constitutes a vendor rebate based on the sales revenues of the dresses. Manufacturer further concludes that the guarantee is not in the scope of other Topics and therefore is in the scope of Topic 606. Because the amount Manufacturer may need to refund Retailer is not known, the guarantee represents variable consideration (see section 5.3).

Question 2.3.30
Are fees from financial guarantees in the scope of Topic 606?

Interpretive response: Generally, no. Fees received to guarantee the indebtedness of a third party are typically in the scope of Topic 460 or Topic 815. [TRG 04-16.52, 310-10-60-4, 942-825-50-2]

Financial instruments

Topic 606 excludes from its scope essentially all contracts involving the sale or transfer of financial instruments. It specifically excludes the following financial instruments and other contractual rights or obligations:

— receivables in the scope of Topic 310;
— investments in debt and equity securities in the scope of Topics 320 or 321;
— equity method investments and investments in joint ventures in the scope of Topic 323;
— other investments in the scope of Topic 325;
— liabilities in the scope of Topic 405;
— debt in the scope of Topic 470;
— derivative instruments and hedging activities in the scope of Topic 815;
— financial instruments in the scope of Topic 825; and
— transfers and servicing of financial assets in the scope of Topic 860. [606-10-15-2(c)]

Example 2.3.15
Vendor rebates that represent a derivative

Manufacturer sells snow removal equipment to resellers as part of its ordinary activities. Manufacturer implements two rebate programs to stimulate demand for its snow blowers.

— The first program provides rebates to resellers based on their volume of purchases.
— The second program provides end customers with a rebate if snowfall during the winter season is significantly below normal levels.

Manufacturer determines that the first rebate program is in the scope of Topic 606 and accounts for the volume rebate as variable consideration in its contract with the reseller. See Question 5.3.30.

Manufacturer determines that the second rebate program meets the definition of a weather derivative as defined by and in scope of Subtopic 815-45.

Although both rebate programs are related to customer sales, the rebate program that represents a weather derivative is not accounted for under Topic 606. Derivatives in the scope of Topic 815 are specifically excluded from the scope of Topic 606.

Question 2.3.40
Is income earned from servicing financial assets in the scope of Topic 606?

Interpretive response: Generally, no. To the extent servicing or sub-servicing arrangements are in the scope of Topic 860, their servicing fees are excluded from the scope of Topic 606. See chapter 10 of KPMG Handbook, Transfers and servicing of financial assets. [TRG 04-16.52]

Servicing income may be earned by a financial institution when it sells a loan to a third party but retains the right to perform services, such as communicating with the borrower and collecting interest, principal and escrow payments. Other entities may also acquire or assume those servicing rights.

This question was raised with the TRG because Topic 860 does not provide explicit guidance on the accounting for contractually specified servicing fees. However, Subtopic 860-50 does provide guidance for the initial recognition and subsequent measurement of assets or liabilities for off-market fees in these arrangements. As such, the TRG generally agreed that Topic 860 provides implicit guidance on the accounting for servicing fees and therefore these fees are excluded from the scope of Topic 606. [TRG 04-16.52]

Question 2.3.50

Are deposit-related fees generated by financial institutions in the scope of Topic 606?

Interpretive response: Yes. Deposit-related fees (e.g. fees related to ATM usage, wire transfers, foreign exchange transactions, stop payment orders, maintenance fees and dormancy fees) are in the scope of Topic 606. This is because those fees are not specifically addressed in Topic 310 (which addresses loan fees but not deposit-related fees), Topic 405 (which addresses only the accounting for the related deposit liability) or other financial instrument Topics. [TRG 04-16.52]

Question 2.3.60

Are credit card fees in the scope of Topic 606?

Interpretive response: It depends. Topic 310 includes guidance on accounting for credit card fees that entitle the cardholder to use the credit card. Fees that are in the scope of Topic 310 are excluded from the scope of Topic 606. [606-10-15-2(c)(1)]

Even though credit card fees may entitle the cardholder to other services (e.g. airport lounge access or roadside assistance), Topic 310 states that credit card fees can cover many cardholder services. To the extent a fee compensates the entity for a service provided during the loan commitment period, Topic 310 states that the separate components of a commitment fee are not identifiable and reliably measurable to allow for separate accounting recognition for each component. Because Topic 310 does not permit separate accounting for credit card fees, no portion of those fees may be accounted for under Topic 606. [310-20-25-15]

The TRG agreed that a credit card issuing bank should not assume that all of its credit card arrangements are outside the scope of Topic 606. In particular, the substance of arrangements being labelled as credit-card lending arrangements may be clearly the sale of other goods or services. [TRG 07-15.36]

Financial institutions charge cardholders other fees in addition to the annual cardholder fees that entitle the cardholder to use the credit card. For example, delinquency fees are included in the scope of Topic 310. Although not all fees charged to cardholders are explicitly referenced in Topic 310, they are generally considered to be in the scope of Topic 310 if they are tied to the loan origination activities under the Topic 310 cardholder arrangement. For example, a foreign exchange fee that is assessed on a cardholder borrowing in a foreign transaction would be in the scope of Topic 310.

Topic 310 does not address the accounting for interchange or discount revenue that is earned by a card-issuing financial institution or a merchant acquirer. These fees are not included in the arrangement with the cardholder. Therefore, these card-related revenue streams are in the scope of Topic 606.

Question 2.3.70

Are credit cardholder rewards programs in the scope of Topic 606?

Interpretive response: It depends. The card-issuing bank should evaluate its specific facts and circumstances. The determination is based on whether the entire arrangement that gives the right to participate in the credit cardholder reward program is in the scope of the receivables guidance in Topic 310.

— If the fee that entitles the cardholder to use the card (which is in the scope of Topic 310 and not Topic 606) also gives the cardholder the right to participate in the loyalty program, the accounting for the loyalty program is outside the scope of Topic 606 because the fee is in the scope of Topic 310 (see Question 2.3.60).

— If the fee that gives the cardholder the right to participate in the loyalty program is not the same as the fee that entitles the cardholder to use the card, the loyalty program fee may not be in the scope of Topic 310 and further analysis is required.

If the entire arrangement with the cardholder is not in the scope of Topic 310, then the card-issuing bank determines whether the cardholder reward program is in the scope of Topic 606 by determining whether the contract for the rewards program is with a customer. The card issuing bank then determines whether the goods and services provided under the cardholder reward program are distinct goods or services. [TRG 07-15.36]

Rewards that are provided outside of the cardholder lending arrangement or promised as part of another arrangement – e.g. a card issuing bank's promise to provide loyalty points to the merchant's customer on their behalf – may be accounted for under Topic 606. If this is the case, the entity determines the nature of the promise and whether the loyalty points represent material rights that would cause the associated revenue to be deferred under Topic 606 until the rewards are redeemed (see section 8.6).

Question 2.3.80

Is an investment manager's carried interest in the scope of Topic 606?

Interpretive response: It depends.

Investment managers are compensated in different ways for providing asset management services including a base management fee, an incentive-based fee or an incentive-based capital allocation in the form of a carried interest in a partnership or similar structure. Incentives are earned based on the performance of the assets under management.

Because carried interest arrangements are generally in-form equity, the TRG discussed whether such arrangements are either in the scope of Topic 606 or accounted for as an ownership interest in the investee entity at its April 2016 meeting. FASB members present at the meeting indicated that the FASB discussed performance fees in asset management contracts when developing Topic 606. All FASB members present at the meeting expressed the view that performance fees in the form of carried interest arrangements were intended to be in the scope of Topic 606. [TRG 04-16.50]

The SEC Observer at the meeting indicated that the SEC staff would accept an application of Topic 606 for these arrangements. However, he also noted that applying an ownership model to these arrangements, rather than Topic 606, may be acceptable based on the specific facts and circumstances. If an entity were to apply an ownership model, the SEC staff would expect the full application of the ownership model, including an analysis of the consolidation guidance in Topic 810, the equity method of accounting under Topic 323 or other relevant guidance. We understand that the SEC staff would not object to the view that the carried interest would be evaluated as a *performance fee* rather than an interest in the fund itself when making an assessment of whether it is a variable interest under Topic 810.

The SEC Observer did not elaborate on the nature of the facts and circumstances that in the SEC staff's view would require application of Topic 606 to these arrangements. We are not aware of any examples in which the SEC staff believe applying an ownership model would be unacceptable when the performance fee is in the form of equity (i.e. carried interest).

Based on our understanding of the SEC staff's views, we believe both private and public companies may account for performance-based fees in the form of a capital allocation under one of the following models (as an accounting policy election to be consistently applied):

- the revenue recognition guidance in Topic 606; or
- an equity ownership model using the guidance in Topic 323, Topic 810 or other relevant guidance.

Based on our current understanding of the views of the FASB and SEC staffs, if an entity applies Topic 606 to these arrangements, we believe it will generally be difficult to support a conclusion that it is preferable to voluntarily change to an ownership model. Future standard setting or regulatory developments may cause our view to change.

If an entity applies an ownership model (e.g. Topic 323), the presentation and disclosure of the equity income from these arrangements would be separate from revenue from arrangements accounted for under Topic 606.

Question 2.3.85

Are commodity sales contracts in the scope of Topic 606?

Interpretive response: It depends. Topic 606 applies to a contract (or a portion of a contract) when it is not in scope of other guidance. Whether a contract related to the sale of a commodity is in the scope (or partially in the scope) of Topic 606 depends on whether the contract meets the definition of a derivative, contains an embedded derivative, and/or whether the normal purchase/sell exception is met and applied.

Therefore, companies analyze their contracts under the derivatives and hedging guidance in Topic 815 before applying Topic 606. See chapters 2 and 3 of KPMG Handbook, Derivatives and hedging.

Question 2.3.86

Is a sale of future revenue in the scope of Topic 606?

Interpretive response: No. The sale of future revenue is typically accounted for as debt under Subtopic 470-10.

Entities may enter into arrangements whereby they sell the rights to future revenue to another party. For example, an entity sells rights to future royalties or other contingent customer payments to an investor in exchange for an upfront cash payment. The classification of the upfront cash payment as debt or deferred income depends on the facts and circumstances of the transaction and an analysis of the rebuttable presumption under Subtopic 470-10. This generally results in debt classification when one or more factors are present. See section 3.7.30 of KPMG Handbook, Debt and equity financing. [470-10-25-2]

Regardless of the classification of the cash payment, the contract to sell future revenue is outside the scope of Topic 606. The customer contract to which the sale of future revenue relates, continues to be accounted for under Topic 606.

Insurance

Contracts in the scope of Topic 944 are excluded from the scope of Topic 606. [606-10-15-2(b)]

Question 2.3.90

Are all contracts provided by insurance entities excluded from the scope of Topic 606?

Interpretive response: No, only contracts in the scope of Topic 944 are excluded from the scope of Topic 606. An insurance entity may have contracts with customers that do not contain insurance elements and are not in the scope of Topic 944, such as claims adjudication and settlement to customers without providing insurance coverage. When an insurance entity enters into a contract with a customer that contains an insurance element or an insurance risk mitigation or cost containment activity, the entity needs to analyze whether *all* of the elements are in the scope of Topic 944. [606-10-15-2(b), ASU 2016-20.BC14]

Insurance entities may perform various activities that are in the scope of Topic 944 because an insurance element is present in the contract (or in a combined set of contracts). For example, an insurance entity may provide claim adjudication/processing activities for a customer that has purchased a high-deductible policy. Although the insurance entity may not be required to make payment under the high-deductible policy, the claim adjudication/processing activities mitigate the insurer's loss of risk above the deductible. As such, the claim adjudication/processing activities are part of the insured activity and therefore in the scope of Topic 944. In contrast, if the insurance entity provides the claim adjudication/processing without an insurance element, these services are in the scope of Topic 606.

Other activities that should be analyzed to determine if they have an insurance element in the scope of Topic 944 include:

- health insurance activities, such as enrollment, provider network access, preventive care, transportation to facilities for treatment and disease management;
- safety inspections;
- roadside assistance;
- cybersecurity activities; and
- title search.

Government grants and subsidies

Question 2.3.100

Are grants, subsidies and other payments from government agencies in the scope of Topic 606?

Interpretive response: It depends. An entity first applies any explicit guidance in other Topics, such as guidance on agricultural subsidies in Topic 905-605 or guidance on grants to not-for-profit entities in Subtopic 958-605. For guidance on accounting for grants (contributions) received by a not-for-profit entity, see Question 2.3.110.

If explicit accounting guidance does not exist in other Topics, the entity next determines if Topic 606 applies by assessing if either the government agency or another party is a customer in the transaction. A customer is 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. If the government agency does not meet the definition of a customer and is not making a payment on behalf of another entity that meets the definition of a customer, the entity should consider the most appropriate guidance to apply by analogy given its specific facts and circumstances.

Some entities account for grants not in the scope of Topic 606 by analogizing to IAS 20, Accounting for Government Grants and Disclosure of Government Assistance. Other entities may analogize to Subtopic 958-605. Although the guidance on contributions in Subtopic 958-605 excludes transfers of assets from governmental entities to business entities, the FASB staff noted that business entities are not prohibited from analogizing to that guidance.

Entities may also apply by analogy the recognition and measurement guidance in Topic 606. However, even if an entity applies the recognition and measurement principles in Topic 606 by analogy, it does not classify the subsidy as revenue from contracts with customers. [606-10-15-2]

Disclosure requirements for certain government assistance payments

ASU 2021-10, Disclosures by Business Entities about Government Assistance, created Topic 832, which requires business entities to disclose information about certain government assistance they receive. Only business entities are in the scope of Topic 832; not-for-profit entities and employee benefit plans are exempt from Topic 832.

Not all government assistance payments received by business entities are subject to Topic 832's disclosure requirements – only government assistance payments that those entities account for by analogy to either IAS 20 or Subtopic 958-605 are subject to the disclosure requirements. If other authoritative guidance (e.g. Topic 606) applies to a transaction between a business entity and the government or if a business entity has applied guidance that is not an analogy to IAS 20 or Subtopic 958-605 (e.g. analogized to Topic 450), the transaction is outside the scope of the Topic 832 disclosure requirements. See KPMG Issues In-Depth, Government assistance disclosures, for further discussion.

Future developments**

FASB project on government grants

On November 1, 2023, the FASB added a project to its technical agenda on the accounting for government grants received by business entities.

For additional discussion of the project, see KPMG Defining Issues, FASB project on government grants.

Contributions received

Question 2.3.110

Are contributions received by an entity in the scope of Topic 606?

Interpretive response: It depends. If an entity determines that the transaction is a contribution and not an exchange transaction, it is accounted for as a contribution under Subtopic 958-605 unless the contribution is a government grant received by a for-profit entity. See Question 2.3.100 for guidance on government grants received by for-profit (business) entities. [TRG 40-41.34]

A contribution is a voluntary nonreciprocal and unconditional transfer of something of value from one entity to another in which the transferring entity is not an owner of the entity. [958-605 Glossary]

Conversely, an exchange transaction in the scope of Topic 606 involves 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 – i.e. a reciprocal transfer. [ASC Master Glossary]

Subtopic 958-605 indicates that an exchange transaction is a reciprocal transaction in which each party receives and sacrifices *commensurate value*. The subtopic provides additional guidance about how to determine if commensurate value has been transferred and indicates that the public benefit of a governmental grant or the execution of the grantor's mission do not represent commensurate value. Therefore, government grants where commensurate value is not exchanged are considered contributions and outside the scope of Topic 606. [958-605-15-5A, 958-605 Glossary]

Entities may enter into some transactions that are contributions and others that are not. Therefore, an entity needs to evaluate which, if any, of its transactions are either fully or partially in the scope of Topic 606. For further discussion of transactions partially in the scope of Topic 606, see section 2.4.

Nonmonetary exchanges

Question 2.3.120

Are nonmonetary exchanges in the scope of Topic 606?

Interpretive response: It depends. Many entities enter into barter transactions to exchange the right to use their product for the right to use another entity's product. These transactions vary, but examples include:

— exchange of oil to fulfill demand from customers in different locations;
— exchange of a software license for another software license that will be sold (or licensed) to customers; and
— exchange of air time and telecommunications network capacity to ensure that customers always have access to wireless services.

Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange, are outside the scope of Topic 606. The facts and circumstances of each nonmonetary transaction should be considered separately to determine whether this scope exception applies. We generally expect this exception to apply when the exchange does not have commercial substance or is for logistical or economic convenience. [606-10-15-2(e)]

If the scope exception applies, then Topic 845 applies to the exchange. If the scope exception does not apply, then Topic 606 applies to the exchange if the counterparty is a customer. If the counterparty is not a customer and the transaction involves the derecognition of a nonfinancial asset, then Subtopic 610-20 applies to the exchange.

Question 2.3.125

Are nonmonetary exchanges of finished goods in the scope of Topic 606?

Interpretive response: It depends. Entities may exchange finished goods with entities in the same line of business to facilitate sales to their customers. This type of finished good exchange is outside the scope of Topic 606. However, the exchange of finished goods for work in process or raw materials will likely be in the scope of Topic 606. [606-10-15-2(e)]

Entities may enter into arrangements to exchange finished goods for raw materials or work in process to be used in their manufacturing process. These types of exchanges are not made to facilitate sales to customers and therefore are not in the scope of Topic 845. If these exchanges are not derivatives, they are evaluated to determine if there is a contract with a customer. That determination is based on whether the exchange party is obtaining goods that are the output of the entity's ordinary activities. For a discussion of ordinary activities, see Question 2.2.10.

Unless the exchange is a derivative in the scope of Topic 815, we generally expect finished goods exchanges for work in process or raw materials to be in the scope of Topic 606. This is because finished goods are outputs of an entity's ordinary operations. For guidance on the accounting for non-cash consideration in a contract with a customer, see section 5.6.

Example 2.3.20

Nonmonetary exchanges

Telco A and Telco B provide wireless services such as voice, data and text to their customers. However, they maintain and operate networks in different regions. Telco A and Telco B have agreed to exchange airtime and network capacity to ensure that their respective customers always have access to wireless services.

The exchange is expected to be approximately equal and the contract requires no payment between the entities. Also, the exchange is neither a sale of property, plant and equipment nor a lease.

This transaction is outside the scope of Topic 606 because Telco A and Telco B have entered into an agreement that is a nonmonetary exchange between entities in the same line of business to facilitate sales to their customers. As a result, this transaction is excluded from disclosures required by Topic 606, including the presentation of revenue from contracts with customers.

Contracts with repurchase provisions

Question 2.3.130

Are contracts with repurchase provisions in the scope of Topic 606?

Interpretive response: It depends on the terms of the repurchase agreement and whether the customer obtains control of the asset. Topic 606 indicates that the customer does not obtain control of the asset in certain situations; depending on the relationship between the repurchase amount and the original selling price, the transaction is accounted for as a lease under Topic 842 or as a financing arrangement. For additional discussion of repurchase provisions, see sections 7.5.50, 7.5.60, 7.5.70. [606-10-55-68]

2.4 Transactions partially in scope

2.4.10 Overview

Excerpt from ASC 606-10

> Transactions

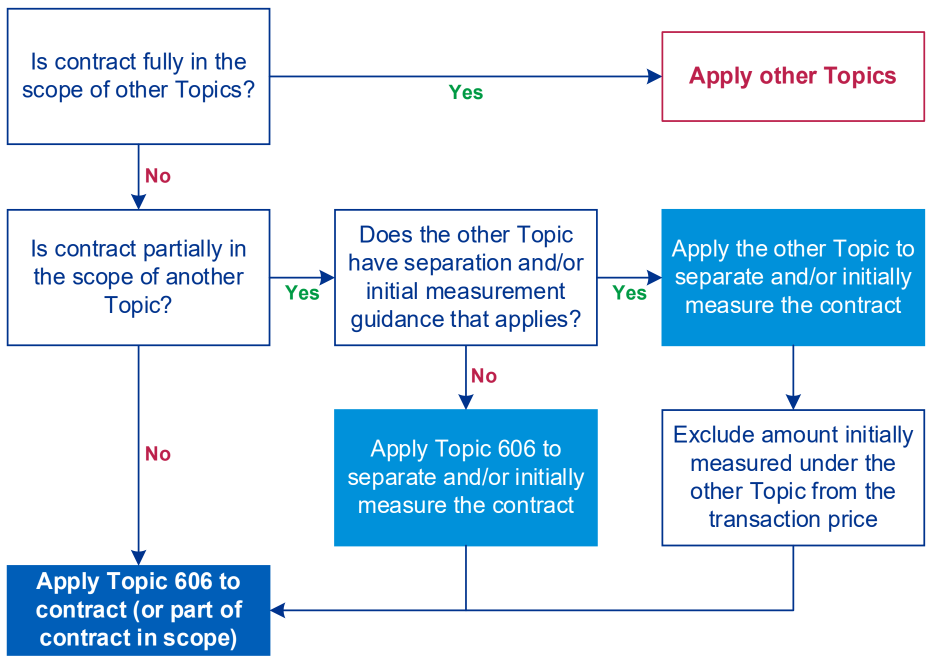
15-4 A contract with a customer may be partially within the scope of this Topic and partially within the scope of other Topics listed in paragraph 606-10-15-2.

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.

A contract can be partially in the scope of Topic 606 and partially in the scope of other guidance. Because Topic 606 is residual guidance, if another Topic specifies how to separate or measure one or more parts of a contract, then the entity first applies that separation or measurement guidance. Any separated elements of a contract that are not in the scope of that other Topic may be in the scope of Topic 606. [606-10-15-4]

The following decision tree highlights the key considerations when determining the accounting for a contract that is partially in the scope of Topic 606.



Question 2.4.10

How does the scoping guidance in Topic 606 apply to arrangements that include parts in the scope of Topic 606 and parts in Topic 842 (leases)?

Interpretive response: Maintenance and other services (e.g. operations services) provided on leased items are in the scope of Topic 606 and therefore not considered a lease component of the contract; any element other than the right to use the underlying asset is outside the scope of Topic 842. [842-10-15-28, 15-31, ASU 2016-02.BC143]

Topic 842 provides guidance on separating lease from non-lease components and measuring the consideration in the contract. Topic 842 also refers to the transaction price allocation guidance in Topic 606 to allocate consideration to the lease and non-lease components. [842-10-15-38]

Topic 842 provides lessors with an optional practical expedient to not separate lease from non-lease components of a contract if certain criteria are met. This practical expedient is an accounting policy election made by class of underlying asset if the following criteria are met: [842-10-15-42A]

— the timing and pattern of transfer to the lessee of the lease component and the non-lease component(s) associated with that lease component are the same; and
— the lease component, if accounted for separately, would be classified as an operating lease.

If a contract includes multiple non-lease components (one or more that meet these criteria and one or more that do not), the lessor combines those components that meet the criteria with the lease component and separately accounts for each non-lease component that does not. [842-10-15-42C]

If the non-lease component(s) is (are) the predominant component(s) of the combined component, the lessor should account for the combined component under Topic 606 instead of the leases guidance in Topic 842. All other combined components would be accounted for under Topic 842 as a single lease component classified as an operating lease. This includes situations in which the lease and non-lease component(s) are equally significant to the contract. [842-10-15-42B]

See sections 4.4.1 and 12.3 of KPMG Handbook, Leases, for further discussion and analysis, including the disclosure requirements that apply when the practical expedient is elected.

Example 2.4.10
Partially in scope transaction

Telco enters into a contract that includes a promise to provide telecom equipment and services to Customer. Telco first applies Topic 842 to assess whether the arrangement contains a lease.

Scenario 1: Topic 842 practical expedient elected

Telco determines that:

— use of the equipment represents an operating lease; and
— the timing and pattern of transfer of the lease is the same as the telecom services.

Telco elects to apply the practical expedient, and accounts for the lease and telecom services combined under Topic 606 because Customer can reasonably expect to ascribe more value to the telecom services (non-lease component) than to the telecom equipment (lease component). [842-10-15-42B]

Scenario 2: Topic 842 practical expedient not elected

Telco elects not to apply the practical expedient in Topic 842 and therefore accounts for the equipment lease under Topic 842.

Telco first applies the applicable leasing guidance to identify the lease component and then applies the transaction price allocation guidance in

Topic 606 to allocate consideration between the lease and non-lease components. Lastly, Telco accounts for the allocated consideration for the leased equipment under Topic 842 and the telecom services under Topic 606.

If Telco concludes that the equipment is not leased, then it accounts for the entire contract under Topic 606. In applying Topic 606, Telco could find that providing the equipment is distinct from providing the services (see section 4.3.20).

Question 2.4.20

Is it possible that there is little or no residual amount left to allocate under Topic 606?

Interpretive response: Yes. For some arrangements, as illustrated in Example 2.4.20, after applying the other accounting guidance on separation and/or initial measurement, there may be little or no amount left to allocate to components of the contract that are in the scope of Topic 606.

Example 2.4.20

Zero residual amount after applying other accounting requirements

Bank enters into a contract with Customer under which it receives a cash deposit and provides associated deposit services and treasury services for no additional charge. The cash deposit is a liability in the scope of Topic 405.

Bank first applies the initial recognition and measurement requirements in Topic 405 to measure the cash deposit. The residual amount is then allocated to the associated deposit services and treasury services and accounted for under Topic 606. Because the amount received for the cash deposit is recognized as a deposit liability, there are no remaining amounts to allocate to the associated deposit services and treasury services.

If Bank also charges a fee for the services, some amounts would be allocated to those services.

Question 2.4.30

Can a counterparty be both a collaborator and a customer?

Interpretive response: Yes. As noted in Question 2.2.40, Topic 606 excludes from its scope contracts with a collaborator or a partner that are not customers, but rather share with the entity the risks and rewards of participating in an activity or process pursuant to Topic 808. However, collaborative arrangements (or parts thereof) could be in the scope of Topic 606 if the counterparty meets the definition of a customer for some or all of the terms of the arrangement. A collaborator or partner could both be a customer for an aspect of the arrangement and not a customer for another. Topic 606 applies to the unit of account (i.e. the distinct good or service) in the arrangement for which the other party is a customer.

It is important for an entity that engages in collaborative arrangements to analyze whether the other parties to these arrangements are customers for some activities, and therefore whether such activities are revenue-generating. Making this assessment requires judgment and consideration of all applicable facts and circumstances of the arrangement. See Question 2.2.40. [ASU 2014-09.BC55]

Question 2.4.40

Does Topic 606 apply to alternative revenue programs in rate-regulated industries?

Interpretive response: Alternative revenue programs (ARPs) allow for an adjustment to rates charged to customers in the future based on changes in demand or if certain other objectives are met. They do not represent contracts with customers but rather are contracts with a regulator. Therefore, they are accounted for under Subtopic 980-605, while Topic 606 applies to the normal operations of rate-regulated entities – e.g. the sale of electricity, gas or water to customers in the course of an entity's ordinary activities.

Subtopic 980-605 requires entities to present ARP revenues separately from revenues from contracts with customers; however, neither Topic 606 nor Subtopic 980-605 provides separation guidance for these transactions where revenue is attributed to both a regulator and a customer. Therefore, based on discussions with the FASB, we believe two acceptable separation methodologies exist: [980-605-45-1]

- **Method A.** Revenue from contracts with customers is recorded based on the total tariff price at the time the utility service is rendered, including amounts representing the collection of previously accrued ARP revenues. The ARP revenue amount in a given period should include both:
  - the recognition of 'originating' ARP revenues (i.e. when the regulator-specified conditions for recognition have been met); and
  - an equal and offsetting reversal of the amount of ARP revenues recorded in revenue from contracts with customers that are being recovered through incorporation in the price of utility service.
- **Method B.** Revenue from contracts with customers should exclude the portion of the tariff price representing ARP revenues that had been initially recorded in prior periods when regulator-specified conditions were met. The ARP revenue amount reflects only the initial recognition of 'originating' ARP revenues – i.e. when the regulator-specified conditions for recognition have been met. When those amounts are subsequently included in the price of utility service and billed to customers, such amounts are recorded as a recovery of the associated regulatory asset or liability.

Example 2.4.30
Alternative revenue programs

Utility Co. bills customers $10 million from tariff-based sales in Year 2 of a contract. This amount includes $2 million of billings related to alternative revenue program (ARP) revenues recognized in Year 1. Utility Co. determines that the remainder of the tariff billings in Year 2 meet the criteria to be recognized as revenue in Year 2.

In Year 2, Utility Co. also recognizes $3 million of ARP revenue that will be billed to customers in Year 3.

The following illustrates the presentation of Utility Co.'s revenues under Methods A and B in Question 2.4.40.

Year 2 (millions)	Method A	Method B
Topic 606 revenue	$10	$ 8[2]
ARP revenue	1[1]	3
Total revenue	**$11**	**$11**

Notes:
1. $3 million less $2 million ARP revenue recognized in Year 1.
2. $10 million tariff billings in Year 2 less $2 million ARP revenue recognized in Year 1.

Question 2.4.50
Are gas-balancing arrangements in the scope of Topic 606?

Interpretive response: It depends. Similar to rate-regulated industries, a gas-balancing arrangement could comprise both the:

— actual sale of product to a third party, which is accounted for as revenue from a contract with a customer in Topic 606; and
— settlement of imbalances between the partners that are not customers, which is not in the scope of Topic 606.

Under Topic 606, entities are required to determine whether a sale represents a contract with a customer. If an entity sells a volume of gas to a customer in excess of its entitled share of production, the entity will need to perform a principal versus agent analysis to determine whether it should record the gross amount of revenue and cost of goods sold equal to the other owners' interests, or recognize the net amount of revenue. Generally, an entity that enters into a contract with a customer will be the principal. Settlements with the other partners that are not customers are accounted for as separate transactions outside the scope of Topic 606.

Question 2.4.60

Are sales of a business that includes an ongoing long-term sales agreement in the scope of Subtopic 810-10, Topic 606 or both?

Interpretive response: Typically, these arrangements are accounted for under both Subtopic 810-10 (consolidation) and Topic 606 as two distinct transactions. The evaluation of whether these two elements are accounted for separately is based on the separation guidance in Topic 606; this is because Subtopic 810-10 does not provide guidance on how to separate in-scope elements from out-of-scope elements.

If the sale of a business is distinct from the long-term sales agreement (e.g. a franchise right or long-term supply contract) the sale of the business is governed by the deconsolidation guidance in Subtopic 810-10. See section 4.3 for further discussion of how to evaluate whether elements in a contract are distinct.

When these two transactions are determined to be distinct, the transaction price is allocated between the two on a relative stand-alone selling price basis. It should not be assumed that any upfront fixed consideration represents the stand-alone selling price of the business even if the rates in the long-term sales agreement are similar to what others currently pay. Similarly, it may not be appropriate to simply defer from upfront fixed consideration an amount equivalent to any fixed fees that are generally charged for such long-term sales agreements. See chapter 6 for discussion of the Topic 606 allocation principles.

The sale of a business is governed by the deconsolidation guidance and Topic 606 requires other GAAP to be applied to transactions first. As such, the gain/loss on the sale of the business (as determined based on the amount of consideration allocated to it using Topic 606 guidance) continues to be recorded on a net basis when control of the business is transferred.

2.5 Portfolio approach

2.5.10 Overview

Excerpt from ASC 606-10

> Meeting the Objective

10-4 This guidance specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

An entity generally applies Topic 606 on an individual contract basis. However, the guidance permits an entity to apply its provisions on a portfolio basis as a practical expedient if the results using the portfolio approach would not differ materially from applying Topic 606 on a contract-by-contract basis. [606-10-10-4]

Although the portfolio approach may be more cost effective than applying Topic 606 on an individual contract basis, significant effort may be needed to:

- evaluate which similar characteristics constitute a portfolio – e.g. the effect of different offerings, periods of time or geographic locations;
- assess when the portfolio approach may be appropriate;
- develop the process and controls needed to account for the portfolio; and
- reassess the appropriateness of the portfolio and use of the portfolio approach as characteristics of contracts change.

Topic 606 includes examples in which the portfolio approach is applied, including for rights of return and breakage. However, it does not provide specific guidance on how to assess whether the results of a portfolio approach would differ materially from applying Topic 606 on a contract-by-contract basis.

A portfolio of similar transactions can be a source of data to make certain estimates, including variable consideration, returns or breakage for an individual contract if the entity has a sufficiently large number of similar transactions or other history. Doing so is not using the portfolio approach. See Question 5.3.130 for a discussion of the use of a portfolio of data to develop estimates required to apply the revenue model in Topic 606. [TRG 07-15.38]

See Question 12.2.10 for discussion of the application of the portfolio approach to contract costs.

Question 2.5.10

How should an entity evaluate whether using a portfolio approach would materially differ from applying Topic 606 on a contract-by-contract basis?

Interpretive response: Selecting the size and composition of a portfolio requires judgment. An entity should take a reasonable approach to determine the appropriate portfolios, but it does not necessarily need to quantitatively assess each potential outcome.

An entity may combine quantitative and qualitative analyses of assumptions and underlying data to establish a reasonable expectation that the effects of applying the guidance to a particular portfolio of contracts would not materially differ from applying the guidance to each individual contract within that portfolio. [ASU 2014-09.BC69]

Although Topic 606 does not provide specific guidance, the following factors could be relevant to the analysis:

- Type of customer – e.g. size, location, duration as a customer, creditworthiness, type of business.
- Contract terms – e.g. delivery terms, contract duration, cancellation terms, rights of return, nature of transaction price consideration.
- Performance obligations – e.g. product warranties, material rights, loyalty programs, discounts and incentives, over-time or point-in-time obligations.
- Volume of contracts with similar characteristics – e.g. high volume of contracts with established history over time.

Question 2.5.20

Can a portfolio approach be used for some aspects of the revenue model, but not all?

Interpretive response: Yes. Although there may be benefits of applying the portfolio approach to all aspects of the revenue model, the portfolio approach may be used only for some aspects or performance obligations. For example, it could be used to account for rights of return even though other types of estimates and judgments required under the revenue model are made on a contract-by-contract basis.

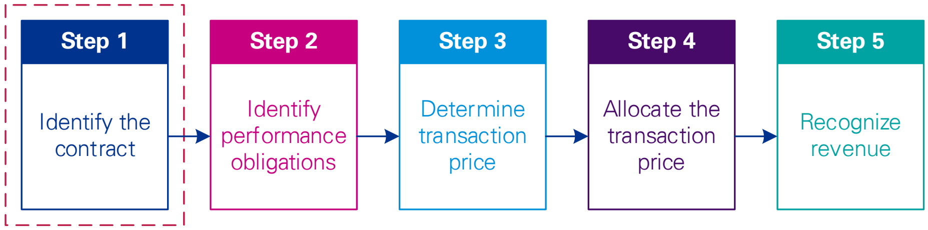
3. Step 1: Identify the contract(s) with a customer

Detailed contents

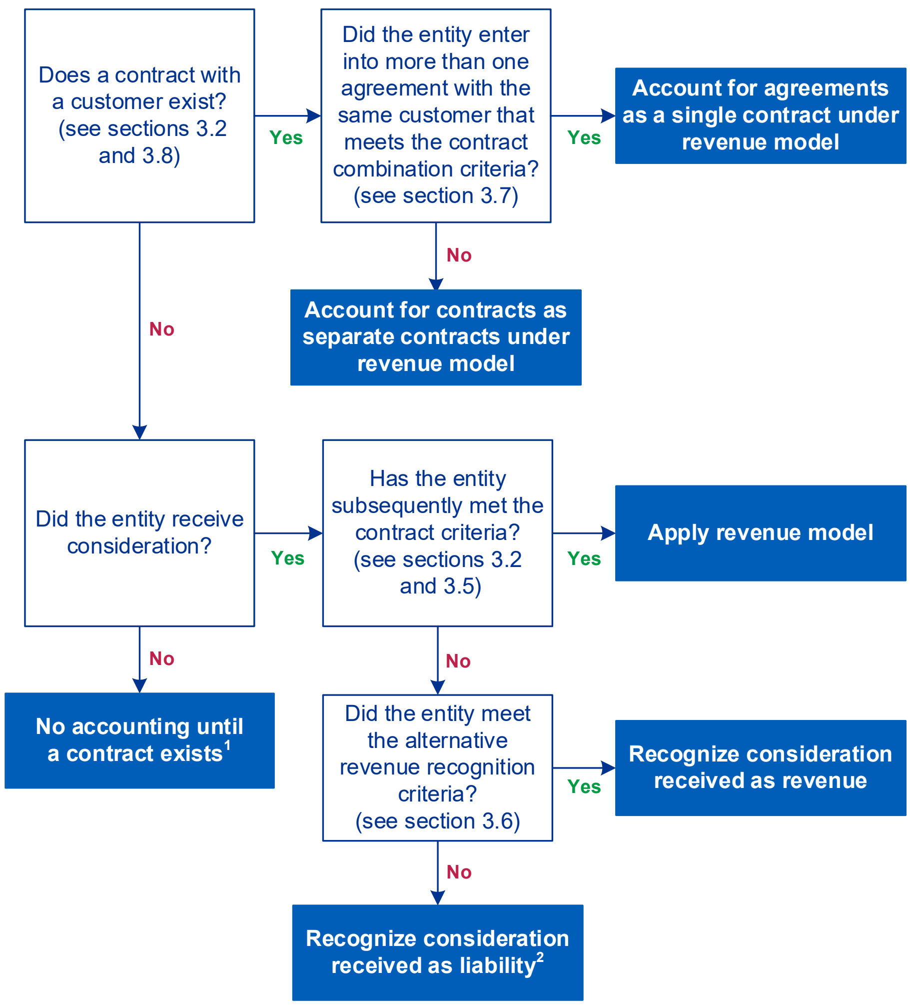
New item added to this chapter: **

Examples

3.1 How the standard works



The first step of the five-step revenue model is to identify the contract with the customer. The following decision tree depicts the main decision points in this step.



[1] An entity continuously reassesses the contract criteria
[2] An entity continuously reassesses the contract and alternative revenue recognition criteria

3.2 Determining whether a contract exists

Excerpt from ASC 606-10

> Identifying the Contract

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 substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C). 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).

25-2 A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

20 Glossary

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

3.2.10 Overview

The first step of the model is to identify the contract with the customer. A contract with a customer exists when the contract is legally enforceable and certain criteria, including collectibility, are met.

If the criteria are not met, then the contract does not exist for purposes of applying the general model of Topic 606. If an entity receives consideration from a customer under an arrangement that does not meet the contract existence criteria, then it accounts for that consideration under the alternative model discussed in section 3.6 rather than the rest of the five-step revenue model.

Definition of a contract

Topic 606 applies only to ***contracts*** with customers. A 'contract' is defined as 'an agreement between two or more parties that creates enforceable rights and obligations'. The definition specifies that enforceability is a matter of law. Therefore, only ***legally enforceable*** agreements are contracts under this definition. Consequently, the assessment of whether a contract exists does not focus on the form of the contract. Rather, the assessment focuses on the legal enforceability of an arrangement regardless of form. Contracts can be written, oral or implied by an entity's customary business practices – e.g. electronic consent. [606-10-25-2]

Whether a contract is legally enforceable is based on the laws and regulations in the relevant jurisdiction – i.e. a state, US territory or foreign country. Determining whether a contract is legally enforceable may require significant judgment in some jurisdictions or for some arrangements, and may result in different conclusions for similar contracts in different jurisdictions.

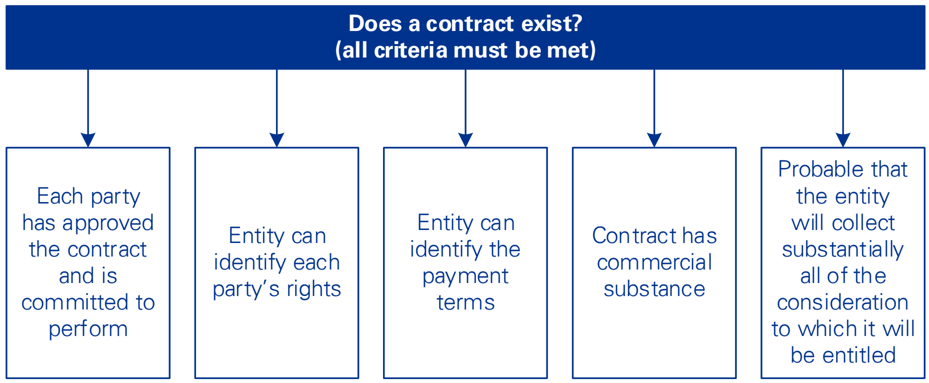
In some cases, the parties to an oral or an implied contract (e.g. in accordance with customary business practices) may have agreed to fulfill their respective obligations. If there is uncertainty about the enforceability of an oral or implied contract, legal interpretation by qualified counsel may be required to support a conclusion that the parties to the contract have approved and are committed to perform their respective obligations.

Although a contract has to create enforceable rights and obligations, not all promises in a contract have to be legally enforceable to be performance obligations. A promise in a contract can be a performance obligation if it creates a reasonable expectation by the customer that the entity will transfer goods or services (see Question 4.2.10). [606-10-25-16]

Contract existence criteria

There are five criteria a contract must satisfy to be accounted for under Topic 606's revenue model. These five criteria complement the definition of a contract because if the criteria are not met, it is questionable whether the contract establishes enforceable rights and obligations. [606-10-25-1, ASU 2014-09.BC33]

The five criteria can be summarized as follows. [606-10-25-1]



Contract does not exist if each party has a unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party.

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

This criterion is included because when the parties to a contract have not approved the contract, it is questionable whether the contract is enforceable. The form of the contract does not, in and of itself, determine whether the parties have approved the contract. Instead, an entity should consider all relevant facts and circumstances in assessing whether the parties intend to be bound by its terms and conditions. Consequently, in some cases, the parties to an oral or an implied contract (e.g. in accordance with customary business practices) may have agreed to fulfill their respective obligations. In other cases, a written contract may be required to demonstrate that the parties to the contract have approved it. In addition, the parties should be committed to performing their respective obligations under the contract. [606-10-25-1(a), ASU 2014-09.BC35–BC36]

Entity can identify each party's rights regarding the goods or services to be transferred

This criterion is included because when an entity cannot identify each party's rights and obligations regarding the goods or services to be transferred, then it cannot identify its performance obligations under Step 2 of the revenue model. [606-10-25-1(b), ASU 2014-09.BC37]

Entity can identify the payment terms for the goods or services to be transferred

This criterion is included because when an entity cannot identify the payment terms in exchange for the promised goods or services, then it cannot determine the transaction price under Step 3 of the revenue model. [ASU 2014-09.BC38]

In some industries it is common for entities to enter into unpriced change orders. Such orders define the scope of work but not the amount of consideration. In some cases, the amount of consideration might not be determined for a period of time. The FASB clarified that its intention was not to preclude revenue recognition for unpriced change orders if the scope of the work has been approved and the entity expects that the price will be approved. In those cases, the entity would consider the guidance on contract modifications (see section 11.2), which allows entities to account for a modification when the parties have approved a change in scope but not the price if the rights and obligations created or changed by the agreement are enforceable. In that case, the change in price is considered variable consideration. [ASU 2014-09.BC39, 606-10-25-11]

Contract has commercial substance

This criterion was included because some contracts with customers include nonmonetary exchanges (see Question 2.3.120). Without this requirement, entities might transfer goods or services back and forth to each other (often for little or no cash consideration) without a bona fide business purpose to artificially inflate their revenue – known as round-tripping. This criterion is important in all contracts (not only nonmonetary exchanges) because without commercial substance it is questionable whether an entity has entered into a transaction that has economic consequences. [606-10-25-1(d), ASU 2014-09.BC40]

Commercial substance is based on the existing guidance for nonmonetary exchange transactions (Topic 845). Determining whether a contract has commercial substance may require judgment. An entity needs to demonstrate a substantive business purpose for the nature and structure of the transaction – i.e. the entity's risk, timing or amount of future cash flows should be expected to change as a result of the contract. [606-10-25-1(d), ASU 2014-09.BC40–BC41]

Collectibility

This criterion was included in the contract existence criteria as a gating question designed to prevent entities from applying the revenue model to non-substantive transactions and recognizing revenue and a large impairment loss at the same time. In essence, the other contract existence criteria in paragraph 606-10-25-1 require an entity to assess whether the contract is valid and represents a genuine transaction. The collectibility criterion is also relevant because a key part of assessing whether a transaction is valid is determining the extent to which the customer has the ability and the intention to pay the promised consideration. In addition, entities generally only enter into contracts for which it is probable they will collect the amounts to which they will be entitled. The collectibility criterion is discussed in sections 3.3 and 3.6. [606-10-25-1(e)]

Wholly unperformed contracts

In addition to the five contract existence criteria, a contract does not exist for accounting purposes if each party to the contract has the unilateral right to terminate a 'wholly unperformed' contract without compensating the other party (or parties). A contract is wholly unperformed if both of the following criteria are met:

- the entity has not yet transferred any promised goods or services to the customer; and
- the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services. [606-10-25-4, ASU 2014-09.BC50]

Question 3.2.10

If an entity obtains signed contracts as its customary business practice, does the agreement have to be signed by both parties for a contract to exist?

Interpretive response: Not necessarily. Even when an entity customarily obtains an agreement signed by both parties, a contract may exist without, or before, both parties' signatures (or even without either party's signature). This is because the assessment of whether a contract exists under Topic 606 focuses on whether the parties have enforceable rights and obligations based on the relevant laws and regulations. The assessment does not focus on the form of the contract – i.e. whether it is oral, implied, electronic assent or written. [606-10-25-2]

The assessment of whether there is an enforceable contract may require significant judgment in some circumstances or jurisdictions and may require the involvement of legal counsel. Similar contracts may give rise to different enforceable rights and obligations based on the governing jurisdiction due to differing laws and regulations.

Further, it may not be possible to conclude that enforceability exists if the contract is subject to additional substantive reviews that have not yet occurred, or authorizations not yet obtained, that could substantively alter the contract's terms and conditions.

An entity should have a process (and related controls) for determining when enforceability exists because the contract existence guidance in Topic 606 is not optional – i.e. an entity cannot elect an accounting policy to account only for contracts with customers that have been dually signed by both parties. For example, if an entity transfers control of a product on or before the reporting date (see section 7.5), but incorrectly determines that a contract with the customer does not exist on or before that date, revenue may be understated for the period.

For the revenue model to apply to a contract, *all* of the criteria in paragraph 606-10-25-1 need to be met, including the collectibility criterion. Therefore, even if enforceability is established, entities will have further work to do before they can begin to apply the rest of the revenue model to the contract.

Question 3.2.20

What should a contract with a customer describe to demonstrate that the parties can each identify their rights and the payment terms for the goods or services?

Interpretive response: Identifying each party's rights regarding promised goods or services (criterion b) and identifying the payment terms for those goods or services (criterion c) are two of the five criteria that a contract must meet for the revenue model to apply.

To determine if these two criteria are satisfied, in general we believe that an entity should consider whether a contract includes a description of the following terms or conditions:

- the goods and/or services promised in the arrangement;
- the key attributes of any license or IP transferred to the customer – e.g. perpetual or time-based, limitation as to geography or use;
- payment terms and fees due from the customer;
- delivery terms;
- warranties, rights (e.g. return rights), obligations and termination provisions; and
- other pertinent contractual provisions – e.g. price protection, service level guarantees.

Absent the above, it may be questionable whether an entity can identify each party's rights and obligations regarding the transfer of goods or services, including the customer's obligation to pay. However, this list above is not necessarily all-inclusive; nor does the absence of one or more of these items necessarily mean that the two criteria are not met.

If an entity does not have a standard or customary business practice of relying on written contracts to document an arrangement, it may have other forms of written or electronic evidence to document the arrangement. A leading practice is to have processes to determine what constitutes enforceable rights and obligations for each jurisdiction, line of business or class of customer because conclusions about enforceability may differ. However, regardless of the form of documentation, the evidence should be final and include (or reference) all of the relevant terms and conditions of an arrangement.

Question 3.2.30

If an MSA exists between an entity and a customer, under which the customer requests goods and services through purchase orders, is the MSA a contract under Topic 606?

Interpretive response: It depends. A master service agreement (MSA) might simply define the terms and conditions under which the customer can order goods and services from the entity but not create enforceable rights and obligations on the parties – i.e. for the entity to transfer goods or services and for the customer to pay for those goods or services. In that case, there is not a contract between the parties until the customer places a purchase order under the MSA to request specific goods or services.

Some entities enter into MSAs with customers, which specify the basic terms and conditions for subsequent transactions between the parties and are signed by both the entity and customer. Under such arrangements, no additional contractual agreement is executed and customers request products through purchase orders that specify the products and quantities. An MSA under which a customer places purchase orders to obtain goods or services does not itself constitute a contract with a customer. This is because the MSA usually does not create enforceable rights and obligations for the parties.

As discussed in Question 3.2.20, for a contract to be enforceable an entity should be able to identify each party's rights regarding the goods and services to be transferred. While the MSA may specify the payment terms, it usually does not specify the goods and services, including quantities thereof, to be transferred. Absent those specific terms and conditions, an MSA itself does not create enforceable rights and obligations. Therefore, it is not a contract to which the revenue model applies – i.e. the contract does not meet the contract existence criteria. [606-10-25-1]

However, some MSAs may include a requirement for the customer to purchase a minimum quantity of goods or services. Such a requirement may be a cumulative minimum for the MSA period or for periods within the MSA – e.g. each year of a multi-year MSA. If the minimum is enforceable, then the MSA itself may constitute a contract under Topic 606. However, if the entity's past practice of not enforcing MSA minimums results in a conclusion by legal counsel that the minimums are not legally enforceable, the MSA would not be a contract under Topic 606 – i.e. just as if the minimum were not included in the MSA at all.

In addition, if relevant experience with the customer suggests that the customer will not meet the required minimums, and that the entity will not enforce them, this would typically demonstrate in the case of an MSA that the entity and the customer are not committed to the minimums in the MSA. Consequently, even if the minimums are legally enforceable, the contract may not meet all of the contract existence criteria, in which case it would not be a contract in the revenue model under Topic 606. [606-10-25-1]

When an MSA does not create enforceable rights and obligations on its own, it normally will when combined with a purchase order. Therefore, the MSA and the purchase order are evaluated together to determine whether the contract existence criteria are met. However, if additional steps must be taken for the purchase order or MSA to create legally enforceable rights and obligations, then a contract with a customer does not exist until those steps are completed. Some examples of such additional steps include:

— executing a supplemental contract or addendum to the MSA subsequent to receipt of the purchase order;
— acceptance of the purchase order;
— issuing a sales order acknowledgment form to the customer.

As a matter of law, if either party can cancel a purchase order without penalty before the entity transfers the ordered goods or services, a contract does not exist; this is true even if all the contract existence criteria are met. [606-10-25-1]

In this situation, a contract is deemed not to exist because each party has a right to terminate the contract and the contract is wholly unperformed. The contract is wholly unperformed because the entity has not transferred any goods or services to the customer and has not yet received (nor is yet entitled to receive) any consideration in exchange for the promised goods or services. In contrast, once the entity transfers some or all of the goods or services in the purchase order, the contract is no longer wholly unperformed. In that case, the entity is at least entitled to receive consideration in exchange for the goods or services transferred to the customer. [606-10-25-4]

Example 3.2.10
Contract approval and enforceability (1)

ABC Corp. sells widgets and has a customary business practice of entering into written contracts with its customers. These written contracts typically describe the terms and conditions under which customers can obtain the widgets upon receipt of an approved customer purchase order.

Customer has established a purchasing policy that requires execution of an agreement with its vendors before it will accept delivery of any products. ABC and Customer negotiate the terms of an arrangement and execute a written MSA that is signed by both parties on December 29, Year 1. The MSA specifies the terms and conditions for the widgets, including the price; however, it does not yet commit Customer to purchase or ABC to transfer the widgets.

Subsequent to the execution of the MSA, Customer requests via an email to the account manager that ABC transfer 100 widgets in accordance with the December 29 MSA, for which it will submit a written purchase order. ABC transfers control of the widgets to Customer on December 31, Year 1. The written purchase order from Customer is not received by ABC until January 2, Year 2.

The MSA signed by both parties on December 29, Year 1 does not, by itself, create enforceable rights and obligations to transfer widgets because Customer may, or may not, choose to order under the MSA.

After consulting with legal counsel, ABC concludes that the MSA in combination with the email communication establish enforceable rights and obligations between the parties with sufficient specificity to meet the contract existence criteria. However, whether the customer email creates enforceable rights and obligations may vary depending on the laws and regulations in the relevant jurisdiction.

Consequently, ABC recognizes revenue for the transfer of the 100 widgets on December 31, Year 1.

Example 3.2.20
Contract approval and enforceability (2)

Assume the same facts and circumstances as in Example 3.2.10, except for the following.

— The MSA outlining the terms and conditions for the widgets, including the unit price, is signed, dated and returned by Customer on January 2, Year 2. ABC Corp. signed the agreement on December 22, Year 1 and it was confirmed via email by Customer the same day.

— ABC receives a written purchase order from Customer for the 100 widgets on December 26, Year 1, referencing the master contract.

— ABC transfers control of the 100 widgets to Customer on December 30, Year 1.

After consulting with legal counsel, ABC concludes that there was a valid contract as of December 26, Year 1 when it received the purchase order. This is because the contract, signed by ABC and sent to Customer, constituted an offer that Customer accepted by executing the purchase order, even if it did not execute the agreement until a few days later.

Consequently, ABC recognizes revenue for the transfer of the 100 widgets on December 30, Year 1.

Example 3.2.30
Prepaid spending account

ABC Corp. enters into an arrangement with Customer whereby Customer agrees to spend $2 million with ABC over a two-year period.

Customer prepays the $2 million at the date the prepaid spending account (PSA) is agreed to and then 'draws down' from that balance over the two years by issuing purchase orders for specific goods and services against a mutually agreed price list.

The price list includes most of ABC's goods and services. The PSA agreement establishes the prepaid amount, the two-year term and the price list. It also includes all of the other relevant terms and conditions under which draw-downs (through purchase orders) will be made – e.g. returns, warranties, delivery mechanisms.

The $2 million upfront payment is subject to a 'use it or lose it' provision – any amount that Customer does not use through draw-downs by the end of the two-year PSA term is forfeited and none of the $2 million is refundable to Customer.

The price list in the PSA permits Customer to select from a wide variety and quantity of ABC's goods and services. For many of the services, an additional statement of work (SOW) is necessary to establish the parameters of the services to be provided; the PSA merely sets out the hourly rate that will be applied to services of that nature.

Consequently, even though the PSA's 'use it or lose it' provision essentially is a minimum quantity requirement, ABC cannot identify each party's rights regarding the goods or services to be transferred until Customer executes a purchase order (and potentially also an SOW). Consistent with Question 3.2.20, ABC cannot identify the good and or services promised because those services in many cases will not be defined until a later date.

ABC also has no obligation to transfer any goods or services until Customer executes a purchase order (and potentially also an SOW) making its selections. Only then does ABC have a present obligation to transfer goods or services to

Customer and can ABC identify each party's rights regarding specific goods or services it will transfer to Customer.

Consequently, the contract between ABC and Customer under Topic 606 is the combination of the PSA and the purchase order (and SOW if necessary to complete the order). Each purchase order will be a separate contract unless it is combined with another purchase order based on the contract combination guidance in paragraph 606-10-25-9 (see section 3.7).

Question 3.2.40

If a contract is subject to contingencies, ongoing negotiations or in a preliminary stage, does it qualify as a contract under Topic 606?

Interpretive response: Probably not. Among the criteria required for the revenue model to apply to a contract are that (a) the parties have approved the contract and are committed to performing their respective obligations and (b) each party's rights with respect to the goods and services, as well as the (c) payment terms, can be identified.

We do not believe these criteria can be met if the contract:

- is subject to contingencies – e.g. substantive additional reviews yet to occur and authorizations yet to be obtained;
- is in a preliminary stage – e.g. a letter of intent; or
- requires additional negotiations and subsequent amendments or revisions.

Therefore, if any of these remain unresolved at the reporting date, a contract to which the revenue model would apply likely does not yet exist. [606-10-25-1]

However, there may be scenarios in which an entity continues to provide services to a customer after expiration of a contract but during contract extension negotiations. These fact patterns are discussed in Question 3.6.10 and Example 3.6.10.

Question 3.2.45

Does a contract that is subject to regulatory approval before sales can occur exist under Topic 606?

Interpretive response: It depends. If the regulatory body from which the approval must be obtained is the entity's customer (e.g. the US government is the customer), the contract likely does not exist until that approval is obtained (see Question 3.2.40).

Likewise, a contract may not exist if regulatory approval is pending from a regulatory body that is not a customer. This is because the parties cannot identify the rights to goods or services and payment terms until the approval contingency is resolved.

However, we believe a pending regulatory approval would not preclude a conclusion that the contract exists if an entity has a high degree of confidence in obtaining regulatory approval and the regulatory body from which the approval must be obtained is not a customer.

Factors to consider in determining whether there is a high degree of confidence include: [AICPA AAG-REV 3.1.09]

— an entity's history of receiving regulatory approval from that regulatory body;
— the level of participation and communication an entity has with the government's due diligence approval process;
— the presence of government officials advocating on the entity's behalf;
— recent regulatory approvals of sales of similar goods to the same country; and/ or
— clauses in the contract that allow the contractor to recover cost plus a reasonable profit if regulatory approval is not obtained.

For example, aerospace and defense entities may enter into direct contracts with foreign governments (i.e. foreign direct commercial sales), which often require regulatory approval from the US federal government. The US federal government is not a party to these types of contracts but obtaining regulatory approval is required for the entity to sell to the foreign government customer. In such cases, when the factors above are present, the requirement to obtain regulatory approvals does not preclude an entity from concluding that a contract exists under Topic 606 if all other contract existence criteria are met. [AICPA AAG-REV 3.1.04-08]

In contrast, when regulatory approvals are not a customary part of an entity's contracting process (e.g. anti-trust approval) there is typically a higher degree of uncertainty. In such cases, based on the factors above, the approval contingency would typically result in a conclusion that a contract does not exist unless approval is perfunctory.

In either case, all of the contract existence criteria must be met to conclude a contract exists.

Question 3.2.50

Does the form of an entity's contracts and evidence of approval have to be consistent across customers?

Interpretive response: No. An entity may have a customary business practice of using written contracts or purchase orders to evidence an arrangement. However, the entity may enter into arrangements with certain customers whose business practices of providing evidence of an arrangement differ from the entity's customary practice of using written contracts – i.e. certain customers may purchase products or services only by purchase orders or by phone.

In fact, the entity may not have a customary business practice if it principally relies on whatever method its customers prefer. For example, an entity may not use written contracts or purchase orders, but certain of the entity's customers may require signed written contracts or written purchase orders to purchase goods or services.

Because the form of the contract does not, in and of itself, determine whether a contract exists, whether the entity is consistent in the form of its contracts and/or its evidence of approval of those contracts also do not, in isolation, affect whether a contract exists.

Question 3.2.60
Are side agreements contracts?

Side agreements

Entities may enter into side agreements with customers outside of the normal contracting process – e.g. as part of the negotiation process or in response to an actual or perceived customer service issue. Those entities' sales and marketing staff or business executives may be motivated to make commitments to customers (verbally, written or electronically transmitted – e.g. email) that are not part of the master arrangement with the customer (often referred to as side agreements or side deals) to consummate a sale.

Interpretive response: It depends. All terms and conditions that create or negate enforceable rights and obligations are considered in evaluating a contract, regardless of whether they are in a side agreement or in the contract – whether in a formal master agreement, statement of work or purchase order.

The form of a side agreement in which additional terms and conditions are agreed to will not generally affect whether those terms and conditions are part of the contract. This is because Topic 606 does not focus on the form of the contract or its approval, but rather on whether enforceable rights and obligations on the parties are specified and the parties are committed to meeting their respective obligations. Therefore, side agreements can be oral, electronic or written.

Side agreements often occur outside the entity's standard contract procedures. Those contract procedures may have been established by an entity to ensure enforceability of contracts entered into with its customers. Therefore, if a side agreement's terms and conditions differ from those in the master agreement, an entity should assess whether the side agreement either establishes new rights and obligations or changes existing rights and obligations.

A particular side agreement may not, in and of itself, create enforceable rights and obligations on the parties. However, the side agreement may create a reasonable expectation on the part of the customer that a promised good or service will be transferred or that a discount, rebate or some other form of price concession (including extended payment terms) will be granted. It may even create a reasonable expectation that the terms of the written contract will not be enforced.

A *pattern* by the entity of providing free or discounted good or services or providing subsequent discounts, rebates or extended payments through side agreements may create implied performance obligations, variable consideration or significant financing components in other contracts even if the side agreements themselves are not legally enforceable. Any implied performance obligations, variable consideration or significant financing components are elements of a contract that are accounted for under Steps 2 and 3 (see chapters 4 and 5). [606-10-25-16, 32-7]

Question 3.2.70

Do fiscal funding clauses affect the assessment of whether a contract exists?

Interpretive response: It depends. When the customer in a contract is a government, there may be a fiscal funding clause stating that the contract is cancellable if the legislature or funding authority does not appropriate the funds necessary for the government to pay.

A funding contingency, from a business enterprise or governmental unit, may render the agreement to not be an enforceable contract under applicable laws and/or regulations if the chance of the fiscal funding contingency being triggered is more than remote. Determining whether the contingency being triggered is more than a remote possibility requires judgment. If this possibility is more than remote, a contract to which the revenue model applies may not exist before funding has been formally approved.

Even when a contract with a fiscal funding clause is determined to exist, the enforceable contract term may be affected if the clause has a more than remote chance of being triggered. This is because the guidance in Topic 606 applies to the contractual period during which the parties have *present* enforceable rights and obligations. Such rights may not exist beyond the existing fiscal authorization because the customer has the unilateral right to terminate services without penalty by not approving funding.

For example, an agreement may be for a stated three-year period, but if the entity's enforceable right to payment for providing the services in Years 2 and 3 is contingent on the customer obtaining fiscal authorization – i.e. the customer may cancel the contract if the legislature or funding authority does not authorize the expenditure, an enforceable contract likely exists for only one year. In that scenario, the contract term under Topic 606 would only be the one year covered by the current funding commitment, and any period beyond that is considered cancellable by the customer. See section 3.8 for discussion of contract term.

We believe there is an acceptable alternative view when the customer is a US governmental unit and a contract otherwise meets the contract existence criteria in paragraph 606-10-25-1. Under this alternative view, even if the chance of the fiscal funding contingency being triggered is more than remote, the unfunded portion of the contract is considered to be variable consideration. An entity adopting this view includes variable consideration in the transaction price, subject to the constraint (see section 5.3).

Question 3.2.80

How should revenue related to goods or services transferred before meeting the contract existence criteria be recognized when the criteria are met?

Interpretive response: Activities may begin and goods or services may be transferred before a contract meets the contract existence criteria in paragraph 606-10-25-1. Revenue is recognized for any promised goods or services that have been transferred to the customer on a cumulative catch-up basis at the date these criteria are met. [TRG 03-15.33]

For example, a contract manufacturer may enter into an agreement to manufacture a customized good. Purchase orders are non-cancellable and the manufacturer has a contractual right to payment for all work in process once the order is received. The manufacturer will pre-assemble some goods to meet the anticipated demand from the customer before the purchase order is executed. At the time the customer enters into the purchase order, the manufacturer has satisfied a portion of the performance obligation that is satisfied over time (see section 7.4). When the entity meets the contract existence criteria, the entity recognizes an amount of revenue that reflects its progress toward completion of the performance obligation on a cumulative catch-up basis.

3.3 Applying the collectibility criterion

Excerpt from ASC 606-10

> Identifying the Contract

25-3 Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations. In evaluating the criterion in paragraph 606-10-25-1(e), an entity shall assess the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectibility of the consideration promised in the contract for all of the promised goods or services (see paragraphs 606-10-55-3A through 55-3C). However, if an entity determines that all of the criteria in paragraph 606-10-25-1 are met, the remainder of the guidance in this Topic shall be applied to all of the promised goods or services in the contract.

• > Assessing Collectibility

55-3A Paragraph 606-10-25-1(e) requires an entity to assess whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. The assessment, which is part of identifying whether there is a contract with a customer, is based on whether the customer has the ability and intention to pay the consideration to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer. The objective of this assessment is to evaluate whether there is a substantive transaction between the entity and the customer, which is a necessary condition for the contract to be accounted for under the revenue model in this Topic.

55-3B The collectibility assessment is partly a forward-looking assessment. It requires an entity to use judgment and consider all of the facts and circumstances, including the entity's customary business practices and its knowledge of the customer, in determining whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that the entity expects to transfer to the customer. The assessment is not necessarily based on the customer's ability and intention to pay the entire amount of promised consideration for the entire duration of the contract.

55-3C When assessing whether a contract meets the criterion in paragraph 606-10-25-1(e), an entity should determine whether the contractual terms and its customary business practices indicate that the entity's exposure to credit risk is less than the entire consideration promised in the contract because the entity has the ability to mitigate its credit risk. Examples of contractual terms or customary business practices that might mitigate the entity's credit risk include the following:

a. Payment terms — In some contracts, payment terms limit an entity's exposure to credit risk. For example, a customer may be required to pay a portion of the consideration promised in the contract before the entity transfers promised goods or services to the customer. In those cases, any consideration that will be received before the entity transfers promised goods or services to the customer would not be subject to credit risk.
b. The ability to stop transferring promised goods or services—An entity may limit its exposure to credit risk if it has the right to stop transferring additional goods or services to a customer in the event that the customer fails to pay consideration when it is due. In those cases, an entity should assess only the collectibility of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer on the basis of the entity's rights and customary business practices. Therefore, if the customer fails to perform as promised and, consequently, the entity would respond to the customer's failure to perform by not transferring additional goods or services to the customer, the entity would not consider the likelihood of payment for the promised goods or services that will not be transferred under the contract.

An entity's ability to repossess an asset transferred to a customer should not be considered for the purpose of assessing the entity's ability to mitigate its exposure to credit risk.

• • > Example 1—Collectibility of the Consideration

• • • > Case A—Collectibility Is Not Probable

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.

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.

55-97 The entity concludes that not all of the criteria in paragraph 606-10-25-1 are met. The entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the entity will collect substantially all of the consideration to which it is entitled in exchange for the transfer of the building. In reaching this conclusion, the entity observes that the customer's ability and intention to pay may be in doubt because of the following factors:

a. The customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience).
b. The customer lacks other income or assets that could be used to repay the loan.
c. The customer's liability under the loan is limited because the loan is nonrecourse.

55-98 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.

3.3.10 Overview

Collectibility is the last criterion under paragraph 606-10-25-1 that must be met for a contract to exist under the revenue model. It is also perhaps the most difficult of the five criteria to apply.

The collectibility criterion is satisfied if it is *probable* that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that the entity will transfer to the customer.

Collection is probable

When assessing whether collection is probable, an entity considers the customer's ability and intention to pay substantially all of the amount of consideration to which the entity expects to be entitled. [606-10-25-1(e)]

— **Customer's ability to pay.** The assessment of the customer's ability (i.e. financial capacity) to pay the amount of consideration to which the entity will be entitled in exchange for the goods or services transferred would include assessing the customer's creditworthiness.

— **Customer's intention to pay.** The assessment of the customer's intention requires an entity to consider all of the facts and circumstances, including the past practice of that customer or customer class. This assessment should be made on the assumption that the corresponding performance obligation will be satisfied and the consideration is not subject to further variability that might affect the entity's entitlement to that consideration.

Consideration to which it will be entitled

The collectibility criterion is applied to the amount to which the entity expects to be entitled *in exchange for the goods and services that will be transferred* to the customer. This amount may not be the stated contract price. Consequently, an entity may need to determine the transaction price in Step 3 of the model before assessing the collectibility criterion. This includes an estimate of variable consideration and potential price concession. See section 3.4 for further details on price concessions in the assessment of collectibility.

In addition, the collectibility criterion is only applied to consideration promised in the contract for goods or service that *will be transferred to the customer* rather than the consideration for all of the goods or services in the contract. The phrase 'will be transferred' is intended to mean the goods or services that will be transferred on the basis of the customary business practices of the entity in dealing with its exposure to the customer's credit risk throughout the contract. [606-10-25-1(e), ASU 2016-12.BC11]

As a result, the consideration to which the entity is entitled would be limited to the lesser of:

— **The consideration attributable to the non-cancellable contract term.** For example, if a contract has a two-year term but either party can terminate after one year without penalty, then an entity assesses the collectibility of the consideration promised in the first year of the contract – i.e. the non-cancellable term of the contract (see section 3.8 on contract term); or

— **The consideration attributable to the goods or services that the entity will transfer to the customer *after* considering its ability to mitigate any credit risk of the customer.** If the entity has the ability and the intent (e.g. based on its customary business practices) to mitigate that credit risk by refusing to transfer further goods or services due to non-payment, then the collectibility assessment is limited to the consideration to which the entity is entitled for those goods or services it will transfer before it discontinues further performance (see Question 3.3.10). However, the contract term for purposes of applying the other steps in the revenue model is the entire term of the contract.

An entity's assessment of collectibility could also be affected by its ability to limit credit exposure through payment terms in the contract. For example, an entity could mitigate its credit risk by requiring security deposits or advance payments. A security deposit or advance payment may still not make it probable that the customer will pay substantially all of the consideration for the promised goods or services in the contract. But security deposits and advance payments may ensure the entity will collect substantially all of the consideration to which it expects to be entitled for the goods or services that it *will* transfer to the customer after taking into account its ability and intent to stop transferring goods or services.

The assessment of collectibility does not include an entity's ability to repossess an asset transferred to a customer. This is because the ability to repossess an asset does not mitigate an entity's exposure to its customer's credit risk for the consideration promised in the contract.

Excerpt from ASC 606-10

• • > Example 1 — Collectibility of the Consideration

• • • > Case B — Credit Risk Is Mitigated

55-98A An entity, a service provider, enters into a three-year service contract with a new customer of low credit quality at the beginning of a calendar month.

55-98B The transaction price of the contract is $720, and $20 is due at the end of each month. The standalone selling price of the monthly service is $20. Both parties are subject to termination penalties if the contract is cancelled.

55-98C The entity's history with this class of customer indicates that while the entity cannot conclude it is probable the customer will pay the transaction price of $720, the customer is expected to make the payments required under the contract for at least 9 months. If, during the contract term, the customer stops making the required payments, the entity's customary business practice is to limit its credit risk by not transferring further services to the customer and to pursue collection for the unpaid services.

55-98D In assessing whether the contract meets the criteria in paragraph 606-10-25-1, the entity assesses whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the services that will be transferred to the customer. This includes assessing the entity's history with this class of customer in accordance with paragraph 606-10-55-3B and its business practice of stopping service in response to customer nonpayment in accordance with paragraph 606-10-55-3C. Consequently, as part of this analysis, the entity does not consider the likelihood of payment for services that would not be provided in the event of the customer's nonpayment because the entity is not exposed to credit risk for those services.

55-98E It is not probable that the entity will collect the entire transaction price ($720) because of the customer's low credit rating. However, the entity's exposure to credit risk is mitigated because the entity has the ability and intention (as evidenced by its customary business practice) to stop providing services if the customer does not pay the promised consideration for services provided when it is due. Therefore, the entity concludes that the contract meets the criterion in paragraph 606-10-25-1(e) because it is probable that the customer will pay substantially all of the consideration to which the entity is entitled for the services the entity will transfer to the customer (that is, for the services the entity will provide for as long as the customer continues to pay for the services provided). Consequently, assuming the criteria in paragraph 606-10-25-1(a) through (d) are met, the entity would apply the remaining guidance in this Topic to recognize revenue and only reassess the criteria in paragraph 606-10-25-1 if there is an indication of a significant change in facts or circumstances such as the customer not making its required payments.

• • • > Case C — Credit Risk Is Not Mitigated

55-98F The same facts as in Case B apply to Case C, except that the entity's history with this class of customer indicates that there is a risk that the customer will not pay substantially all of the consideration for services received from the entity, including the risk that the entity will never receive any payment for any services provided.

55-98G In assessing whether the contract with the customer meets the criteria in paragraph 606-10-25-1, the entity assesses whether it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. This includes assessing the entity's history with this class of customer and its business practice of stopping service in response to the customer's nonpayment in accordance with paragraph 606-10-55-3C.

55-98H At contract inception, the entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the customer will pay substantially all of the consideration to which the entity will be entitled under the contract for the services that will be transferred to the customer. The entity concludes that not only is there a risk that the customer will not pay for services received from the entity, but also there is a risk that the entity will never receive any payment for any services provided. Subsequently, when the customer initially pays for one month of service, the entity accounts for the consideration received in accordance with paragraphs 606-10-25-7 through 25-8. The entity concludes that none of the events in paragraph 606-10-25-7 have occurred because the contract has not been terminated, the entity has not received substantially all of the consideration promised in the contract, and the entity is continuing to provide services to the customer.

55-98I Assume that the customer has made timely payments for several months. In accordance with paragraph 606-10-25-6, the entity assesses the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met. In making that evaluation, the entity considers, among other things, its experience with this specific customer. On the basis of the customer's performance under the contract, the entity concludes that the criteria in 606-10-25-1 have been met, including the collectibility criterion in paragraph 606-10-25-1(e). Once the criteria in paragraph 606-10-25-1 are met, the entity applies the remaining guidance in this Topic to recognize revenue.

• • • > Case D — Advance Payment

55-98J An entity, a health club, enters into a one-year membership with a customer of low credit quality. The transaction price of the contract is $120, and $10 is due at the beginning of each month. The standalone selling price of the monthly service is $10.

55-98K On the basis of the customer's credit history and in accordance with the entity's customary business practice, the customer is required to pay each month before the entity provides the customer with access to the health club. In response to nonpayment, the entity's customary business practice is to stop providing service to the customer upon nonpayment. The entity does not have exposure to credit risk because all payments are made in advance and the entity does not provide services unless the advance payment has been received.

55-98L The contract meets the criterion in paragraph 606-10-25-1(e) because it is probable that the entity will collect the consideration to which it will be entitled in exchange for the services that will be transferred to the customer (that is, one month of payment in advance for each month of service).

Question 3.3.10

In assessing collectibility, what does payment for goods or services that 'will be transferred to the customer' mean for a typical service arrangement?

Interpretive response: Topic 606 provides that when an entity has the ability (i.e. the right and the capability) and the intent (typically evidenced by its customary business practices) to stop providing services in the event of customer non-payment, the entity does not have credit risk with respect to those services it would not be required to provide. It is for this reason that Topic 606 requires an entity to consider only the collectibility of the promised consideration in the contract (i.e. the entity's exposure to credit risk) for the goods or services that the entity will transfer to the customer *before* it can stop providing further goods or services due to customer non-payment.

Example 1, Cases B to D, in Topic 606 (reproduced above) demonstrate applying this concept to service contracts. [606-10-55-98A – 55-98L]

In Cases B and C, even though the contract includes a promise by the entity to provide three years of services, for which the customer pays monthly fees in arrears, the entity has the ability and intent to stop providing the promised services due to customer non-payment. Therefore, the services that 'will be transferred to the customer' include only those services that the entity will provide before its customary business practices stop services to the customer. Although not specifically illustrated in either case, this might mean the services that 'will be transferred to the customer' are only one or two months of service or some longer period, depending on the entity's customary business practice with respect to how long it permits a non-paying customer to continue receiving services.

Case D illustrates a one-year gym membership, where the contract requires *advance* payment each month by the customer; services (i.e. access to the gym) are not provided for any given month if the advance payment has not been received. Consequently, in Case D, the services that will be provided to the customer are only the one month of services for which the customer has prepaid.

If an entity does not have either the ability to stop providing services to the customer or the demonstrated intent to do so, the collectibility criterion is assessed against the promised consideration for all of the promised services in the contract. The following are examples.

— An entity may not have the right to stop providing promised services once a customer files bankruptcy. This is because bankruptcy rules in some jurisdictions require service providers to continue providing services that are essential to the customer while the customer undergoes restructuring.

— For practical reasons, an entity may not be able to discontinue a service. For example, a shipping company cannot simply dump the cargo into the sea, and the ship is needed at the port of call in any event to fulfill the entity's next contract.

— The entity may have demonstrated its intent *not* to discontinue services in a timely manner in the event of customer non-payment. Particularly if the incremental costs of providing services to the customer are minor, an entity may continue providing services and merely intend to pursue collection at a later point. However, we believe a circumstance of this nature may strongly indicate a price concession will be granted (see Question 3.4.10).

Even if an entity concludes it has the ability and the intent to discontinue services for non-payment, the collectibility criterion is not automatically met. Rather, the length of time the entity might continue to provide services to a non-paying customer before stopping those services may influence the assessment (see Question 3.3.20). To determine the length of time it might continue to provide services in this case, an entity considers its customary business practices or any other evidence of its intent regarding when to stop services.

Collectibility will generally not be a concern in service arrangements that are prepaid. For example, if the customer is required to prepay for all of the *promised* services in the contract (e.g. prepay for a monthly gym membership) then the 'will be transferred' notion will not apply.

Question 3.3.20

Does an entity's ability and intent to stop providing goods or services automatically mean the collectibility criterion is met?

Interpretive response: No. The collectibility criterion is met only when it is probable that the entity will collect *substantially all* of the consideration to which it will be entitled in exchange for *the goods or services that will be transferred to the customer*.

The entity may not be able to conclude that it is probable it will collect *substantially all* of the consideration to which it is entitled for the goods or services it will provide if:

— it is not probable the entity will collect *any* consideration from the customer; or

— the entity does not have the ability or the demonstrated intent to discontinue services in a timely manner after the customer stops paying for the services. [606-10-25-1(e)]

Consider the following examples.

— Consistent with Example 1, Case C in Topic 606 (reproduced above), if an entity has the ability and intent to timely discontinue services, but it is not probable it will collect substantially all of the promised consideration for any services it would provide before it discontinues, the arrangement is not a genuine and substantive transaction. [606-10-55-3A, ASU 2016-12.BC12]

— Assume an entity concludes it is probable a customer will pay for the first 12 months of service in a 36-month contract, but that collectibility of the remainder of the fees is *not* probable. If the entity does not have the ability or intent to discontinue services for a number of months (say, four months) after a customer stops paying for those services, the entity may conclude that it is not probable that it will collect *substantially all* of the consideration to which it will be entitled for the services that will be provided to the customer.

  Under this fact pattern, the entity will provide 16 months of service: the first 12 months (for which the customer pays) plus an additional four months (before it stops service). If the monthly fee is $100, the promised consideration for the services the entity will provide is $1,600, but it is only probable that the entity will collect $1,200 ($100 × 12). Therefore, it is not probable the entity will collect *substantially all* of the promised consideration for the services it will provide to the customer.

— If either of these circumstances, including the one in which the entity expects to provide a price concession, apply, the entity accounts for the contract using the alternative model explained in section 3.6 until collectibility of a sufficient portion –i.e. substantially all – of the promised consideration for the services that will be provided becomes probable.

However, in the latter case, when the entity does not have the ability or the demonstrated intent to discontinue services, it may be that the entity is implicitly willing to accept an amount of consideration that is less than the promised amount (i.e. it will grant an implicit price concession) *even if* the entity pursues collection of all amounts owed. If that is the case, the entity may conclude it *is* probable that it will collect the reduced amount to which it expects to be entitled ($1,200 in the above example), and that therefore the collectibility criterion is met. See Question 3.4.10 for additional discussion of implicit price concessions.

Example 3.3.10
Assessing collectibility when new customer has low credit quality

ABC Corp. enters into a non-cancellable 36-month contract to provide services to Customer. Customer is a new customer of low credit quality. The consideration promised in the contract is $3,600, with $100 payable in advance each month.

Based on ABC's substantive history with this class of customer, ABC concludes it is *not* probable that Customer will pay all of the promised consideration for the promised 36 months of services. However, based on its experience with similar customers, ABC expects Customer to make the required payments for at least 10 months.

If Customer stops making the required payments, ABC has the right to deny Customer further access to the service. Moreover, ABC's customary business practice is to mitigate its credit risk by discontinuing services. In the event of customer default, ABC always pursues collection for unpaid services.

Scenario 1: Discontinuation of services at the end of the month

ABC's customary business practice is to discontinue services by the end of the month for which a customer has not paid. For example, if a customer pays in advance for May, but does not pay for June, ABC typically discontinues services by the end of June. ABC vigorously pursues collection from all its customers and typically is successful in recovering some portion of the fees for which the customer has not paid. No implicit price concession by ABC is expected.

ABC concludes it is probable it will collect substantially all of the consideration to which it is entitled in exchange for services that will be provided to Customer.

This is because ABC expects to collect:

— all of the promised consideration in the contract for at least 10 months of service; and
— if Customer defaults, some portion of the fees to which it would be entitled for the month of service after that Customer stops paying.

Scenario 2: Discontinuation of service after five months

ABC's customary business practice is to discontinue services only after a customer has not paid for the service for five months. For example, if a customer pays in advance for May, but does not pay for June – October, ABC typically discontinues services by the end of October.

ABC only discontinues services in this timeframe because its incremental costs to provide the services are minor. Even if it cannot recover the entire contracted fees for the unpaid months, it pursues collection vigorously and usually will recover a portion of those fees that is sufficient to cover its costs of providing the services and an acceptable profit margin. However, that portion of the promised fees is a minor portion of the promised consideration.

ABC's experience with this class of customer and its history of providing services well after a customer has defaulted on its payments suggests that ABC is implicitly willing to accept a lower fee than that stated in the contract with Customer. However, ABC expects those lower fees to result in a recovery of consideration that provides a reasonable profit margin on the contract. As a result, ABC concludes the lower fees are considered a price concession and therefore considers the lower fees as the consideration it expects to be entitled to for purposes of assessing collectibility.

Because ABC has a history of collecting the lower fees, ABC concludes it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the services that will be provided to Customer. However, the transaction price includes variable consideration that ABC needs to estimate, subject to the constraint (see section 5.3). Applying the constraint means that ABC will not recognize revenue of $100/month at least in the earlier part of the contract period. See section 3.4 for a discussion of price concessions.

Example 3.3.20

Assessing collectibility when an entity has a subprime customer base with a history of default

ABC Corp. enters into non-cancellable contracts with customers to sell consumer appliances. Substantially all of the appliance sales are financed by the customer over a three-year period.

ABC has a large percentage of subprime customers, and as a result it has historically collected approximately 65% of the sales price of all appliances sold. If a customer defaults on their payments, ABC has the right to repossess the appliance.

ABC does not assess the collectibility under a portfolio approach; instead, there is a thorough underwriting process on a customer-by-customer basis to evaluate creditworthiness of an individual. ABC's underwriting process includes the following protocols.

— The transaction must happen in person and a credit score is obtained.

— The customer's ability to pay is verified through validation of income sources, and job and residence information.

— The approval and the specific terms of the financing (e.g. down payment, interest rate, co-sign requirements) are based on the customer's credit score, income and job verification.

As a result of its underwriting process, ABC has a history of denying financing to 30% of applicants. The high default rate for those provided financing is due to events or circumstances affecting the customer's creditworthiness after obtaining financing (e.g. job loss, divorce, medical event).

Based on an appropriately designed underwriting process, ABC concludes it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the appliance provided to the customer. Therefore, the collectibility criterion under paragraph 606-10-25-1 is met. ABC records operating expense to reserve for bad debts.

Question 3.3.30

Do extended payment terms affect the evaluation of collectibility?

Interpretive response: Extended payment terms do not in and of themselves affect whether the collectibility criterion is met. However, they will likely factor into the entity's assessment of the credit risk to which it is subject as a result of the contract.

Extended payment terms introduce additional credit risk about the customer's ability or intention to pay the consideration that may not exist if the customer were required to pay for the goods or services as transferred or under non-extended payment terms. Therefore, extended payment terms may indirectly affect the evaluation of the collectibility criterion.

As discussed further in sections 5.3 and 5.5, extended payment terms may indicate that:

— there is the risk of a future price concession, which would make the transaction price variable. In that case, the entity would need to consider whether it expects to provide a concession, and the transaction price would be subject to Topic 606's constraint on variable consideration;

— a significant financing component exists in the contract.

Question 3.3.40

How should an entity assess collectibility for a portfolio of contracts?

Interpretive response: The TRG agreed that collectibility should be assessed at the individual contract level – i.e. the individual contract is the unit of account. [TRG 01-15.13]

For example, assume that an entity has 1,000 similar contracts and historical experience indicates that the entity will not collect on 2% of these contracts. This does not mean that the collectibility criterion is not met for 2% of the contracts. Rather, the entity evaluates whether collection is probable for an individual contract based on its customary procedures performed prior to entering into the arrangement to determine the credit risk associated with the individual customer. [TRG 01-15.13]

If this evaluation indicates that collectibility is probable, the entity accounts for the contract under Topic 606. [TRG 01-15.13]

However, in some situations, an entity may use a portfolio of historical data to estimate the amounts that it expects to collect. This type of analysis may be appropriate when an entity has a high volume of homogeneous transactions. These estimates are then used as an input into the overall assessment of collectibility for a specific contract.

For example, if on average a vendor collects 60% of amounts billed for a homogeneous class of customer transactions and does not intend to offer a price concession, this may be an indicator that collection of the full contract amount for a contract with a customer in that class is not probable. Therefore, the collectibility criterion may not be met for that contract.

Conversely, if on average a vendor collects 90% of amounts billed for a homogeneous class of contracts with customers, then this may indicate that collection of the full contract amount for a contract with a customer in that class is probable. In that case, the collectibility criterion may be met.

However, if the average collections were 90% because the vendor generally collected only 90% from each individual contract, this may indicate that the vendor has granted a 10% price concession to its customer. For a discussion of the differentiation between collectibility and a price concession see Question 3.4.10.

Question 3.3.50

Is a receivable recognized if the collectibility criterion is not met?

Interpretive response: No. When an entity concludes that a contract does not exist because the collectibility criterion is not met (or because any of the other contract existence criteria are not met), an entity does not record a receivable for consideration that it has not yet received for the goods or services it has already transferred to the customer.

This is consistent with the premise in Topic 606 that when collection is not probable the contract is not substantive and therefore the legal right to consideration is also not substantive for accounting purposes. [606-10-25-2]

Question 3.3.60

How is 'substantially all' defined for the collectibility assessment?

Interpretive response: 'Substantially all' is not defined in Topic 606. In ASU 2016-12, the FASB amended the collectibility criterion so that it is met if 'substantially all' of the consideration to which the entity will be entitled is collectible rather than 'all' of the consideration. The FASB decided that a contract could represent a substantive transaction even if it is not probable the entity will collect 100% of the consideration to which it expects to be entitled. [ASU 2016-12.BC12]

The term 'substantially all' is used in other places in US GAAP – e.g. Topic 842 (leases) – and generally understood to mean approximately 90%. For example, Topic 842 provides guidance that 90% might be appropriate for evaluating 'substantially all' (see section 3.3.3 of KPMG Handbook, Leases). We believe 90% should *not* be viewed as a safe harbor or bright-line and entities should consider all relevant facts and circumstances about the customer and the transaction. [842-10-55-2(c)]

3.4 Price concessions

3.4.10 Overview

Before applying the collectibility criterion, an entity determines if it expects to grant a price concession to the customer. If yes, the entity includes the estimate of the concession in the amount of consideration to which it ultimately expects to be entitled. It then applies the collectibility criterion to this estimated amount. In other words, in some cases an entity effectively needs to determine the transaction price (Step 3 of the model) and the guidance on estimating variable consideration before assessing the collectibility criterion. Variable consideration and price concessions are discussed in section 5.3.

The collectibility assessment is made after considering any expected price concessions because price concessions are not related to a customer's ability and intention to pay the consideration. Rather, concessions are typically granted in response to other factors – e.g. competition and price pressures, sales channel overload, regulatory changes.

When an entity expects to receive less than the stated consideration in a contract, it can be difficult to determine whether the shortfall will be due to a future price concession (variable consideration) or to the customer's ability and intention to pay (collectibility). Judgment is required in performing an evaluation.

Topic 606 includes two examples of implicit price concessions, reproduced here: a life science prescription drug sale (Example 2), and a transaction to provide healthcare services to an uninsured (i.e. self-pay) patient (Example 3). In both examples, the entity concludes that the transaction price is not the stated price or standard rate and that the promised consideration is variable because the entity expects to grant a price concession. [606-10-55-99 – 55-105]

Excerpt from ASC 606-10

• • > Example 2—Consideration is Not the Stated Price—Implicit Price Concession

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.

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.

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.

• • > Example 3—Implicit Price Concession

55-102 An entity, a hospital, provides medical services to an uninsured patient in the emergency room. The entity has not previously provided medical services to this patient but is required by law to provide medical services to all emergency room patients. Because of the patient's condition upon arrival at the hospital, the entity provides the services immediately and, therefore, before the entity can determine whether the patient is committed to perform its obligations under the contract in exchange for the medical services provided. Consequently, the contract does not meet the criteria in paragraph 606-10-25-1, and in accordance with paragraph 606-10-25-6, the entity will continue to assess its conclusion based on updated facts and circumstances.

55-103 After providing services, the entity obtains additional information about the patient including a review of the services provided, standard rates for such services, and the patient's ability and intention to pay the entity for the services provided. During the review, the entity notes its standard rate for the services provided in the emergency room is $10,000. The entity also reviews the patient's information and to be consistent with its policies designates the patient to a customer class based on the entity's assessment of the patient's ability and intention to pay. The entity determines that the services provided are not charity care based on the entity's internal policy and the patient's income level. In addition, the patient does not qualify for governmental subsidies.

55-104 Before reassessing whether the criteria in paragraph 606-10-25-1 have been met, the entity considers paragraphs 606-10-32-2 and 606-10-32-7(b). Although the standard rate for the services is $10,000 (which may be the amount invoiced to the patient), the entity expects to accept a lower amount of consideration in exchange for the services. Accordingly, the entity concludes that the transaction price is not $10,000 and, therefore, the promised consideration is variable. The entity reviews its historical cash collections from this customer class and other relevant information about the patient. The entity estimates the variable consideration and determines that it expects to be entitled to $1,000.

55-105 In accordance with paragraph 606-10-25-1(e), the entity evaluates the patient's ability and intention to pay (that is, the credit risk of the patient). On the basis of its collection history from patients in this customer class, the entity concludes it is probable that the entity will collect $1,000 (which is the estimate of variable consideration). In addition, on the basis of an assessment of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1 also are met. Consequently, the entity accounts for the contract with the patient in accordance with the guidance in this Topic.

Question 3.4.10

What factors should an entity consider in determining whether there is an implicit price concession and not a collectibility issue?

Interpretive response: Topic 606, including the two examples of implicit price concessions (Examples 2 and 3), does not provide any explicit guidance about how to determine if an entity may grant an implicit price concession.

However, the basis for conclusions to ASU 2014-09 states that an entity's customary business practices, published policies or specific statements may provide evidence that the entity is willing to accept a lower price in exchange for the promised goods and services. It also indicates that price concessions may be more likely to be granted when doing so would enhance a customer relationship or encourage future sales. [ASU 2014-09.BC192]

The FASB decided against providing further guidance on implicit price concessions. However, we believe that the following factors that might indicate an entity intends to offer a price concession may be useful for entities to consider in the absence of authoritative guidance.

— The goods or services promised to the customer are not expected to expose the entity to a significant economic loss if the customer does not pay the promised consideration. If the entity would not incur a significant loss it might be willing to provide a price concession. For example, the incremental costs that an entity incurs to produce the good or service or transfer it to the customer is negligible.

— The entity has previously chosen not to enforce its rights to the promised consideration in similar contracts with the customer (or class of customer) under similar circumstances. This pattern of accepting less consideration than promised in similar contracts may provide evidence the entity will provide a potential price concession.

— The entity has experience (or other evidence) about the customer not fulfilling its obligations to pay the promised consideration in other contracts. An entity's willingness to enter into a new contract with the customer despite that history may suggest it will provide a price concession.

— The entity has experience (or other evidence) about the class of customer to which the customer belongs not fulfilling their obligations to pay the promised consideration in similar contracts under similar circumstances.

Again, the entity's willingness to enter into a contract with a customer in a high credit risk class may suggest the entity will provide a price concession.

Variable consideration and price concessions are discussed in section 5.3.

Example 3.4.10

Collectibility criterion assessed based on amount entity expects to receive for goods or services transferred (1)

ABC Corp. enters into an arrangement with Customer for 1,000 units of Product X for two years for $1,000,000. ABC's standard payment terms for similar customers are two equal payments, one due at contract inception and the second due at the beginning of Year 2.

Customer has a history of requesting a reduction in the second payment due, which ABC has frequently granted to encourage Customer to make additional purchases, including new products, in the future. ABC further notes that this practice is not isolated to Customer. Other high-volume customers have made similar requests that ABC has granted.

Based on all relevant facts and circumstances, ABC determines it is likely to accept an amount of consideration less than the $1,000,000 promised amount. It estimates that the amount of consideration to which it expects to be entitled after taking the price concession into account is $900,000. For further discussion of estimating variable consideration, see section 5.3.

Accordingly, when assessing the collectibility criterion, ABC assesses whether it is probable that it will receive $900,000 – i.e. the amount to which it expects to be entitled after the expected price concession.

See also Example 3.3.10, Scenario 2 and Example 3.4.20.

Example 3.4.20

Collectibility criterion assessed based on amount entity expects to receive for goods or services transferred (2)

Hospital treats an uninsured patient and is not in a position to, and does not, assess the patient's ability to pay at the time of service. Hospital bills the patient $10,000. Although Hospital expects to pursue collection of that amount, its experience with similar patients indicates that it will only collect $1,000.

Hospital estimates that the transaction price is $1,000 when considering the guidance on variable consideration and the constraint. The $9,000 that it does not expect to receive is an implicit price concession as opposed to a bad debt; this is because the hospital was willing to provide services without performing a credit assessment before providing the service. Patient service revenue of $1,000 is recognized.

Subsequently, Hospital collects only $950 of the $1,000 it expected to collect. The difference of $50 is accounted for as an increase in the implicit price concession (reduction of patient service revenue), if there has been no patient-specific event indicating the patient no longer has the ability and intent to pay.

Alternatively, if there was a patient-specific event that is known to the hospital suggesting that the patient no longer has the ability and intent to pay the amount due (e.g. the patient had a job at the time of service but subsequently lost it), the amount not collected ($50) would be recognized as bad debt expense.

See also Example 3.3.10, Scenario 2 and Example 3.4.10.

3.5 Reassessment of contract existence criteria

Excerpt from ASC 606-10

> Identifying the Contract

25-5 If a contract with a customer meets the criteria in paragraph 606-10-25-1 at contract inception, an entity shall not reassess those criteria unless there is an indication of a significant change in facts and circumstances. For example, if a customer's ability to pay the consideration deteriorates significantly, an entity would reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C).

25-6 If a contract with a customer does not meet the criteria in paragraph 606-10-25-1, an entity shall continue to assess the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met.

3.5.10 Overview

If a contract does not meet contract existence criteria, the entity continues to reassess the contract to determine when those criteria are met and when the entity can begin to apply the revenue model to that contract.

If a contract meets all of the contract existence criteria at contract inception, the entity does not reassess any of those criteria unless there is a significant change in facts and circumstances. If, on reassessment, an entity determines that the criteria are no longer met, then it ceases to apply the revenue model to the contract from that date, but does not reverse any revenue previously recognized. If a contract does not exist on reassessment, then the entity follows the guidance discussed in section 3.6 on consideration received from a customer before meeting the contract existence criteria. [606-10-25-5]

Example 4 in Topic 606 (reproduced below), illustrates a scenario when the entity subsequently concludes the arrangement no longer meets the contract existence criteria. In that example, the entity reassessed and concluded in year 3 of an arrangement that a contract no longer existed. However, there could be circumstances where the entity reaches a conclusion earlier than they did in the illustrative example. For example, if the customer indicated that it is no longer a going concern, it may have provided earlier evidence of a significant change in facts and circumstances.

Excerpt from ASC 606-10

• • > Example 4—Reassessing the Criteria for Identifying a Contract

55-106 An entity licenses a patent to a customer in exchange for a usage-based royalty. At contract inception, the contract meets all the criteria in paragraph 606-10-25-1, and the entity accounts for the contract with the customer in accordance with the guidance in this Topic. The entity recognizes revenue when the customer's subsequent usage occurs in accordance with paragraph 606-10-55-65.

55-107 Throughout the first year of the contract, the customer provides quarterly reports of usage and pays within the agreed-upon period.

55-108 During the second year of the contract, the customer continues to use the entity's patent, but the customer's financial condition declines. The customer's current access to credit and available cash on hand are limited. The entity continues to recognize revenue on the basis of the customer's usage throughout the second year. The customer pays the first quarter's royalties but makes nominal payments for the usage of the patent in quarters 2–4. <u>The entity accounts for any impairment of the existing receivable in accordance with Topic 310 on receivables.</u>

55-109 During the third year of the contract, the customer continues to use the entity's patent. However, the entity learns that the customer has lost access to credit and its major customers and thus the customer's ability to pay significantly deteriorates. The entity therefore concludes that it is unlikely that the customer will be able to make any further royalty payments for ongoing usage of the entity's patent. As a result of this significant change in facts and circumstances, in accordance with paragraph 606-10-25-5, the entity reassesses the criteria in paragraph 606-10-25-1 and determines that they are not met because it is no longer probable that the entity will collect the consideration to which it will be entitled. Accordingly, the entity does not recognize any further revenue associated with the customer's future usage of its patent. <u>The entity accounts for any impairment of the existing receivable in accordance with Topic 310 on receivables.</u>

Pending Content

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* ¦ Transition Guidance: 326-10-65-1

55-108 … The entity accounts for any credit losses on the existing receivable in accordance with Subtopic 326-20 on financial instruments measured at amortized cost.

55-109 … The entity accounts for additional credit losses on the existing receivable in accordance with Subtopic 326-20.

Question 3.5.10

When does an entity reassess the collectibility criterion?

Interpretive response: Once an entity determines that a contract exists under Step 1 of the revenue model (including assessing the collectibility criterion), it does not reassess the collectibility criterion unless there is a significant change in facts and circumstances that results in a significant deterioration in the customer's creditworthiness. For example, a significant deterioration in a customer's ability to pay because it lost one of its customers that accounts for 75% of its annual sales would likely lead to a reassessment. [606-10-25-5]

The determination of whether there is a significant deterioration in the customer's creditworthiness will be situation-specific and will often be a matter of judgment. The evaluation is not intended to capture:

— changes of a more minor nature that do not call into question the existence of the contract; or

— changing circumstances that might reasonably fluctuate during the contract term (especially for a long-term contract) that do not have a significant effect. [TRG 01-15.13]

If, after a significant change in facts and circumstances, the entity determines that collectibility is no longer probable, it discontinues using the general revenue model and follows the guidance on accounting for consideration received when a contract does not exist – the alternative model (see section 3.6). However, the entity does not reverse revenue previously recognized.

If an entity determines that a contract does not exist under Step 1 of the revenue model, it continually reassesses the arrangement. If the criteria for Step 1 are subsequently met, the entity begins applying the revenue model to the arrangement. See Question 3.2.80 on applying the revenue model to goods or services transferred before meeting the contract existence criteria.

3.6 Consideration received from customer before meeting contract existence criteria

Excerpt from ASC 606-10

> Identifying the Contract

25-6 If a contract with a customer does not meet the criteria in paragraph 606-10-25-1, an entity shall continue to assess the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met.

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 one or more of the following events have 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.
c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

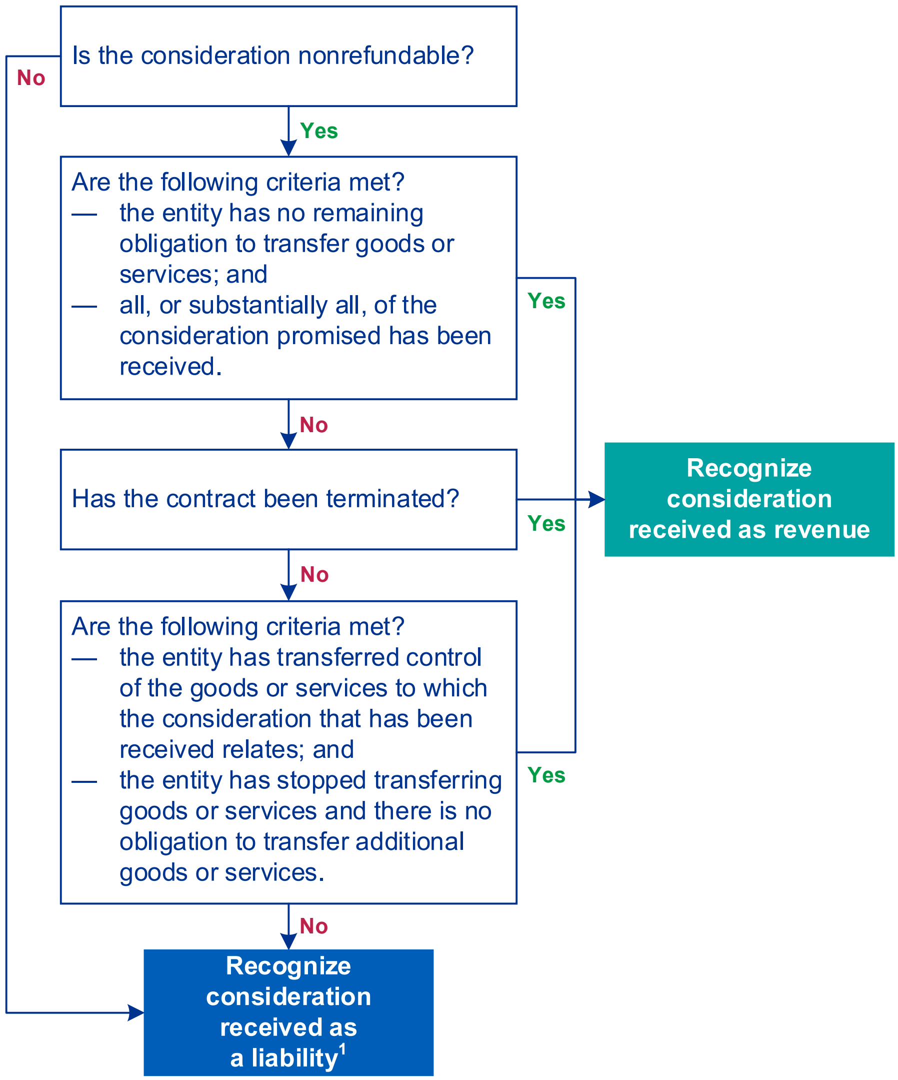
25-8 An entity shall recognize the consideration received from a customer as a liability until one of the events in paragraph 606-10-25-7 occurs or until the criteria in paragraph 606-10-25-1 are subsequently met (see paragraph 606-10-25-6). Depending on the facts and circumstances relating to the contract, 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.

3.6.10 Overview

If a contract initially or upon reassessment does not meet the contract existence criteria in paragraph 606-10-25-1 (see the discussion in section 3.5 regarding reassessment), an entity recognizes the consideration received as revenue only when one of the three events in paragraph 606-10-25-7 has occurred. [606-10-25-6]

This guidance is often referred to as the alternative model for recognizing revenue because it was included to address how to account for consideration and potentially recognize revenue when the contract existence criteria may never be met.

The following decision tree describes the criteria to recognize revenue under the alternative model.



[1] An entity continuously reassesses the contract existence and alternative revenue recognition criteria

The first two criteria allow entities to recognize revenue when the contracts are complete or cancelled and the entity received nonrefundable consideration. The FASB added the third criterion to address situations when an entity has stopped transferring goods or services but have not yet cancelled the contract in order to maintain its legal rights and pursue collection. Without the third criterion, an entity might have recognized a liability for nonrefundable consideration for a significant period of time until the contract was legally terminated and the second criterion was met. However, the third criterion is not equivalent to a 'cash basis' accounting because the entity must either stop transferring goods or services to the customer or not have any additional promised goods or services to transfer. [ASU 2014-09.BC47, ASU 2016-12.BC23–BC24]

The FASB considered whether to include asset derecognition guidance (and therefore cost recognition guidance) for assets related to a contract that does not meet the contract existence criteria. However, it decided that including asset derecognition guidance for these types of transactions would be outside the scope of the revenue recognition project. The FASB, however, noted that an entity should apply other US GAAP to determine if it should derecognize assets related to contracts that do not meet the contract existence criteria. An entity may not be able to defer any costs when the contract existence criteria is not met if it does not control the asset transferred to the customer. [ASU 2014-09.BC49]

Question 3.6.10

How does an entity account for services provided after expiration of a contract?

Interpretive response: It depends. In some cases, an entity may continue to deliver services to a customer under the terms of a contract after it has expired – e.g. when terms of the new contract to replace the existing one are not finalized before the expiration date of the existing contract. If the entity has legally enforceable rights and obligations related to these services, then the services delivered are accounted for under the revenue model.

Conversely, if the entity does not have legally enforceable rights and obligations for the services delivered after the contract expires, then it applies the guidance on accounting for consideration received before meeting the contract existence criteria. Assessing whether enforceable rights and obligations continue to exist is often complex and may require the advice of legal counsel.

Determining if an enforceable contract exists

Even if there are no provisions in the contract to continue the services after expiration of the contract an entity could continue to provide the services under the terms of the expired contract while a new contractual arrangement is being negotiated. Even in this case, enforceable rights and obligations may still exist and there may be evidence that both parties are committed to those obligations. There may be circumstances in which an entity could conclude that there are legally enforceable rights and obligations after a contract expires even in the absence of a formal renewal agreement. Judgment may be required to support that both parties are committed to their respective obligations after the expiration of the written agreement.

Additional evidence could include the following.

— The entity's past practice of invoicing for continued services after expiration of the agreement, whether its customers (including the present customer if applicable) have continued to pay, and the enforceability of those amounts had they not paid. The entity's provision of the services and the customer's continued payment may provide evidence to demonstrate the parties' commitment.

— Any customer purchase orders it received, whether contract negotiations have begun, and any email communications evidencing the customer's intent to continue the services and pay for such services.

— The entity's history with the customer, and potentially other similar customers, in terms of whether the customer has previously continued services after contract expiration and paid for such services or entered into a contract extension that addressed those services.

Ultimately though, evidence of behaviors may not be sufficient to conclude that enforceable rights and obligations exist and legal interpretation by competent counsel may be required.

Lastly, the entity would need to conclude that collectibility of amounts due for the continued services is probable.

If there is an enforceable contract in the scope of the revenue model

If there is an enforceable contract in the scope of the revenue model, revenue continues to be recognized as the services are provided based on the terms and conditions of the contract.

If the fees for the services are uncertain because of ongoing negotiations to enter into a new formal agreement, the fees are considered variable consideration and estimated subject to the constraint (see section 5.3).

When the formal agreement is executed, if the fees for the services provided post-expiration are changed, this results in either:

— an adjustment to the variable consideration included in the transaction price; or

— if the consideration was not deemed to be variable, as a contract modification (see section 11.2); this might occur when the entity had no indication that the formal contract would not include the fees it was charging the customer.

If there is *not* an enforceable contract in the scope of the revenue model

The entity considers the guidance for consideration received before meeting the contract existence criteria (see section 3.6.10) to determine if revenue can be recognized. We believe that a conclusion about whether revenue can be recognized under the alternative model could be different depending on the reason why the contract existence criteria was not met. Different conclusions could be reached:

a. because enforceable rights and obligations do not exist – i.e. a legally binding contract does not exist; or
b. solely because the collectibility criterion is not met.

Regardless of the reason, the entity would defer any consideration received from the customer and recognize it as a deposit liability until there is an enforceable contract in the scope of the revenue model. At that point in time, the entity recognizes revenue on a cumulative catch-up basis for the services already provided under the newly established contract and accounts for the remainder of the contract in the same manner as any other services.

Enforceable rights and obligations do not exist

If there is no legally binding contract, we do not believe it would be possible for the entity to conclude that it has met any of the criteria in the alternative model (see decision tree in section 3.6.10).

Collectibility criterion not met

If a legally binding contract exists, but the revenue model does not apply solely because the collectibility criterion is not met, the entity may be able to conclude that the criteria in the alternative model have been met. Therefore, it may recognize revenue for payments received upon the occurrence of one of the events represented in the alternative model.

For example, if the legally binding contract does not obligate the entity to provide services beyond either those already performed or for which the customer has already paid – e.g. the current month's services paid in advance, the entity would likely be able to recognize revenue for the services it has already provided and for which it has received a nonrefundable payment for substantially all of the consideration to which it is legally entitled. That is, under paragraph 606-10-25-7(a), the entity may be able to conclude that it has no remaining obligation to provide further services – i.e. beyond those already provided after the previous contract expired – and has received a nonrefundable payment for substantially all of the consideration to which it is entitled for those services. If this is the case, it can recognize revenue for the services once those services are complete and substantially all of the consideration to which it is entitled for those services has been received. [606-10-25-7(a)]

Example 3.6.10
Contract continuation for a service

ABC Corp. and Customer have a longstanding relationship wherein ABC provides cleaning services. The parties' latest 12-month service agreement expired on May 31, Year 2, and did not include any provision for automatic renewal of the service. Customer paid $120,000 upfront for the 12 months of service on June 1, Year 1, which was the observable stand-alone selling price for the service. ABC recognizes its service revenue over time using a time-based measure of progress (see sections 7.3 and 7.4.40).

The following additional facts are relevant.

- A new service agreement requiring a fee of $108,000 for the 12-month period June 1, Year 2 to May 31, Year 3 is signed on July 31, Year 2.
- No agreement existed from June 1, Year 2 until July 31, Year 2, although ABC continued to provide in anticipation of executing an agreement.
- As per its customary business practice, ABC invoiced Customer for the June 1, Year 2 to May 31, Year 3 service in May Year 2 at the amount that was agreed for the preceding year ($120,000).
- ABC concludes, based on advice of legal counsel, that an enforceable contract did not exist between June 1, Year 2 and July 31, Year 2.

Scenario 1: Customer does not pay initial invoice

Customer did not pay ABC's $120,000 invoice issued in May Year 2. ABC cancelled that invoice on July 31, Year 2 when the new contract was executed and issued a new invoice for the agreed-upon $108,000, which the Customer paid shortly afterwards.

ABC records the following journal entry on July 31, Year 2.

	Debit	*Credit*
Receivable	108,000	
Contract liability		90,000
Revenue[1]		18,000
To recognize contract with Customer.		

Note:

1. Two months of revenue (June and July) already earned: $108,000 / 12 × 2. The remaining $90,000 of service revenue will be recognized at $9,000 per month for the remaining 10 months.

Scenario 2: Customer partially pays initial invoice

Customer partially paid ($40,000) the $120,000 invoice issued by ABC in May Year 2. When the new contract was executed on July 31, Year 2, Customer paid ABC the balance of the $108,000 new contract service fee ($108,000 – $40,000 = $68,000).

Despite the fact that Customer partially paid the $120,000 invoice, ABC does not recognize any revenue until the new agreement is established on July 31, Year 2. This is because the criteria in the alternative model are not met before the new agreement is established consistent with the advice of legal counsel.

ABC records the following journal entries.

	Debit	*Credit*
Cash	40,000	
Deposit liability		40,000
To recognize cash received in May, Year 2.		
Cash	68,000	
Deposit liability	40,000	
Contract liability[1]		90,000
Revenue		18,000
To recognize contract with Customer on July 31, Year 2.		

Note:

1. $90,000 remaining consideration to recognize.

Scenario 3: Customer partially pays initial invoice and entity has history of enforcing payment

Assume the same facts as in Scenario 2, except that ABC concludes that an enforceable contract *does* exist based on relevant experience with enforcing similar arrangements and the advice of legal counsel.

Because an enforceable contract exists on June 1, Year 2, ABC continues to recognize service revenue as it provides it to the Customer. However, it does not continue to recognize $10,000 per month because the transaction price for the service it is providing subsequent to expiration of the prior agreement is uncertain – ABC knows from relevant experience that Customer will likely negotiate a lower service fee than the $120,000 in the prior year.

ABC applies the guidance on estimating variable consideration, including the constraint (see section 5.3), and estimates revenue of $7,000 per month. When the new agreement is signed on July 31, Year 2, ABC trues up the revenue recognized for the post-expiration period based on resolution of the uncertainty surrounding the transaction price for the service provided during those periods.

ABC records the following journal entries.

	Debit	*Credit*
Cash	40,000	
Contract liability		40,000
To recognize cash received in May, Year 2.		
Contract liability	14,000	
Revenue		14,000
To recognize revenue for June and July, Year 2.		
Cash	68,000	
Contract liability		64,000
Revenue[1]		4,000
To recognize contract with Customer on July 31, Year 2.		

Note:
1. $18,000 (see Scenario 2) less $14,000 already recognized.

Question 3.6.20

Can revenue be recognized on a cash basis when the collectibility criterion is not met and the entity continues to provide goods or services to the customer?

Interpretive response: Generally, no. If the collectibility criterion is not met, an entity continuing to provide goods or services to the customer cannot record revenue based on its collections unless the alternative model criteria in paragraph 606-10-25-7 are met (see decision tree in section 3.6.10). Under the alternative model, an entity cannot recognize revenue when it has a remaining obligation to transfer goods or services to a customer or it chooses to continue to transfer goods or services to a customer when substantially all of the consideration to which it is legally entitled has not been received.

There are limited scenarios in which an entity can continue to transfer goods or services under a contract, determine collectibility is not probable, but nevertheless recognize some revenue. This is because the collectibility criterion is evaluated based only on the goods or services expected to be transferred. See Questions 3.3.10 and 3.3.20 for the evaluation of arrangements where an entity has the ability and intent to stop providing the promised goods or services due to customer non-payment.

Example 3.6.20

Cash received when collectibility criterion is not met

ABC Corp. provides Customer with three years of access to its networking platform in exchange for monthly payments of $10,000. In January of Year 2 of the contract, Customer experiences a significant decline in its business and has difficulty meeting its financial commitments.

ABC agrees to extended payment terms that allow Customer to make nonrefundable payments of $2,000 per month during Year 2, with the remaining amounts due in Year 3. The contract is not terminated, ABC continues to provide Customer with access to its platform and intends to enforce payment for remaining amounts in Year 3. ABC performs a reassessment of the contract existence criteria and determines that collectibility of the remaining consideration to which it expects to be entitled is not probable.

ABC receives $15,000 in partial payments in Year 2. Because the collectibility criterion was not met upon reassessment, ABC must evaluate the alternative model criteria in paragraph 606-10-25-7 to determine how to recognize revenue for the $15,000 nonrefundable payment received.

- The first criterion is not met because Customer has not remitted substantially all of the consideration promised for the services provided.
- The second criterion is not met because the contract has not been terminated.
- The third criterion is not met because ABC has not stopped transferring services to Customer.

Based on the evaluation of the alternative model criteria, ABC cannot recognize revenue for the cash received from Customer in Year 2. Therefore, even though ABC received $15,000 in cash consideration, ABC recognizes a deposit liability for $15,000 and records no related revenue.

Note: If the contract existence criteria (including the collectibility criterion) or one of the criteria in the alternative model is met upon reassessment in Year 3, ABC would record a cumulative catch-up to revenue for the services already provided.

3.7 Combining contracts

Excerpt from ASC 606-10

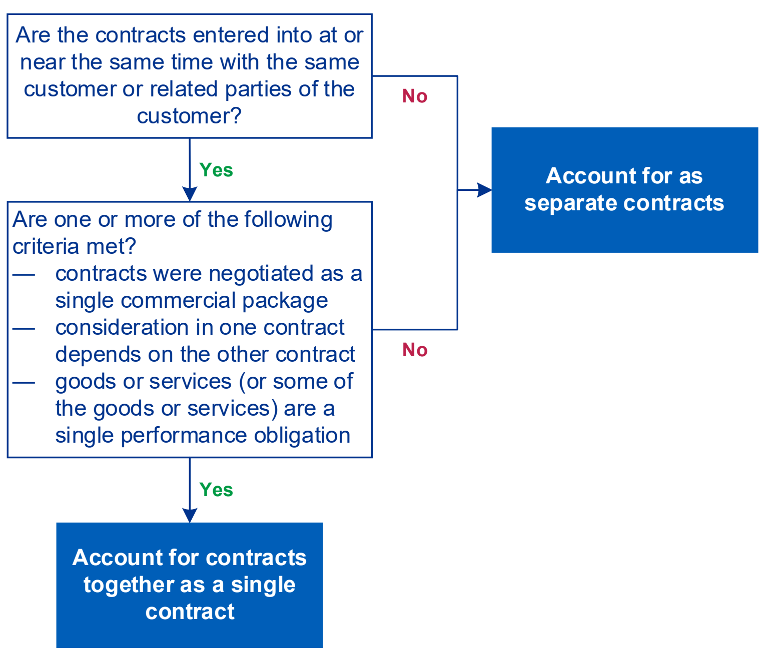
> Combination of Contracts

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.

3.7.10 Overview

When an entity enters into multiple contracts with the same customer it needs to determine if in substance those arrangements should be accounted for as a single contract. Determining when multiple contracts should be combined requires judgment and consideration of both the form and the substance of an arrangement. The following decision tree outlines the criteria for determining when an entity combines two or more contracts and accounts for them as a single contract.



In addition to entering into contracts at or near the same time with the same customer, one or more of the criteria in paragraph 606-10-25-9 need to be met for the contracts to be combined.

When either criterion (a) or (b) in paragraph 606-10-25-9 is met, the relationship between the consideration in the contracts (i.e. the price interdependence) is such that if those contracts were not combined, the amount of consideration allocated to the performance obligations in each contract might not faithfully depict the value of the goods or services transferred to the customer.

The criterion in paragraph 606-10-25-9(c) was included to avoid the possibility that an entity could effectively bypass the guidance for identifying performance obligations depending on how the entity structures its contracts. [ASU 2014-09.BC73]

Often entities have continuing and multifaceted relationships with their customers (including resellers), and this business relationship will lead to numerous signed or oral arrangements between the two parties that will need to be evaluated. However, in order for two or more contracts to be combined, they should be with the same customer.

In some situations, contracts with related parties (as defined in Topic 850) should be combined if there are interdependencies between the separate contracts with those related parties. [ASU 2014-09.BC74]

Excerpt from ASC 850-10

20 Glossary

Related Parties

Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method of the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

See chapter 8 of KPMG Handbook, Financial statement presentation, for further discussion of related parties.

Question 3.7.10

What constitutes 'at or near the same time' when evaluating whether two or more contracts should be combined?

Interpretive response: Topic 606 does not provide a bright-line for evaluating what constitutes 'at or near the same time' to determine whether two or more contracts should be combined. Although facts and circumstances may vary, we believe it may be helpful for an entity to have an accounting policy for making that determination.

For example, an entity may perform services for a majority of the customers that buy a certain product and have a business practice of entering into follow-on contracts to provide those services. In this scenario, the entity might specifically consider the period of time that generally lapses between the initiation of the contract for the goods and the follow-on contract for the services to determine what represents a *minimum* period of time within which the entity would conclude two or more contracts were entered into at or near the same time. In other words, any contracts entered into under the minimum timeframe established would be considered at or near the same time.

However, just because two contracts are not entered into within the minimum period established by the entity does not mean they were not entered into 'at or near the same time'. An entity should have processes in place that consider specific facts and circumstances in cases that may not be 'customary' or usual. For example, an entity should not ignore the fact that two nonstandard agreements, such as ones that are different from or larger than the entity's typical arrangements, were being discussed or negotiated over the same period of time and would appear to be significantly interrelated solely because they were not executed within the entity's established 'minimum period'.

An entity should have processes and controls to ensure multiple contracts initiated with the same customer at or near the same time are identified on a timely basis, and therefore appropriately considered as to whether they should be accounted for as a single contract. This may include processes and controls to identify ongoing negotiations so that revenue related to a contract is not recognized until the entity has evaluated whether the contract under negotiation should be combined with other contracts.

In addition, an entity should consider whether a separate agreement is a modification to the original agreement and whether it should be accounted for as a new contract or as part of the existing contract. For a discussion of contract modifications, see section 11.2.

Example 3.7.10
Combining contracts (1)

ABC Corp. sells equipment, Product P. Product P functions as designed without any customization or modification services, and can be installed at a customer site without ABC's assistance.

ABC entered into a contract with Customer to sell Product P. After 45 days, ABC and Customer enter into a separately papered agreement for ABC to provide services to modify Customer's Product P. The services include significant modification of Product P that enhances and changes its functionality.

While executed separately, the two agreements were negotiated during the same time period (even though commencement and completion of the negotiations were not co-terminus) and largely by the same ABC and Customer personnel.

ABC concludes that, if the two contracts were combined, Product P and the service to customize Product P would be a single performance obligation (see section 4.3). ABC also concludes that the two agreements were negotiated as a package with a single commercial objective – i.e. to enable Customer to use the customized equipment.

Therefore, because the contract for Product P and the services agreement were entered into near the same time, the two agreements constitute a single contract and ABC accounts for the Product P and the customization services as a single performance obligation.

Example 3.7.20
Combining contracts (2)

Assume the same facts as in Example 3.7.10, except for the following.

- The services agreement is executed nearly five months after the contract for Product P.
- The size of the two agreements and the extent of the services are larger than any other arrangement that ABC Corp. has entered into in recent years.
- ABC has an accounting policy, based on its customary business practices, that contracts entered into within 90 days of each other have been entered into 'at or near the same time'.

Consistent with Example 3.7.10, ABC concludes that:

- if the two contracts were combined, Product P and the services to customize the equipment would be a single performance obligation; and
- the two agreements were negotiated as a package with a single commercial objective – to enable Customer to use the customized equipment.

In this case, ABC concludes that the two agreements were entered into near the same time as each other even though five months is longer than its established policy of treating 90 days or less as 'at or near the same time'. Consistent with the discussion in Question 3.7.10, even though ABC has an accounting policy in this regard that is reasonable to ABC's customary customer arrangements, ABC considers that this is an 'atypical' customer arrangement – i.e. it is unusually large and complex – such that the specific facts and circumstances should also be considered. The significantly overlapping negotiations and negotiating parties, along with the overall context of the two agreements, leads ABC to conclude that a delay in obtaining final agreement on the services contract does not mean that the contract for Product P and the services agreement were not entered into near the same time as each other.

Example 3.7.30
Combining contracts (3)

ABC Corp. enters into a contract with Customer to provide equipment (Product P). Product P is fully functional upon basic installation that most customers can perform themselves or obtain from numerous service providers other than ABC. However, approximately one month after the contract is executed, Customer decides that it wants ABC to provide some services so that Customer can more effectively use Product P. Consequently, ABC and Customer enter into a services agreement for ABC to provide specified installation services.

The installation services are not complex. However, Customer views the services as important to its ability to immediately begin using Product P as intended; when it executes the services agreement, Customer requires a clause that it is permitted to withhold up to 50% of the fees required under the contract for Product P until the services are successfully completed and accepted.

The two agreements were executed near the same time (approximately one month apart). Moreover, the services agreement effectively modifies the product agreement by changing its payment terms – i.e. permitting a delay in Customer's payments for Product P until the services agreement is successfully fulfilled. In addition, the consideration to be paid for Product P is dependent on the successful completion of the services in the services agreement. Therefore, ABC concludes that the contract for Product P and the services agreement should be combined.

Note: Just because the agreements should be combined does not necessarily mean that Product P and the services are a single performance obligation in the combined contract. For further discussion of identifying the performance obligations in a contract under Step 2 of the revenue model, see section 4.3.

Question 3.7.20

Should contracts entered into between different divisions of the same entity or the same customer be evaluated for possible combination?

Interpretive response: Yes. There is no exception for considering whether two or more contracts should be combined because they were executed by different divisions of the entity or the customer. In fact, contracts with related parties of the customer that may not even be part of the same consolidated entity are considered for possible combination.

However, whether the contracts were negotiated by the same parties or, instead, were negotiated with different divisions of the entity or the customer may significantly influence whether any of the three specified criteria in paragraph 606-10-25-9 are met. For example, two contracts entered into by different divisions of one or both parties may be less likely to have been 'negotiated as a package with a single commercial objective' or to have goods or services that are a single performance obligation.

Question 3.7.30

Can contracts entered into at or near the same time with multiple customers be combined?

Interpretive response: No. The FASB considered whether to specify that all contracts should be combined if they were negotiated as a package to achieve a single commercial objective, regardless of the customer. However, the FASB decided against this approach because it was concerned that doing so could have the unintended consequence of an entity combining too many contracts and not faithfully depicting the entity's performance. [ASU 2014-09.BC75]

Further, in an SEC staff speech, it was noted that the SEC's Office of the Chief Accountant had been consulted on the contract combination guidance. It was noted that because Topic 606 explicitly limits what contracts may be combined, the staff objected to a registrant's proposal to extend the contract combination guidance beyond contracts with the same customer or related parties of the same customer. [2016 Baruch]

Question 3.7.40

Do purchase orders under the same MSA need to be combined?

Interpretive response: It depends. Even if the MSA is not legally enforceable, the pricing among the purchase orders may be interrelated and required to be combined into a single contract. As a consequence, purchase orders that are issued separately should be evaluated and combined if the criteria for combining contracts are met.

For example, if an entity receives two separate purchase orders at or near the same time for units to be delivered in Month 1 and Month 2, then the entity assesses whether the purchase orders were negotiated as a single commercial package – e.g. price adjustments were made for cash flow reasons – or independent of one another.

If the purchase orders are combined, this may result in the transaction price allocated to performance obligations in an individual purchase order being different from the stated contract price. For example, assume a customer submits two purchase orders that are combined for 200 units each to be transferred in Month 1 and Month 2 and stated the unit prices are $100 in Month 1 and $80 in Month 2. In that scenario, the transaction price allocated to each unit would likely be $90 if the stand-alone selling price is the same for each unit.

When purchase orders are not combined, the MSA may contain implicit or explicit promises that are relevant to other steps in the revenue model. This includes considering whether the pricing on subsequent purchase orders may include a material right under Step 2 or any variable consideration under Step 3 (e.g. a rebate or discount) that are not disclosed in the purchase orders.

3.8 Term of the contract

Excerpt from ASC 606-10

> Identifying the Contract

25-3 Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations. In evaluating the criterion in paragraph 606-10-25-1(e), an entity shall assess the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectibility of the consideration promised in the contract for all of the promised goods or services (see paragraphs 606-10-55-3A through 55-3C). However, if an entity determines that all of the criteria in paragraph 606-10-25-1 are met, the remainder of the guidance in this Topic shall be applied to all of the promised goods or services in the contract.

25-4 For the purpose of applying the guidance in this Topic, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties). A contract is wholly unperformed if both of the following criteria are met:

a. The entity has not yet transferred any promised goods or services to the customer.

b. The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

3.8.10 Overview

When a contract exists under Topic 606, the revenue model is applied to the duration of that contract – i.e. the contractual period – in which the parties to the contract have presently enforceable rights and obligations. The determination of the contract term is important because it may affect all of the following:

- the collectibility assessment (Step 1);
- the measurement (Step 3) and allocation (Step 4) of the transaction price;
- the timing of revenue recognition (Step 5);
- contract modifications; and
- the identification of material rights.

Additionally, the length of the contract may affect the applicability of certain practical expedients, including those related to identifying significant financing components (see section 5.5) and disclosure of the transaction price allocated to the remaining performance obligations (see section 15.7).

Determining the contract term typically is not difficult when a contract has a stated duration and neither party has the unilateral right to cancel the contract. In contrast, it can be more challenging when either party has cancellation rights.

For example, a contract does not exist for accounting purposes if each party to the contract has the unilateral right to terminate a 'wholly unperformed' contract without compensating the other party (or parties). A contract is wholly unperformed if both of the following criteria are met:

- the entity has not yet transferred any promised goods or services to the customer; and
- the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services. [606-10-25-4, ASU 2014-09.BC50]

Similarly, the contract term can be shorter than the stated term if both parties have the unilateral right to terminate the contract without penalty. Further, if only the customer has a right to terminate the contract without penalty, the contract term may be shorter than the stated contract term (see Question 3.8.20 for a discussion of the effect of termination penalties). As a result, entities will need to carefully evaluate each party's rights under the contract to determine the appropriate contract term. [TRG 10-14.10, TRG 11-15.48]

Question 3.8.10
What is the contract term in a period-to-period contract that may be cancelled by either party, or cancelled by the customer only, without penalty?

Excerpt from ASU 2014-09

BC50. The Boards decided that Topic 606 should not apply to wholly unperformed contracts if each party to the contract has the unilateral enforceable right to terminate the contract without penalty. Those contracts would not affect an entity's financial position or performance until either party performs. In contrast, there could be an effect on an entity's financial position and performance if only one party could terminate a wholly unperformed contract without penalty. For instance, if only the customer could terminate the wholly unperformed contract without penalty, the entity is obliged to stand ready to perform at the discretion of the customer. Similarly, if only the entity could terminate the wholly unperformed contract without penalty, it has an enforceable right to payment from the customer if it chooses to perform.

BC391. A renewal option gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. This type of option could be described as a renewal option within a relatively short contract (for example, a one-year contract with an option to renew that contract for a further year at the end of the first and second years) or a cancellation option within a longer contract (for example, a three-year contract that allows the customer to discontinue the contract at the end of each year). A renewal option could be viewed similarly to other options to provide additional goods or services. In other words, the renewal option could be a performance obligation in the contract if it provides the customer with a material right that it otherwise could not obtain without entering into that contract.

Interpretive response: Entities may enter into contracts under which services are provided period-to-period – e.g. month-to-month or year-to-year basis – unless cancelled by either party without penalty at the end of a period. A period-to-period contract would also include a contract that provides the option to renew each period – e.g. place a new order, sign a new contract. In both cases, either party has the choice to discontinue services at each point in time it has a termination or renewal right. Similarly, a contract that has a stated term (e.g. one year) but can be cancelled by either party at periods during that stated term (e.g. each month) without penalty would be considered a period-to-period contract.

Period-to-period contracts (with or without stated terms) may be referred to as evergreen contracts. Some evergreen contracts renew automatically while others require a specific action by one or both parties to renew.

In a period-to-period contract, the contract term does not extend beyond the period that can be cancelled without penalty. This would also be the case when only the customer has a unilateral option to terminate a contract without penalty. For the effect of termination penalties on contract term, see Question 3.8.20.

Both parties have termination rights

When both parties to the contract have the unilateral right to terminate the contract without penalty at the end of any designated period, a contract does not exist for periods beyond the then-current period. The contract term would be the same if only the customer has a unilateral option to terminate a period-to-period contract without penalty. For example, in a month-to-month contract, the contract term is the current (one) month. [606-10-25-4, TRG 10-14.10]

Customer-only termination rights

When *only the customer* has a unilateral option to terminate a period-to-period contract, some enforceable rights and obligations continue to exist even though the contract term is only the then-current period: the customer has the unilateral right to continue to receive services; and the entity has an obligation to provide those services if elected by the customer for an optional period.

However, because those services are optional to the customer, the entity does not account for the option unless it provides the customer with a material right. If the option does not provide the entity with a material right, the entity only accounts for the current period's services that are not subject to cancellation. When the customer exercises its option for the next period (which includes by not cancelling the services), the entity accounts for that period as a separate contract. If the renewal option gives the customer a material right, the material right is accounted for as a performance obligation in the current contract (see chapter 8). [TRG 11-15.48]

Example 3.8.10
Contract with unspecified term cancellable by either party

ABC Corp. contracts with Customer to provide its service offering for a flat fee of $130 per month, subject to annual increases based on the lesser of 2% or changes in the consumer price index (CPI). $130 is the stand-alone selling price for this service at contract inception. The contract term is indefinite, and it is cancellable at the end of each month by either party without penalty.

ABC determines that the initial contract term is only one month and that the contract term will always be one month under this arrangement. This is because each subsequent month represents a wholly unperformed contract – each party has the unilateral, enforceable right to terminate the contract at the end of the then-current month without compensating the other party. A new contract is deemed to exist each month once each party forgoes its cancellation right for that period.

Question 3.8.20

How does a termination penalty affect assessment of the contract term?

Interpretive response: It may be the case that goods or services provided under a contract can be terminated only by compensating the other party (i.e. a penalty). For example, one party may be required to pay the other a termination penalty, which may or may not be characterized explicitly as a termination penalty.

Examples of provisions that act like a termination penalty contain a requirement to either:

— continue to pay the contractual fees for a period of time even after the services are no longer being provided; or
— forfeit an otherwise refundable deposit paid to the entity upfront.

If a penalty is substantive, the duration of the contract is the shorter of the stated term or the period to which the contract can be terminated without paying a penalty. A substantive termination penalty that compensates the other party is evidence that enforceable rights and obligations exist throughout the entire term. In other words, only by paying the penalty is the terminating party relieved of its remaining enforceable obligations, and only in return for that compensation does the non-terminating party forgo its remaining enforceable rights.

The TRG concluded that entities should reach the above conclusion regardless of whether both entities have the right to terminate the contract or only the customer. Therefore, if the customer has a termination right but must pay a substantive penalty to exercise that right, the contract term is the shorter of the stated term or the period to which the customer has the right to terminate the contract without paying a substantive penalty. [TRG 10-14.10, TRG 11-15.48]

In making the assessment of whether a termination penalty is substantive, an entity considers all relevant factors, including whether the penalty is insignificant. A penalty that is insignificant would generally not change the enforceable rights or obligations of the parties from those that would exist absent a penalty.

The substantive penalty evaluation would also generally include consideration of the legal enforceability of the right to compensation on termination. For example, an entity's past practice of not enforcing termination penalties may result from a conclusion that the termination penalty is not enforceable under the relevant laws of the relevant jurisdiction. Advice of legal counsel is likely required to determine the legal enforceability of a penalty.

If the entity's past practice makes its right to compensation upon termination (and the customer's obligation to pay that amount) unenforceable based on the applicable laws and regulations, then the entity would assess the contract term as it would for a contract without a termination penalty (see Question 3.8.10). In contrast, if the entity's past practice does not change the parties' legally enforceable rights and obligations, then that past practice would not affect whether the termination penalty is substantive.

If the penalty is not considered substantive such that it affects the contract term, the penalty could still indicate that a material right is present. [TRG 11-15.49]

When a cancellation occurs

If a cancellation occurs during the contract term determined in accordance with the preceding discussion (with or without a penalty applying), the termination is accounted for as a contract modification. This is because a termination changes the scope of the contract by shortening it (see Question 11.3.60). [TRG 11-15.48]

Example 3.8.15**
Wireless contract with termination penalties

ABC Corp., a telecommunications company, enters into a 24-month wireless contract with Customer that includes voice and data services for $70 per month and a handset for $200. The services and handset are regularly sold separately for $60 per month and $600, respectively.

Scenario 1: Substantive early-termination penalty

Customer can terminate the contract at any time. In case of early termination, ABC will charge Customer an early termination fee (ETF) of $150 plus $20 per month for each of the months remaining in the service term. ABC has separately concluded that the ETFs are enforceable.

ABC assesses whether the ETF is substantive and observes that at any point during the contract, the ETF compensates ABC at an amount greater than the goods and services already transferred. Specifically, the ETF of $150 together with the $20 per month remaining in the contract more than compensates ABC for the handset already transferred. Therefore, Customer is not simply paying for the handset it received but is also incurring a penalty. In addition, at any point during the contract, the ETF is significant, when compared with the monthly service fee.

Therefore, ABC concludes that the ETF is substantive, and that the contract term is 24 months.

Scenario 2: No termination penalty

Assume the same facts and circumstances as Scenario 1, except for the following:

— The rate for voice and data services is $90 per month.
— Customer cannot terminate the contract before Month 12. After Month 12, Customer can terminate the contract without paying any termination fee.

Because there are no enforceable rights beyond Month 12, the contract term is 12 months.

Scenario 3: Early-termination penalty not deemed substantive

Assume the same facts and circumstances as Scenario 1, except for the following.

- The rate for voice and data services is $80 per month.
- After Month 12, Customer can terminate the contract by paying an ETF of $10 per month of remaining service term and ABC has separately concluded that the ETF is enforceable.

Also, assume that ABC determines that the financing component was not significant to the contract. See section 5.5 for guidance on significant financing component in a contract.

ABC determines that the ETF does not fully compensate ABC for the goods and services already transferred. The ETF of $10 per month after Month 12 (i.e. $120 total for Months 13-24) is less than the unpaid balance of the handset, which at Month 12 would be $160 [i.e. ($600 − $200) − ($20 × 12)]. Therefore, the Customer is paying for the handset it received rather than incurring a termination penalty that is incremental to the standalone selling price for the transferred handset. ABC also observes that the ETF is not significant when compared with the monthly service fee (i.e. $10 compared with $80) and potential offers in the market.

ABC determines that the ETF in Months 13–24 is not a substantive penalty and concludes that the contract term is 12 months.

If ABC determines that the financing component is significant to the contract, the loss of the financing discount is viewed as a termination penalty and evaluated to determine if it is substantive. If substantive, ABC would determine the number of additional months (13 up to 24) to include in the contract term based on the number of months for which the loss of the financing discount would be considered a substantive penalty.

Example 3.8.20

Past practice of allowing customers to terminate without enforcing collection of termination penalty

ABC Corp. enters into a contract to provide services to Customer for 24 months. Customer has the enforceable right to terminate the contract by paying a substantive penalty to ABC. The penalty does not change during the contract term. ABC has a past practice of allowing customers to terminate substantially similar contracts after 12 months without enforcing collection of the termination penalty.

Because the penalty is substantive, the contract term is the shorter of the 24 month stated term or the period for which Customer must pay a *substantive* termination penalty.

The period during which Customer must pay a substantive penalty may be affected by ABC's past practice of not enforcing the termination penalty after 12 months of the contract term. Specifically, this period is affected if that past practice is considered to restrict ABC's legal right to enforce the termination penalty after 12 months or Customer's legal obligation to pay. The determination in this regard could vary depending on the laws and regulations of the jurisdiction governing the contract and potentially other factors.

If ABC's past practice does not change its enforceable rights (and, correspondingly Customer's enforceable obligations), the contract term will be the full 24-month stated term. However, if ABC's past practice results in the conclusion that the termination penalty is not enforceable under the relevant laws and regulations of the governing jurisdiction, the contract term is only 12 months – that is, the period during which a substantive penalty applies.

Example 3.8.30
Contract term with decreasing termination penalty

ABC Corp. enters into a four-year contract with Customer to provide services. The contract requires Customer to pay an annual fee of $100. Customer can terminate the contract at any point without cause, but up until Year 4 would incur a termination penalty.

ABC always enforces its right to receive a termination penalty. The following table shows the payments under the contract, as well as the termination penalty that would apply during each year of the stated contract term.

	Year 1	Year 2	Year 3	Year 4
Annual fee	$100	$100	$100	$100
Termination penalty	30	20	10	-
Cumulative fee if Customer cancels in this year	**$130**	**$220**	**$310**	**$400**

ABC determines that the contract term is three years. Three years is the shorter of the stated contract term (four years) and the period during which a substantive termination penalty applies to any Customer cancellation (three years). ABC concludes that the penalty is substantive as it is neither insignificant, nor is there any question as to the enforceability of the termination penalty based on ABC's past practices. ABC concludes the termination penalty is not insignificant during the first three years because it represents at least 10% of the remaining annual fees (in aggregate) over the first three years.

The termination penalty does not affect ABC's accounting for the three-year contract. No portion of the penalty is factored into the transaction price of the contract, nor does the penalty change that ABC's performance obligation is to provide the service for three years unless the contract is terminated – at which point the termination will be accounted for as a modification of the contract.

Question 3.8.25

Do contracts governed by Federal Acquisition Regulations (FAR) include a substantive termination penalty?

Interpretive response: It depends. It is common for contracts with the US federal government to be governed by the FAR and to include a 'termination for convenience' clause that provides the US federal government with the ability to terminate the contract for reasons other than default – e.g. whenever it is in the government's interest.

FAR 49.201(a) states that when contracts are terminated for reasons other than default, the US federal government "should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit." [FAR 49.201(a)]

When a contract is terminated for reasons other than default, the entity with a contract governed by FAR 49 is entitled to recover its costs incurred to date, including costs to cease the activities performed to meet the obligations of the contract. For some contracts, these costs are often significant and typically would not have been incurred if the contract was not terminated – e.g. costs to shut down a production line. The entity is also entitled to a reasonable profit on all costs recovered. We believe the compensation required to be provided to the entity in those cases is generally significant enough to be considered a substantive termination penalty.

However, if the entity is providing a standard product or service that is readily available and sold to customers that are not a US federal government entity, then the costs associated with terminating the contract for convenience may not be significant. Judgment is required in making these assessments and in evaluating termination rights in contracts with the US federal government that do not contain a FAR termination for convenience clause.

Question 3.8.30

Does forfeiture of a significant upfront fee constitute a termination penalty?

Interpretive response: It depends. A customer may pay a significant upfront fee that it would forfeit upon termination of the contract. Whether forfeiture of this fee constitutes a termination penalty depends on whether the fee would be refundable if the contract is not terminated.

— **Upfront fee is refundable.** In general, forfeiture of an upfront fee does not constitute a termination penalty unless the customer would be entitled to a refund of that fee if it does not terminate the contract. For example, a customer pays a $100 upfront fee at the beginning of a four-year contract, and will receive that fee (or a significant portion thereof) back only if it chooses not to exercise a termination right. We believe the requirement to forfeit the upfront fee is no different from having to pay a $100 fee upon termination.

— **Upfront fee is nonrefundable.** If the upfront fee is nonrefundable, its forfeiture generally does not constitute a termination penalty because refundability is not contingent on termination. Instead, entities will generally consider whether payment of a nonrefundable upfront fee provides the customer with a material right with respect to renewing the services (including by not electing an option to cancel the services). Whether payment of a nonrefundable upfront fee provides the customer with a material right upon renewal of a services contract is discussed in section 5.8.

Notwithstanding that the non-refundable fee generally does not constitute a termination penalty, there are fact patterns where the customer's ability to terminate a contract with an upfront fee does not affect the contract term. This would be the case if a nonrefundable upfront fee is the only consideration in a contract that meets the contract existence criterion (see section 3.2.10). In that case, the customer does not have a separate purchasing decision to make with respect to renewing (i.e. by not terminating) the contract because it has prepaid, on a nonrefundable basis, for all of the goods or services promised in the contract. Therefore, the termination option is not substantive and any contractual termination right does not affect the contract term and a material rights analysis would not be performed. For example, a one year service contract where the customer pays a nonrefundable upfront fee that is the only consideration would be considered a one-year contract regardless of whether the customer could technically terminate the contract.

Question 3.8.35

Does forfeiture of rights to access symbolic IP constitute a termination penalty?

Interpretive response: It depends. If a customer forfeits its right to access symbolic IP on cancellation of a contract, the determination of whether a termination penalty exists depends on whether the customer has relinquished control of a valuable asset, the entity has regained control of a valuable asset, and whether consideration is received by the customer in exchange for those rights.

For example, when the rights conveyed to the customer are exclusive such that the entity cannot benefit from those rights beyond the customer contract, the customer would potentially be transferring control of something valuable to the entity when it relinquishes its rights. Topic 805 (business combinations) notes that a reacquired right, such as the right to use the acquirer's trade name under a franchise agreement, is an identifiable intangible asset that is recognized separately from goodwill at fair value.

If the customer is required to transfer those exclusive rights for no consideration, they may be incurring a penalty by relinquishing the rights to access the IP for no consideration.

Conversely, if consideration is received by the customer in exchange for the right (consideration would include avoiding significant fixed payments), the forfeiture of exclusive rights to access symbolic IP on cancellation of a contract would likely not represent a termination penalty in determining the contract term.

When the forfeiture of rights is determined to represent a termination penalty, the penalty is then assessed to determine if it is substantive; and if so, what effect the penalty has on the contract term.

Example 3.8.35
Forfeiture of rights to access symbolic intellectual property on termination of a contract

ABC Corp. is an operator and franchisor of quick service restaurants. ABC entered into an agreement with a customer (Franchisee) that conveys rights to Franchisee to access and use ABC's symbolic IP in operating restaurants under ABC's brand.

The contract provides Franchisee with the exclusive right to access and use the IP in a designated geographic area. In exchange for the right to access this IP, ABC receives a 7% royalty on sales generated by Franchisee using ABC's IP.

The stated term of the contract is 20 years. However, a termination clause allows Franchisee to terminate the contract at any time for convenience without any cash payment to ABC. If the contract is terminated, Franchisee must cease use of the IP at the designated location and in the designated geographic area, including removal of signage and branding from the restaurant interior and exterior.

Because Franchisee forfeits its rights to access the IP, and they revert to ABC, ABC determines that exercise of the termination clause qualifies as a termination penalty. The right to access ABC's IP is an asset of Franchisee because Franchisee can exclusively operate restaurants using the IP. As a result, Franchisee is required to transfer an asset (other than cash) to ABC for no consideration to terminate the contract. No consideration includes the fact that Franchisee does not avoid significant fixed payments by transferring its right. In doing so, not only is Franchisee incurring a penalty by relinquishing an asset for no consideration, but it is also transferring something of value to ABC. Once returned, this right can then be used by ABC to open and operate an ABC-branded restaurant in that geographic area itself, or to grant a similar right to another customer in exchange for value.

ABC then evaluates whether the penalty is substantive. If it is, ABC evaluates the effect of such penalty on the term to be used in accounting for the contract.

If, however, the franchise right is transferable by Franchisee to another party for consideration, the Franchisee could avoid the termination penalty. When transfer rights are granted to the Franchisee, it may be appropriate for ABC to account for a transfer of IP as a continuation of the original contract instead of a termination (i.e. in effect the new franchisee replaces the original franchisee under the terms of the franchise agreement which remains in place). If a transfer of the franchise right would be accounted for as a continuation of the original contract, transferability would not affect the analysis of the penalty (i.e. there is a penalty to terminate the contract).

See Question 11.4.30 for factors to evaluate to determine the appropriate accounting for a transfer of the license.

Question 3.8.40

Can a cancellation right exist if the contract is silent as to cancellation or termination?

Interpretive response: It depends. If a contract does not provide for cancellation or termination, the entity would consider what recourse it would have at law in the event the customer unilaterally terminates for convenience.

However, the contract term is dictated by the present enforceable rights and obligations of the parties to the contract. Therefore, a legally enforceable cancellation or termination right may exist even if the written contract is silent in this regard. *If* such a right exists, entities still need to consider whether a termination penalty would apply (see Questions 3.8.20 and 3.8.30). The assessment of whether there is an enforceable contract may require significant judgment in some circumstances or jurisdictions and may require the involvement of legal counsel.

Question 3.8.50

Does a cancellation right available only on a breach of contract affect the contract term?

Interpretive response: No. If a contract exists under Topic 606, that means the parties can identify their rights and obligations under the contract and are committed to perform their respective obligations. Therefore, if a contract exists, an entity should not assume that a breach of contract will occur when determining the contract term. [606-10-25-1]

Question 3.8.60

Does a contract exist during a free trial period before the customer accepts an offer to continue the services beyond that period?

Interpretive response: No. Entities may offer customers the right to obtain their services for free for a period, during which time the customer can decide to contract for the services going forward. For example, a customer can decide to obtain the entity's video subscription for 12 months after the end of the free trial period. Service providers may offer additional incentives, such as free or discounted services or a discounted price on the service, if the customer enters into a long-term contract.

Some stakeholders in the United States asked the question about what services would be sales incentives and what services would be part of a contract with a customer if the customer accepts the entity's offer before the free trial period ends. Based on discussions with the FASB staff, it is our understanding that their view is that services provided during a free trial period, before the customer accepts the entity's offer to provide services beyond the free trial period, should be accounted for as sales incentives.

No contract exists until the customer accepts the entity's offer to provide services after the free trial period because the customer can opt out anytime during the free trial period. No enforceable right to consideration exists for the entity until the customer contracts for post-trial period services. Once the customer accepts the entity's offer, the entity accounts for remaining free trial period services (from the date a contract exists) and the post-free trial services as committed performance obligations of the contract.

In circumstances in which a customer enters into a contract before the end of the free trial period, the FASB staff indicated that, in limited circumstances, it may be reasonable to account for only the post-free trial period goods or services as performance obligations of the customer contract. The staff indicated this would be the case only if either:

— the customer's right to the remaining free trial period goods or services are not enforceable; or

— on a portfolio basis, accounting for only the post-free trial period goods or services as performance obligations would not materially differ from accounting for both the remaining free trial period goods or services and the post-free trial period goods or services as performance obligations of the contract with the customer.

Example 3.8.40
Free trial period

ABC Corp. offers three free months of its service to Customer. At any time during the three-month free trial period, Customer can decide to continue the service for 12 months after the end of the three-month free trial period for a fee of $12,000 (payable $1,000 in advance each month during the 12-month post-trial period).

Alternative 1

ABC's accounting for this contract depends on *when* Customer accepts ABC's offer to provide 12 months of its service after the end of the free trial period.

— If Customer accepts and agrees to pay for the post-trial period services on Day 1 of the free trial period, ABC's performance obligation is to provide 15 months of services for $12,000. Therefore, ABC recognizes $800 each month ($12,000 / 15). None of the cost of providing the services during the free trial period is recognized as a sales and marketing expense but would be considered cost of sales.

— If Customer accepts and agrees to pay for the post-trial period services at the beginning of the third month of the three-month free trial period, ABC's performance obligation is to provide 13 months of its services for $12,000. Therefore, ABC recognizes $923 each month ($12,000 / 13). The cost of providing the first two months of the services during the free trial period is recognized as a sales and marketing expense.

— If Customer accepts and agrees to pay for the post-trial period services on the last day of the three-month free trial period, ABC's performance obligation is to provide 12 months of services for $12,000. Therefore, ABC recognizes $1,000 each month ($12,000 / 12). The cost of providing the three free trial months of the services is recognized as a sales and marketing expense.

In the first two scenarios, ABC recognizes revenue on the services before it is legally entitled to receive any consideration from Customer. For example, in the first scenario, ABC recognizes $2,400 ($800 × 3) before it is legally permitted to bill Customer for the services. ABC's offsetting entry is to a contract asset, which ABC will derecognize over the 15-month contract period once it begins to bill Customer under the terms of the contract.

Alternative 2

Alternatively, it *may* be reasonable, regardless of when Customer accepts and agrees to pay for the post-trial period services, to consider ABC's performance obligation as one to provide 12 months of post-trial services for $12,000. In that case, the accounting is the same as in the third scenario above.

However, this alternative is appropriate only if either:

— ABC does not have an enforceable obligation, as a result of entering into the contract with Customer, to provide the remaining free trial period services; or

— ABC has a number of similar contracts that would permit it to apply this accounting on a portfolio approach basis. This would be the case when accounting for the cost of committed free trial period services as a sales and marketing cost for contracts in the portfolio would not materially affect the entity's accounting results (see section 2.5 on the portfolio approach).

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

Detailed contents

New item added to this chapter: **

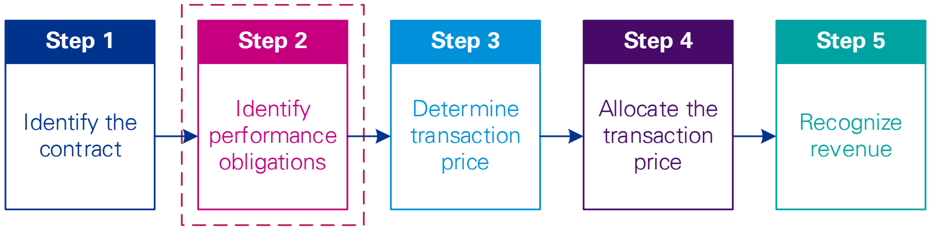
4.2.70	How does an entity distinguish between an administrative task/set-up activity and a promised good or service that transfers to the customer?
4.2.80	Are pre-production or non-recurring engineering activities a promised good or service or administrative activity?
4.2.90	Are promises to defend a patent, copyright or trademark an administrative activity or a promised good or service?
4.2.100	Is an exclusivity provision a promised good or service?
4.2.110	Is a promise to provide end-user documentation an administrative activity or promised good or service?
4.2.120	Is an entity's participation in a joint steering committee considered a promised service in a contract with a customer?
4.2.130	Does an entity apply the practical expedient for immaterial goods or services on a contract-by-contract basis?
4.2.140	Can the shipping and handling accounting policy election be applied to other activities?
4.2.150	Can an entity apply the shipping and handling accounting policy election when a third party provides the shipping?
4.2.160	What is the appropriate income statement classification for shipping and handling costs?

Examples

4.2.10	Pattern of granting concessions
4.2.20	Implied promise to reseller's customers
4.2.30	Nature of the promise – stand-ready obligation or defined quantity of goods or services
4.2.40	Supply agreement not a stand-ready obligation
4.2.50	Take-or-pay contracts not a stand-ready obligation
4.2.60	Contingent promise as a material right
4.2.70	Contingent promise not a performance obligation
4.2.80	Service arrangement is not a contingent promise
4.2.90	Transaction processor not a contingent promise
4.2.100	Snow removal as a stand-ready obligation
4.2.110	Installation services that represent set-up activities
4.2.120	Installation services that represent a promised good or service
4.2.130	Set-up activities vs. implementation services in a SaaS arrangement
4.2.140	Goods or services immaterial in the context of the contract

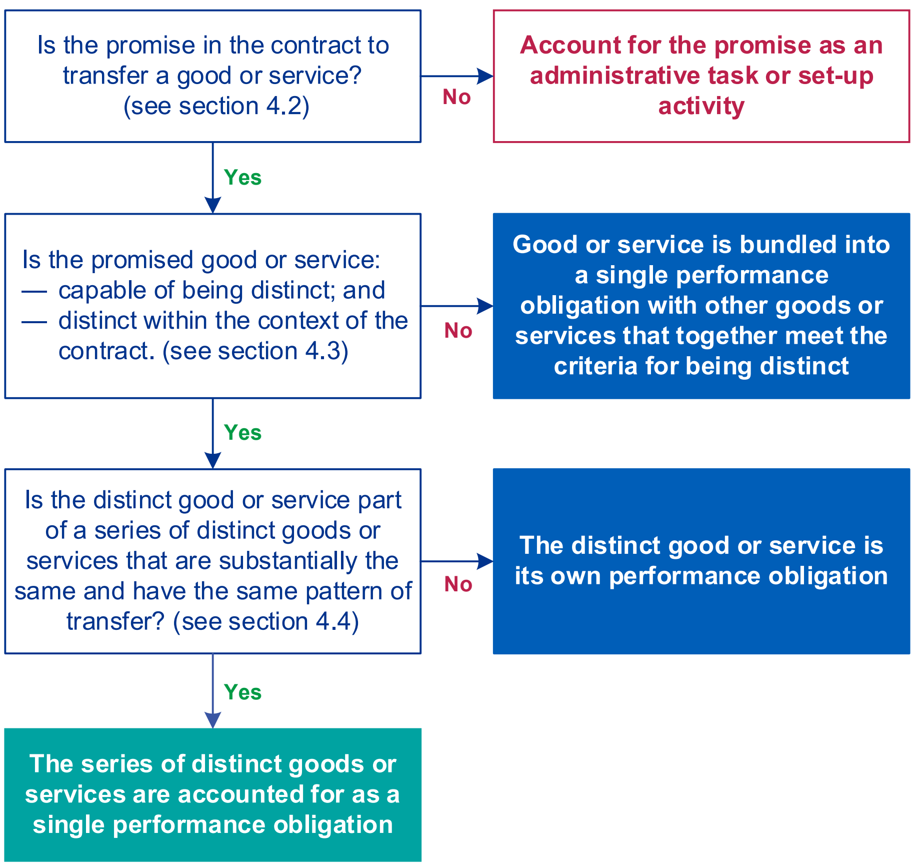
Examples

4.1 How the standard works



In Step 2, an entity identifies the performance obligations in a contract that was identified in Step 1. A performance obligation is the unit of account for recognizing revenue. The entity allocates the transaction price identified in Step 3 to the performance obligation in Step 4 and recognizes revenue when it satisfies a performance obligation in Step 5.

Identifying a contract's performance obligations involves two major tasks: identifying the contract's promised goods or services; and determining how those promised goods or services are grouped into performance obligations. The steps involved in performing these two tasks are summarized in the following decision tree.



4.2 Identify the promised goods or services

Excerpt from ASC 606-10

• > Promises in Contracts with Customers

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 promised goods or services 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 reasonable expectation of the customer that the entity will transfer a good or service to the customer.

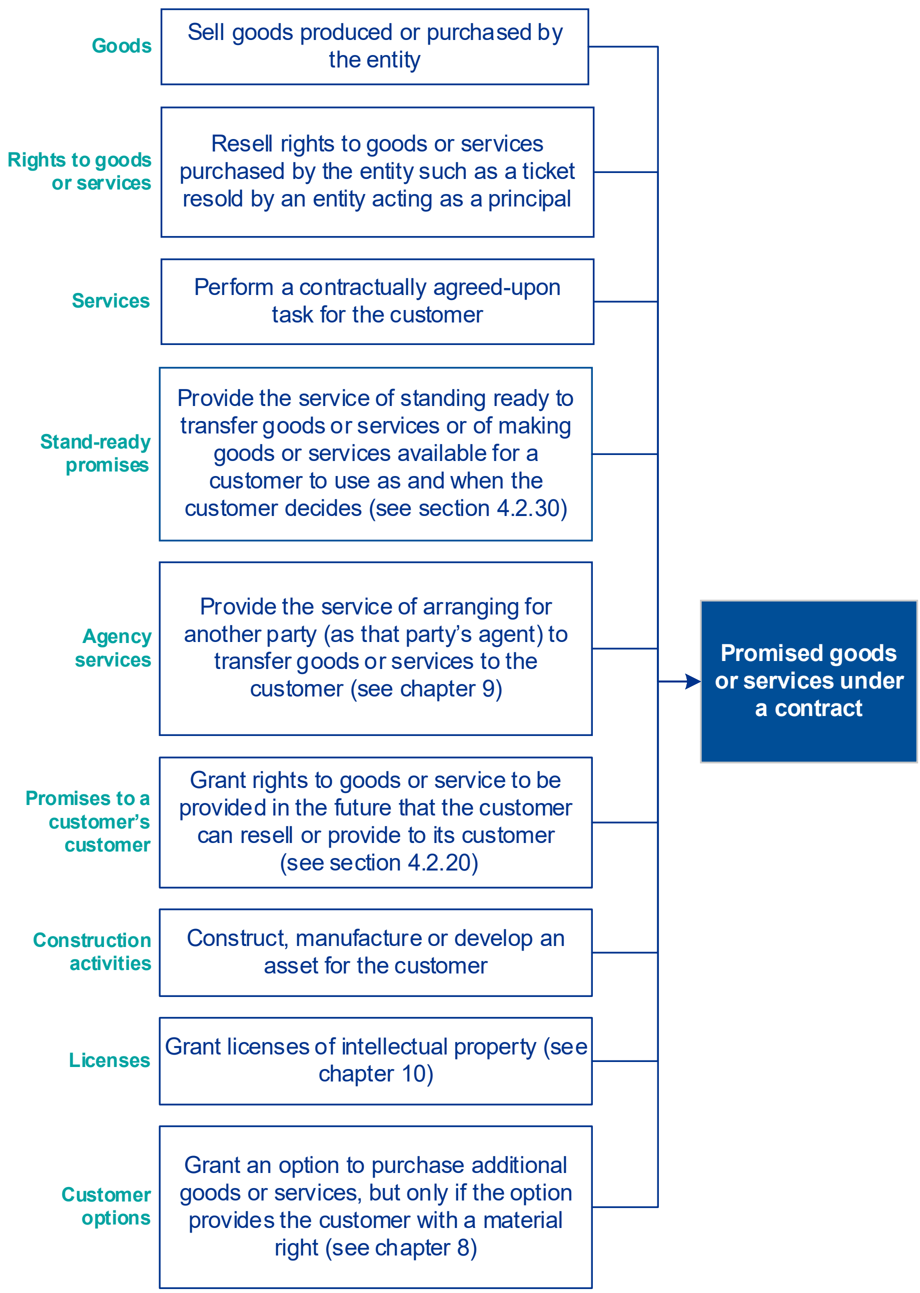
25-18 Depending on the contract, promised goods or services may include, but are not limited to, the following:

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 55-60 and paragraphs 606-10-55-62 through 55-65B)
j. Granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs 606-10-55-41 through 55-45).

4.2.10 Overview

Step 2 entails identifying the promised goods or services in the contract with a customer, and then determining if they are separate performance obligations, or bundled with other goods and services into a single performance obligation. Therefore, the first task in applying Step 2 is to identify the goods or services promised in a contract with a customer.

Promises to transfer goods or services can take many forms, as the following chart illustrates. [606-10-25-18]



Promises to transfer goods or services are usually explicitly stated in the contract. However, they can be implicit based on specific statements or established business practices or published policies that create a reasonable expectation that the entity will transfer the good or service to the customer. An implicit promise typically exists when the customer has a reasonable expectation that additional goods or services are a part of the negotiated exchange for which it has paid. [606-10-25-16, ASU 2014-09.BC87]

Question 4.2.10

Do promises need to be legally enforceable to be considered a promised good or service in a contract with a customer?

Interpretive response: No, whether the promise is implied or the entity can legally cancel an explicit promise (e.g. loyalty points, see Question 8.6.10), a promise does not need to be enforceable by law. If the customer has a reasonable expectation that those goods or services will be transferred, then the customer views those promises as part of a negotiated exchange. In other words, the customer expects to receive those goods or services and has either paid or expects to pay for them as part of the contract. If an entity does not identify implied promises it could result in revenue being recognized incorrectly and often earlier than when the entity transfers all of the goods or services to the customer. [ASU 2014-09.BC87]

Implied promises can arise from the entity's customary business practices, published policies or specific statements to the customer.

Question 4.2.20

Does a history of granting concessions to customers in the form of free or significantly discounted goods or services create additional promised goods or services in a contract?

Interpretive response: It depends.

If an entity has established a historical pattern of giving customers free or significantly discounted goods or services, that may create additional promised goods or services in a contract with a customer. This is because promised goods or services include those implied by an entity's customary business practices, published policies or specific statements.

Examples of granting concessions that represent implied promises include, but are not limited to:

- providing discounted or free goods or services that were not included in the terms of the original contract;
- allowing the customer to access or receive additional goods or services without a commensurate increase in the transaction price;

— for time-based services, extending the period for which a customer receives the service for little or no additional consideration; and
— permitting additional uses of a licensed IP (if the license included such restrictions initially).

Price concessions do not affect the determination of the promised goods or services in the contract. Rather, price concessions expected at contract inception result in variable consideration (see section 5.3).

When a concession (price or other) is unexpected at contract inception, those concessions are accounted for as contract modifications – i.e. as a change to the price or scope of the contract. Unexpected concessions generally arise from situations where a pattern of granting concessions did not exist at the time of entering into the contract and there was no reasonable expectation of granting one. Section 11.3 addresses the accounting for contract modifications.

Example 4.2.10
Pattern of granting concessions

ABC Corp. sells equipment to its customers. ABC is new to the market; it therefore has a significant incentive to ensure that it keeps its existing customers from moving to one of its larger competitors, and to try to develop a competitive advantage against those competitors.

ABC's contracts do not generally include future maintenance services; it hopes to be able to charge its customers for those. However, ABC has developed a practice of providing future maintenance services free of charge to its largest customers, and to those in discussions to purchase additional equipment. ABC does this to incentivize those customers to continue to do business with them.

Because customers in the marketplace communicate (e.g. personnel move from one customer to another), ABC's customary business practice is known by both renewing and prospective customers.

ABC concludes that its history of providing free maintenance services to its customer base creates an implied promise in its equipment contracts to provide future maintenance services.

The duration of that promise depends on ABC's customary business practice. ABC will need to determine for what period it typically provides such free services and how many free services it provides, which may differ for different classes of customer – e.g. ABC's largest customers versus smaller customers.

Question 4.2.25
Do merchandising goods or services provided to a distributor or reseller represent a promise to a customer?

Interpretive response: Generally, yes. Entities often provide goods and services to their customers (distributors and retailers) that are aimed at selling their products through the distribution channel to the end customer. For example, consumer products companies may provide product displays, product dispensing or storage equipment to their customers. They may also provide merchandising services within the retailer's store by operating brand-specific counters and providing various other forms of in-store advertising. These goods and services generally represent promises to their customers, the retailer or distributor.

To determine if a promise to provide merchandising goods or services represents a separate performance obligation, an entity considers whether it's capable of being distinct and distinct within the context of the contract. An entity also evaluates whether control of the merchandising good is transferred to the customer, or the entity retains control and instead provides a lease of its property or equipment. Section 4.3 discusses performance obligations.

An entity may conclude that merchandising goods or services are immaterial in the context of a contract (e.g. a simple cardboard end-cap display) and elect to apply the related practical expedient; this results in these goods or services not being accounted for as separate performance obligations. The determination of whether the practical expedient can be applied is based on a contract-specific quantitative and qualitative assessment. Section 4.2.50 discusses the practical expedient for immaterial goods or services.

In some cases, a retailer may perform merchandising services related to the entity's products and be reimbursed for a portion of its cost by the entity. The reimbursement to the retailer is generally accounted for as consideration payable to a customer and recognized as a reduction of transaction price that reduces revenue when the entity transfers the related goods to the retailer. Section 5.7 discusses consideration payable to a customer, and Question 5.7.40 addresses the accounting for slotting fees paid to a customer.

4.2.20 Promises made to a customer's customer

Entities often promise goods or services as sales incentives to end customers of its customer (the distributor) to encourage the sale of its products through the distribution channel. These promises may be made explicitly in the contract with the distributor or implied by an entity's customary business practices, published policies or specific statements.

An entity needs to evaluate the promise to the end customer to determine whether it is a promise (and potential performance obligation) in the contract with the distributor. If so, the promised goods or services to the end customer (i.e. the customer's customer) are accounted for as if the goods or services were promised to the customer (distributor). See Question 4.2.30. [606-10-25-18(g), ASU 2014-09.BC92]

Question 4.2.30

When are promises to provide goods or services to a customer's customers a promised good or service in a contract with the distributor?

Interpretive response: It depends on when the entity makes the explicit or implicit promise to transfer the goods or services.

When an entity sells to an intermediary, such as a distributor or reseller, and makes promises to the intermediary's end customers, those promises could be accounted for in the contract with the distributor regardless of whether the entity views those promises as a sales incentive. Examples of these circumstances are when:

- an auto manufacturer offers free maintenance services to customers who purchase cars from dealerships;
- a software provider implicitly offers free technical support or unspecified updates/upgrades/enhancements to end users of its software (see Question C100 and Example C100.1 of KPMG Handbook, Revenue for software and SaaS); and
- a consumer goods company provides mail-in offers for free goods to end customers.

If an explicit or implicit promise to transfer goods or services is made before or at the time the entity transfers control of the related goods or services to the intermediary, it should be identified as a promised good or service of the contract between the entity and the intermediary. This would occur when the promise to transfer those goods or services was made in the contract or implied by an entity's customary business practices, published policies or specific statements such that it created a reasonable expectation by the intermediary or end customer that the entity will transfer a good or service.

Conversely, if the explicit or implicit promise was made after the transfer of control of the good or service to the intermediary the promise is not a part of the original sale between the entity and the intermediary (assuming the intermediary is not solely the entity's agent in its transaction with the end customer). In this case, all the revenue is recognized when the goods are transferred to the distributor and the entity accrues the cost of the incentive when the promise is made. However, once the entity makes an initial offer it needs to consider whether it establishes a pattern that creates an expectation by the intermediary or end customer. As a consequence, this scenario may be limited.

Example 4.2.20

Implied promise to reseller's customers

Scenario 1: Historical practice

Car Manufacturer has a historical practice of offering free maintenance services – e.g. oil changes and tire rotation – for two years to the end customers of dealers who purchase its vehicles. Although the two years of free maintenance is not explicitly stated in the contract with its dealers, it is typically stated in Car Manufacturer's advertising for the vehicles.

As a result of the promise made in Car Manufacturer's advertising, the maintenance is treated as a separate performance obligation in the sale of the vehicle to the dealer. Revenue from the sale of the vehicle is recognized when control of the vehicle is transferred to the dealer. Revenue from the maintenance services is recognized as the maintenance services are provided to the end customer; see Question 7.4.55 on the timing of revenue recognition.

Scenario 2: No historical practice

Unlike Scenario 1, Car Manufacturer does not have a customary business practice of offering free maintenance, and instead announces a maintenance program as a limited-period sales incentive after control of the vehicle has transferred to the dealer.

Before the announcement, the end customers and dealers did not have a reasonable expectation that Car Manufacturer would make this offer. In this scenario, the free maintenance is not a separate performance obligation in the sale of the vehicle to the dealer.

Car Manufacturer recognizes the full amount of revenue when control of the vehicle is transferred to the dealer. Subsequently when it creates an obligation by announcing that it will provide incentives, Car Manufacturer accrues as an expense its expected cost of providing maintenance services on the vehicles in the distribution channel (i.e. controlled by dealers) when the program is announced. Further, any future sales during the incentive period would include the incentive as a promised good or service.

After the program is complete, Car Manufacturer will need to evaluate if the program has established a practice and reasonable expectation among its customers.

4.2.30 Stand-ready obligations

One type (see chart in section 4.1) of a promised good or service is the service of standing ready to provide goods or services or of making goods or services available for a customer to use as and when the customer decides (typically referred to as a stand-ready obligation). A stand-ready performance obligation is typically satisfied over time throughout the contract term rather than at a point in time (see chapter 7). An example of a stand-ready obligation is a typical health club membership where the promise is to stand ready to make a health club available. [606-10-25-18(e), ASU 2014-09.BC160]

However, not all promises to stand ready are promised goods or services (Questions 4.2.50 and 4.2.60). For example, an entity's promise to accept product returns or provide refunds are not promised goods or services. Instead, rights of return or refund are treated as variable consideration and factored into a contract's transaction price. See section 5.4 for more information on rights of return. [606-10-55-23, 55-24]

Similarly, a customer option that requires the seller to stand ready to repurchase an asset (e.g. a put option) does not represent an additional promised good or service in a contract. See section 7.5.50 for a discussion of the accounting for repurchase features, including put rights. [606-10-55-66 – 55-78]

Determining whether a promise is a stand-ready obligation or an obligation to transfer specific goods or services is critical to many aspects of Topic 606. It is particularly important when identifying performance obligations in Step 2, applying the series guidance (see section 4.4) and recognizing revenue in Step 5 (see Question 7.4.50 regarding the appropriate measure of progress for a stand-ready obligation). However, entities should not assume all stand-ready elements of a contract are promised goods or services.

Question 4.2.40

How should an entity determine if it has promised to provide a service of standing ready?

Interpretive response: The TRG agreed upon scenarios when the nature of the entity's promise is to stand ready for a period of time rather than provide the goods or services underlying the obligation. Examples of stand-ready obligations discussed by the TRG include the following. [TRG 01-15.16]

— A promise to deliver unspecified goods, services or intellectual properties in which the decision to proceed is within the control of the entity, but the entity must still further develop its deliverable. An example is a software entity promising to transfer unspecified software upgrades at the entity's discretion.

— A promise to deliver a good or service upon events that are outside the control of both the entity and the customer. An example is an entity's promise to remove snow from an airport's runways for a year in exchange for a fixed fee (see Question 4.2.60).

— A promise to deliver a good or service in which the delivery is within control of the customer. An example is an entity agreeing to provide periodic maintenance, when-and-if needed, on a customer's equipment after a pre-established amount of usage by the customer (see Example 4.4.30).

— A promise to make a good or service available to the customer continuously. An example is a health club membership.

To determine if a promise to a customer is the act of standing ready or the underlying goods or services, an entity should evaluate the nature of the promise in the contract. In some of the scenarios above, the entity is continuously performing (e.g. health club) while in others the entity only performs upon the occurrence of an event (e.g. snow removal). In the latter scenario, the nature of the promise to the customer may be that of making a scarce resource available for a specified period of time.

The TRG agreed that an obligation to provide an unknown quantity of goods or services over the contract term may be a strong indicator that the nature of the promise is to stand ready to provide goods or services. In contrast, a promise to provide a specified number of goods or services during the contract term indicates that the nature of the promise is to provide each of the underlying goods or services. [TRG 01-15.16]

In some cases, it will be relatively straightforward to determine when the contract requires an entity to provide a defined quantity of goods or services. However, in more complex fact patterns an entity should focus on whether a quantity diminishes with each usage over the contract period.

— If the quantity diminishes, the nature of the promise is the delivery of the specified quantity. For example, a contract that obligates the entity to provide a customer access to its health club ten times would diminish each time the customer uses the health club.

— If the quantity does not diminish, the nature of the promise is more akin to a stand-ready obligation because each use does not affect the amount of the remaining goods or services to which the customer is entitled. For example, the quantity does not diminish in a contract to access a health club for an annual period. The entity's obligation to the customer does not diminish each time the customer uses the facilities during the time period. The passage of time would not be considered a diminishing quantity for these purposes.

When the contract has a specified quantity that diminishes, the entity also considers whether the quantity is substantive. This issue could arise when a quantity is represented by a maximum or minimum amount that is protective and does not change the nature of the service being provided.

For example, ABC Corp. enters into a contract with a single performance obligation to provide 24/7 customer support service for one year with a limit of 100 calls for that period. Based on ABC's historical experience, customers very rarely come close to that amount. As a result, the maximum is not substantive and is only protective in nature. Conversely, if the number of calls is reasonably expected to approximate the call limit, the maximum is substantive and the nature of the promise may be to provide a specified quantity.

Example 4.2.30

Nature of the promise – stand-ready obligation or defined quantity of goods or services

Scenario 1: Capacity does not diminish

Provider provides data storage services in a 'use it or lose it' arrangement. Customer can store up to 100GB of data during the year for a fixed fee. Any usage above 100GB during the year is priced at $10 per GB. If Customer uses less than 100GB during the year, usage does not carry over into the following year.

This scenario represents a stand-ready obligation. Provider is standing ready to continuously make 100GB of capacity available to Customer over the contract period because the storage capacity does not diminish during the contract term. If Customer uses 10GB on Day 1, the same 10GB remains available to Customer on Day 2 and thereafter. See Question 7.4.50 for a discussion of measures of progress for stand-ready obligations.

Scenario 2: Capacity diminishes

Provider provides data processing services in a 'use it or lose it' arrangement. Customer can process up to 100GB of data during the year for a fixed fee. Any usage above 100GB is priced at $10 per GB. Based on Provider's historical experience of usage, the maximum quantity is substantive.

Scenario 2 is not a stand-ready obligation. The processing of each GB is considered a discrete delivery of underlying goods or services; this is because each time data is processed the quantity available to the customer diminishes. For example, if Customer uses 1GB of data processing service on Day 1, it has 99GB of the service available for the remaining term. The quantity of GBs available diminishes meaningfully over the contract term. As such, an entity typically would use a measure of progress to recognize revenue based on the number of GBs used. See section 7.4 on determining the appropriate measures of progress.

Question 4.2.50

Do all arrangements with undefined quantities include the service of standing ready?

Interpretive response: No. The TRG agreed that an undefined quantity of goods or services in a contract does not always mean an entity has promised to provide a service of standing ready. In those cases, the nature of the promise is to provide the underlying goods or services to the customer, or in some cases the nature of the promise may be a customer option to purchase the underlying goods or services. [TRG 11-15.48]

It is common for an entity to enter into an agreement that requires it to deliver goods or services to customers over a specified timeframe during which the customer makes separate purchasing decisions. In those cases, the entity must stand ready to provide the good or service at the customer's request. This is often the case in supply agreements or other arrangements where there is a master service agreement (MSA) and the customer submits purchase orders to acquire the goods or services.

The TRG discussed an example of an MSA that provided the customer with the ability to purchase an unlimited quantity of parts over a specified period of time. The TRG agreed that the nature of the promise in these situations is to provide the parts even though the entity has an obligation to stand ready to provide the parts when the purchase order is submitted. This is because in that case before submitting the purchase order, the MSA does not create enforceable rights and obligations for the parties (see Question 3.2.30). As such, the customer only has an option to purchase the additional goods. After the customer exercises its right to purchase the parts, the entity is obligated to fulfill the promise to the customer, which requires the entity to transfer control of the parts to the customer. [TRG 11-15.48]

These arrangements can often be distinguished from stand-ready obligations based on the enforceable rights and obligations. Further, a key difference between these arrangements and stand-ready obligations discussed in Question 4.2.40 is the customer is making a separate purchasing decision to acquire additional goods rather than using a good or service for which it has previously contracted and controls. See Question 5.3.10 for further discussion of distinguishing between contracts that have optional purchases and those that have variable consideration.

Example 4.2.40

Supply agreement not a stand-ready obligation

Supplier enters into a three-year exclusive MSA with Customer that requires it to produce and sell parts to Customer when a purchase order is submitted. The MSA requires that each part is delivered within a specified time period after the purchase order is submitted and there is a penalty to the Supplier for not delivering the parts within that specified time period. As a result, Supplier produces parts ahead of time in anticipation of Customer sending a purchase order. Customer paid Supplier a $1,000,000 nonrefundable upfront payment when it entered into the MSA.

Customer is not legally obligated to purchase any parts; however, it is highly likely that it will purchase parts because the part is required to manufacture its product. Each part is a distinct good that transfers to the customer at a point in time.

Supplier considers its enforceable rights and obligations. As in Question 3.2.30 an MSA typically does not meet the contract existence criteria until the purchase order is submitted. Therefore Supplier determines that each purchase order is an optional purchase. This is further supported by the following:

- Customer is not obligated to purchase any parts but has the right to choose the quantity of additional distinct goods it wishes to purchase.
- Supplier is not obligated to transfer any parts until Customer submits a purchase order.
- Each purchase order submitted by Customer creates a new performance obligation for Supplier.

Supplier would need to evaluate whether the upfront fee conveys a material right to the customer for the future goods. See section 5.8 on upfront fees and chapter 8 on customer options.

Example 4.2.50

Take-or-pay contracts not a stand-ready obligation

Supplier enters into a take-or-pay contract with Customer in which Customer agrees to purchase 10,000 widgets from Supplier over an annual period at a price of $5 per widget, or $50,000 in total. Each widget is a distinct performance obligation.

Supplier provides each widget to Customer only after Customer submits a request. If Customer does not take all 10,000 widgets during the established timeframe, it will be required to pay Supplier the difference between the 10,000 widgets agreed upon and the actual widgets purchased.

While Supplier must stand ready to provide the widgets, it concludes that the nature of the promise is to provide the specified quantity of widgets – it is not the service of standing ready to provide 10,000 widgets. The contract has a specified quantity of distinct goods and the quantity of the goods available to Customer diminishes as each request is made (see Question 4.2.50). Further, Supplier is not obligated to transfer a widget until Customer makes a request and any amounts purchased in excess of 10,000 would require a new contract and separate purchasing decision by Customer.

Question 4.2.60

Do promises to provide a good or service when or if a contingent event outside the control of the entity and customer occurs represent a stand-ready obligation?

Interpretive response: It depends. As described in Question 4.2.40, one type of stand-ready obligation is to provide a good or service upon a contingent event that is outside the control of the entity and the customer. An example is a contract to remove snow from an airport's runway for a fixed fee. However, not all promises to provide a good or service upon a contingent event outside the control of both the customer and entity is a stand-ready performance obligation.

Depending on the arrangement the promise could be accounted for as either:

— **A contingent promise akin to an optional purchase**. Although contingent promises are different from customer options because the underlying contingency is not within the customer's control, we believe in certain situations these promises should be evaluated similarly to customer options. In these situations, entities would evaluate whether a contingent promise conveys a material right to the customer and if so, account for that promise as a separate performance obligation. If not a material right, the obligation provides goods or services and would be accounted for separately. For further discussion of material rights, see chapter 8.

— **A stand-ready obligation**. When the nature of the entity's promise is to provide a service of standing ready or continuous service the promised good or service is typically a performance obligation satisfied over time in the current contract. The entity may be continuously performing by making a good or service available or the customer may be paying to secure a scarce resource (see Question 4.2.40).

Distinguishing between contingent promises and stand-ready obligations

Significant judgment will be required to evaluate the nature of the promise when an entity agrees to provide a good or service upon a contingent event outside the control of both the entity and the customer. We believe the following factors may be helpful to distinguish between a contingent promise accounted for like an optional purchase and a stand-ready obligation (list not exhaustive):

— **Amount of uncertainty that exists**. If there is substantive uncertainty at contract inception about the contingent event occurring and the entity having to perform, the nature of the promise may be more akin to providing an option to the customer rather than standing ready to provide a service that is likely to occur but it is uncertain as to the timing or amount. As discussed in Question 4.2.50, an unknown quantity over the contract term is a strong indicator that the service is one of standing ready. As a result, a contingent promise would typically have a higher level of uncertainty as to whether the event will occur. For example, an obligation to transfer additional goods or services upon regulatory approval (e.g. FDA approval) will typically have a substantive amount of uncertainty. In contrast, the number and type of updates an entity will provide for anti-virus software, which is generally considered a stand-ready obligation, may be uncertain but the entity understands that it will frequently provide updates throughout the contract term and the customer is paying for the continued protection throughout the term of the contract.

— **Significant incremental performance by the entity is required to transfer the additional goods or services**. If the result of the contingency obligates the entity to create or purchase a distinct good that is subsequently transferred to the customer or incur significant costs to perform the additional services it may indicate the nature of the promise is the underlying good or services and not the act of standing ready. For example, an obligation to manufacture additional goods upon a contingent event would typically be more akin to an option rather than a stand-ready obligation. In contrast, if the entity is continuously performing or making goods or services available regardless of the event occurring, the nature of the promise may be standing ready. For example, an entity providing an outsourced call center service that requires it to take an unlimited number of calls when and if they occur may be a stand-ready obligation because the entity is performing by having people and infrastructure available daily to accept the calls on the customer's behalf.

— **Additional distinct goods or services.** If the resolution of the contingency increases the number of distinct goods or services from what was previously specified, the entity's promise may be more akin to a customer option to obtain additional goods or services. This may be the case if the contract called for the entity to provide a specified number of goods or services and the resolution of the contingency required an incremental amount to be provided. Similarly, if the customer can cancel the contingent goods or services or must make an additional request in order to obligate the entity to provide the additional items, the contingent promise is akin to an option.

— **Payment terms.** In some cases, payment terms may be instructive to understanding the nature of the entity's promise and enforceable rights and obligations in the contract. When a customer pays a fixed fee, or a variable fee that is not directly connected and proportional to the goods and services provided, for an unspecified quantity of services, it may indicate the nature of the promise is to stand ready. In contrast, when the entity is only paid after performing upon the occurrence of the contingent event, it may indicate that the nature of the promise is to provide the good or service each time the event occurs. However, in some cases the nature of the promise may still be a service of standing ready and the contingent payments would be variable consideration. See Question 5.3.10.

Example 4.2.60
Contingent promise as a material right

Manufacturer enters into a contract to provide 100 widgets for $10 per widget to Customer. Manufacturer is in the process of renegotiating its supply contract with its main supplier and Customer is aware of this. If Manufacturer is able to renegotiate its contract with its main supplier, it will provide an additional 10 widgets at no additional charge to Customer.

Manufacturer concludes that this arrangement includes a contingent promise and not a promise to stand ready based on the following.

— There is substantial uncertainty as to whether it will be able to renegotiate with its supplier and resolution of the contingency is outside both Manufacturer and Customer's control.

— Upon resolution of the contingency the entity will provide a specified quantity of the additional widgets.

— The additional performance of manufacturing and then transferring 10 additional widgets is significant and Manufacturer is not continuously performing for Customer over a specified period regardless of the outcome of the contingency.

— While there is no additional payment for the incremental widgets, the fixed payment Customer makes is for a specified quantity of widgets rather than an unspecified quantity of goods or making available the scarce resources.

Manufacturer evaluates whether the contingent promise conveys a material right to Customer (see section 8.2). An entity conveys a material right to a customer if it provides the customer with a right that the customer would not receive without entering into the contract such as a discount that is incremental to the discounts offered to a similar class of customers. The contingent promise in this example provides Customer with a material right because the free goods are at a significant discount and the Customer would not be able to get these free goods without entering into the contract with Manufacturer. Therefore, the promise is a separate performance obligation. [606-10-55-42]

Example 4.2.70
Contingent promise not a performance obligation

Biotech enters into an agreement to license certain rights and provide R&D services to Customer to develop Drug D. Biotech also will manufacture Drug D for Customer, assuming its successful development. The development of Drug D is in its early stages and it is uncertain whether the arrangement will result in successful clinical trials of Drug D.

The following additional facts are relevant.

— The specified pricing for the manufacturing services is consistent with stand-alone selling price.

— The price of the license and R&D services are commensurate with stand-alone selling price exclusive of the manufacturing services.

The manufacturing services are explicitly outlined in the contract and are not optional to Customer if clinical trials of Drug D are successful. At contract inception, Biotech concludes that these services are contingent promises instead of a stand-ready obligation based on the following.

— There is substantial uncertainty about the successful development of Drug D.

— The manufacturing services will require significant incremental performance to manufacture and transfer goods to Customer.

— Customer will pay an additional fee for the manufacturing services.

— The manufacturing services requires the entity to transfer additional goods or services that are incremental to the goods and services provided prior to the resolution of the contingency.

As such, Biotech evaluates whether Customer's right to the future goods or services conveys a material right to Customer. The guidance regarding material rights discussed in section 8.2 provides that a material right does not exist if the customer has an option to acquire additional goods or services at the stand-alone selling price for those goods or services. Given the pricing for the manufacturing services in this example is at its stand-alone selling price, there is no material right. [606-10-55-43]

Example 4.2.80
Service arrangement is not a contingent promise

Security Provider enters into a contract with Nightclub to provide security services each day for a year. Nightclub pays Security Provider a fee based on the number of patrons that attend the club each day. Security Provider deploys its professionals each day to perform regardless of the number of patrons that attend the club.

While the number of patrons is outside the control of Security Provider and Nightclub, Security Provider concludes that the contract does not contain a contingent promise and the nature of Security Provider's promise is to provide a daily service over the contract term based on the following:

— There is uncertainty as to the number of patrons that will attend the club but not in the Security Provider's obligation to perform each day.

— Security Provider does not incur significant incremental costs at the time a patron enters the club. Service Provider may incur incremental costs when planning its staffing levels for nights that are expected to be busier but the contingent event does not require Security Provider to transfer additional services to Nightclub.

— While the payment terms are variable, Security Provider is performing at Nightclub regardless of the number of patrons rather than waiting for the contingent event to occur and then performing and obtaining payment based on completing that performance.

— Each patron that comes into the club does not require Security Provider to transfer additional services to Customer. Security Provider is obligated to perform each night.

As a result, Security Provider would evaluate the per patron fees as variable consideration. See Question 5.3.10. [TRG 11-15.48]

Example 4.2.90
Transaction processor not a contingent promise

Transaction Processor and Customer execute a non-cancellable 10-year transaction processing arrangement in which Transaction Processor will provide continuous access to its system and process all transactions on behalf of Customer. Customer is charged a fee for each transaction processed.

While the number of transactions is outside the control of Transaction Processor and Customer, Transaction Processor concludes that the contract does not contain a contingent promise and the nature of Transaction Processor’s promise is to provide a continuous daily service over the contract term based on the following.

— There is not a substantial amount of uncertainty as to whether the transactions will occur only an uncertainty as to the number of transactions that will be processed. In addition, there is no uncertainty in Transaction Processor’s obligation to make the platform available each day.

— Transaction Processor does not perform significant incremental services at the time a transaction is processed. Transaction Processor may incur some incremental costs when the transaction volume is higher but the contingent event does not require Transaction Processor to transfer additional services.

— While the payment terms are variable, Transaction Processor is performing by making the platform available regardless of the number of transactions rather than waiting for the contingent event to occur and then performing and obtaining payment based on completing that performance.

— Each transaction does not require Transaction Processor to transfer additional services to Customer. Transaction Processor is obligated to perform each day regardless and Customer does not make an additional request to have each transaction processed.

As a result, Transaction Processor would evaluate the per transaction fees as variable consideration (see Question 5.3.10).

Example 4.2.100
Snow removal as a stand-ready obligation

Snow Plow enters into a contract with Airport to plow the runways each time it snows during a calendar year for a nonrefundable payment fee of $1,000. Snow Plow is obligated to perform each time it snows and Airport is paying Snow

Plow regardless of the number of times it snows during the year. Snow Plow has equipment on site at the airport in order to quickly remove snow when it snows.

Snow Plow concludes that the nature of the promise is to stand ready based on the following.

- There is uncertainty as to the number of times it will snow. However, based on experience it is likely that it will snow during the annual period.
- Snow Plow does incur significantly more costs during periods of snow fall; however, it stages its equipment and incurs some fixed costs to be ready in order to perform each time the event occurs.
- The payment terms are fixed, Snow Plow gets paid $1,000 regardless of the number of times it snows.
- The contract does not specify a number of services to be provided before or after the contingent event and the snow removal only occurs when and if the snowfall occurs.

Snow Plow concludes that the contract includes a single service of standing ready and the nature of the promise is to secure a scarce resource. See Question 7.4.50 for evaluation of the appropriate measure of progress for stand-ready obligations.

Note: Even if Snow Plow concluded that the nature of the promise was not one of standing ready, it would conclude that there is a material right based on the nonrefundable payment of $1,000, which may ultimately be recognized as revenue in a pattern similar to the stand-ready obligation.

4.2.40 Distinguishing promised goods or services from administrative or set-up activities

Excerpt from ASC 606-10

• > Promises in Contracts with Customers

25-17 Promised goods or services 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 promised goods or services in the contract with the customer.

Promised goods or services do not include activities that do not transfer a good or service to a customer even if those activities are required to fulfill a contract. For example, an entity may need to perform various administrative tasks to set up a contract, but those tasks do not transfer a good or service to the customer as the tasks are performed. Such activities are typically referred to as administrative or set-up activities. [606-10-25-17]

An entity does not account for these activities as a promised good or service in the contract or evaluate whether they are a performance obligation. This is the case even if the customer makes a payment to reimburse the entity for the cost of performing those tasks. When an entity receives a payment for these costs, which is often in the form of a nonrefundable upfront fee, an entity accounts for those fees as a part of the transaction price and allocates that fee to the performance obligations in the contract, which could also include material rights. See section 5.8 on accounting for nonrefundable upfront payments. [606-10-25-17, 55-50 – 55-53]

However, entities will need to evaluate whether the costs of these activities should be capitalized as a cost to fulfill a contract. See section 12.5 on accounting for costs to fulfill a contract.

Question 4.2.70

How does an entity distinguish between an administrative task/set-up activity and a promised good or service that transfers to the customer?

Interpretive response: We believe an entity should focus on whether the activities provide incremental benefit to the customer beyond solely providing access to the subsequent good or service. Because the transfer of a promised good or service requires the customer to be able to obtain the benefit from that good or service, an activity that does not provide benefit beyond access to other goods or services generally is an administrative task or set-up activity.

Goods or services transferred to a customer that provide some measure of benefit *beyond* solely being able to access another good or service generally will be promised goods or services. When another entity provides similar services to customers on a stand-alone basis or the customer could perform the tasks, it is a strong indicator the particular service is a promised service rather than a set-up activity.

Evaluating whether upfront installation or activation activities are promised goods or services may be challenging. Some entities charge customers a fee related to the set-up activities or incur significant costs to complete the activities. However, the fact that the entity charges a fee alone does not mean that the entity is transferring a good or service to the customer. [606-10-25-17]

In general, activities involving the entity's own systems or IP will not provide the customer with incremental benefits. Examples of set-up activities include (not exhaustive) the following.

— **Activation of a wireless contract.** Entities may charge a fee to activate a wireless customer's access to the network and to cover the cost of required tasks such as setting up the wireless service, processing a new customer in the billing system and performing a credit check. Those activities do not provide the customer with benefit beyond allowing the customer to access the subsequent services.

— **Outsourcing contracts.** An entity may need to design or build technology for its internal use to provide a service to a customer. The costs of designing and migrating data for *internal use* to provide services to the customer in the future do not provide the customer with incremental benefits beyond accessing the service.

— **Software as a Service (SaaS).** A SaaS provider may implement a user interface that permits the customer to access its online platform. These activities, permitting the customer to access the SaaS for which it has contracted, provide no incremental benefit beyond the customer accessing the platform.

Examples of upfront activities that generally are promised goods or services include:

— performing customer-specific services that enhance the customer's asset; and
— providing training services to permit the customer to use the service more effectively.

Example 4.2.110
Installation services that represent set-up activities

Customer purchases a customized telecommunications package from Telco that requires Telco to make a significant network investment. Customer enters into a 10-year network services contract and pays:

— $500,000 upfront (to compensate Telco for its network investment costs); and
— $10,000 per month for the services.

The network subject to the contract is not transferred to Customer but is used and managed by Telco to deliver the specific network services.

Telco concludes that the activities related to the network investment are set-up activities because they do not result in the transfer of goods or services to Customer. Accordingly, the provision of network services is the only activity that transfers a good or service to Customer; any activity related to the network investment is a set-up activity. Therefore, the $500,000 upfront fee is an advance payment for the transfer of network services and is considered part of the transaction price allocated to the network services. Telco recognizes revenue for the network services as they are performed (see section 5.8 on treatment of nonrefundable upfront fees).

Because the network assets are owned by Telco but used to satisfy this contract, Telco also assesses if the contract includes a lease (see section 2.3). If it concludes that the equipment is subject to a lease, then it accounts for that lease under the appropriate guidance (such as Topic 842) and the remainder of the contract under Topic 606.

Example 4.2.120
Installation services that represent a promised good or service

A new residential customer (Customer) purchases television services from Provider under a three-year contract. The contract requires that Provider perform certain installation activities, including connecting its network to Customer's house and wiring the inside of the house so that set-top boxes can be connected. Customer could have selected a third party to perform the inside wiring services.

Under the terms and conditions of the contract, the connection to Customer's house belongs to Provider, and it is responsible for any repairs or maintenance. Provider concludes that connecting the network to Customer's house results in an extension of its own network, does not transfer a good or service to Customer and is not a performance obligation. However, Provider still has to determine whether to treat the costs of connecting the network as either capitalized property, plant and equipment or as costs of fulfilling a contract (see section 12.5).

Provider concluded that the inside wiring is a promised service in the contract because it provides the customer with a benefit beyond simply accessing the television services. This is also evidenced by the fact that the customer could have obtained the service from a third party. Provider will need to evaluate whether the services are a separate performance obligation.

Example 4.2.130
Set-up activities vs. implementation services in a SaaS arrangement

SaaS Provider enters into a contract to provide Customer with access to its SaaS for three years.

As part of the contract, SaaS Provider will:

1. before commencement of the SaaS term, set up the user interface that Customer will need to access the online application;
2. undertake data conversion and migration activities for Customer to configure and move the relevant data from Customer's current on-premise solution to SaaS Provider's hosted environment; and
3. provide training to relevant Customer personnel on best practices for efficient use of SaaS Provider's hosted application.

The set-up of the user interface provides no *incremental* benefit to Customer beyond permitting Customer to access the hosted application. Therefore, SaaS Provider concludes that (1) is a set-up activity rather than a promised service to Customer.

In contrast, (2) and (3) are services that provide Customer with incremental benefits beyond just access to the hosted application. The data conversion and migration activities would otherwise need to be performed (and could be performed) by Customer or another service provider, or they can be used with other SaaS providers. The training of Customer's personnel will permit Customer to more effectively use SaaS Provider's hosted application. In both cases, SaaS Provider's activities are doing more than simply setting up or enabling Customer's access to the SaaS.

Question 4.2.80

Are pre-production or non-recurring engineering activities a promised good or service or administrative activity?

Interpretive response: It depends. Some long-term supply arrangements require a supplier to undertake efforts in upfront engineering and design (E&D) to create new technology or adapt existing technology or product design to the needs of the customer. In addition, some contracts require the development or procurement of the tools, molds or dies (tooling) required to manufacture parts. Moreover, these pre-production and non-recurring engineering (NRE) activities are often a prerequisite for delivering goods or services under a production contract. These arrangements take various forms and often do not contractually commit the customer to purchase any minimum volume of parts ultimately manufactured by the supplier.

Entities need to first consider whether the pre-production and NRE activities are in the scope of Topic 606. If the pre-production and NRE goods or services are not an output of the entity's ordinary activities, Topic 606 may not apply (see section 2.2.10). However, if the entity transfers nonfinancial assets to another party, similar principles will apply to the recognition and measurement of the transaction accounted for in the scope of Subtopic 610-20 on the derecognition of nonfinancial assets.

When these activities are within the scope of Topic 606, they could be characterized as performance obligations, administrative tasks or fulfillment activities. The TRG agreed that the fundamental issue when characterizing these activities is determining whether the activities transfer control of a good or service to the customer for which the entity is entitled to consideration. [TRG 11-15.46]

Typically, if the supplier retains the rights to the E&D output, such as the IP it produces, then no goods or services are transferred. The TRG provided the following examples of when a pre-production activity could be considered a promised good or service because the supplier has transferred a good or service.

— A supplier is performing E&D services to develop a new product for a customer. The customer will own the IP, such as patents, that results from those activities. In that scenario, the supplier likely would conclude that it is transferring control of the IP to the customer because the customer is benefiting from obtaining the IP.

— A supplier is performing E&D services to develop a new product for a customer. The supplier provides the customer with periodic progress reports in a level of detail that would not require the customer to contract with another entity to reperform the work. Alternatively, the supplier may be required to provide the customer with the design information completed to date in the case of a termination. In these scenarios, the supplier effectively transfers the know-how or IP it is developing and the customer is obtaining an incremental benefit from those services as the services are performed. These scenarios may result in a loss to the supplier in situations where the supplier is reimbursed in part through lump sum payments from the customer and also through future orders which are not enforceable.

Tooling could also be a separate performance obligation when the customer owns the tooling and the supplier does not have a non-cancellable right to use the tooling during a long-term supply agreement. This is because control transfers to the customer and the supplier is entitled to consideration from the customer.

If the pre-production activities do not result in the transfer of control of a good or service to the customer, then they might be fulfillment activities or property, plant and equipment. In these instances, any customer reimbursement would still be recorded as revenue but would attach itself to other performance obligations in the contract (e.g. the parts). See chapter 12 for further information on costs.

If the entity does not transfer goods or services to the customer, is not entitled to consideration, and the pre-production or NRE contract is not combined with another contract (i.e. production) for accounting purposes then the activities may not be in the scope of Topic 606. There is diversity in accounting practice among suppliers that engage in pre-production activities associated with long-term supply arrangements. The SEC staff has stated that it will continue to respect well-reasoned, practical judgments when those judgments are grounded in the principles of the accounting literature – including Topic 606 and Subtopic 340-40.

Pre-production costs related to long-term supply arrangements are discussed in section 12.10.

Question 4.2.90

Are promises to defend a patent, copyright or trademark an administrative activity or a promised good or service?

Interpretive response: An entity's promise to defend its patent, copyright or trademark is an administrative activity, not a promised good or service, because it does not transfer goods or services to the customer. These types of activities do not benefit the customer beyond the access to the good or service provided in the contract and relate to the entity's own assets. [606-10-55-64A]

In contrast, if an entity enters into a contract with a customer that is a named defendant in a patent infringement lawsuit and agrees to provide legal support to the customer rather than promising to defend its own patent the entity may be providing a legal service to the customer.

Question 4.2.100
Is an exclusivity provision a promised good or service?

Interpretive response: Generally, no. Entities may enter into contracts with customers that provide the customer with the exclusive right to the entity's goods or services, restrict the entity's ability to sell its goods or services to other customers or geographies, or both. For example, an entity might enter into a supply contract with a distributor and agree not to sell its products to the customer's competitors, or to provide the distributor the benefit of being an 'authorized dealer' and use the entity's trademarks in conjunction with the sale of branded merchandise purchased from the entity.

The FASB discussed exclusivity clauses in the context of licenses of IP and noted that exclusivity is another restriction that represents an attribute rather than the nature of the underlying IP or the entity's promise in granting a license. Therefore, an entity does not separately account for exclusivity in a license arrangement and the exclusivity does not affect whether that license is transferred at a point in time or over time (see chapter 10). [ASU 2014-09.BC412(b)]

Based on the above, we generally believe exclusivity is an attribute of the promise to the customer rather than a promised good or service itself as it does not change the nature of the underlying promise to the customer, which is to provide the goods or services. Exclusivity may affect the value of or price for the underlying good or service. However, the promised good or service is typically what the customer will have the right to obtain or use.

In some cases a customer may make a payment for the exclusivity or an upfront payment upon entering into the exclusive arrangement. In that case, the entity will need to evaluate whether the payment indicates that contract includes a material right. A material right might be present if the contract provides the customer with options to purchase additional goods or services during the exclusivity period. If no material right is present, the payment would be a part of the transaction price (see section 5.8).

In some cases, the entity may pay the customer to enter into an exclusive relationship. In that case, an entity will need to evaluate whether the payment is for a distinct good or service or whether it should be accounted for as a reduction of revenue. Similarly, an entity will need to evaluate whether the payment meets the definition of an asset and should be capitalized and amortized. See Question 5.7.50 on upfront payments to customers.

Question 4.2.110
Is a promise to provide end-user documentation an administrative activity or promised good or service?

Interpretive response: In general, we believe that providing end-user documentation, such as instruction manuals, is an administrative task if that documentation merely allows the customer to obtain the inherent utility of the good or service. In that case, the end-user documentation does not provide incremental benefit to the customer.

If the end-user documentation is necessary for the customer to benefit from the good or service, the entity may conclude that control of the good or service has not been transferred to the customer until the documentation has been provided. This might occur when the customer cannot make substantive use of the good or service without the documentation and there are no alternative resources available with which the customer could make substantive use of the good or service, such as consultants or third-party documentation.

Providing *standard* end-user documentation of the nature described in the preceding paragraph should be distinguished from a promise to provide additional materials that would provide incremental benefit to the customer, such as information of a consulting nature (e.g. training) that helps the customer do more than simply achieve the base utility from the good or service.

Question 4.2.120

Is an entity's participation in a joint steering committee considered a promised service in a contract with a customer?

Interpretive response: It depends. Joint steering committees (JSCs) are often created through collaborative R&D agreements to ensure that all the parties are working to achieve the goals of the activity. For example, an entity may license technology to another entity and agree to provide R&D services to develop technology that will benefit sales of both parties' products. As part of this arrangement, the entity may agree to participate with the other party on a JSC for development.

Topic 606 explicitly excludes from its scope a contract, or portion of a contract, that is with a collaborator or partner who shares with the entity the risks and benefits of developing a product to be marketed. The rationale for this exclusion is that such parties are not an entity's customers. Therefore, it is important for an entity that engages in collaborative arrangements to analyze whether the other parties in its contracts are customers. A customer is a party that has contracted with the entity to obtain goods or services that are an output of the entity's ordinary activities. For further discussion of whether an arrangement is a collaboration, see section 2.2.20.

When an entity agrees to participate in a JSC, it evaluates the substance of the contractual provision relative to JSC participation. If participation in a JSC is required under the contract, that participation is generally an additional promised service. However, if participation in the JSC is permitted but not required, JSC participation may not be an additional promised service in the contract, but rather a right of the entity to protect its own interests in the arrangement.

The presence of any of the following factors generally indicates that participation in the JSC is a promised service in the contract, rather than solely a protective or participating right of the entity:

— participation requires distinct and specific action by the entity – e.g. specific persons with unique skills that are significant to the project, specific time commitment;

— failure to perform would result in a substantive penalty for the entity; or

— inclusion or exclusion of the JSC participation from the contract would significantly affect the other terms of the contract (e.g. the transaction price, timing of payments or customer acceptance).

Promised goods and services in a contract do not have to be explicit contractual requirements, but rather can be implied promises that a customer would reasonably expect the entity to perform based on the entity's customary business practices and policies (see section 4.2.10). As such, entities may need to evaluate their customary business practices and policies regarding JSC participation to determine whether JSC participation is implied, even if the contract is silent or such participation is optional.

If the participation in the JSC is determined to be a performance obligation, a portion of the transaction price is allocated to the JSC participation based on its relative stand-alone selling price.

4.2.50 Practical expedient for immaterial goods and services

Excerpt from ASC 606-10

• > Promises in Contracts with Customers

25-16A An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer. If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, then the related costs to transfer those goods or services shall be accrued.

25-16B An entity shall not apply the guidance in paragraph 606-10-25-16A to a customer option to acquire additional goods or services that provides the customer with a material right, in accordance with paragraphs 606-10-55-41 through 55-45.

An entity is permitted, as a practical expedient, *not* to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer. This evaluation is based on materiality at the contract level. Therefore, an entity does not also need to evaluate whether the aggregated immaterial promised goods or services are material at the financial statement level. [606-10-25-16A, ASU 2016-10.BC12]

An entity evaluates whether a promised good or service is immaterial in the context of the contract from the perspective of the customer and considers *both quantitative* and *qualitative* factors. That is, an entity should consider the relative significance or importance of the good or service to the entire arrangement with the customer. [ASU 2016-10.BC12]

If the practical expedient is applied, the goods or services that are immaterial in the context of the contract become part of other performance obligations. When an entity satisfies a performance obligation that includes the immaterial goods or services, it recognizes the revenue allocated to the performance obligation even if the immaterial goods or services have not yet been transferred to the customer. If this happens, the entity accrues the costs to transfer the immaterial goods or services when (or as) it recognizes the revenue rather than waiting until it transfers the immaterial goods or services. [606-10-25-16A]

This practical expedient is not applicable to material rights stemming from customer options (see Question 8.2.60). Therefore, if an option conveys a material right to the customer, that material right cannot be deemed immaterial in the context of the contract. In other words, an entity assesses whether an express or implied option in a contract conveys a material right to the customer, even if the material right is immaterial in relation to the goods or services promised in the contract. [606-10-25-16B]

Question 4.2.130

Does an entity apply the practical expedient for immaterial goods or services on a contract-by-contract basis?

Interpretive response: No, we believe entities should apply the practical expedient to immaterial goods or services consistently to similar promises in similar contracts.

Example 4.2.140

Goods or services immaterial in the context of the contract

Supplier enters into a supply arrangement with Customer. The arrangement has a three-year term and includes minimum purchases of five million products per year. Supplier also promises to provide:

— a toll-free customer service line for consumers purchasing the goods. Supplier spends $500,000 per year to maintain the customer service line for all of its customers, and estimates the cost associated with providing this service to Customer to be less than $10,000 per year. Call volume is low because the goods are not highly specialized; and

— an annual statement showing the purchase activity for each of Customer's stores. Customer can obtain this information from its own stores but the annual statement provides the information in a format that allows Customer to better analyze the stores' purchases. Supplier does not incur significant cost or effort but simply writes a report using its own sales system. Supplier does not sell this service separately and estimates a stand-alone selling price to be less than $10,000.

Based on the minimum volume commitments included in the contract, Supplier determines that the transaction price is $15 million.

In evaluating the promises in the contract, Supplier determines that the telephone support and the annual statement are immaterial in the context of the contract for the following reasons.

— Quantitatively, the services are less than 1% [$60 thousand / $15 million] of the total value of the goods and services in the contract.

— Qualitatively, the telephone support services and monthly statements are deemed significantly less important than the actual supply of goods. Supplier does not expect the telephone support services to be significant to Customer, and the annual statements do not affect the utility of the goods or Customer's ability to benefit from the goods.

Therefore, Supplier determines that these activities are immaterial in the context of the contract and does not account for them as separate performance obligations.

Example 4.2.150

Goods or services immaterial in the context of the contract – qualitative assessment

Manufacturer enters into a contract to provide Customer with equipment customized to Customer's specifications. The contract also provides Customer with the right to receive up to 20 hours of training services on how to operate the equipment at no additional cost.

In evaluating the promises in the contract, Manufacturer determines that although the promised training hours are not quantitatively significant, they are not considered immaterial in the context of the contract for the following reasons:

— The training services will allow Customer to optimize the customized equipment within a short period of time.
— Customer's ability to optimize the customized equipment it is procuring is likely important to Customer.

Therefore, Manufacturer considers both the equipment and training services as promises in the arrangement. Manufacturer further assesses whether those promises are distinct from one another and if so, accounts for them as separate performance obligations. [606-10-55-309, 55-310]

4.2.60 Accounting policy election for shipping and handling

Excerpt from ASC 606-10

• > Promises in Contracts with Customers

25-18A An entity that promises a good to a customer also might perform shipping and handling activities related to that good. If the shipping and handling activities are performed before the customer obtains control of the good (see paragraphs 606-10-25-23 through 25-30 for guidance on satisfying performance obligations), then the shipping and handling activities are not a promised service to the customer. Rather, shipping and handling are activities to fulfill the entity's promise to transfer the good.

25-18B If shipping and handling activities are performed after a customer obtains control of the good, then the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good. The entity shall apply this accounting policy election consistently to similar types of transactions. An entity that makes this election would not evaluate whether shipping and handling activities are promised services to its customers. If revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities shall be accrued. An entity that applies this accounting policy election shall comply with the accounting policy disclosure requirements in paragraphs 235-10-50-1 through 50-6.

Whether shipping and handling activities represent a promised good or service depends on when they are performed. If those activities are performed *before* the customer obtains control of the goods, then they are fulfillment activities and not a promised good or service. This is because before the goods transfer to the customer, the activities relate to the entity's asset rather than the customer's asset. [606-10-25-18A]

When shipping and handling activities are performed *after* the customer obtains control of the goods, they are a promised good or service because the entity is performing a service related to the customer's asset. However, the entity may elect to account for the shipping and handling costs (including the cost of insurance) in this instance as fulfillment costs. Such an election is an accounting policy election that requires consistent application and disclosure (see section 15.10). Based on the entity's election it would account for the shipping and handling as follows.

— **A fulfillment activity.** If an entity elects to treat shipping and handling activities performed after the customer obtains control as fulfillment activities, the entity recognizes the costs of these activities when it recognizes revenue for the goods. This means that the related costs will be accrued and the revenue will be recognized before the shipping and handling activities are performed.

— **A promised good or service.** If an entity does not elect to treat shipping and handling as a fulfillment activity, the entity determines whether they are a separate performance obligation. [606-10-25-18B]

Question 4.2.140

Can the shipping and handling accounting policy election be applied to other activities?

Interpretive response: No. It would be inappropriate to apply the shipping and handling accounting policy election by analogy to other activities that occur after the entity has transferred the promised goods or services.

The FASB considered whether this policy election should be applied more broadly to other activities such as custodial or storage services, but it decided to limit the scope of this guidance to shipping and handling activities. The FASB did note that an entity should consider whether those other activities transfer a promised good or service to a customer or are more akin to an administrative activity. In addition, if those other activities transfer a promised good or service, they could be immaterial in the context of the contract, in which case the entity need not identify a separate performance obligation related to them if it elects to apply the practical expedient for immaterial goods or services (see section 4.2.50). [ASU 2016-10.BC23]

Question 4.2.150

Can an entity apply the shipping and handling accounting policy election when a third party provides the shipping?

Interpretive response: Yes. The shipping and handling accounting policy election can be applied when the entity either ships the goods itself or arranges for a third party to ship the goods.

The key to determining when an entity can apply the policy election to shipping and handling activities is when control of the good transfers. If the shipping and handling activities occur after a customer obtains control, then the policy election is available and the entity may elect to account for the activities as fulfillment activities rather than as a separate performance obligation. On the other hand, if the shipping and handling activities are performed before the customer obtains control of the good, those activities are automatically fulfillment activities.

If the entity elects to treat shipping and handling as fulfillment activities, we believe that third-party shipping and handling costs charged to the entity's customer should be reported gross in revenue when the entity is the principal for the good being transferred. If the shipping and handling is accounted for as a performance obligation, the entity needs to evaluate that specified service under the principal-agent guidance (see Question 9.3.70).

Question 4.2.160

What is the appropriate income statement classification for shipping and handling costs?

Interpretive response: It depends. Topic 606 does not explicitly address the presentation of shipping and handling costs in the income statement.

Classifying the cost of these activities as cost of sales because they are considered fulfillment activities is an acceptable presentation.

If before the adoption of Topic 606 an entity historically presented shipping and handling costs in another income statement line item such as SG&A, the SEC staff does not object if the entity either (1) maintained its historical presentation or (2) changed its classification to cost of sales upon adoption of Topic 606. However, if an entity historically presented these costs as cost of sales, it would not be appropriate for the entity to change its classification to another income statement line item.

In addition, the SEC staff encourages entities that classify significant shipping and handling costs outside of cost of sales to continue to provide disclosure about these costs and where they are presented in the income statement. [2017 AICPA Conf]

4.2.70 FASB example of explicit and implicit promises in a contract

Example 12 in Topic 606 illustrates how to evaluate promises in a contract, including those that are explicitly stated in a contract and those that can be implicit based on established business practices or published policies that create a reasonable expectation that the entity will transfer the good or service to the customer. [606-10-25-16, ASU 2014-09.BC87]

Excerpt from ASC 606-10

• • > Example 12—Explicit and Implicit Promises in a Contract

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

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.

55-153 The contract with the customer includes two promised goods or services—(a) the product and (b) the maintenance services (because the promise of maintenance services is a promise to transfer goods or services in the future and is part of the negotiated exchange between the entity and the distributor). The entity assesses whether each good or service is distinct in accordance with paragraph 606-10-25-19. The entity determines that both the product and the maintenance services meet the criterion in paragraph 606-10-25-19(a). The entity regularly sells the product on a standalone basis, which indicates that the customer can benefit from the product on its own. The customer can benefit from the maintenance services together with a resource the customer already has obtained from the entity (that is, the product).

55-153A The entity further determines that its promises to transfer the product and to provide the maintenance services are separately identifiable (in accordance with paragraph 606-10-25-19(b)) on the basis of the principle and the factors in paragraph 606-10-25-21. The product and the maintenance services are not inputs to a combined item in this contract. The entity is not providing a significant integration service because the presence of the product and the services together in this contract do not result in any additional or combined functionality. In addition, neither the product nor the services modify or customize the other. Lastly, the product and the maintenance services are not highly interdependent or highly interrelated because the entity would be able to satisfy each of the promises in the contract independent of its efforts to satisfy the other (that is, the entity would be able to transfer the product even if the customer declined maintenance services and would be able to provide maintenance services in relation to products sold previously through other distributors). The entity also observes, in applying the principle in paragraph 606-10-25-21, that the entity's promise to provide maintenance is not necessary for the product to continue to provide significant benefit to the customer. Consequently, the entity allocates a portion of the transaction price to each of the two performance obligations (that is, the product and the maintenance services) in the contract.

• • • > Case B—Implicit Promise of Service

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.

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 reasonable expectations of the entity's customers (that is, the distributor and end customers) in accordance with paragraph 606-10-25-16. Consequently, the entity assesses whether the promise of maintenance services is a performance obligation. For the same reasons as in Case A, the entity determines that the product and maintenance services are separate performance obligations.

• • • > Case C—Services Are Not a Promised Service

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.

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.

55-157A Although the maintenance services are not a promised service in the current contract, in future contracts with customers the entity would assess whether it has created a business practice resulting in an implied promise to provide maintenance services.

4.3 Determine the performance obligations

Excerpt from ASC 606-10

> Identifying Performance Obligations

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).

4.3.10 Overview

After an entity has identified the promised goods and services in the contract, it evaluates each promise to determine whether it constitutes its own performance obligation or should be combined with other promises to form a performance obligation. The performance obligation is the 'unit of account' for recognizing revenue. In other words, an entity does not account for the promised goods or services in the contract – it accounts for the performance obligations.

A performance obligation is one of the following:

1. a good or service that is distinct on its own;
2. a bundle of goods or services that are not distinct on their own but are as a group; or
3. a series of distinct goods or services that are substantially the same and meet two additional criteria discussed in section 4.4 (thereby forming a 'series' performance obligation). [606-10-25-14]

The key principle in identifying a performance obligation is the notion of a promised good or service being distinct. The term distinct, in an ordinary sense, suggests something that is different, separate or dissimilar. All performance obligations comprise promises that are distinct individually or distinct when combined with other promises. In order to determine whether a promised good or service is distinct the FASB developed two criteria, which are discussed in section 4.3.20.

If a promised good or service is *not* distinct individually, it is either bundled with other nondistinct promised goods or services that collectively meet the distinct criteria or combined with another distinct good or service (or distinct bundle of goods or services). Consequently, even if a promised good or service is distinct, it may not be a separate performance obligation if at least one or more other goods or services is (are) not distinct. For example, if in a contract with a customer, Product P is determined to be distinct, but Service S is not distinct and those are the only two promised goods and services in the contract, Product P and Service S would be a single performance obligation.

See section 10.5 for a discussion of applying the 'distinct' criteria to licenses.

Question 4.3.10

Is separating goods or services into distinct performance obligations optional?

Interpretive response: No. Separating goods or services into distinct performance obligations is not optional. Identifying all performance obligations in a contract is a critical aspect of the revenue model because it directly affects the timing and amount of revenue recognition.

However, from a practical perspective, it may not be necessary to apply the separation and allocation requirements of Topic 606 if each distinct good or service is concurrently delivered and has the same pattern of transfer to the customer. This is because an entity may be able to account for such goods and services as if they represent a single performance obligation if the outcome is the same as accounting for the goods and services as individual performance obligations. [ASU 2014-09.BC116, ASU 2016-10.BC47]

However, SEC registrants should keep in mind the SEC requirement to present tangible product sales and sales from services and their respective costs of sales separately. [Reg S-X Rule 5-03(b)]

4.3.20 Assess whether a promised good or service is distinct

Excerpt from ASC 606-10

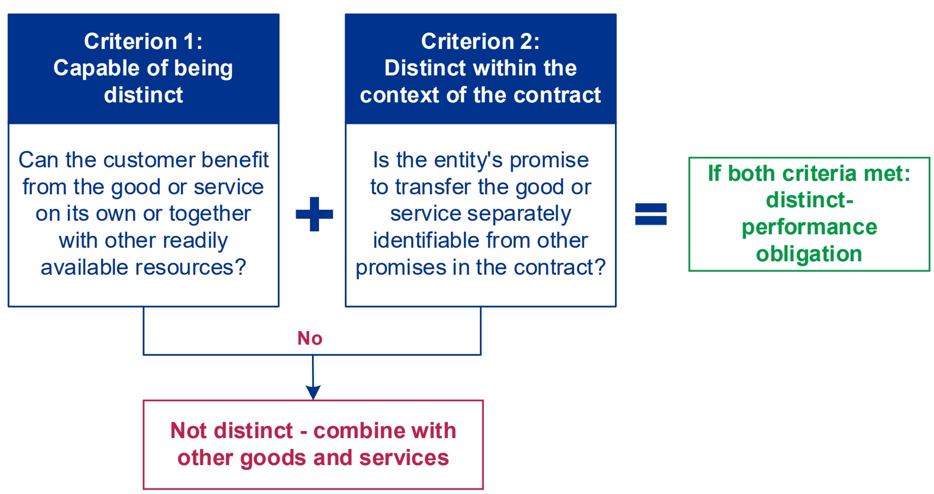
• > Distinct Goods or Services

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 promise to transfer the good or service is distinct within the context of the contract).

25-22 If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

A performance obligation is a promised good or service (or bundle of goods or services) that is distinct. A promised good or service is distinct if both of the following criteria are met.



4.3.30 Capable of being distinct

Excerpt from ASC 606-10

• > Distinct Goods or Services

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 promise to transfer the good or service is distinct within the context of the contract).

25-20 A customer can benefit from a good or service in accordance with paragraph 606-10-25-19(a) if the good or service could be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only 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. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

The 'capable of being distinct' criterion focuses on the economic benefits of the goods or services. When a good or service is capable of being distinct, a customer can benefit from a good or service on its own or in conjunction with:

— other readily available resources that are sold separately by the entity, or by another entity; or
— resources that the customer has already obtained from the entity – e.g. a good or service delivered upfront – or from other transactions or events. [606-10-25-20]

A customer can benefit from a good or service if it can be used, consumed or sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. The fact that a good or service is regularly sold separately by the entity is a strong indicator that the customer can benefit from a good or service on its own or with other readily available resources. This is the case because otherwise there would be no market for an entity to provide that good or service on a stand-alone basis. [ASU 2014-09.BC99]

However, whether the entity or another entity sells an identical or largely interchangeable good or service separately, or whether the good or service can be resold by the customer is not a requirement to conclude the good or service is capable of being distinct. Factors beyond how the good or service is sold in the marketplace by the entity or others, such as the stand-alone functional utility of the product or service, are also considered in this evaluation.

The capable of being distinct criterion establishes a baseline level of economic substance that an individual good or service needs to be distinct. Therefore, even if the economic benefits that can be derived from the good or service are minor compared to the economic benefits the customer can obtain from the good or service together with the other promises in the contract, the good or service could be capable of being distinct. [ASU 2016-10.BC33]

The capable of being distinct assessment should be based on the characteristics of the promised goods or services themselves and not the customer's intended use or the way in which contractual terms permit the customer to use the good or service. Contractual restrictions can affect the customer's ability to derive benefit from the good or service on its own, as is the case when the customer's ability to use or resell a good is restricted. They also can affect the customer's ability to access a readily available resource, as is the case when the customer is prohibited from obtaining a related good or service from an available alternative provider. Nevertheless, such contractual restrictions do not affect the entity's evaluation of whether the good or service is capable of being distinct – that is, the evaluation ignores the contractual restriction. [ASU 2014-09.BC100-101]

Question 4.3.20

Can the order of delivery of goods or services affect the determination of whether the customer can benefit from a good or service together with other readily available resources?

Interpretive response: Yes. A readily available resource includes goods or services that the customer has already obtained from the entity, which includes goods or services that the entity will have already transferred under the contract. Therefore, the order of delivery of goods or services could affect the evaluation. [606-10-25-20]

For example, an entity enters into an arrangement to transfer two products to its customer. These two products are never sold separately and no equivalent of either product is sold separately by any other entity. Product A can be used on its own, but Product B cannot be used without Product A. If Product A is delivered first, Product A has benefit to the customer on its own and Product B has benefit to the customer together with a readily available resource (Product A). Therefore, in this example, each product is distinct.

In contrast, if Product B is delivered first, the customer is not able to benefit from Product B on its own. Moreover, Product A is not yet considered readily available because it is not sold separately by the entity, nor is there an equivalent product sold separately by an alternate entity. As such, Product B is not distinct and therefore is combined with Product A into a single performance obligation.

Question 4.3.30

Can a good or service only sold separately in renewals be considered a readily available resource?

Interpretive response: Yes. A readily available resource is a good or service that is sold separately or a resource that the customer has already obtained from the entity or from other transactions or events. We believe the sale of a good or service on a renewal basis is a separate sale and therefore could be considered a readily available resource. This approach is consistent with viewing renewals as separate sales for purposes of determining a stand-alone selling price.

For example, some entities sell services that require initial implementation services for the customer to use the subsequent services, such as SaaS or outsourcing services. In many cases, implementation services are always bundled with the subsequent services in the initial contract. See Question 4.2.70 for distinguishing between set-up activities and implementation services that transfer a good or service to the customer.

When the entity does not separately sell implementation services and they are not available from any other provider, it may not be able to conclude that the customer could benefit from the implementation services on their own – e.g. without the subsequent services. As such, to determine if the implementation service is capable of being distinct, it is critical to determine if the subsequent services are considered readily available resources. Because the implementation services are performed first, to be a readily available resource the subsequent services would need to be sold separately by the entity or other entities.

An entity may not have a history initially of selling the subsequent services on a stand-alone basis and no other entities provide implementation services or the customer cannot complete implementation on its own. However, when the entity sells the subsequent services on a renewal basis without additional implementation services, those renewals could still provide evidence of stand-alone sales.

Many established entities will have a history of actual renewals. Some early stage entities or entities with new service lines may not have actually sold a particular service on a renewal basis. However, we believe that when an entity is offering renewals and has a substantive plan to continue selling the service separately on a renewal basis, those renewals could be considered a readily available resource.

4.3.40 Distinct within the context of the contract

Excerpt from ASC 606-10

• > Distinct Goods or Services

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 promise to transfer the good or service is distinct within the context of the contract).

25-21 In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 606-10-25-19(b), the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

a. The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

For a promised good or service to be distinct, it has to be both capable of being distinct (see section 4.3.30) and distinct within the context of the contract. A good or service is distinct within the context of the contract when it is separately identifiable. [606-10-25-19]

The objective in applying this criterion is to determine whether the promise is to transfer each good or service that is capable of being distinct individually or whether the promise is to transfer a combined item to which those goods or services are inputs. In other words, the objective is to determine whether the nature of the entity's promise is to transfer (a) multiple promised goods or services or (b) a combined item that comprises multiple promised goods or services. [ASU 2016-09.BC29]

Consistent with the 'capable of being distinct' analysis, contractual restrictions or requirements (e.g. to use the entity's services rather than an alternative provider's services) do not affect the 'distinct with the context of the contract' evaluation. [606-10-55-150F]

The FASB created this criterion because requiring a good or service to merely be capable of being distinct could result in an unfaithful depiction of the entity's performance in a contract. This is especially true for many construction- and production-type contracts that transfer goods or services capable of being distinct, such as sheet rock and roofing materials, used as part of an integrated product such as a building. Accounting for those individual goods or services as separate performance obligations would result in recognizing revenue as those goods or services are transferred instead of when the entity performs the construction or production of the item for which the customer has contracted. [ASU 2014-09.BC102]

The distinct within the context of the contract evaluation depends on whether the promised goods or services are separately identifiable. This is the case if they have an additive relationship to each other, rather than a transformative relationship on each other.

— **Additive relationship.** Two goods or services that have an additive relationship are separately identifiable and not combined into a single performance obligation. An additive relationship exists when only one good or service significantly affects or depends on the other. For example, an additive relationship might exist between a piece of equipment and installation services. The fact that the installation service depends on the entity transferring the equipment does not mean the entity's promise to transfer the equipment is not separately identifiable if both items do not significantly affect each other. This is illustrated in Example 11 Case C in Topic 606 where equipment and installation services are distinct (see Question 4.3.40). [ASU 2016-10.BC32]

— **Transformative relationship.** Two goods and services that have a transformative relationship are combined into a single performance obligation. Goods and services have a transformative relationship when they significantly affect each other such that they create a combined item(s) that is more than or different from the sum of the component parts of services. To have a transformative relationship, *each* of the goods or services needs to significantly affect the other. [ASU 2016-10.BC29]

Topic 606 provides three indicators to assist in evaluating whether the nature of the entity's promise to the customer is to transfer (a) multiple goods or services or (b) a combined item that comprises the multiple promised goods or services in the contract. The indicators are not exhaustive and are not intended to be evaluated as *criteria* or to be considered in isolation from the principle that they support. The individual indicators will be more or less relevant to the evaluation depending on the nature of the contract, and entities will likely attach more or less importance to a particular indicator depending on the facts and circumstances of an arrangement. In other words, the first indicator may provide more persuasive evidence in one contract, while the second or third provides more persuasive evidence in another contract. [ASU 2016-10.BC31]

Significant integration services

When providing a significant integration service, the entity is responsible for ensuring the individual goods or services are incorporated into the combined output. This indicator may be relevant in many construction contracts in which the contractor provides an integration service to manage the various construction tasks and to assume the risk associated with the integration of these tasks. Moreover, the integration service will require a contractor to coordinate the tasks performed by any subcontractors and ensure those tasks are performed in accordance with contract specifications. [ASU 2014-09.BC107]

Consistent with the overall principle, entities should evaluate whether the various goods or services are transformed into a combined output. For example, in a contract to build a house, the contractor is responsible for integrating the construction materials and activities that transform those inputs into the final house for the customer. However, this indicator is not meant to apply to contracts in which the integration services are relatively simple and the risk associated with integrating the promised goods or services are negligible. [ASU 2014-09.BC108]

Significant modification or customization

A service of modifying or customizing other goods or services has a transformative effect on the other goods or services because the functionality of the customized good or service is different from the individual inputs used to create the combined item. This indicator may be relevant in evaluating contracts in the software industry when an entity promises to modify or customize a software application (software and services that are inputs) into a customized solution (the combined output). However, it could also be relevant to other industries. For example, an entity could promise to provide a complex piece of equipment or machinery whose functionality is significantly modified or customized beyond the functionality of the component pieces. [ASU 2014-09.BC109]

Highly interdependent or interrelated

This indicator addresses situations in which it is unclear whether there is a significant integration service or whether the goods or services are significantly modified or customized but the goods or services may still not be separately identifiable. This may be the case when the goods or services are so highly dependent on or highly interrelated with other goods or services that the customer could not choose to purchase one good or service without significantly affecting the other promised goods or services. In other words, the entity could not fulfill its individual promises independently from each other. [ASU 2014-09.BC111]

To be highly interdependent or interrelated, the goods or services should significantly affect each other. The fact that one good or service is dependent on the other does not mean the goods or services are inputs into a combined output. Example 11, Case E in Topic 606 illustrates that equipment and consumables that can only be used by the customer together are separately identifiable when the entity can fulfill each of those promises independently of each other. In that example, two promises do not significantly affect each other such that the functionality of either item changes. Further, the entity sells the consumables separately such that the entity could fulfill that promise separately and the equipment separately. In other words, even though the customer's use of one item is dependent on first obtaining the other item, when those items do not significantly affect each other they can be separately identifiable. [606-10-55-150G – 55-150I]

The separately identifiable principle also considers the utility (i.e. the customer's ability to benefit from the goods or services) of the promised goods or services in limited circumstances. When the provision of one promise significantly affects the utility of another promise, they may in effect be inputs to a combined output. That is because when the utility of the promises are significantly affected by other promises it may create a two-way dependency between the items such that *the entity's ability to fulfill* its overall promise to the customer is dependent on transferring both items. In other words, the customer could not obtain the intended benefit from the contract without the entity fulfilling both promises. Example 10, Case C and Example 55 in Topic 606 (see section 4.3.50) illustrate scenarios where the provision of one promise is integral to the customer's ability to derive or maintain benefit from another promise such that the entity cannot fulfill its combined promise without providing both items. [ASU 2016-10.BC33]

Question 4.3.40
Are promises to provide equipment and installation services distinct?

Interpretive response: We generally expect equipment and installation services will be distinct when (1) the equipment is not being significantly customized or modified by the services, (2) the equipment is not being integrated into a larger tangible deliverable (e.g. a piece of equipment being installed into a ship or an airplane), and/or (3) there is a secondary market where the equipment is sold for more that scrap value.

Example 11, Case C and Case D, in Topic 606 illustrate fact patterns where equipment and installation services are distinct. In those examples, the equipment was operational without any customization or modification. Further, the installation services were not complex and were capable of being performed by alternative service providers. [606-10-55-150A]

In those examples, the equipment and installation were not inputs into a combined outputs because:

— the services did not significantly customize or modify the equipment;

— the entity did not provide a significant integration service; and

— the services did not significantly affect the equipment because the entity is able to fulfill its promise to transfer the equipment independently of the services. [606-10-55-150C]

Case C describes a scenario where even though the customer can only benefit from the services after it has obtained control of the equipment, the installation does not affect the equipment and therefore there is only a one-way dependency between the equipment and services rather than a two-way dependency that indicates they are inputs to a combined output.

Case D illustrates that contractual restrictions do not affect this conclusion. In that fact pattern, the customer is required to purchase installation services from the entity but the installation and equipment are still distinct. [606-10-55-150F]

The examples in Topic 606 illustrate fact patterns where the services are not complex and are available from third parties. However, we do not believe either of those facts are necessarily determinative.

When installation is complex or is not provided by third parties, we believe the analysis would continue to focus on whether the services and equipment affect each other such that the functionality of the equipment is significantly different or enhanced. That is, the analysis focuses on whether promises have a transformative relationship.

As a result, the key analysis is typically whether the services significantly customize or modify the equipment. This could be the case when the installation goes above and beyond tasks such as assembly, set up, and testing, etc. A service that significantly modifies or customizes the equipment results in different functionality of the equipment and typically requires design and development services to modify or create the customized equipment for the customer.

Installation services typically do not result in the entity providing a significant integration service. However, if the services combine equipment with other inputs (including assets of the customer) that increases or creates a combined functionality that is significantly different than the sum of the individual parts, those services could result in a conclusion that services and equipment are not separately identifiable.

Finally, because the separately identifiable principle considers whether the customer's ability to derive its intended benefit from the contract depends on *the entity* fulfilling both promises, there could be limited situations when complex installation services are considered so integral that the customer could not obtain the benefit it contracted for without *the entity* transferring all of the goods or services. However, we believe this would be rare given that this conclusion would only be reached when:

— the services are integral (i.e. essential) to the customer's ability to derive its intended benefit from the equipment and the functionality of the equipment would be significantly limited compared to the customer's intended purchase;

— the services cannot be performed by another party (e.g. the services rely on the entity's proprietary knowledge of the equipment/technology). This analysis is not based on contractual restrictions; and

— the customer cannot acquire the equipment in the secondary market.

The absence of any of the above indicate the customer's ability to derive its intended benefit is not dependent on the entity fulfilling both promises.

Example 4.3.10
Equipment and installation are distinct

Supplier enters into a contract with Customer to sell manufacturing equipment and installation services. The installation is complex and takes several months but it is standardized to ensure the equipment functions to the manufacturer's specifications. No third parties are capable of providing the implementation services.

Supplier provides installation on a stand-alone basis when the equipment is sold in the secondary market. The installation process typically includes:

- assembling and setting up of the equipment;
- installing the equipment's core operating software; and
- testing.

The installation does not change the functionality of the equipment but is nevertheless important to Customer, and proper installation is critical to Customer being able to use the equipment according to specifications.

Capable of being distinct

Supplier concludes that the equipment and services are capable of being distinct because the Customer can benefit from the equipment either by reselling it or together with the services, which are a readily available resource since they are sold separately by Supplier.

The services are capable of being distinct because Customer can benefit from the services on their own (i.e. Supplier sells the services separately) or together with the equipment that has been previously transferred.

Distinct in the context of the contract

Supplier concludes that the equipment and services are separately identifiable based on the following.

- The installation services do not significantly customize or modify the equipment.
- Supplier is not providing a significant service of integrating the equipment with other inputs.
- Supplier can fulfill each promise independently of each other. While performing the services is dependent on first providing the equipment, the services do not significantly affect the equipment.

While the services are important to Customer maximizing its ability to use the equipment, the equipment and implementation do not significantly affect each other such that they are inputs into a combined output.

Even though Customer could not obtain the installation separately, it does not change the fact that the services do not significantly affect the equipment. The services and equipment together do not result in a significantly different functionality and the Customer's ability to derive its intended benefit is not dependent on the entity fulfilling both promises – e.g. Customer could still derive substantial benefit by selling the equipment in the secondary market.

Example 4.3.20
Equipment and services are not distinct

Assume the same facts as Example 4.3.10 except that the Customer requests Supplier to provide services that will customize equipment to enable it to provide different functionality that works within the Customer's environment. In addition to the assembly and testing, these services involve modifying the equipment's operating system software and design and development work as part of the installation at the customer's site. Supplier estimates the services will take significantly longer than a typical installation.

While Supplier sells installation services separately, those services are typically standardized based on Supplier's specifications and help the customer to use the equipment according to Supplier's published specifications.

Capable of being distinct

Supplier concludes that the equipment is capable of being distinct because Customer can benefit from the equipment by reselling it or together with the basic installation services, which are a readily available resource since they are sold separately by the Supplier.

The services are capable of being distinct because Customer can benefit from the services together with the equipment that is transferred prior to the services commencing.

Distinct in the context of the contract

Supplier concludes that the equipment and services are not separately identifiable. Supplier's services are modifying and customizing the equipment in such a manner that the functionality of the equipment is significantly different.

Supplier concludes that the equipment and services are both inputs used to create the customized equipment (the combined output) and are not distinct in the context of the contract.

Example 4.3.30**
Internet services and equipment

Telco A enters into a two-year contract for internet services with Customer. Customer also purchases a modem and a router from Telco A and obtains title to the equipment. Telco A does not require customers to purchase its modems and routers and will provide internet services to customers using other equipment that is compatible with Telco A's network. There is a secondary market on which modems and routers can be purchased or sold for amounts greater than scrap value.

Telco A concludes that the modem and router are each distinct and that the arrangement includes three performance obligations (the modem, the router and the internet services) based on the following evaluation.

Capable of being distinct

- Customer can benefit from the modem and router on their own because each can be resold for more than scrap value.
- Customer can benefit from the internet services using readily available resources. Said another way, Customer can benefit from the internet services through either (a) delivery of the modem and router at the time of contract set-up, or (b) through purchasing a compatible modem and router from alternative retail vendors.

Distinct in the context of the contract

- The modem and router are distinct within the context of the contract because Telco A does not provide an integration service.
- The modem, router and internet services do not modify or customize one another.
- Customer could benefit from the internet services using routers and modems that are not sold by Telco A. Therefore, the modem, router and internet services are not highly dependent on, or highly interrelated with, each other.

Question 4.3.50

Are individual advertisement spots within an advertisement campaign distinct?

Interpretive response: It depends. Media and entertainment entities commonly enter into contracts with customers to broadcast or publish a specified number of advertisement spots. Some of these contracts promise customers a certain number of spots and a cumulative guaranteed viewership across an entire advertisement campaign.

Capable of being distinct

An individual spot is capable of being distinct if the customer can benefit from it on its own or together with readily available resources. As described in section 4.3.30, this criterion establishes a baseline level of economic substance that an individual good or service needs to be distinct. The economic benefits to a customer are generated by the audience that watches the spot and not solely from the act of airing it. However, we believe that a spot generally is capable of being distinct because there is a baseline of economic substance in each spot regardless of whether additional spots are provided or a guaranteed audience was promised.

Distinct in the context of the contract

An individual spot, however, may not be separately identifiable when the nature of the promise is to provide cumulative guaranteed viewership across an advertising campaign and the entity will provide additional spots until the viewership is achieved.

For example, an entity uses the airing of individual spots as an input to deliver the combined output of total spots and cumulative guaranteed viewership, and the total consideration is non-cancellable after the airing of the first spot. Each spot and the viewership obtained affect the entity's ability to deliver its promises for the entire campaign. If the designated spots fail to deliver the cumulative guaranteed viewership, the entity has not satisfied its promise and must air more spots to achieve the guarantee.

In this example, the individual spots are all highly interrelated inputs used to fulfill the promise to provide viewership and advertisement spot guarantee (the combined output) and are not distinct in the context of the contract. Because each of the promises is not distinct, the promises are combined into a single performance obligation – the advertising campaign, insertion order or flight plan.

However, to the extent that a cumulative guaranteed viewership is not included in the arrangement and each spot is not dependent on any other spot – i.e. the spots are no longer highly affected or highly interrelated with other promises in the contract – an entity may conclude that each spot is distinct in the context of the contract.

4.3.50 FASB examples applying the distinct criteria

Identifying and analyzing relevant facts and circumstances is critical to determining a contract's performance obligations. To assist in determining performance obligations, Topic 606 includes many examples illustrating different scenarios and indicating whether the promises in the contract are capable of being distinct and separately identifiable (distinct in the context of the contract).

The following table summarizes the examples in Topic 606.

Example #	Description of the scenario	Conclusion
10A	Entity provides a significant integration service for a building construction and delivers a single output to the customer	Single performance obligation
10B	Entity provides a significant integration service and delivers multiple complex and specialized items as single outputs to the customer	Single performance obligation
10C	Entity provides a license to anti-virus software and future unspecified updates that are highly interrelated	Single performance obligation
11A	Entity provides the customer with software, installation, unspecified upgrades and telephone support from which it can benefit separately	Multiple performance obligations
11B	Entity provides the customer with installation services that involve significant customization of the underlying software	Single performance obligation

Example #	Description of the scenario	Conclusion
11C & 11D	Entity provides customer with equipment and a separately identifiable installation service; customer required to use entity's installation service in 11D	Multiple performance obligations
11E	Entity provides the customer with equipment and proprietary consumables that are separately identifiable	Multiple performance obligations
55	Entity provides the customer with a license to IP related to design and production processing for a good, including future updates that are integral to the customer's ability to derive benefit from the license.	Single performance obligation

Excerpt from ASC 606-10

• • > Example 10 – Goods and Services Are Not Distinct

• • • > Case A – Significant Integration Service

55-137 An entity, a contractor, enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing.

55-138 The promised goods and services are capable of being distinct in accordance with paragraph 606-10-25-19(a). That is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling, or holding those goods or services.

55-139 However, the promises to transfer the goods and services are not separately identifiable in accordance with paragraph 606-10-25-19(b) (on the basis of the factors in paragraph 606-10-25-21). This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.

55-140 Because both criteria in paragraph 606-10-25-19 are not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

• • • > Case B – Significant Integration Service

55-140A An entity enters into a contract with a customer that will result in the delivery of multiple units of a highly complex, specialized device. The terms of the contract require the entity to establish a manufacturing process in order to produce the contracted units. The specifications are unique to the customer based on a custom design that is owned by the customer and that were developed under the terms of a separate contract that is not part of the current negotiated exchange. The entity is responsible for the overall management of the contract, which requires the performance and integration of various activities including procurement of materials; identifying and managing subcontractors; and performing manufacturing, assembly, and testing.

55-140B The entity assesses the promises in the contract and determines that each of the promised devices is capable of being distinct in accordance with paragraph 606-10-25-19(a) because the customer can benefit from each device on its own. This is because each unit can function independently of the other units.

55-140C The entity observes that the nature of its promise is to establish and provide a service of producing the full complement of devices for which the customer has contracted in accordance with the customer's specifications. The entity considers that it is responsible for overall management of the contract and for providing a significant service of integrating various goods and services (the inputs) into its overall service and the resulting devices (the combined output) and, therefore, the devices and the various promised goods and services inherent in producing those devices are not separately identifiable in accordance with paragraphs 606-10-25-19(b) and 606-10-25-21. In this Case, the manufacturing process provided by the entity is specific to its contract with the customer. In addition, the nature of the entity's performance and, in particular, the significant integration service of the various activities mean that a change in one of the entity's activities to produce the devices has a significant effect on the other activities required to produce the highly complex specialized devices such that the entity's activities are highly interdependent and highly interrelated. Because the criterion in paragraph 606-10-25-19(b) is not met, the goods and services that will be provided by the entity are not separately identifiable, and, therefore, are not distinct. The entity accounts for all of the goods and services promised in the contract as a single performance obligation.

• • • > Case C – Combined Item

55-140D An entity grants a customer a three-year term license to anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The entity frequently provides updates that are critical to the continued utility of the software. Without the updates, the customer's ability to benefit from the software would decline significantly during the three-year arrangement.

55-140E The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer), while the customer can benefit from the updates together with the software license transferred at the outset of the contract.

55-140F The entity concludes that its promises to transfer the software license and to provide the updates, when-and-if available, are not separately identifiable (in accordance with paragraph 606-10-25-19(b)) because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The updates significantly modify the functionality of the software (that is, they permit the software to protect the customer from a significant number of additional viruses that the software did not protect against previously) and are integral to maintaining the utility of the software license to the customer. Consequently, the license and updates fulfill a single promise to the customer in the contract (a promise to provide protection from computer viruses for three years). Therefore, in this Example, the entity accounts for the software license and the when-and-if available updates as a single performance obligation. In accordance with paragraph 606-10-25-33, the entity concludes that the nature of the combined good or service it promised to transfer to the customer in this Example is computer virus protection for three years. The entity considers the nature of the combined good or service (that is, to provide anti-virus protection for three years) in determining whether the performance obligation is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and in determining the appropriate method for measuring progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37.

• • > Example 11 – Determining Whether Goods or Services Are Distinct

• • • > Case A – Distinct Goods or Services

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, 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.

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. The customer can benefit from the updates together with the software license transferred at the outset of the contract. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 606-10-25-19(a) is met.

55-143 The entity also considers the principle and the factors in paragraph 606-10-25-21 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus, the criterion in paragraph 606-10-25-19(b) is met). In reaching this determination the entity considers that although it integrates the software into the customer's system, the installation services do not significantly affect the customer's ability to use and benefit from the software license because the installation services are routine and can be obtained from alternate providers. The software updates do not significantly affect the customer's ability to use and benefit from the software license because, in contrast with Example 10 (Case C), the software updates in this contract are not necessary to ensure that the software maintains a high level of utility to the customer during the license period. The entity further observes that none of the promised goods or services significantly modify or customize one another and the entity is not providing a significant service of integrating the software and the services into a combined output. Lastly, the entity concludes that the software and the services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the initial software license independent from its promise to subsequently provide the installation service, software updates, or technical support.

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.

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 paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A (see Example 54 in paragraphs 606-10-55-362 through 55-363B).

• • • > Case B – Significant Customization

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.

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 first assesses whether the criterion in paragraph 606-10-25-19(a) has been met. For the same reasons as in Case A, the entity determines that the software license, installation, software updates, and technical support each meet that criterion. The entity next assesses whether the criterion in paragraph 606-10-25-19(b) has been met by evaluating the principle and the factors in paragraph 606-10-25-21.The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) specified in the contract (see paragraph 606-10-25-21(a)). The software is significantly modified and customized by the service (see paragraph 606-10-25-21(b)). Consequently, the entity determines that the promise to transfer the license is not separately identifiable from the customized installation service and, therefore, the criterion in paragraph 606-10-25-19(b) is not met. Thus, the software license and the customized installation service are not distinct.

55-148 On the basis of the same analysis as in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

55-149 On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a. Software customization which is comprised of the license to the software and the customized installation service
b. Software updates
c. Technical support.

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 and paragraphs 606-10-25-31 through 25-37 to measure progress toward complete satisfaction of those performance obligations determined to be satisfied over time. In applying those paragraphs to the software customization, the entity considers that the customized software to which the customer will have rights is functional intellectual property and that the functionality of that software will not change during the license period as a result of activities that do not transfer a good or service to the customer. Therefore, the entity is providing a right to use the customized software. Consequently, the software customization performance obligation is completely satisfied upon completion of the customized installation service. The entity considers the other specific facts and circumstances of the contract in the context of the guidance in paragraphs 606-10-25-23 through 25-30 in determining whether it should recognize revenue related to the single software customization performance obligation as it performs the customized installation service or at the point in time the customized software is transferred to the customer.

• • • > Case C – Promises Are Separately Identifiable (Installation)

55-150A An entity contracts with a customer to sell a piece of equipment and installation services. The equipment is operational without any customization or modification. The installation required is not complex and is capable of being performed by several alternative service providers.

55-150B The entity identifies two promised goods and services in the contract: (a) equipment and (b) installation. The entity assesses the criteria in paragraph 606-10-25-19 to determine whether each promised good or service is distinct. The entity determines that the equipment and the installation each meet the criterion in paragraph 606-10-25-19(a). The customer can benefit from the equipment on its own, by using it or reselling it for an amount greater than scrap value, or together with other readily available resources (for example, installation services available from alternative providers). The customer also can benefit from the installation services together with other resources that the customer will already have obtained from the entity (that is, the equipment).

55-150C The entity further determines that its promises to transfer the equipment and to provide the installation services are each separately identifiable (in accordance with paragraph 606-10-25-19(b)). The entity considers the principle and the factors in paragraph 606-10-25-21 in determining that the equipment and the installation services are not inputs to a combined item in this contract. In this Case, each of the factors in paragraph 606-10-25-21 contributes to, but is not individually determinative of, the conclusion that the equipment and the installation services are separately identifiable as follows:

a. The entity is not providing a significant integration service. That is, the entity has promised to deliver the equipment and then install it; the entity would be able to fulfill its promise to transfer the equipment separately from its promise to subsequently install it. The entity has not promised to combine the equipment and the installation services in a way that would transform them into a combined output.
b. The entity's installation services will not significantly customize or significantly modify the equipment.
c. Although the customer can benefit from the installation services only after it has obtained control of the equipment, the installation services do not significantly affect the equipment because the entity would be able to fulfill its promise to transfer the equipment independently of its promise to provide the installation services. Because the equipment and the installation services do not each significantly affect the other, they are not highly interdependent or highly interrelated.

On the basis of this assessment, the entity identifies two performance obligations (the equipment and installation services) in the contract.

55-150D The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time.

• • • > Case D – Promises Are Separately Identifiable (Contractual Restrictions)

55-150E Assume the same facts as in Case C, except that the customer is contractually required to use the entity's installation services.

55-150F The contractual requirement to use the entity's installation services does not change the evaluation of whether the promised goods and services are distinct in this Case. This is because the contractual requirement to use the entity's installation services does not change the characteristics of the goods or services themselves, nor does it change the entity's promises to the customer. Although the customer is required to use the entity's installation services, the equipment and the installation services are capable of being distinct (that is, they each meet the criterion in paragraph 606-10-25-19(a)), and the entity's promises to provide the equipment and to provide the installation services are each separately identifiable (that is, they each meet the criterion in paragraph 606-10-25-19(b)). The entity's analysis in this regard is consistent with Case C.

• • • > Case E – Promises Are Separately Identifiable (Consumables)

55-150G An entity enters into a contract with a customer to provide a piece of off-the-shelf equipment (that is, it is operational without any significant customization or modification) and to provide specialized consumables for use in the equipment at predetermined intervals over the next three years. The consumables are produced only by the entity, but are sold separately by the entity.

55-150H The entity determines that the customer can benefit from the equipment together with the readily available consumables. The consumables are readily available in accordance with paragraph 606-10-25-20 because they are regularly sold separately by the entity (that is, through refill orders to customers that previously purchased the equipment). The customer can benefit from the consumables that will be delivered under the contract together with the delivered equipment that is transferred to the customer initially under the contract. Therefore, the equipment and the consumables are each capable of being distinct in accordance with paragraph 606-10-25-19(a).

55-150I The entity determines that its promises to transfer the equipment and to provide consumables over a three-year period are each separately identifiable in accordance with paragraph 606-10-25-19(b). In determining that the equipment and the consumables are not inputs to a combined item in this contract, the entity considers that it is not providing a significant integration service that transforms the equipment and consumables into a combined output. Additionally, neither the equipment nor the consumables are significantly customized or modified by the other. Lastly, the entity concludes that the equipment and the consumables are not highly interdependent or highly interrelated because they do not significantly affect each other. Although the customer can benefit from the consumables in this contract only after it has obtained control of the equipment (that is, the consumables would have no use without the equipment) and the consumables are required for the equipment to function, the equipment and the consumables do not each significantly affect the other. This is because the entity would be able to fulfill each of its promises in the contract independently of the other. That is, the entity would be able to fulfill its promise to transfer the equipment even if the customer did not purchase any consumables and would be able to fulfill its promise to provide the consumables even if the customer acquired the equipment separately

55-150J On the basis of this assessment, the entity identifies two performance obligations in the contract for the following goods or services:

a. The equipment
b. The consumables.

55-150K 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.

• > Licensing

• • > Example 55—License of Intellectual Property

55-364 An entity enters into a contract with a customer to license (for a period of three years) intellectual property related to the design and production processes for a good. The contract also specifies that the customer will obtain any updates to that intellectual property for new designs or production processes that may be developed by the entity. The updates are integral to the customer's ability to derive benefit from the license during the license period because the intellectual property is used in an industry in which technologies change rapidly.

55-365 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer can benefit from (a) the license on its own without the updates and (b) the updates together with the initial license. Although the benefit the customer can derive from the license on its own (that is, without the updates) is limited because the updates are integral to the customer's ability to continue to use the intellectual property in an industry in which technologies change rapidly, the license can be used in a way that generates some economic benefits. Therefore, the criterion in paragraph 606-10-25-19(a) is met for the license and the updates.

55-365A The fact that the benefit the customer can derive from the license on its own (that is, without the updates) is limited (because the updates are integral to the customer's ability to continue to use the license in the rapidly changing technological environment) also is considered in assessing whether the criterion in paragraph 606-10-25-19(b) is met. Because the benefit that the customer could obtain from the license over the three-year term without the updates would be significantly limited, the entity's promises to grant the license and to provide the expected updates are, in effect, inputs that, together fulfill a single promise to deliver a combined item to the customer. That is, the nature of the entity's promise in the contract is to provide ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. The promises within that combined item (that is, to grant the license and to provide when-and-if available updates) are therefore not separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b).

55-366 The nature of the combined good or service that the entity promised to transfer to the customer is ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. Based on this conclusion, the entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to determine the appropriate method for measuring progress toward complete satisfaction of the performance obligation. The entity concludes that because the customer simultaneously receives and consumes the benefits of the entity's performance as it occurs, the performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) and that a time-based input measure of progress is appropriate because the entity expects, on the basis of its relevant history with similar contracts, to expend efforts to develop and transfer updates to the customer on a generally even basis throughout the three-year term.

4.4 Assess whether a series of distinct goods or services exists

Excerpt from ASC 606-10

> Identifying Performance Obligations

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).

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.

4.4.10 Overview

A promised good or service that meets the distinct criteria may have to be combined with goods or services that are substantially the same into one performance obligation under the series guidance. For example, a two-year services contract may consist of 24 distinct monthly (or even 730 daily) service periods during which the entity is providing the same service to the customer. If the series guidance applies, rather than having 24 (or even 730) separate performance obligations, an entity has one performance obligation comprising the distinct services performed over the two-year contract period.

The series guidance applies only to promised goods or services that are distinct individually. Two or more distinct promised goods or services are combined under this guidance into one performance obligation when the following criteria are met.

The series guidance was included in Topic 606 to simplify application of the revenue model and to promote consistency in identifying performance obligations. In particular, without this guidance some repetitive service contracts may have been separated into multiple performance obligations (e.g. delivering electricity or transaction processing). This would require an entity to allocate consideration to each increment of service. For example, without the series guidance, an entity may need to allocate consideration to each hour or day of service in a cleaning service contract. [ASU 2014-09.BC114]

The series guidance is not limited to traditional services. The guidance also can apply to contracts to manufacture or create multiple tangible assets; however, each of the distinct goods must be transferred over time. For example, this may apply to contracts in the aerospace and defense industries or with contract manufacturers (see Example 4.4.40).

4.4.20 Effect of series guidance

Applying the series guidance to a group of distinct goods or services can affect the allocation of variable consideration, accounting for contract modifications and disclosure requirements.

Effect on variable consideration. Typically variable consideration is attributable to the entire performance obligation unless the variable consideration allocation exception applies (see section 6.7). In particular, that exception has specific application to performance obligations that are considered a series. If the criteria to apply the exception are met, variable amounts are allocated entirely to one or more, but not all, portions of the series. [606-10-32-39 – 32-40]

Consider an example of a performance obligation to provide hotel management services for one year that is a series of distinct days and in which the consideration is variable and determined based on 2% of daily occupancy fees. Assuming the criteria to apply the exception are met, if occupancy fees were $1,000 on Day 1 and $2,000 on Day 2, based on the 2% rate charged, the entity would allocate $20 to Day 1 and $40 to Day 2 and so forth rather than allocating the daily fees to the entire performance obligation. [ASU 2014-09.BC285]

In some cases, such as the example in the preceding paragraph, entities would not need to estimate the variable consideration for the entire contract and could in effect recognize the fees in the period in which they are earned. See section 6.7 for guidance on applying the variable consideration allocation exception to a series.

Effect on disclosure. When variable consideration is allocated entirely to a distinct good or service that is wholly unperformed (i.e. has not been transferred or partially satisfied), the entity may not need to disclose an estimate of those variable amounts in the remaining performance obligation disclosure if it elects to apply one of the optional exemptions (see section 15.7).

Effect on contract modifications. Identifying a performance obligation as a series could significantly affect the accounting for contract modifications. This is because the contract modification accounting model differs depending on whether the remaining goods or services to be provided after a contract modification are distinct from the goods or services provided before the modification. When the remaining goods or services are part of a performance obligation that is a series, the remaining items in that performance obligation are distinct. Consequently, the accounting for a modification will differ depending on whether the entity concludes that a contract contains (1) a performance obligation containing a series of distinct goods or services or (2) a performance obligation that is not a series. See section 11.3 for guidance on accounting for contract modifications. [ASU 2014-09.BC79, BC115]

Question 4.4.10

Is the series guidance optional?

Interpretive response: No, the series guidance is not optional. If the series requirements are met for a group of goods or services, then those items are treated as a single performance obligation.

Further, an entity is not permitted to account for a single performance obligation comprising a series of distinct goods or services in the same manner as a single performance obligation that comprises nondistinct goods or services. For example, as noted above, variable consideration could be allocated differently depending on whether the single performance obligation is a series or not a series.

Question 4.4.20

To apply the series guidance, does the accounting result need to be the same as if the underlying distinct goods or services were accounted for as separate performance obligations?

Interpretive response: No. There are criteria to determine whether the series guidance is applied. Those criteria do not require an assessment of the amount or timing of revenue that would have been recognized in a period with or without applying the series guidance. [606-10-25-15, TRG 03-15.27]

Consider the following scenarios that demonstrate the result can and often will be different because of the series guidance.

An entity contracts with a customer to perform a manufacturing service that results in the production of 50 widgets over a three-year period. The contract price is $500 million and the stand-alone selling price for each widget is $10 million.

Total expected costs are anticipated to be $400 million. The service the entity will provide to the customer in producing each widget is substantially the same, but the design is new, so the entity expects a decline in production costs over time. Production of the first 25 units is expected to cost $9 million/widget. The cost to produce the other 25 widgets are expected to be $7 million/widget.

The entity determines that each service the entity will provide in producing one of the 50 widgets is distinct, meets the criteria to be satisfied over time, and that the same cost-based measure of progress would be used for each service the entity provides to produce one widget (therefore, the series criteria are met). The following demonstrates the difference in accounting that results from concluding the series guidance applies compared to the accounting that would result if it was determined that the contract is for 50 separate performance obligations.

Total contract		Series provision (1 PO)		50 Separate POs	
(in millions)		Units 1-25[1]	Units 25-50[2]	Units 1-25[3]	Units 25-50[3]
Revenue	$500	$281	$219	$250	$250
Costs	400	225	175	225	175
Margin	$100	$ 56	$ 44	$ 25	$ 75

Although $100 million in margin is recognized for the contract under both scenarios, there is a timing difference in terms of revenue recognition and margin recognition because more revenue is recognized in relation to the service to produce the first 25 widgets and less in relation to its service to produce the final 25 widgets when the series is accounted for as a single performance obligation using a single measure of progress towards complete satisfaction.

Notes:

1. Revenue: ($225 million in costs / $400 million total costs) × $500 million total revenue = $281 million.
   Costs: $9 million/widget × 25 widgets = $225 million.
2. Revenue: ($175 million in costs / $400 million total costs) × $500 million total revenue = $219 million.
   Costs: $7 million/widget × 25 widgets = $175 million.
3. Revenue (both tranches): ($500 million total revenue / 50 widgets) × 25 widgets = $250 million.
   Costs (Tranche 1): $9 million/widget × 25 widgets = $225 million.
   Costs (Tranche 2): $7 million/widget × 25 widgets = $175 million.

See chapter 7 for more information regarding the pattern of recognizing revenue. [TRG 03-15.27]

Question 4.4.30

Do the distinct goods or services need to be provided consecutively to apply the series guidance?

Interpretive response: No. To apply the series guidance, it is not necessary that the goods be delivered or services performed consecutively over the contract period. There may be a gap or an overlap in delivery or performance, and this would not affect the assessment of whether the series guidance applies. Although the FASB specifically contemplated a consecutively delivered contract (e.g. repetitive service arrangement), it did not make this a criterion for applying the series guidance. [TRG 03-15.27]

Both of the following scenarios meet the criteria to be accounted for as a series despite the fact that the parts are produced over different periods.

Scenario 1: An entity has contracted with a customer to provide a manufacturing service in which it will produce 500 parts per month for a four-year period. The service will be performed evenly over the four years with no breaks in production (consecutively). The parts produced under this contract are substantially the same and are manufactured to the specifications of the customer.

Assume that the entity's service of producing each part is a distinct service because it meets the two criteria for being distinct. Additionally, the service is accounted for as a performance obligation satisfied over time because:

- the parts are manufactured specific to the customer – the entity's performance does not create an asset with alternative use to the entity; and
- if the contract were to be cancelled, the entity has an enforceable right to payment (cost plus a reasonable profit margin).

Therefore, the criteria under the series guidance are met. [TRG 03-15.27]

Scenario 2: Assume the same facts as in Scenario 1, except that the entity does not plan to perform evenly over the four-year service period (non-consecutive performance). That is, the entity does not produce 500 parts a month, continuously. Instead, the entity plans to perform the manufacturing service over the four years, but in achieving the production targets, the entity produces 1,000 parts in some months and zero parts in other months. The entity would still conclude that the parts are a series because the guidance does not require consecutive performance. [TRG 03-15.27]

4.4.30 Applying the series guidance

Overview

The series guidance requires that all of the distinct goods or services in a series be substantially the same and have the same pattern of transfer. An entity could evaluate whether a contract includes a performance obligation that is a series in a number of ways. [606-10-25-14 – 25-15]

In some cases, an entity might apply a bottoms-up approach. In a bottoms-up approach, the entity starts by identifying each distinct good or service in a contract and then considers whether those items should be combined with other distinct goods or services into a series. For example, when the entity enters into a contract to provide customized widgets, the entity may start its analysis by identifying each widget as a distinct item. From there, it would determine if each distinct item is satisfied over time. If each widget is satisfied over time, the entity would then need to consider whether the widgets are substantially the same and have the same pattern of transfer as other widgets in the contract.

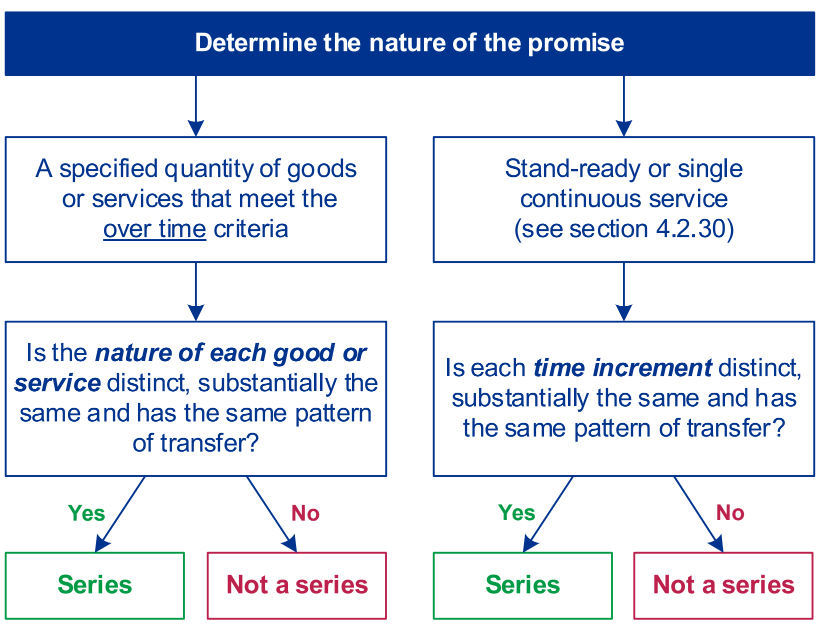
In other cases, an entity may apply a top-down approach. Under this approach, an entity first identifies the performance obligations in the contract and then evaluates whether each performance obligation that is satisfied over time is a series. For example, an entity might enter into a contract to provide cleaning services for a year and conclude that it is providing a single performance obligation satisfied over time. However, because identifying whether a performance obligation is a series could be critical to the accounting for modifications or variable consideration, the entity would still need to evaluate whether that single performance obligation is a series. In that case, the entity would evaluate whether the cleaning services could be divided into distinct service increments that are substantially the same.

Identifying the nature of the promise

To be a series, each distinct good or service needs to be substantially the same and have the same pattern of transfer. This means an entity evaluates each promise to determine if it (1) is distinct, (2) is substantially the same as other distinct promises and (3) has the same pattern of transfer as other distinct promises that are substantially the same. [606-10-25-14 – 25-15]

The TRG agreed that understanding the nature of the promise will help entities with this evaluation. Specifically, the key to this evaluation will typically be whether the nature of the promise is to (1) provide specified quantities of goods or services or (2) provide a service of standing-ready or a single continuous service. This is key because the good or service the entity evaluates the criteria against may differ based on the nature of the goods or services. [TRG 07-15.39]

The following chart illustrates the steps that an entity might take under either approach.



Specified quantity of a good or service

If the nature of the promise is the delivery of a specified quantity of goods or services, an entity evaluates whether each unit of the good or service is distinct, substantially the same and has the same pattern of transfer.

For example, if the entity promises to process 25 transactions, it evaluates whether **each transaction** is distinct, substantially the same and has the same pattern of transfer. Similarly, if the entity promises to manufacture 10 customized goods that each meet the criteria to be recognized over time, the entity considers whether **each of the customized goods** is distinct, substantially the same and has the same pattern of transfer.

Stand-ready or single continuous service

If the nature of the entity's promise is to stand ready or to provide a single service for a period of time, the entity evaluates whether **each time increment** is distinct, substantially the same and has the same pattern of transfer. It is generally not important that the entity might undertake different activities to fulfill that promise. Rather, what is important is that the overall promise is the same for each service period (see Question 4.4.50). See section 4.2.30 for further discussion of identifying a stand-ready obligation.

Evaluating whether the overall promise is the same each day is consistent with the conclusion that the underlying activities are not distinct but are inputs (or fulfillment activities) to provide the combined output (the overall service). For example, in the hotel management scenario illustrated in Example 12A in Topic 606 (reproduced below), the entity concludes that each day of service is substantially the same even though the underlying fulfillment activities change each day because those individual activities are not distinct from each other. If the underlying activities are distinct from each other, those activities should be accounted for as separate performance obligations. [TRG 07-15.39]

The TRG discussed application of the series guidance in the context of service contracts. That discussion and paper effectively applied a top-down approach to performance obligations in long-term service arrangements that are stand-ready obligations or a single continuous service. The top-down approach takes place after identification of the performance obligations and is not a substitute for applying the separation criteria. [TRG 07-15.39]

Excerpt from ASC 606-10

• • > Example 12A—Series of Distinct Goods or Services

55-157B An entity, a hotel manager, enters into a contract with a customer to manage a customer-owned property for 20 years. The entity receives consideration monthly that is equal to 1 percent of the revenue from the customer-owned property.

55-157C The entity evaluates the nature of its promise to the customer in this contract and determines that its promise is to provide a hotel management service. The service comprises various activities that may vary each day (for example, cleaning services, reservation services, and property maintenance). However, those tasks are activities to fulfill the hotel management service and are not separate promises in the contract. The entity determines that each increment of the promised service (for example, each day of the management service) is distinct in accordance with paragraph 606-10-25-19. This is because the customer can benefit from each increment of service on its own (that is, it is capable of being distinct) and each increment of service is separately identifiable because no day of service significantly modifies or customizes another and no day of service significantly affects either the entity's ability to fulfill another day of service or the benefit to the customer of another day of service.

55-157D The entity also evaluates whether it is providing a series of distinct goods or services in accordance with paragraphs 606-10-25-14 through 25-15. First, the entity determines that the services provided each day are substantially the same. This is because the nature of the entity's promise is the same each day and the entity is providing the same overall management service each day (although the underlying tasks or activities the entity performs to provide that service may vary from day to day). The entity then determines that the services have the same pattern of transfer to the customer because both criteria in paragraph 606-10-25-15 are met. The entity determines that the criterion in paragraph 606-10-25-15(a) is met because each distinct service meets the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time. The customer simultaneously receives and consumes the benefits provided by the entity as it performs. The entity determines that the criterion in paragraph 606-10-25-15(b) also is met because the same measure of progress (in this case, a time-based output method) would be used to measure the entity's progress toward satisfying its promise to provide the hotel management service each day.

55-157E After determining that the entity is providing a series of distinct daily hotel management services over the 20-year management period, the entity next determines the transaction price. The entity determines that the entire amount of the consideration is variable consideration. The entity considers whether the variable consideration may be allocated to one or more, but not all, of the distinct days of service in the series in accordance with paragraph 606-10-32-39(b). The entity evaluates the criteria in paragraph 606-10-32-40 and determines that the terms of the variable consideration relate specifically to the entity's efforts to transfer each distinct daily service and that allocation of the variable consideration earned based on the activities performed by the entity each day to the distinct day in which those activities are performed is consistent with the overall allocation objective. Therefore, as each distinct daily service is completed, the variable consideration allocated to that period may be recognized, subject to the constraint on variable consideration.

Question 4.4.40

Are stand-ready obligations a series of distinct service periods?

Interpretive response: Generally, yes. If a performance obligation is a stand-ready obligation (see section 4.2.30), it will qualify as a series. This conclusion and underlying rationale is consistent with examples of outsourcing arrangements and transaction processors by the TRG (see Examples 4.4.10 and 4.4.20), as well as the hotel manager example in Topic 606 (Example 12A). In each of those examples, the nature of the entity's promise was the same integrated or stand-ready service each period and deemed to be substantially the same, distinct and have the same pattern of transfer.

Similarly, other stand-ready obligations are typically a series of distinct service periods. For a service obligation to be a series of distinct time periods, there needs to be multiple time periods within the overall performance obligation that:

- are distinct from each other;
- are substantially the same;
- are satisfied over time (based on the over-time recognition criteria – see section 7.3); and
- have the same pattern of transfer to the customer – e.g. the entity would measure progress toward complete satisfaction of each distinct service period obligation using the same measure of progress.

Consider the example of a promise to stand ready to provide an annual health club membership. Taking each of the above criteria to evaluate this performance obligation:

- **Distinct.** Each service period (e.g. each month, or even each day) within the annual period benefits the customer on its own, meaning that each service period is capable of being distinct. In addition, the entity's promises to make the health club available in one service period is separately identifiable from those service periods preceding and following it. This means that no one period of service is essential to, dependent on, or significantly modifies or customizes another period of service.
- **Substantially the same.** The entity will perform various services during each period, such as cleaning the equipment, making available different classes or activities, providing maintenance activities on the equipment. Even though the mix and quantity of activities that the entity will perform each distinct period may differ, the nature of the entity's promise each period is substantially the same.
- **Satisfied over time.** Because the nature of the entity's promise is a stand-ready obligation, rather than to provide specified goods or perform specified activities, the customer consumes and receives benefit from having access to the health club throughout the overall obligation period. Therefore, the entity's promise to perform each service period is satisfied over time.
- **Same pattern of transfer.** Regardless of the measure of progress selected for the stand-ready obligation, we would expect the same measure of progress to be applied to each distinct service period. See Question 7.4.50 for evaluation of the appropriate measure of progress for stand-ready obligations.

Question 4.4.50

Does an entity need to carry out the same activities in each time increment for a distinct service period to be considered substantially the same?

Interpretive response: No. As described in the chart above when the nature of the promise is to provide a stand-ready or continuous service to a customer, the performance obligation could be a series of time increments.

When evaluating whether a distinct time increment (e.g. day/month/year) in a stand-ready or single continuous service are substantially the same, the relevant analysis is whether the nature of the promise is the same each day and not whether the activities performed to fulfill that promise are substantially the same. When the activities are inputs into the combined output they are essentially fulfillment activities of the entity.

The TRG agreed that when the nature of the promise is to stand ready or provide a single service for a period of time, the underlying activities could vary significantly from day to day but the nature of the promise does not change from day to day. The TRG specifically discussed arrangements such as hotel management and IT outsourcing which had integrated activities that formed a single performance obligation of which the nature of the promise was a single service to the customer each day.

For example, in the hotel management service the activities required to fulfill the contract could include management of the different hotel functions such as training, procurement, reservations, etc. In that example, the underlying activities could vary significantly within a day and from day to day; however, the promise to the customer to manage the hotel is the same each day. [TRG 07-15.39]

See Question 4.4.40 for further discussion of whether a stand-ready obligation is a series.

Example 4.4.10

IT outsourcing

This example is adapted from TRG 07-15.39.

Outsourcer and Customer execute a 10-year IT outsourcing arrangement in which Outsourcer will continuously deliver outsourced activities.

Customer is billed monthly based on the different activities performed during the month and the bill may vary from month to month based on the activities performed. Outsourcer concludes that the activities are not distinct and consist of a single performance obligation that is satisfied over time. The performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits provided by its services as it performs.

Outsourcer evaluates whether the single performance obligation is a series.

Evaluate the nature of the overall promise

Outsourcer determines it is providing a single integrated outsourcing service and not a defined number of activities and services. As such, it evaluates whether the performance obligation consists of distinct service periods (e.g. time increments) that are substantially the same, distinct and have a similar pattern of transfer.

Evaluate whether each promise is distinct

Outsourcer concludes that each day of service is considered distinct because Customer can benefit from each day of service on its own and each day of service is separately identifiable – i.e. one service period does not significantly affect, modify or customize another. Outsourcer has a normal business practice to agree to extensions of similar outsourcing arrangements, and this suggests that its service in being provided in a series of time increments rather than a single, integrated service creating one combined output of the contract.

Evaluate whether each distinct service is substantially the same

Outsourcer also concludes that each day of service is substantially the same. The activities provided on a day-to-day basis to fulfill the overall promise may change, but the promise each day is the same – to provide continuous access to its service.

Evaluate whether each distinct service has the same pattern of transfer

Outsourcer concludes each distinct service period has the same pattern of transfer. That is because the nature of the promise is the same each day and therefore the same measure of progress is applied to each distinct service period.

Because all of the criteria in the series guidance are met, the performance obligation is a series.

Example 4.4.20
Transaction processor

This example is adapted from TRG 07-15.39.

Transaction Processor and Customer execute a 10-year transaction processing arrangement in which Transaction Processor will provide continuous access to its system and process all transactions on behalf of Customer. Customer is charged a fee for each transaction processed but the number of transactions processed is outside the control of Customer.

Transaction Processor concludes that the contract contains a single performance obligation satisfied over time because Customer simultaneously receives and consumes the benefits as it performs. Transaction Processor evaluates whether the single performance obligation is a series.

Evaluate the nature of the overall promise

Transaction Processor concludes that it is providing continuous access to its system (standing ready), rather than processing a particular quantity of transactions. As such, Transaction Processor evaluates whether the performance obligation consists of distinct service periods (time increments) that are substantially the same, distinct and have a similar pattern of transfer.

Evaluate whether each promise is distinct

Transaction Processor concludes that each day's service is considered distinct because Customer can benefit from accessing its system each day and each day is separately identifiable – i.e. one service period does not significantly affect, modify or customize another.

Evaluate whether each distinct service is substantially the same

Transaction Processor concludes that each day of service is substantially the same because the nature of the promise (to provide continuous access to the platform) is the same regardless of the number of transactions processed.

Evaluate whether each distinct service has the same pattern of transfer

Transaction Processor concludes that each distinct service period has the same pattern of transfer. That is because the nature of the promise is the same each day and therefore the same measure of progress is applied to each distinct service period.

Because all of the criteria in the series guidance are met, the performance obligation is a series.

Example 4.4.30
Maintenance contract

Original Equipment Manufacturer (OEM) enters into a 10-year maintenance contract with Customer. OEM provides Customer with an integrated service of maintenance and related activities for equipment that OEM sold to Customer. The scope of the contract includes services such as routine maintenance, overhauls, planned and unplanned outages and component repair or replacement. Customer pays OEM based on the equipment hours used during the contract period regardless of whether OEM performs maintenance, overhauls or makes repairs during that time period.

OEM concludes that the various promised activities – including routine maintenance, overhauls, planned and unplanned outages and component repair or replacement – in the contract are not distinct and instead comprise a single performance obligation that is satisfied over time because it is providing a significant integration service of all of the activities that are integral to maintaining the equipment each day.

Further, the performance obligation is satisfied over time because Customer simultaneously receives and consumes the benefits provided by its services as it performs. OEM evaluates whether the single performance obligation is a series.

Evaluate the nature of the overall promise

OEM concludes that it is providing a stand ready service to Customer because the nature of the promise is to deliver an unknown quantity of the underlying services including routine maintenance, overhauls, planned and unplanned outages and component repair or replacement as an integrated service when-and-as needed by Customer for 10 years. As such, OEM evaluates whether the performance obligation consists of distinct service periods (time increments) that are substantially the same and have a similar pattern of transfer.

Evaluate whether each promise is distinct

OEM concludes that each day of service is distinct because Customer can benefit from the equipment being covered by the contract and each day is separately identifiable – i.e. one service period does not significantly affect, modify or customize another. OEM also observes that as a normal business practice it agrees to extensions of similar arrangements and this suggests that its service is being provided in a series of time increments rather than a single, integrated service creating one combined output. Finally, the significant integration service combines the activities each day into a combined output rather than integrating days of service.

Evaluate whether each distinct service is substantially the same

OEM concludes that each day of service is substantially the same because the nature of the promise – standing ready to provide an unknown quantity of the underlying services when-and-if needed – is the same in every day.

Evaluate whether each distinct service has the same pattern of transfer

OEM concludes that each distinct service period has the same pattern of transfer.

Conclusion

Because all of the criteria in the series guidance are met, the performance obligation is a series.

Example 4.4.40
Customized goods

Manufacturer agrees to produce 1,000 customized widgets for use by Customer in its products. Manufacturer applies a bottoms up approach to evaluate whether its performance obligation is a series.

Evaluate the nature of the overall promise

Manufacturer determines that the nature of the promise is to deliver the specified quantity of widgets over time.

Evaluate whether each promise is distinct

Manufacturer concludes that each of the 1,000 widgets is distinct because:

- Customer can use each widget on its own; and
- each widget is separately identifiable from the others because one does not significantly affect, modify or customize another.

Evaluate whether each distinct good or service is substantially the same

Manufacturer concludes that each widget is substantially the same.

Evaluate whether each distinct good or service has the same pattern of transfer

Manufacturer concludes that the widgets will transfer to Customer over time because:

— they have no alternative use to Manufacturer; and
— Customer is contractually obligated to pay Manufacturer for any finished or in-process widgets, including a reasonable margin, if Customer terminates the contract for convenience.

Manufacturer uses a cost-to-cost measure of progress for each widget.

Despite the fact that each widget is distinct, Manufacturer concludes that the 1,000 units are a single performance obligation because:

— each widget will transfer to Customer over time; and
— Manufacturer uses the same method to measure progress toward complete satisfaction of the obligation to transfer each widget to Customer.

Because all of the criteria in the series guidance are met, the performance obligation is a series.

Consequently, the transaction price for all 1,000 widgets is recognized over time using the cost-to-cost measure of progress. This outcome may be different from the outcome of allocating a fixed amount to each widget if each one were a performance obligation (see Question 4.4.20).

Question 4.4.60

Is a performance obligation to provide a *single* tangible asset satisfied over time a series?

Interpretive response: Generally, no. A contract to construct or manufacture a single tangible asset typically includes various promised goods or services (e.g. procurements of raw materials, design, and constructing or manufacturing the tangible asset). However, the nature of the overall promise when creating or enhancing an asset (e.g. the construction of a single piece of equipment) is to produce a single output. Those promised goods or services are not distinct from each other because they are inputs into the combined output. Because a series requires multiple distinct goods or services, the performance obligation to produce a single tangible asset would not be a series. Further, because the nature of the promise to produce a single output is not a stand-ready obligation, the entity does not consider whether the performance obligation is made up of a series of distinct time increments.

Conversely, a contract to create or enhance more than one distinct tangible asset that each meet the criteria to be recognized over time could be a series if all the other series criteria are met (see Question 4.4.20 and Example 4.4.40).

Question 4.4.70

Are project-based services satisfied over time a series?

Interpretive response: Generally, no. A project-based service satisfied over time would be one in which the entity provides a defined final deliverable that the customer does not benefit from until completion. An example is a service that culminates in a valuation report. Typically, these performance obligations are satisfied over time when the entity's performance does not create an asset with an alternative future use to the entity and the entity has an enforceable right to payment for performance completed to date (see section 7.3.40).

We believe the nature of the promise in these types of services is to produce a single combined output, such as a valuation report in the above example. Consistent with Question 4.4.60, because the entity is promising a specified quantity of services, such as a single valuation report, it does not consider whether the performance obligation is made up of distinct time increments. Further, the services performed to fulfill that promise would not be distinct from each other because they are inputs into the combined output. However, a contract to provide two such services in a single contract could be a series of two distinct services.

Question 4.4.80

Is each year in a multi-year sponsorship arrangement a separate performance obligation?

Background: An entity that owns a sports team or venue (e.g. arena or stadium) may enter into contracts with customers referred to as sponsorship arrangements that provide the customer with advertising rights related to the team or venue. These arrangements often involve a substantial number of promises and may include leases, in which case the entity needs to separate the lease and non-lease components before applying the revenue standard to these contracts unless it applies the lessor practical expedient under Topic 842 (see Question 2.4.10).

For example, a team may enter into a multi-year contract with a car company that allows the car company to use the team's logos and trademarks in its own advertising and be considered the official car of the team. In addition, the contract provides the car company with advertising (e.g. announcements during the game, on tickets, on game programs, its logo on the playing surface) or naming rights (e.g. the official car company section of the stadium). Typically, many, if not all, of the promises are the same in each year of the contract.

It is important to determine whether the promises that are satisfied over time over multiple periods should be combined into a single series performance obligation or multiple performance obligations, because that could affect the allocation of the transaction price and measure of progress. For example, the entity will need to evaluate whether naming rights for the entire contract should be a single performance obligation or multiple performance obligations (i.e. each year is separate). If the services transferred over time in each year are substantially the same each period and have the same pattern of transfer, the services are combined into a single series performance obligation. If they are not substantially the same or do not have the same pattern of transfer, the services in each year would be separate performance obligations.

Interpretive response: Generally, no. In most cases, we believe that each year of a multi-year enforceable sponsorship arrangement is not a separate performance obligation. If the entity has promised the same service in each period and that service is transferred over time, it should be accounted for as a single series performance obligation for the entire enforceable contract period. This is because the nature of the promise is substantially the same each year and the service has the same pattern of transfer in each period. For example, each year when providing naming rights or other advertising, the underlying activities (e.g. the season being played) is not relevant. The promise is the right or specified advertising activity and not the season or events.

Typically, these arrangements contain multiple, distinct promises that are satisfied over time, each of which span the entire arrangement. For example, if a contract includes naming rights and a promise to display the customer's logo on a team's basketball court for five years, there are two performance obligations that are each satisfied over five years. In that case, the entity may have multiple series performance obligations.

In contrast, if a contract provides different services each year, those different services are different performance obligations. For example, if an entity promises to display the customer's logo on the court in Year 1 and display the logo on its napkins in the concession stand in Year 2, there are two performance obligations that are satisfied in different years because the nature of the promise is different each year.

When a performance obligation spans the entire contractual period, it is inappropriate to allocate fixed consideration to each period of the arrangement based on stated contractual prices for those periods. Instead, the entity recognizes the amount allocated to the entire performance obligation using a single measure of progress. See Question 6.7.110 for guidance on allocating fixed consideration to distinct goods or services within a series.

Example 4.4.50
Sponsorship arrangement

Basketball Team enters into a five-year non-cancellable sponsorship contract with Car Company for a fixed fee paid in quarterly installments. The fee is $1,000 ($250 per quarter) in Year 1, increases by $100 each year, and is due at the beginning of each year.

The contract includes two promises:

— **License:** Car Company has the right to use Basketball Team's brand and logo throughout the five-year term.

— **Advertising:** An obligation to display Car Company's logo on the court during the team's 41 regular season home games during the five-year term.

The contract does not contain a lease, and the standalone selling price is $4,000 for the license and $2,000 for the advertising. Basketball Team evaluates the contract as follows.

What is the contract term?

Basketball Team concludes that the contract is term is five years because both parties have enforceable rights and obligations throughout the five-year period. See section 3.8.10.

Are the promises distinct from each other?

Basketball Team concludes that the license and advertising are separate performance obligations. Each promise is capable of being distinct because Car Company can benefit from each promise on its own. Additionally, each promise is distinct within the context of the contract because there is no significant service of integrating the promises, the two promises do not modify each other, and the two services are not highly interdependent or interrelated; each service can be fulfilled independently by Basketball Team.

Is each year a separate performance obligation?

Basketball Team concludes that the license is related to symbolic IP and therefore is a series (see Example 10.9.10) and a single performance obligation. As such, while each increment of time in the license is distinct, those increments of time are accounted for as a single performance obligation satisfied over five years.

Further, Basketball Team concludes the advertising is a series for the following reasons.

— **Each time increment is distinct.** Each time increment (e.g. each game, season, contract period) is capable of being distinct because the customer can benefit from the advertising on its own (i.e. without other time increments). Further, each time increment is separately identifiable because Basketball Team does not provide a service of integrating each time increment, each time increment does not customize or modify other time increments and each time increment does not significantly affect the other (i.e. can be fulfilled independently).

— **Each time increment is satisfied over time.** Car Company simultaneously receives and consumes the benefits of the advertising as a game is played. Therefore, Criterion 1 of the criteria to be satisfied over time has been met (see section 7.3.30).

— **Each time increment of service is substantially the same.** The nature of the promise is to provide advertising during each time increment. The underlying season, time period, players, etc. do not change the nature of the promise. Car Company's ability to change the advertising does not change what Basketball Team has promised (the same right to advertise on the court each home game).

— **Each time increment has the same pattern of transfer.** The nature of the promise is the same each game and therefore the same measure of progress is applied to each game period.

Because all of the criteria are met, the advertising is a series and a single performance obligation for the entire contract term. Accordingly, each game, season or year cannot be a separate performance obligation.

What is the transaction price?

The transaction price consists of fixed consideration each period. The total transaction price is $6,000: $1,000 + $1,100 + $1,200 + $1,300 + $1,400.

How is the transaction price allocated to each performance obligation?

The transaction price is allocated to the two performance obligations on a relative stand-alone selling price basis. Since the consideration is fixed, the contractual amount cannot be allocated to a portion (i.e. year) of either performance obligation (see Question 4.4.20).

Basketball team allocates $4,000 ($6,000 × ($4,000/6,000)) to the license and $2,000 ($6,000 × ($2,000/6,000)) to advertising.

What is the appropriate measure of progress?

Basketball Team concludes the following for each performance obligation.

- **License.** A time-elapsed measure of progress is appropriate because the customer benefits from its rights under the license of symbolic IP throughout the term and not just during the season (see Question 10.9.10).
- **Advertising.** A per-game output method depicts Basketball Team's progress toward complete satisfaction. Because the same number of games occur in a fiscal/contract year, the same number will be recognized in each period.

The as-invoiced practical expedient (i.e. recognize revenue in an amount that it has the right to invoice) does not apply because the pattern of invoicing (each quarter) does not correspond to Basketball Team's performance for both performance obligations. The unit of account for applying the as-invoiced expedient is a performance obligation, but in this example there are two performance obligations that are satisfied in different patterns. Even if the pattern of invoicing corresponded with the performance for both performance obligations, Basketball Team would need to evaluate whether the increasing prices represented changes in value to the customer. See Question 7.4.60.

Summary

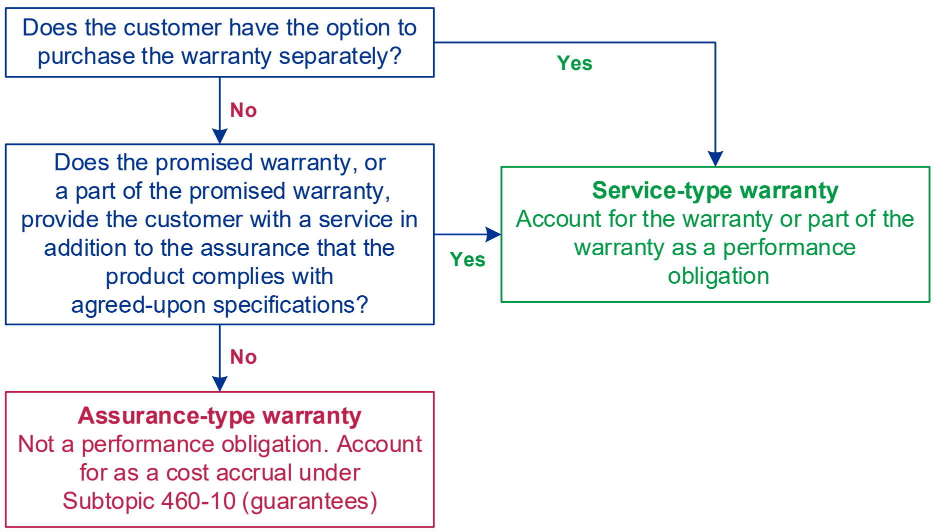
Basketball Team records the following over the five-year term.

Contract year	License revenue	Advertising revenue	Total revenue	Cash received	Contract asset EOY
1	$800	$400	**$1,200**	$1,000	$200
2	800	400	**$1,200**	1,100	300
3	800	400	**$1,200**	1,200	300
4	800	400	**$1,200**	1,300	200
5	800	400	**$1,200**	1,400	0
Total	**$4,000**	**$2,000**	**$6,000**	**$6,000**	

4.5 Warranties

4.5.10 Overview

The accounting for a warranty depends on whether it is a performance obligation under the contract. If it is, Topic 606 applies in the same way as for all other performance obligations. The following diagram summarizes the process of determining the appropriate accounting.



Excerpt from ASC 606-10

• > Warranties

55-30 It is common for an entity to provide (in accordance with the contract, the law, or the entity's customary business practices) a warranty in connection with the sale of a product (whether a good or service). The nature of a warranty can vary significantly across industries and contracts. Some warranties provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

55-31 If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity should account for the promised warranty as a performance obligation in accordance with paragraphs 606-10-25-14 through 25-22 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 606-10-32-28 through 32-41.

55-32 If a customer does not have the option to purchase a warranty separately, an entity should account for the warranty in accordance with the guidance on product warranties in Subtopic 460-10 on guarantees, unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

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.

55-34 If a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation. Therefore, an entity should allocate the transaction price to the product and the service. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity should account for both of the warranties together as a single performance obligation.

55-35 A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark, or other infringement by the entity's products does not give rise to a performance obligation. The entity should account for such obligations in accordance with the guidance on loss contingencies in Subtopic 450-20 on contingencies.

• • > Example 44 – Warranties

55-309 An entity, a manufacturer, provides its customer with a warranty with the purchase of a product. The warranty provides assurance that the product complies with agreed-upon specifications and will operate as promised for one year from the date of purchase. The contract also provides the customer with the right to receive up to 20 hours of training services on how to operate the product at no additional cost. The training services will help the customer optimize its use of the product in a short time frame. Therefore, although the training services are only for 20 hours and are not essential to the customer's ability to use the product, the entity determines that the training services are material in the context of the contract on the basis of the facts and circumstances of the arrangement.

55-310 The entity assesses the goods and services in the contract to determine whether they are distinct and therefore give rise to separate performance obligations.

55-311 The product and training services are each capable of being distinct in accordance with paragraphs 606-10-25-19(a) and 606-10-25-20 because the customer can benefit from the product on its own without the training services and can benefit from the training services together with the product that already has been transferred by the entity. The entity regularly sells the product separately without the training services.

55-312 The entity next assesses whether its promises to transfer the product and to provide the training services are separately identifiable in accordance with paragraphs 606-10-25-19(b) and 606-10-25-21. The entity does not provide a significant service of integrating the training services with the product (see paragraph 606-10-25-21(a)). The training services and product do not significantly modify or customize each other (see paragraph 606-10-25-21(b)). The product and the training services are not highly interdependent or highly interrelated as described in paragraph 606-10-25-21(c). The entity would be able to fulfill its promise to transfer the product independent of its efforts to subsequently provide the training services and would be able to provide training services to any customer that previously acquired its product. Consequently, the entity concludes that its promise to transfer the product and its promise to provide training services are not inputs to a combined item and, therefore, are each separately identifiable.

55-313 The product and training services are each distinct in accordance with paragraph 606-10-25-19 and therefore give rise to two separate performance obligations.

55-314 Finally, the entity assesses the promise to provide a warranty and observes that the warranty provides the customer with the assurance that the product will function as intended for one year. The entity concludes, in accordance with paragraphs 606-10-55-30 through 55-35, that the warranty does not provide the customer with a good or service in addition to that assurance and, therefore, the entity does not account for it as a performance obligation. The entity accounts for the assurance-type warranty in accordance with the requirements on product warranties in Subtopic 460-10.

55-315 As a result, the entity allocates the transaction price to the two performance obligations (the product and the training services) and recognizes revenue when (or as) those performance obligations are satisfied.

4.5.20 Distinguishing assurance-type from service-type warranties

When an entity sells a good or service to a customer, it often provides a customer with a warranty for those goods or services. The warranty may be described as a manufacturer's warranty, a standard warranty or an extended warranty.

The underlying feature of all warranties is that an entity promises to stand ready to replace or repair the product in accordance with the terms and conditions of the warranty. However, the FASB observed that some types of warranties are different from others. As such, Topic 606 requires an entity to account for a warranty (or part thereof) as one of the following. [606-10-55-32, 55-34]

Type of warranty	Description
Assurance	Only covers a product's or service's compliance with agreed-upon specifications. Assurance-type warranties are accounted for under Subtopic 460-10 (guarantees).
Service	Provides the customer with a service in addition to the product's compliance with agreed-upon specifications. Service-type warranties are accounted for as separate performance obligations under Topic 606.

As shown in the decision tree in section 4.5.10, the key to determining the type of warranty is whether it goes beyond assurance that the product will comply with agreed-upon specifications.

A customer option to purchase the warranty separately provides objective evidence that the warranty is a service in addition to the promised product. [606-10-55-31]

Even when an entity does not sell a warranty separately, it may still be identified as a performance obligation. To assess whether a warranty that is not sold separately provides a customer with an additional service, an entity considers factors such as:

— **Whether the warranty is required by law.** The existence of a law indicates an assurance-type warranty; this is because such requirements typically exist to protect customers from the risk of purchasing defective products.

— **The length of the warranty coverage period.** The longer the coverage period, the more likely it is that the entity is providing a service, rather than just guaranteeing compliance with agreed-upon specifications.

— **The nature of the tasks that the entity promises to perform.** For example, if an entity is required to perform a return shipping service for a defective product, that task is likely not a service. [606-10-55-33]

Similar to warranties required by law, product liability laws do not give rise to performance obligations. These laws typically require an entity to pay compensation if one of its products causes harm or damage. Any obligation of the entity to pay compensation for the damage or harm that its product causes is separate from the performance obligation. Product recalls occur when a concern is raised about the safety of a product and may be either voluntary or involuntary. Costs attributable to product liability laws and product recalls are recognized under Subtopic 450-20 (loss contingencies). [606-10-55-35]

If a single warranty provides both a service-type and assurance-type warranty the entity would typically account for those items separately. However, the assurance-type and service-type warranty would be accounted for together, as a single performance obligation, if the entity cannot reasonably account for them separately. [606-10-55-34]

However, the ‘reasonably account’ threshold is not defined in the standard. In this situation, the FASB decided that accounting for both warranties as a service-type warranty ensures that the entity does not accelerate revenue. [ASU 2014-09.BC376]

Example 4.5.10

Warranty contains an assurance and a service component

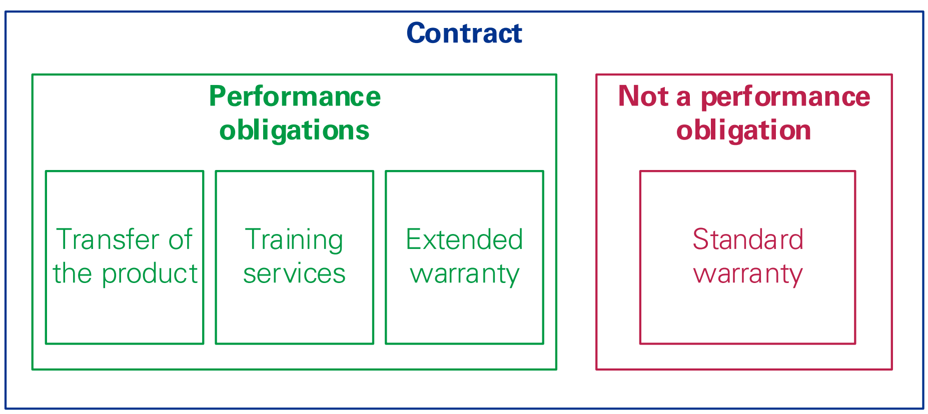
Manufacturer grants its customers a standard warranty with the purchase of its product. Under the warranty, Manufacturer:

— provides assurance that the product complies with agreed-upon specifications and will operate as promised for three years from the date of purchase; and

— agrees to provide up to 20 hours of training services to the customer.

Customer also chooses to purchase an extended warranty for two additional years.

Manufacturer concludes that there are three performance obligations in the contract.



The training services are a performance obligation because they provide a distinct service in addition to ensuring that the product complies with stated specifications.

The extended warranty is a performance obligation because it can be purchased separately and is distinct based on the Step 2 criteria (see section 4.3.20).

The component of the standard warranty that provides assurance that the product complies with stated specifications is an assurance-type warranty, and therefore is not a performance obligation. As a consequence, Manufacturer accounts for it as a cost accrual under subtopic 460-10 when control of the product transfers to the customer.

Question 4.5.10

Is a service-type warranty always a separate performance obligation?

Interpretive response: We expect most service-type warranties to be distinct – and therefore a separate performance obligation.

However, in order to determine whether a service-type warranty is distinct, we believe the entity should apply the criteria in Step 2 (see section 4.3.20) and assess whether:

- the customer can benefit from the warranty on its own or with resources that are readily available; and
- the warranty is separately identifiable from other promises.

Although the implementation guidance suggests that a service-type warranty is a performance obligation, the revenue model requires entities to apply the criteria in Step 2 to assess whether each good or service promised in a contract to a customer is distinct. [606-10-25-14, 55-34]

Entities should carefully identify all performance obligations, particularly when an entity promises both an assurance-type warranty and a service-type warranty.

Question 4.5.20

Is the length of the warranty period a determinative factor in determining the type of warranty (assurance- or service-type)?

Interpretive response: No. Topic 606 lists the length of the warranty period as a factor to consider when assessing whether the warranty provides a customer with a service. However, it is only one of the factors.

An entity usually considers the length of the warranty in the context of the specific market, including geography, product line and what is common in the industry. In addition to the length of the warranty period, the nature of costs incurred in performing the warranty work may provide evidence of the nature of the warranty promise. However, the longer the warranty period is, the more likely it is that the warranty contains a service element. [606-10-55-33]

Example 4.5.20

Lifetime warranty

Manufacturer is a leading manufacturer in the specialty luggage industry. It provides a lifetime warranty on all bags. If a bag is broken or damaged, whether caused by the customer or the result of a product defect, it will repair or replace the bag free of charge.

There are currently no regulations in the specialty luggage industry on warranties.

Manufacturer considers the following factors in assessing whether the lifetime warranty is a service-type warranty.

Factor	Rationale
No legal requirement	There is no law that requires Manufacturer to make a promise for the lifetime of the product. Therefore, this factor suggests that the warranty is a service-type warranty.
Longer coverage period	The length of the warranty is for the life of the baggage, compared with other manufacturers that offer a warranty for a specific period. Therefore, this factor suggests that the warranty is a service-type warranty.
Promises beyond agreed-upon specifications	The nature of the tasks includes not only repairing or replacing baggage that does not meet the promised specifications, but also includes repairing damage that occurs after the customer obtains control of the luggage. Therefore, the baggage warranty goes beyond the promise that the baggage complies with agreed-upon specifications and is essentially a promise to indemnify the customer by providing a repaired or new bag free of charge, regardless of whatever caused the issue. This suggests that the warranty is a service-type warranty.

Based on its analysis, Manufacturer concludes that the lifetime warranty is a service in addition to the assurance that the product complies with agreed-upon specifications. It therefore accounts for the service as a separate performance obligation. [TRG 03-5.29]

Question 4.5.30

If an entity customarily performs repairs of defective products outside of the warranty period, does that affect whether the warranty is an assurance- or service-type warranty?

Interpretive response: Not necessarily. An entity may have a customary business practice to provide repairs outside the warranty period – i.e. an 'implied warranty'. In some cases, it may not be clear if the repairs provided during the implied warranty period are an assurance- or service-type warranty.

For example, if an entity determines that the repairs made during the implied warranty period generally involve correcting defects that existed at the time of sale, the repairs could be an indicator of an assurance-type warranty. Conversely, if the entity determines that the repairs made during the implied warranty period provide a service to the customer beyond fixing defects that existed at the time of sale, the repairs could be an indicator of a service-type warranty.

An entity also needs to consider the length of the implied warranty in the context of the specific market, including geography and product line, and what is common in the industry. If providing an implied warranty for a similar period of time is customary that could be an indicator of an assurance-type warranty.

However, the longer the warranty period, including the implied period, the more likely it is that the warranty contains a service element.

Example 4.5.30
Customary practice of providing repairs or replacement outside the warranty period

ABC Corp. sells doorbell switches to customers with a three-year warranty. ABC customarily provides its customers with a free replacement if a switch malfunctions within four years of the date of purchase. The practice of providing replacement switches during the fourth year is common within the industry and among ABC's competitors.

ABC concludes that its practice of replacing the switch in the fourth year is not a service-type warranty (separate performance obligation) because:

- its obligation does not go beyond guaranteeing that the switch will operate as originally intended; and
- implicitly extending the guarantee to the fourth year is not an unreasonably long period of time – it is consistent with the industry and ABC's competitors.

Therefore, ABC accounts for the guarantee in accordance with Subtopic 460-10.

Question 4.5.40
Can an 'extended warranty' that the customer did not have an option to purchase separately be an assurance-type warranty?

Interpretive response: Yes. A warranty that is marketed as being an 'extended warranty' could be either an assurance-type or a service-type warranty.

Following general principles (see section 4.5.20), the facts need to be evaluated to determine whether the warranty provides a service beyond the assurance that the product meets the agreed-upon specifications. The mere labeling of a warranty as 'extended' or 'enhanced' is not determinative.

An entity considers all facts and circumstances, including an evaluation of the factors included in Topic 606 in making that determination (see section 4.5.20). This includes, but is not limited to, the length of the warranty coverage period.

Question 4.5.50
Is a statutory warranty that requires an entity to provide for repairs or replacements for products that develop defects within a specified period a service-type warranty?

Interpretive response: No. Statutory warranties should be accounted for as assurance-type warranties and not as a separate performance obligation.

The FASB noted that in some cases, laws could require an entity to repair or replace products that develop defects within a specified period from the time of purchase. Such statutory warranties may appear to be service-type warranties because they cover defects arising after the time of sale versus at the time of sale.

However, the FASB concluded that the objective of statutory warranties is to protect the customer against the risk of purchasing a defective product. Such laws presume that if a defect arises within a specified period, the product was defective at the time of sale. Consequently, such statutory warranties are accounted for as assurance-type warranties. [ASU 2014-09.BC377]

4.5.30 Distinguishing warranties from variable consideration

Not all customer rights associated with the satisfaction of a good or service is a warranty. For example, a customer's right of return (see section 5.4) is not accounted for the same as a warranty. Similarly, some contractual features such as penalties may be similar to warranties but are accounted for as variable consideration. It is important to carefully distinguish between a warranty and other rights because the accounting is different depending on the nature of the rights.

Question 4.5.60
Is a customer's right to a refund for unsatisfactory services a warranty or a variable consideration?

Interpretive response: Generally, variable consideration. If an entity offers a refund to customers who are dissatisfied with the service provided, it applies the guidance on a sale with a right of return (see section 5.4), and follows the guidance on estimating variable consideration in determining the transaction price for the service being provided (see section 5.3).

The guidance in Topic 606 on warranties is intended to apply to services as well as goods. However, it does not further explain how the concept should be applied to services. In a contract for the delivery of services, an entity may offer to 'make good' or offer a refund. If an entity offers to 'make good' – e.g. to repaint an area that a customer was not pleased about – then it would consider the requirement of 'making good' in determining the timing of the transfer of control and revenue recognition – i.e. whether the customer's acceptance of the service impacts when control is transferred.

Question 4.5.70

Is the right to return a defective item a right of return or an assurance-type warranty?

Interpretive response: It depends. We believe the right to return a defective product for cash or credit generally should be accounted for the same way as a right of return for a non-defective product. Specifically, when a right of return for cash or credit exists, revenue is not recognized for the portion of the sale that is expected to be returned.

In contrast, when the right of return for a defective product is limited only to an exchange of the product (or return for repair), the return right is more like an assurance warranty. In this instance, the estimate of the cost to perform should be recognized as a liability and expensed when the sale is consummated (see Question 5.4.20).

Question 4.5.80

Are liquidated damages or similar provisions accounted for as a product warranty?

Interpretive response: In some cases, yes. Many contracts contain terms providing for liquidated damages and similar compensation to the customer upon the occurrence or nonoccurrence of certain events. These terms may be considered variable consideration because the standard identifies penalties as variable consideration (see Question 5.3.100).

However, in some circumstances the terms may be similar to a warranty. Judgment is required to distinguish those terms that are accounted for as warranties from the more common scenarios in which the terms give rise to variable consideration.

For example, if a third party repairs a defective product sold by an entity and the entity reimburses the customer for costs incurred, that may be similar to a warranty. This may include contracts where the reimbursement of costs is limited to a certain dollar amount or other threshold. Those payments to a customer are typically accounted for as an assurance-type warranty rather than variable consideration. Similarly, the payments are typically not treated as consideration payable to a customer because the payments provide the entity with an identifiable benefit of repairing the goods or services initially provided to the customer.

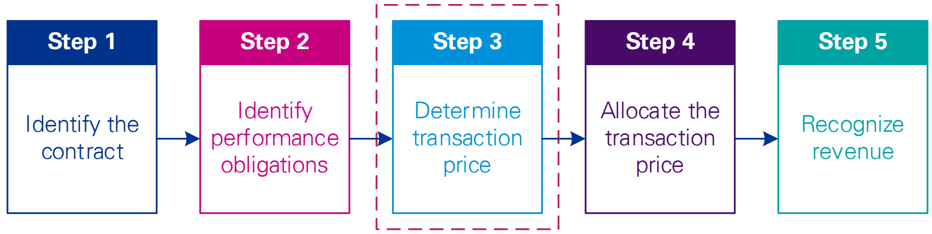
5. Step 3: Determine the transaction price

Detailed contents

Item has been moved in this edition ●

Examples

5.1 How the standard works



The third step in the revenue recognition model is to determine a contract's transaction price, which will be allocated among the contract's performance obligations in Step 4.

The transaction price is the consideration to which an entity expects to be entitled for providing goods or services under the contract. It includes not only fixed cash consideration but also several other types of consideration and adjustments.

Transaction price		
Fixed cash consideration Fixed consideration is typically the stated amount in the contract that is not subject to change based on the occurrence or nonoccurrence of a future event	**Variable consideration (and the constraint)** An entity estimates the amount of variable consideration to which it expects to be entitled, giving consideration to the risk of revenue reversal in making the estimate (see section 5.3)	**Significant financing component** For contracts with a significant financing component, an entity adjusts the promised amount of consideration to reflect the time value of money (see section 5.5)
Noncash consideration Noncash consideration is measured at fair value, if that can be reasonably estimated; if not, an entity uses the stand-alone selling price of the good or service that was promised in exchange for noncash consideration (see section 5.6)	**Consideration payable to a customer** An entity needs to determine whether consideration payable to a customer represents a reduction of the transaction price, a payment for a distinct good or service, or a combination of the two (see section 5.7)	**Nonrefundable up-front fees** An entity needs to determine if a fee is for the transfer of a good or service or represents an advanced payment for future goods or services and if the fee provides the customer with a material right (see section 5.8)

5.2 Elements of transaction price

Excerpt from ASC 606-10

32-1 When (or as) a performance obligation is satisfied, an entity shall recognize as revenue the amount of the transaction price (which excludes estimates of variable consideration that are constrained in accordance with paragraphs 606-10-32-11 through 32-13) that is allocated to that performance obligation.

> Determining the transaction price

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.

32-2A An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process shall be excluded from the scope of the election. An entity that makes this election shall exclude from the transaction price all taxes in the scope of the election and shall comply with the applicable accounting policy guidance, including the disclosure requirements in paragraphs 235-10-50-1 through 50-6.

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).

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.

5.2.10 Overview

The transaction price is the amount of consideration an entity expects to be entitled to for providing goods or services to the customer. The transaction price includes the amounts to which the entity has rights under the contract, which could include consideration to be paid by the customer or third parties – e.g. health insurance companies or governmental agencies. [606-10-32-2, ASU 2014-09.BC185, BC187]

There are two main reasons why determining the transaction price can be challenging.

- Because it is the amount of consideration an entity *expects*, the transaction price is often an estimate. Estimating the transaction price requires an entity to apply a number of principles that can involve significant judgment and often requires updates each reporting period.
- The transaction price can be influenced not only by the explicit contract terms, but also by the entity's customary business practices. Therefore, an entity needs to understand both the terms of its contracts and its customary business practices.

The transaction price consists of fixed cash consideration, estimated variable consideration and the fair value of noncash consideration. These amounts are adjusted for the time value of money if there is a significant financing component in the contract. Lastly, the transaction price may be reduced by any consideration payable by the entity to the customer. [606-10-32-2 – 32-3]

5.2.20 Items not included in transaction price

The transaction price includes only amounts to which the entity has rights under the contract. It does not include the following items, which typically are associated with a contract but are not amounts owed under a contract for the goods or services promised to the customer:

Amounts collected on behalf of third parties

The transaction price does not include amounts: [606-10-32-2]

- collected on behalf of third parties – e.g. sales taxes collected by the entity for which it is not the primary obligor to the taxing authority; or
- collected by the entity on behalf of a principal for goods or services provided to the customer by a third party when the entity is acting as the third-party's agent.

Judgment will be required in some cases to determine whether a payment from a customer is an amount collected on behalf of a third party or an element of the transaction price.

The FASB recognized that for some sales and similar taxes this judgment can be very challenging. Consequently, Topic 606 permits an entity to elect to exclude all sales and other similar taxes from the transaction price. Similar taxes include use, value added and some excise taxes that are imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer. This accounting policy election permits the entity to present all collections from customers for these taxes on a net basis, rather than having to assess whether the entity is acting as an agent or a principal in each taxing jurisdiction. If an entity makes this policy election it is applied to all contracts. In contrast, if it does not make this election, it needs to evaluate whether it is the principal or agent in each taxing jurisdiction. [606-10-32-2A, ASU 2016-12.BC32]

Consideration from future exercise of options and future change orders

The transaction price does not include estimates of consideration from:

— the future exercise of options for additional goods or services; or
— future change orders until the customer exercises its option or approves the change order.

Estimates of this type of consideration are excluded because the transaction price is based on the entity's rights to consideration existing under the current contract. The entity does not have a right to consideration from the above items until the customer either exercises an option or a change order is approved. [ASU 2014-09.BC186]

Possibility of the contract being canceled, renewed or modified

When determining the transaction price, an entity assumes that the goods or services will be transferred to the customer based on the contract term (as determined for accounting purposes (see section 3.8)). Therefore, it does not consider the possibility of the contract being canceled, renewed or modified. This concept is particularly important when estimating variable consideration, which is discussed in section 5.3. [606-10-32-4]

Customer credit risk

In general, the transaction price does not include the effects of customer credit risk because it includes the amount the entity expects to be entitled; not the amount an entity expects to collect. Further, credit risk is a factor in determining whether a contract exists in Step 1 (see section 3.3). If a contract exists, any amounts that the entity expects to be entitled to and recognizes as revenue but are not subsequently collected are recorded as bad debt expense. [606-10-55-3C]

Question 5.2.05

What types of taxes or fees qualify for the policy election to be excluded from the transaction price?

Interpretive response: Topic 606 permits an entity to elect to present all collections from customers for certain taxes on a net basis, rather than having to assess whether the entity is acting as principal or agent in each tax jurisdiction. [606-10-32-2A]

Taxes qualify for the policy election if they are collected from customers and remitted to governmental authorities that imposed the tax both on and concurrent with a specific revenue-producing transaction between a seller and a customer. These taxes may include, but are not limited to, sales, use, value-added and some excise taxes as well as other taxes referred to as 'fees'.

However, the policy election does not apply to tax schemes that are based on gross receipts and taxes that are imposed during the inventory procurement process. See Questions 3.2.10 and 3.2.20 of KPMG Handbook, Inventory, for further discussion of taxes paid upon acquisition of inventory. [606-10-32-2A]

Collecting the tax from the customer does not automatically designate the tax as specific to revenue-producing activities. An entity evaluates the nature of the tax to determine if the tax is imposed on and concurrent with specific revenue-producing transactions or if the tax is more akin to a gross receipts tax.

We believe the following are indicators that the tax is imposed on individual transactions and would qualify for the Topic 606 policy election to be excluded from the transaction price and presented on a net basis.

- The tax is imposed on individual sales transactions as identified in a law or regulation.
- The individual sales transaction is what creates the obligation on the entity to remit fees or taxes to the governmental authority.
- The tax is applied to specific types of transactions, on certain revenue streams or for certain products and services.
- Transactions or revenues with specified entities (e.g. not-for-profit entities) may be exempt.

The following are indicators that the tax is a gross receipts tax, and therefore not eligible for the Topic 606 policy election.

- The tax is imposed on an accumulation of earnings or applied based on graduated rates.
- The tax allows specified deductions (other than specific revenue-related adjustments – e.g. billing credits, sales returns, uncollected accounts), credits for other taxes paid or apportionment factors.
- There are minimum thresholds to be exceeded before there is an obligation to file a return or remit taxes or fees.
- It includes types of income that are not the result of transactions with customers (e.g. nonoperating income).
- It interacts with other tax systems (e.g. the tax is the lesser or greater of a sales-based calculation or an income-based calculation).

None of the above factors is presumptive or determinative. Certain taxes include characteristics of both sales taxes and gross receipts taxes and may require significant judgment to determine their eligibility for the policy election. All relevant facts and circumstances should be considered.

Example 5.2.05
Taxes collected from customer – gross reporting

ABC Corp. provides professional services to companies on cloud platforms. A tax is imposed on companies who provide professional services on a digital platform with annual platform revenues in excess of $500 million. The tax is 5% on amounts in excess of $500 million and is due in February based on the taxable revenue collected in the previous calendar year. ABC passes on this tax to its customers and collects the tax each time the customer is invoiced.

ABC evaluates whether the tax due is specific to revenue-producing transactions or is more akin to a gross receipts tax on the business. This tax is based on revenue generated over a certain dollar threshold and is taxed on revenue for professional services provided by companies on a digital platform; therefore, it is more consistent with a gross receipts tax rather than a tax imposed on and concurrent with a specific revenue-producing transaction.

As a result, ABC concludes that the tax is a gross receipts tax that does not qualify for the policy election to net costs against revenue.

Question 5.2.10

Are customer reimbursements for out-of-pocket costs part of the transaction price?

Interpretive response: It depends on whether the out-of-pocket costs being reimbursed are:

— the entity's costs – i.e. because the entity is receiving the good or service from the third party (the entity is acting as a principal); or
— the customer's costs – i.e. because the customer is the party receiving the good or service from the third party (the entity is acting as an agent).

Entity's costs

Entities performing services for customers often incur out-of-pocket costs as part of delivering that service, such as travel and lodging. This is frequently the case for entities providing professional services (e.g. implementation services, training, consulting services). Customers frequently agree to reimburse the out-of-pocket costs, often subject to restrictions such as imposing a ceiling on total reimbursements or requiring the entity to follow specific policies (e.g. the customer's expense reimbursement policies) or using the customer's preferred airline or hotel vendor(s).

Regardless of whether a customer imposes restrictions or limits on its reimbursement of out-of-pocket costs, estimated customer reimbursements of the entity's costs are part of the contract's transaction price and recognized based on the entity's measure of progress for the performance obligation(s) to which they are allocated. Such costs are subject to the same accounting guidance as any other variable consideration (see section 5.3). Entities also need to consider the variable consideration allocation guidance to determine if customer reimbursements are to be allocated entirely to one or more, but not all, distinct goods or services in a contract. Section 6.6 discusses the variable consideration allocation guidance.

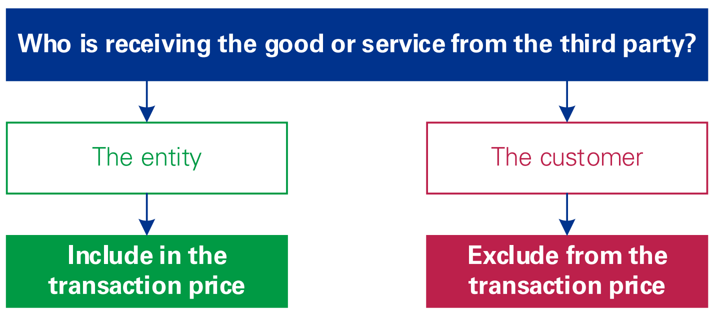
The costs the entity incurs are fulfillment costs. Therefore, typical out-of-pocket costs (e.g. travel, meals, lodging) and the reimbursements of such costs from the customer are presented on a gross basis. This is because the goods or services giving rise to the out-of-pocket costs do not transfer a good or service to the customer. Rather, the goods or services are used or consumed by the entity in fulfilling its performance obligation to the customer.

Customer's costs

The accounting treatment is different if the customer reimbursement is for costs that the entity has paid *on behalf of the customer* to a third party. For example, an agent may, as part of providing a service of arranging for a third party to provide a specified good or service, remit payment to the third party (i.e. the principal) for the specified good or service and then obtain reimbursement for that payment from the customer.

In that case, because the payment to the third party is payment for the customer's cost (rather than the entity's cost), the reimbursement is not part of the transaction price of the entity's contract with its customer. Consequently, the reimbursement is not part of the contract's transaction price. Instead, the transaction price is the amount the agent will retain net of the payments made to the third-party principal. For more information on principal versus agent considerations, see chapter 9.

The following diagram summarizes the above discussion.



Example 5.2.10
Reimbursable and pass-through costs

ABC Corp. enters into a contract with Customer to provide IT outsourcing and certain implementation services. The IT outsourcing and the implementation services are distinct from each other (see section 4.3) and both are performance obligations satisfied over time. ABC also arranges for Partner, a third party for which it has an alliance agreement, to provide data conversion and migration services to Customer that ABC does not provide to any of its customers.

This arrangement includes three contracts:

— a contract between ABC and Customer for IT outsourcing and implementation services, which stipulates that Customer will reimburse ABC for any out-of-pocket costs ABC incurs in performing the implementation services – e.g. ABC personnel travel-related costs to come to Customer's location;

— a contract between Customer and Partner for data conversion and migration services, which designates ABC as an authorized agent of Partner; and

— a partnership agreement between ABC and Partner, which stipulates that ABC will receive 5% of the consideration in the contract between Customer and Partner.

The contracts, together, stipulate that Customer will remit payment for both the ABC-provided IT outsourcing and the Partner-provided data conversion and migration services to ABC, who will then remit the agreed payment to Partner net of the commission to which it is entitled under its partnership agreement. ABC does not control the services provided by Partner to Customer and is considered an agent in that transaction.

The contract price for the IT outsourcing and the implementation services is $100,000 plus reimbursement of out-of-pocket costs; the contract price for the third-party services is $10,000 (of which ABC receives 5%, or $500).

Payments for third-party services

The amount that ABC (as agent) retains ($500) net of the agreed payment to Partner is included in the transaction price. The remaining payment ($9,500) made to ABC for Partner's services is not part of the transaction price of the contract between ABC and Customer. Consistent with paragraph 606-10-32-2, that payment is an amount collected on behalf of Partner for services Partner is providing (as a principal) to Customer.

Out-of-pocket expenditures

ABC's out-of-pocket expenditures are fulfillment costs to satisfy its performance obligation to provide implementation services to Customer; they are not third-party services being provided to Customer. Therefore, the costs are presented on a gross basis separate from the related customer reimbursements.

The out-of-pocket fulfillment costs are expensed as incurred, consistent with any other fulfillment costs that ABC incurs related to the implementation services – when incurred, they relate to a partially satisfied implementation services performance obligation. Section 12.5 discusses costs of fulfilling a contract.

5.3 Variable consideration

Excerpt from ASC 606-10

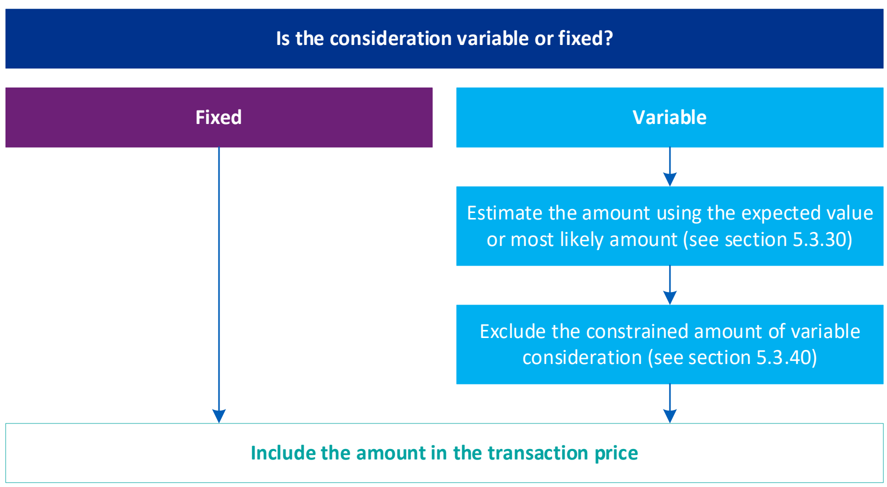
• > Variable Consideration

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.

5.3.10 Overview

Variable consideration, like fixed consideration, is part of the transaction price. However, due to its nature, an entity estimates the amount of variable consideration at contract inception and each reporting period until the amount is known – unless the variable amounts are sales- and usage-based royalties promised in exchange for a license of IP, in which case they are subject to separate guidance (see section 10.11).

Therefore, an entity first determines if consideration is fixed or variable (see section 5.3.20). If the entity determines that consideration is variable, it then estimates the amount to which it expects to be entitled (see section 5.3.30). Finally, the entity applies the variable consideration constraint so that variable consideration is included in the transaction price only to the extent it is probable that a subsequent change in estimate will not result in a significant revenue reversal compared to the cumulative revenue recognized under the contract (see section 5.3.40).



5.3.20 Types of variable consideration

Excerpt from ASC 606-10

• > Variable Consideration

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.

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.

• • > Example 20—Penalty Gives Rise to Variable Consideration

55-194 An entity enters into a contract with a customer to build an asset for $1 million. In addition, the terms of the contract include a penalty of $100,000 if the construction is not completed within 3 months of a date specified in the contract.

55-195 The entity concludes that the consideration promised in the contract includes a fixed amount of $900,000 and a variable amount of $100,000 (arising from the penalty).

55-196 The entity estimates the variable consideration in accordance with paragraphs 606-10-32-5 through 32-9 and considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

• • > Example 24—Volume Discount Incentive

55-216 An entity enters into a contract with a customer on January 1, 20X8, to sell Product A for $100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to $90 per unit. Consequently, the consideration in the contract is variable.

55-217 For the first quarter ended March 31, 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

55-218 The entity considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $100 per unit) will not occur when the uncertainty is resolved (that is, when the total amount of purchases is known). Consequently, the entity recognizes revenue of $7,500 (75 units × $100 per unit) for the quarter ended March 31, 20X8.

55-219 In May 20X8, the entity's customer acquires another company and in the second quarter ended June 30, 20X8, the entity sells an additional 500 units of Product A to the customer. In light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and, therefore, it will be required to retrospectively reduce the price per unit to $90.

55-220 Consequently, the entity recognizes revenue of $44,250 for the quarter ended June 30, 20X8. That amount is calculated from $45,000 for the sale of 500 units (500 units × $90 per unit) less the change in transaction price of $750 (75 units × $10 price reduction) for the reduction of revenue relating to units sold for the quarter ended March 31, 20X8 (see paragraphs 606-10-32-42 through 32-43).

Variable consideration includes amounts that change based on the occurrence or nonoccurrence of certain events, even if a transaction price seems fixed based on the terms of the contract. For example, the amount of consideration promised in a fixed-price maintenance contract is variable if the contract includes service level guarantees that require the entity to provide credits or refunds to the customer as a penalty for not meeting the specified service levels (see Question 5.3.80). [606-10-32-6 – 32-7]

The amount of consideration can vary because of one or more of, but not limited to, the following: [606-10-32-6]

- discounts
- rebates
- refunds
- rights of return
- credits
- price concessions
- incentives
- usage-based fees
- performance bonuses or penalties.

Variability in the contract consideration may be explicit or implicit. For example, explicit price concessions may be granted to enhance a customer relationship and encourage future sales to that customer; however, implicit concessions occur when the entity's customary business practices, published policies or specific statements, or other relevant facts and circumstances indicate that the entity may accept a lower price than that stated in the contract. For this reason, an entity needs to understand both the contract terms and its customary business practices to determine if they create a valid expectation of variability by the customer. [606-10-32-7]

Question 5.3.10

How does an entity distinguish between variable consideration and optional purchases?

Interpretive response: Distinguishing between optional purchases and variable consideration is important because of the different accounting requirements. Variable consideration is estimated and included in the transaction price that is allocated to the performance obligations in the contract at contract inception. In contrast, optional purchases are accounted for as separate contracts when the option is exercised unless the option conveys a material right to the customer (see chapter 8).

In some situations it will not always be clear whether a contract includes variable consideration or optional purchases. That is because the usage of variable quantities of a good or service that the customer controls could result in variable consideration, but a customer's action to acquire additional quantities of distinct goods or services are optional purchases. In both cases, the customer pays the entity additional amounts. However, when variable consideration exists, those payments are in the context of the current contract, whereas payments for optional purchases are a result of additional customer contracts. [TRG 11-15.48]

The key difference to evaluate between the two is whether the variability arises from the resolution of a contingency (variable consideration) related to a good or service the customer controls or a new obligation to provide additional goods or services (an option). In order to make this evaluation, an entity will need to assess the nature of its promise to the customer and evaluate the presently enforceable rights and obligations of the parties to the arrangement. The TRG generally agreed that the following generally describes optional purchases and variable consideration. [TRG 11-15.48]

— **Options for additional goods or services:** A customer has a present contractual right (as opposed to an obligation) to purchase additional distinct goods or services. Each exercise of an option is a separate purchase decision and results in the transfer of control of additional goods and services by the entity. Before the customer exercises the option, the entity is not obligated to provide those goods or services and does not have a right to receive consideration.
— **Variable consideration:** An entity is presently obligated to transfer promised goods or services and the customer has already made its purchasing decision. The event that results in additional consideration occurs after (or as) the performance obligation is satisfied – i.e. after (or as) control of the goods or services transfers to the customer. The entity's performance obligations do not change as a result of the event or customer's actions.

The following Questions apply these concepts to more detailed situations:

— 5.3.20 – Usage-based or user-based fees in a service contract;
— 5.3.30 – Volume-based rebates and discounts;
— 10.11.40 – Options to acquire additional licenses or usage-based royalties.

Example 5.3.10
Variable consideration

This example is adapted from TRG 11-15.48.

ABC Corp. enters into a contract to transfer control of equipment to Customer. The equipment is a single performance obligation transferred at a point in time. ABC charges Customer based on usage of the equipment at a fixed rate per unit of consumption. The contract has no minimum payment guarantees.

Customer is not contractually obligated to use the equipment; however, ABC is contractually obligated to transfer the piece of equipment to Customer, and Customer obtains control of the equipment when it is delivered.

The usage of the equipment by Customer introduces variability that affects the amount of consideration owed to ABC. It does not affect ABC's performance obligation, which is to transfer control of the piece of equipment to Customer. In other words, ABC has previously performed by transferring the distinct good, and Customer's actions that result in additional payments occur after the goods have been transferred and do not require ABC to provide additional goods or services to Customer.

As a consequence, ABC estimates the total amount of consideration it expects to receive by estimating the usage of the equipment by Customer. This amount (reduced by the constraint, if necessary) is recognized as revenue when ABC transfers control of the equipment to Customer even though ABC is not entitled to any payment from Customer at that time.

Example 5.3.20

Supply agreement accounted for as optional purchases

This example is adapted from TRG 11-15.48.

Supplier enters into a three-year exclusive master services agreement (MSA) with Customer that requires it to produce and sell parts to Customer when a purchase order is submitted. The MSA requires that each part be delivered within a specified time period after the purchase order is submitted. Customer pays Supplier a $1,000,000 nonrefundable upfront payment when it enters into the MSA.

Customer is not legally obligated to purchase any parts; however, it is highly likely that Customer will purchase parts because the part is required to manufacture its product. Each part is a distinct good that transfers to the customer at a point in time.

Supplier considers its enforceable rights and obligations. As in Question 3.2.30, an MSA typically does not create an accounting contract until the purchase order is submitted. Therefore, Supplier determines that each purchase order submitted is an optional purchase and not variable consideration.

This is further supported by the following.

- Customer is not obligated to purchase any parts and merely has the right to choose the quantity of additional distinct goods it wishes to purchase.
- Supplier is not obligated to transfer any parts until the customer submits a purchase order.
- Each purchase order submitted by Customer changes Supplier's performance obligations and Customer's rights.

Supplier would need to evaluate whether the upfront fee conveys a material right to the customer for the future goods. See section 5.8 on upfront fees and section 8.2 on customer options.

Question 5.3.20
Are usage-based or user-based fees variable consideration?

Interpretive response: It depends. An entity will need to apply the concepts in Question 5.3.10 to determine whether a usage-based or user-based fee provides the customer with a right to purchase additional goods or services or is variable consideration. If the amounts are variable consideration, the entity includes them in the transaction price. If each transaction or user represents an optional purchase, those purchases are accounted for as a separate contract.

Goods

As illustrated in Example 5.3.10, when a customer pays a fee based on the usage of a good that it already controls, the usage-based fees are variable consideration. In contrast, Example 5.3.20 illustrates that when the entity transfers control of additional distinct goods after the customer makes a purchasing decision, the contract contains options that are accounted for separately unless there is a material right conveyed by the options. A key difference between those examples is that in the former, the entity transfers control of the good before the customer's action (usage) occurs. In the latter, the customer action (the exercise of the option) occurs before control of the goods is transferred to the customer.

The determination between optional purchases and variable consideration may be straight-forward when the nature of the entity's promise is to transfer distinct goods such as inventory produced by the entity or resold to the customer. That determination can be more challenging in service arrangements when the usage- or user-based fees are triggered as the entity is transferring control rather than after the entity has completed its performance.

Services

The TRG discussed examples of usage-based fees in IT outsourcing and transaction processing service arrangements. In those examples, the price per transaction or level of usage was fixed but the unknown quantity of usage gave rise to variable consideration. In those examples, the contract provision giving rise to the fees was effectively a measurement that described how the entity was compensated for the services rather than a provision allowing the customer to obtain additional services. [TRG 11-15.48]

As in Question 5.3.10, an entity will first need to determine the nature of the promise for the service. In general, if the nature of the promise is a service of standing ready or providing continuous access to a service for the contract term, consideration based on usage or number of users generally represents variable consideration. See section 4.2.30 for a discussion of stand-ready performance obligations.

Consistent with Question 5.3.10, the following indicate the usage- or user-based provision is variable consideration.

— The entity is continuously transferring control of the service to the customer by providing access to the service and the customer's usage occurs as the entity is transferring control.

— The customer's increase in usage or number of users does not change the entity's obligation or provide the customer with incremental rights to services for the remainder of the term.

— The customer is not making a separate purchasing decision that results in an entity having additional obligations to the customer.

In addition, the following factors could also indicate that the nature of the promise is a single service and the usage- or user-based provision is variable consideration (not exhaustive).

— The customer is not required to execute **an additional contract**, whether characterized as a purchase order, an addendum, an amendment, a modification of the existing contract, or a termination of the existing contract and creation of a new contract. These actions typically suggest an affirmative, additional purchasing decision by the customer to acquire incremental services.

— The quantity of usage of a service, system or application is **outside the control of the customer**. For example, an entity may provide a customer with continuous access to a processing platform so that when the customer's customer submits a transaction, it is processed for the customer. In this scenario, the customer does not control the number of transactions processed and the customer's purchasing decision was contracting with the entity for access to the processing platform. Because the actual transactions processed are not at the request of the customer, each transaction processed is not an optional purchase.

— The entity maintains **significant infrastructure**, particularly *dedicated* infrastructure, to fulfill the terms of the contract.

— The presence of a **service level provision** anchored to availability of the service. For example, a provision that entitles the customer to service level credits if system or application availability is less than X% during the measurement period suggests the nature of the promise to the customer is availability of the service.

— The presence of a **significant fixed fee** (regardless of whether it is payable upfront or over time). A significant fixed fee suggests that the customer ascribes significant value to the availability of the system or service, not just to the ability to obtain specified outputs. A significant fixed fee component may be written in the contract as a guaranteed transaction- or usage-based minimum.

In contrast, a service contract could be structured to provide a defined number of tasks or provide the customer with an option to have the entity (a service provider) perform a task if called on to do so. For example, a customer may have the right under a contract to upload data to a hosted application and have that application produce one or more reports using that data. The arrangement in that case may involve little more than the promise that if the customer accesses the service via the internet and uploads the data, the hosted application will return the requested report and, in that case, the customer makes an affirmative decision to acquire a report using the system. As such, this fact pattern may represent optional purchases.

See Examples 5.3.30 to 5.3.70 for further illustrations.

Example 5.3.30
Usage fee accounted for as variable consideration

Outsourcer enters into a contract with Customer to provide call center services for one year. These services include providing dedicated infrastructure and staff to answer calls. Outsourcer receives $0.50 for each call answered.

Outsourcer concludes that its performance obligation is the overall service of standing ready to provide call center services for one year, rather than each call answered being an optional purchase. Its conclusion is based on the following.

- Outsourcer is obligated to make its dedicated service available each day during the contract term.
- Customer does not make separate purchasing decisions every time a user places a call to the center – i.e. the calls are outside of Customer's control.
- Outsourcer is continuously performing by making the call service available during the contract period.
- Customer's usage does not change Outsourcer's obligation. After each call, Outsourcer is still obligated to stand ready to answer an unlimited number of calls for the remaining contract period.
- Outsourcer has dedicated infrastructure and staff in place to stand ready to answer calls.

As a result, Outsourcer concludes that the per-call fee is variable consideration.

Example 5.3.40
Optional purchases in a service arrangement

Telco enters into a contract with Customer to provide mobile phone service for one year. The service allows Customer to use up to 10,000 call minutes for a fixed fee. The contract also specifies a price for any additional minutes the customer chooses to purchase in any month. Each minute is a distinct service.

Telco concludes that the nature of the promise is to provide 10,000 minutes rather than a stand-ready obligation or continuous access to its network for two years because there is a specified quantity of services that significantly diminish over the contract term and the network provides no benefit to the customer beyond the calls (see Question 4.2.40).

Telco concludes the additional minutes are optional purchases based on the following. [TRG 11-15.48]

- Customer has the choice to purchase additional distinct services (the calls) and until that decision is made Telco is not obligated to perform its service of connecting the call.
- Each additional call is a distinct service that was not contracted for by Customer in the initial contract.

— Each additional call changes Customer's rights because Customer cannot further use Telco's services without making the decision to purchase additional minutes.

— While Telco has substantial infrastructure, it is not dedicated to Customer.

Example 5.3.50

Transaction processing accounted for as variable consideration

This example is adapted from TRG 11-15.48.

ABC Corp. enters into a five-year agreement with Customer. Over the five-year period, ABC will provide continuous access to its transaction processing platform and process all transactions on behalf of Customer. Customer is obligated to use ABC's system to process all of its transactions; however, the ultimate quantity of transactions is not known and is outside the control of both ABC and Customer. ABC charges Customer on a per-transaction basis.

ABC concludes that the nature of promise is to provide Customer with continuous access to the platform and that each transaction processed represents variable consideration. Its conclusion is based on the following.

— The number of transactions processed is outside Customer's control and therefore Customer does not make separate purchasing decisions for each transaction processed.

— Customer's usage occurs as ABC is making the transaction processing platform continuously available to Customer.

— Customer's usage does not change ABC's obligation or provide Customer with an incremental right. After each usage, ABC is still required to stand ready to process an unlimited number of transactions for the remaining time period and Customer has the same rights to unlimited transactions for the remaining time period.

— While the platform is not specifically dedicated to Customer, ABC maintains significant infrastructure to support the platform's continuous availability to Customer and other similar customers.

As a result, ABC concludes that the per-transaction fee is variable consideration.

Example 5.3.60

Service agreement accounted for as variable consideration

ABC Corp. enters into a contract with Customer to provide a single distinct service of claims processing for a two-year period. ABC charges Customer a 'per member per month fee' (PMPM) during the two-year period and a fixed upfront fee.

ABC concludes that its performance obligation is to provide a single continuous service. Its conclusion is based on the following.

— ABC is continuously transferring control of a single service regardless of the number of users.

— A change in the number of members does not change ABC's performance obligation or provide Customer with incremental rights. ABC is still obligated to provide the same service each month. Similarly, Customer's remaining rights are the same for the remainder of the period because an incremental member does not provide it with an additional service for the rest of the contract and the pricing resets each month based on the members in that period.

— Customer does not make separate purchasing decisions for each member. Customer previously made the choice (by entering into the contract) that obligated ABC.

As a result, ABC concludes that the PMPM fee is variable consideration.

Example 5.3.70
Service agreement accounted for as optional purchases

Assume the same facts as Example 5.3.60 except that the contract term is for one month with the option to renew each month at the same PMPM pricing. As such, ABC only has a one month contract (see Question 3.8.10 on contract term).

The nature of the promise is to stand ready to process claims when and if claims come in during that *one month*. Consistent with the rationale in Example 5.3.60, ABC concludes that the PMPM fee for that *one month* contract term is variable consideration.

However, *additional months* would be considered optional purchases and would not be considered variable consideration. This is because Customer has the option to purchase additional months of service. It is not obligated to purchase additional months of service and ABC is not obligated to perform the service for additional months. Engaging ABC to continue providing the service in subsequent months would be a separate purchasing decision. ABC is not obligated to provide the claims processing service until Customer exercises its option and enters into a new contract with ABC.

Question 5.3.30
Are volume-based discounts and rebates variable consideration?

Interpretive response: It depends. Many types of contracts contain volume-based discounts or rebates and the type of incentive can significantly vary from customer to customer or industry to industry. For example, service contracts that have transaction- or usage-based fees often include tiered pricing and/or volume rebates or credits based on the level of usage for that service. Similarly, an entity may provide rebates or discounts if the customer executes a specified level of future purchases.

An entity will need to determine the nature of the promise and whether the future purchases or usage represent variable consideration or options to purchase additional goods or services (see Question 5.3.10).

- If the discount or rebate is based on volumes that represent variable consideration (e.g. a transaction-based fee for transaction processing services), any discounts or rebates that adjust the price per volume of use are also variable consideration.
- If the discount or rebate is based on the customer executing future contracts for additional goods or services (e.g. based on customer options), the accounting for the discount or rebate depends on whether it applies prospectively or retrospectively.

The following are examples of volume-based rebates or discounts based on purchases of additional distinct goods or services.

- An MSA states the pricing for each widget when the customer submits a purchase order and that price decreases on a *retrospective basis* as the customer executes additional contracts. For example, the customer must pay $1 per widget for the first 100 widgets, and if the customer reaches that milestone the customer will receive a rebate (or credit) of $0.10 on the first 100 widgets sold and the price will be $0.90 per widget for each purchase going forward.
- An MSA states the pricing for each widget when the customer submits a purchase order and that price decreases *prospectively* as the customer purchases more widgets. For example, $1 per widget for the first 100 widgets sold, $0.90 for the second 100 widgets sold and $0.75 per widget for those above 200.

A volume-based rebate or discount on optional purchases that applies retrospectively is considered variable consideration because the final transaction price is unknown until the customer completes (or fails to complete) the specified volume of purchases. A volume-based discount on optional purchases that applies prospectively is not considered variable consideration. Rather, an entity evaluates this type of discount on the customer option for the presence of a material right. For further discussion, see Questions 8.2.40 and 8.2.50.

Example 5.3.80
Retrospective volume discount on optional purchases

Manufacturer enters into an MSA with Customer to supply widgets for $2 per widget. However, Customer is not obligated to purchase a minimum quantity and each purchase order is considered a separate contract.

In order to provide an incentive for the customer to purchase additional widgets, Manufacturer notifies Customer that if it purchases more than 1,000 widgets during a year, the price will be reduced to $1.50 per widget on a retrospective basis for all purchases made during that year.

Because the volume discount of $0.50 per widget is applied retrospectively, it is considered variable consideration. Manufacturer determines the likelihood of Customer reaching that threshold in order to estimate the transaction price using either the most-likely-amount or expected-value approach. That estimate may be reduced by the constraint (see section 5.3.40).

Manufacturer determines that Customer will likely purchase 1,000 widgets and be eligible to receive the $0.50 per widget volume discount. Consequently, the transaction price for each widget purchased is $1.50.

Customer purchases 400 widgets during the first half of the year. At the end of Q2, Manufacturer believes Customer will purchase 600 widgets in the second half of the year and continues to record revenue at the ultimately expected $1.50 discounted widget price.

Customer purchases only 50 widgets during Q3. Based on discussions with Customer during Q3, Manufacturer does not expect Customer to purchase an additional 550 widgets in Q4 and therefore Customer will not earn the $0.50 per widget retrospective volume discount. Manufacturer does not intend to provide the discount without Customer achieving the 1,000 widget threshold. Manufacturer determines that it is probable that including the entire stated fee of $2 per widget, without any reduction for possible volume discounts, in the transaction price will not result in a significant revenue reversal.

During Q1–Q3, Manufacturer has recognized $675 (450 widgets × $1.50 per widget) of revenue. As a result of the change in estimate of the variable consideration related to the volume discount, Manufacturer records a cumulative catch-up of additional revenue of $225 (450 widgets × $0.50 per widget) to retrospectively increase the transaction price per widget to $2.00 for those widgets sold in Q1–Q3. Manufacturer records its Q4 sales at $2.00 per widget.

See FASB Example 24 (volume discount incentive, reproduced at the beginning of section 5.3.20) for another example of a retrospective volume discount. [606-10-55-216 – 55-220]

Example 5.3.90
Prospective volume discount on optional purchases

Assume the same facts as Example 5.3.80 except that the pricing in Year 1 is $2 per widget, regardless of purchase volume. If Customer purchases 1,000 widgets in Year 1, the pricing in Year 2 is reduced to $1.50 per widget; however, there is no rebate or credit on previous purchases from Year 1.

The future discount is not variable consideration because it does not affect the outcome of a current contract. However, because the right to a discount in future years is an accumulating right, Manufacturer will need to determine if the potential discount conveys a material right to Customer (see section 8.3).

Question 5.3.40
Are all concessions variable consideration?

Interpretive response: No. Price concessions and concessions in the form of free or significantly discounted goods or services are treated differently. Price concessions are considered variable consideration. In contrast, concessions to customers in the form of free or significantly discounted good or services generally represent implied promises to the customer – i.e. potential performance obligations. The effect of implied promises are discussed in Question 4.2.20.

Price concessions generally refer to either:

- changes that would have affected the original amount of revenue recognized; or
- changes that reduce the arrangement fee or extend the terms of payment.

Examples of price concessions include, but are not limited to:

- extending payment due dates in the arrangement;
- decreasing total payments due under the contract;
- paying financing fees on a customer's financing arrangement that was not contemplated in the original arrangement;
- accepting returns that were not required to be accepted under the terms of the original arrangement; or
- providing coupons or rebate offers to the customer's customer.

Anticipated price concessions affect a contract's transaction price because the price concessions are variable consideration. If an entity has a history of granting price concessions, it estimates the amount of consideration to which it expects to be entitled after any price concessions – i.e. using an expected-value or most-likely-amount method.

Because the amount of a future price concession is estimated, it is subject to the variable consideration constraint – meaning the entity constrains the estimate by excluding amounts that are probable of significant reversal. The variable consideration constraint is addressed in section 5.3.40.

If an entity estimates a price concession, it later adjusts the transaction price for any changes in the estimate or ultimately trues up the estimate to the actual concession amount. In contrast, if an entity grants a price concession when there is no previous pattern of such concessions, and therefore no concession was estimated in the initial transaction price, the entity accounts for that price concession as a contract modification affecting price only (see section 11.3). We expect that accounting for price concessions as modifications will be relatively infrequent because a history of providing concessions can be created with relatively few instances of such price concessions.

If concessions, such as extending payment due dates or decreasing contract payments, occur because of customer credit problems, the entity also reassesses whether a contract with the customer exists (see section 3.5).

When a receivable is forgiven or written off due to the customer's credit worthiness, the entity recognizes a bad debt expense in accordance with Topic 310.

Example 5.3.100

Pattern of granting price concessions and estimating the transaction price

ABC Corp. sells machines to its customers, along with maintenance services that are paid either annually or quarterly in advance.

ABC is new in the market, and therefore has a significant incentive to ensure it keeps its existing customers from moving to one of the larger competitors. As a result, ABC frequently provides its customers a discount on its maintenance fees from those stated in the original contract for the final year, as an incentive to renew the contract. This discount has ranged from 20% to 60% with no discernible pattern and is generally expressed to the customer as a 'reward' for the customer's past loyalty and is reflected on the maintenance invoice for the discounted period.

ABC enters into a contract with Customer for a total contract price of $480,000:

- a sale of a machine for $300,000, paid upfront; and
- concurrent three-year maintenance services for $180,000, paid in three $60,000 installments at the beginning of each year.

The machine and the three years of maintenance constitute two separate performance obligations, and ABC transfers the machine to Customer at contract inception.

Determine the transaction price

ABC concludes that its substantive history of providing maintenance fee discounts requires it to include an estimate of the future discount it expects to provide Customer in the transaction price. ABC estimates the discount amount using an expected-value method because there is no most-likely discount amount. It estimates that a discount of 42% in the third-year maintenance fees will be granted.

Consequently, the transaction price at contract inception, prior to applying the variable consideration constraint, is $454,800 ($480,000 – ($60,000 × 42%)).

Allocate the transaction price

ABC allocates the unconstrained transaction price based on the relative stand-alone selling prices of the machine and the maintenance of $300,000 and $200,000, respectively, as follows.

	Stand-alone selling price	Selling price ratio	Price allocation
Machine	$300,000	60%	$272,880
Maintenance	200,000	40%	181,920
Total	**$500,000**	**100%**	**$454,800**

Constraint on variable consideration

Because estimating the future discount carries a risk of revenue reversal (i.e. the discount in Year 3 might be higher), ABC next applies the variable consideration constraint to the estimate. That constraint is explained and illustrated in section 5.3.40.

Because ABC's historical discount range has varied unpredictably (between 20% and 60% with no discernible pattern), including any of the potential maintenance discount less than the 60% maximum in the transaction price carries the risk of a revenue reversal.

However, ABC does not constrain its estimate of the transaction price below $454,800 because the revenue reversal that would result from the possible incremental discount of 18% (60% – 42%), or $10,800 ($60,000 × 18%), would not be significant to the cumulative revenue recognized to date under the contract (see Question 5.3.240). This is regardless of when the adjustment occurs during the contract period.

The following hypothetical adjustments to the transaction price illustrate this point, assuming that a time-based measure of progress is applied to the three-year maintenance performance obligation.

— An adjustment immediately after transfer of control of the machine would result in a reversal of only $6,480[1] – compared to cumulative revenue recognized of $272,880.

— An adjustment at the end of Year 2 – i.e. immediately before issuing the Year 3 maintenance invoice – would result in a reversal of only $9,360[2] – compared to cumulative revenue recognized of $394,160.[3]

Notes:

1. $10,800 × ($272,880 / $454,800) = $6,480.
2. $10,800 × ($394,160 / $454,800) = $9,360.
3. $272,880 + ($181,920 × 2/3) = $394,160.

Question 5.3.50
Do customer price protection clauses create variable consideration?

Background: An entity may include a price protection clause in a contract with an end customer or a reseller. Under such a clause, the entity agrees to provide a rebate or credit for a portion of the arrangement fee if it reduces the price of its products. This may include reseller scenarios where the reseller has not yet sold the products to end customers. These clauses may also apply to services or usage-based fees; for example, a promise that if the entity offers better per-transaction pricing to another customer, it will provide the customer a credit for the difference between what it paid and what the new customer is paying.

Interpretive response: Yes, if the price protection clause is applied retrospectively. Because retrospective price protection clauses change the price paid for goods or services already transferred (e.g. products already delivered) or partially transferred (e.g. a partially completed equipment customization project) to the customer, they are in effect just another form of potential price concession. See Question 5.3.40 on price concessions.

Price protection clauses, which apply retrospectively, should be distinguished from most-favored nations (MFN) clauses that apply only prospectively to *distinct* promised goods or services (including distinct goods or services within a single performance obligation), or optional goods or services not yet transferred to the customer. Such clauses do not create variable consideration. Rather, when the transaction price changes, the entity accounts for the price changes as a contract modification (see section 11.2).

Example 5.3.110

Reseller arrangement and price protection capped by the contract

ABC Corp. enters into a distribution agreement with Reseller on January 1. The distribution agreement contains a clause that stipulates that if ABC reduces the price of any product in a transaction with a similarly situated customer, ABC will provide Reseller with a credit equal to the difference between:

- the original purchase price; and
- the new purchase price of the product for:
  - any units in Reseller's inventory at the time of the price reduction; plus
  - any units of the product purchased and sold by the Reseller within 180 days of the price reduction.

The credit is capped at a maximum amount of 40% of the original purchase price.

On January 1, ABC transfers control of 1,000 units of Product P for a nonrefundable fee of $100,000 (i.e. $100 per unit). At the same time, ABC's pricing committee is in the process of evaluating its pricing for units of Product P that will apply to similar customers in the future.

Scenario 1: Maximum price adjustment assumed

Because the pricing committee is evaluating a variety of considerations in attempting to determine the future pricing for units of Product P, there is significant uncertainty in both the amount and timing of the price concession that will be granted to Reseller.

As a result, ABC concludes that only $60,000 of the $100,000 contract price is not subject to the risk of a significant revenue reversal – i.e. ABC assumes the maximum amount of price protection stipulated in the agreement with Reseller will be provided ($100,000 × 40%). Consequently, the transaction price is only $60,000 at the point in time ABC transfers control of the 1,000 units to Reseller, i.e. on January 1.

On April 1, ABC's pricing committee decides to reduce the price from $100 per unit to $70 per unit, and determines that no further price reductions are reasonably expected during the 180-day price protection period with Reseller. As such, ABC updates its estimated transaction price for this contract from $60,000 to $70,000 and recognizes an additional $10,000 in revenue on April 1.

Scenario 2: Less than maximum price adjustment assumed

ABC's pricing committee is further along in its deliberations of the pricing for units of Product P such that it is probable on January 1 that the price reduction will not exceed 25% of the original $100 fee per unit. In this case, the transaction price would be $75,000, which is recognized on January 1 – i.e. the point in time ABC transfers control of the 1,000 units to Reseller.

On February 1, ABC's pricing committee decides to reduce the price from $100 per unit to $80 per unit, and determines that no further price reductions are reasonably expected during the 180-day price protection period with Reseller. As such, ABC updates its estimated transaction price for this contract from $75,000 to $80,000 and recognizes an additional $5,000 in revenue on February 1.

Question 5.3.60

Do extended payment terms create variable consideration?

Interpretive response: Not exactly. Extended payment terms may be explicitly stated in a contract or they may be implied through an entity's past actions or customer expectations. Extended payment terms are not in and of themselves a form of variable consideration, as long as those payment terms are fixed. However, contracts that feature extended payment terms may be more likely to include other forms of variable consideration.

For example, the potential that an entity will grant a concession to the customer increases when there are extended payment terms; this is because an entity's commitment to enforce payment may diminish if new or enhanced products are introduced by the entity or its competitors. This risk increases if the product sold is susceptible to rapid technological obsolescence. That is, if the product is at risk of becoming technologically obsolete before a customer must make payment to the entity, a concession becomes even more likely.

As part of its overall assessment of price concessions, an entity generally should consider its collection history for sales of similar products and services when estimating the frequency, extent and likelihood of potential price concessions for a group of contracts, or for a specific contract. If a contract, or group of contracts, have payment terms that are longer than an entity typically offers for a given type of product, then historical collection patterns may be a less useful predictive measure when estimating the likelihood and amount of potential price concessions. This may also be the case when an entity enters a new market with a product that may have a different technological useful life than the entity's other products. The existence of extended payment terms and the payment term length offered to different customers would also be considered when applying an approach that uses a portfolio of data (Question 5.3.130) for the purposes of estimating payment concessions.

Entities apply the variable consideration guidance in accounting for any potential changes in the transaction price related to concessions arising from extended payment terms.

Even if a contract with extended payment terms does not give rise to a potential price concession, such contracts may include a significant financing component that should be accounted for in determining the transaction price. The existence and accounting for significant financing components is discussed in section 5.5.

Question 5.3.70

Are prompt payment discounts variable consideration?

Interpretive response: Yes. Contracts with customers often have terms that incentivize prompt payment by the customer such as '2/10 net 30' (2% discount for payment to an entity within 10 days or otherwise pay the full invoice amount within 30 days). The potential 2% discount is variable consideration that affects the transaction price in the same manner as any other variable consideration.

As such, the entity estimates the consideration to which it expects to be entitled as a result of offering these terms using a most-likely-amount or expected-value method. Consistent with the overall variable consideration model, the entity analyzes its experience with similar customers and transactions in making this estimate, and it subjects the estimate to the variable consideration constraint.

Question 5.3.80

Are service level agreements that could result in refunds or credits to the customer variable consideration?

Interpretive response: Yes. Credits or refunds to a customer that result from the failure of the entity to meet certain standards under the contract are adjustments to the transaction price (reductions of revenue). Therefore, they may need to be estimated at the outset of the arrangement in the same manner as any other variable consideration – i.e. using a most-likely-amount or expected-value method. Those estimates are then subject to the variable consideration constraint. The estimates, including the effect of the constraint on those estimates, are revised and the transaction price adjusted over the performance period of the contract.

Some penalties under service level agreements may meet the variable consideration allocation exception, in which case estimates would not need to be made. For example, in the case of a stand-ready obligation that is a series, an entity may be able to allocate certain penalties to each distinct time increment depending on the nature of the penalty, the entity's efforts and the overall arrangement. This would have the practical effect of recognizing the penalties on the day to which they relate. See sections 6.6 and 6.7 for a discussion of the application of the variable consideration allocation exception.

Example 5.3.120
Service level agreements

ABC Corp. enters into a contract with Customer to provide access to its building maintenance service for one year. Monthly fees are $100 throughout the term, subject to a service level agreement (SLA).

Under the SLA, ABC warrants that it will respond to all maintenance requests within 12 hours. If more than five maintenance requests are not responded to within 12 hours during the annual period, Customer will be entitled to a 10% credit of the annual fees.

Scenario 1: Significant experience and no expectation of service level credits

ABC has significant experience with similar contracts and has an established history of only rarely taking more than 12 hours to respond to a maintenance request. Based on this experience, ABC concludes that a most-likely-amount method to estimate the variable consideration will best predict the consideration to which it will be entitled.

Applying that method, ABC concludes that it expects to be entitled to 100% of the contract price – i.e. response time will be 12 hours or less for all maintenance requests for the duration of the agreement.

Further, ABC's experience is of such a substantive nature and the company so rarely grants service level credits that the estimate is not constrained – i.e. it is probable that including the entire stated fees for the one-year term of $1,200 ($100 × 12), without any reduction for possible service level credits, in the transaction price at contract inception will not result in a significant revenue reversal. Consequently, the transaction price does not reflect any expectation of service level credits.

If ABC subsequently incurs a service level penalty, it adjusts the transaction price with a corresponding reduction of revenue as well as its estimates for the rest of the contract and potentially other similar contracts (see Question 5.3.250 on reversals of revenue).

Scenario 2: Limited experience with similar arrangements

ABC has been operating for a relatively short period of time such that its experience with these types of arrangements is limited. Consequently, ABC cannot conclude that it is probable it will not grant any service level credits to Customer during the course of the contract and will need to estimate expected service level credits over the one-year term.

ABC considers all of its available and relevant evidence; this includes, but is not limited to, knowledge about the quality of its infrastructure, industry benchmarks and its own limited experience in developing an expected-value method estimate of the credits it expects to provide to Customer over the one-year term. ABC further considers whether it is probable, if it uses that estimate as the transaction price, that no significant revenue reversal will result. ABC is not able to conclude that there will not be a significant reversal in the amount of cumulative revenue; as such, ABC applies the constraint and further reduces the estimated transaction price to $1,080 ($100 × 12 × 90%[1]).

Under either scenario, ABC will continue to reevaluate its estimate of the transaction price, including the constraint, each reporting period for changes in circumstances - e.g. additional experience gained.

Note:

1. The maximum credit that Customer can receive is 10%. As a result of its limited experience in these arrangements, ABC has constrained its estimate of the transaction price to 90%.

Question 5.3.90

Does denomination in a currency other than the entity's functional currency mean the contract includes variable consideration?

Interpretive response: No. Although the contract may state a fixed price in a foreign currency, the amount expressed in the entity's functional currency will vary based on the changes in the exchange rate in effect between the date the contract is entered into and when the payment is received or revenue is recognized. This potential variation does not turn the fixed price in the foreign currency into variable consideration.

In addition, the guidance requiring an entity to measure noncash consideration at contract inception does not apply because foreign-denominated currency is not noncash consideration. That is, the entity would not fix the exchange rate at contract inception for purposes of estimating the transaction price, which would be the case if the foreign-denominated currency were considered noncash consideration.

Therefore, contracts denominated in a currency other than the entity's functional currency are measured into the entity's functional currency using the foreign exchange rate in accordance with Topic 830. Changes in the foreign exchange rate after contract inception ultimately affect the amount of revenue reported in the financial statements, but they do not create variable consideration. See section 3 of KPMG Handbook, Foreign currency, for further discussion on foreign currency transactions. [830-20-30-1]

Question 5.3.100

Are liquidated damages or similar provisions variable consideration?

Interpretive response: Generally, yes. Many contracts contain terms providing for liquidated damages and similar compensation to the customer upon the occurrence or nonoccurrence of certain events. These terms typically give rise to variable consideration, given the standard identifies penalties as variable consideration. [606-10-32-6]

However, in some circumstances the terms may be similar to a warranty provision. Judgment is required to distinguish those terms that are accounted for as warranties from the more common scenarios in which the terms give rise to variable consideration.

For example, if a third party repairs a defective product sold by an entity and the entity reimburses the customer for costs incurred, that may be similar to a warranty. Those payments to a customer are typically accounted for as an assurance-type warranty rather than variable consideration. Similarly, the payments are typically not treated as consideration payable to a customer because the payments provide the entity with an identifiable benefit of repairing the goods or services initially provided to the customer (see Question 4.5.80).

Question 5.3.105

Should Medicare Part D Coverage Gap reimbursements be accounted for as variable consideration?

Background: Many pharmaceutical companies sell drugs subject to the Medicare Part D Coverage Gap – often referred to as the 'donut hole'. This government program requires pharmaceutical companies to pay a percentage of the cost of their branded drugs (through a payment to the insurer) when a Medicare beneficiary falls within the coverage gap during a calendar year. A beneficiary enters the coverage gap once the cost of prescription drugs purchased during the year (from all manufacturers) exceeds the amounts covered by Medicare. While in the coverage gap, beneficiaries pay only their portion of the drug cost and the pharmaceutical companies subsidize the remainder of the cost.

Interpretive response: It depends. Topic 606 does not provide explicit guidance on this type of government program, and an entity needs to consider its particular facts and circumstances to determine the right approach to account for the coverage gap.

Depending on the situation, we believe the following approaches may be appropriate.

— **Specific identification approach (i.e. variable consideration).** Under this approach, an entity views the coverage gap reimbursements as variable consideration attributable to individual sales of a product and not to overall annual sales. At the point of sale, the entity estimates the amount of reimbursement that will be required for that particular sale, which reduces the revenue recognized.

— **Material right approach.** Under this approach, an entity views coverage gap reimbursement requirements as giving rise to a material right. This is because the program in effect provides discounts on future purchases through the Medicare channel. The entity allocates a portion of the transaction price to the material right, and recognizes that amount as revenue when Medicare beneficiaries use the coverage gap subsidies. Alternatively, an entity may apply the alternative approach to allocating consideration to material rights if certain criteria are met (see section 8.5.10). Under the alternative approach, an entity may estimate total expected consideration and allocate it proportionate with expected sales during the year.

While either approach may be reasonable in certain circumstances, we do not believe the material right approach is appropriate when donut hole rebates are expected to be made predominantly in the early part of a year, which could be the case for a costly medication available from a single entity that must be taken periodically. A pattern of providing most of the rebates on early sales is not consistent with the notion that the customer has obtained a discounted option to buy goods in the future.

5.3.30 Estimating variable consideration

Excerpt from ASC 606-10

• > Variable Consideration

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).

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.

• • > Example 21—Estimating Variable Consideration

55-197 An entity enters into a contract with a customer to build a customized asset. The promise to transfer the asset is a performance obligation that is satisfied over time. The promised consideration is $2.5 million, but that amount will be reduced or increased depending on the timing of completion of the asset. Specifically, for each day after March 31, 20X7 that the asset is incomplete, the promised consideration is reduced by $10,000. For each day before March 31, 20X7 that the asset is complete, the promised consideration increases by $10,000.

55-198 In addition, upon completion of the asset, a third party will inspect the asset and assign a rating based on metrics that are defined in the contract. If the asset receives a specified rating, the entity will be entitled to an incentive bonus of $150,000.

55-199 In determining the transaction price, the entity prepares a separate estimate for each element of variable consideration to which the entity will be entitled using the estimation methods described in paragraph 606-10-32-8:

a. The entity decides to use the expected value method to estimate the variable consideration associated with the daily penalty or incentive (that is, $2.5 million, plus or minus $10,000 per day). This is because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.
b. The entity decides to use the most likely amount to estimate the variable consideration associated with the incentive bonus. This is because there are only 2 possible outcomes ($150,000 or $0) and it is the method that the entity expects to better predict the amount of consideration to which it will be entitled.

55-200 The entity considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the entity should include some or all of its estimate of variable consideration in the transaction price.

Once an entity identifies variable consideration, it then estimates the amount of the variable consideration to include in the transaction price by using one of two methods. The selection of a method is not a free choice. Rather, the entity chooses the method it expects to better predict the amount of consideration to which it will be entitled. Once it identifies the appropriate method for a particular contract or source of uncertainty, the entity applies the same method to similar contracts or uncertainties. [606-10-32-8, ASU 2014-09.BC195]

Expected value	The entity considers the probability-weighted amounts for a range of possible consideration outcomes. This may be an appropriate estimate of the amount of variable consideration if the entity has a large number of contracts with similar characteristics, and/or the contract has a large number of possible outcomes.
Most likely amount	The entity considers the single most likely amount from a range of possible consideration outcomes. This may be an appropriate estimate of the amount of variable consideration if the contract has only two (or perhaps a few) possible outcomes – e.g. an entity will either achieve a performance bonus or it will not.

As noted above, an entity typically needs a large number of contracts with similar characteristics to properly apply the expected-value method. Judgment is required to determine whether the prior transactions from which the expected value is derived are:

— sufficiently similar with one another;
— consistent with the current contract whose variable consideration is being estimated; and
— numerous enough to develop an expected value.

An entity considers all information available when making its estimate of variable consideration and updates the estimate at each reporting date. [606-10-32-9]

Once an entity estimates its variable consideration using one of the above methods, it applies the variable consideration constraint to the estimate. This constraint allows the estimated variable consideration to be recognized in the transaction price only to the extent that it is probable that a subsequent change in the estimate would not result in a significant revenue reversal. The variable consideration constraint is discussed and illustrated in section 5.3.40. [606-10-32-11]

The above requirements do not apply to sales- and usage-based royalties promised in exchange for a license of IP. Such royalties are accounted for under different guidance provided for licenses of IP (see section 10.11). [606-10-55-65]

Example 5.3.130
Estimate of variable consideration – expected value

Manufacturer sells 1,000 televisions to Retailer for $500,000 ($500 per television). Manufacturer provides price protection to Retailer by agreeing to reimburse Retailer for the difference between this price and the lowest price that it offers for that television during the following six months.

Based on Manufacturer's extensive experience with similar arrangements, it estimates the following possible outcomes.

Price reduction in next six months	Probability
$0	70%
$50	20%
$100	10%

After considering all relevant facts and circumstances, Manufacturer determines that the expected-value method provides the best prediction of the amount of consideration to which it will be entitled.

As a result, it estimates the transaction price to be $480 per television: ($500 × 70%) + ($450 × 20%) + ($400 × 10%). This is before considering the constraint (see section 5.3.40).

Question 5.3.110
Are there any exceptions to the requirement to estimate variable consideration?

Interpretive response: Yes. An entity does not have to estimate variable consideration in the following scenarios.

The 'as-invoiced' practical expedient

The 'as-invoiced' practical expedient can be applied to a performance obligation satisfied over time. It permits an entity to recognize revenue in the amount to which it has a right to invoice the customer if that amount corresponds directly with the value to the customer of the entity's performance completed to date. See section 7.4.50, which discusses in further detail when use of this practical expedient is, and is not, appropriate. [606-10-55-18]

When this practical expedient applies, the entity does not need to estimate the transaction price in order to recognize revenue. For example, a contract to provide a service satisfied over time where the entity bills the customer on a time and material basis may be eligible for the practical expedient.

Series of distinct service periods

The performance obligation is determined to be a series of distinct service periods (see section 4.4 which discusses when a performance obligation is a series) and the entity meets the requirements to allocate the fees entirely to each distinct service period as they are earned in the contract (see section 6.6 on the variable consideration allocation exception guidance).

For example, an entity that provides a series of distinct transaction processing services may be able to allocate the fee per transaction entirely to the period the fee is earned, and therefore would not need to estimate that amount. Section 6.7 discusses when service providers will and will not be able to allocate the variable fee to distinct service periods within a service performance obligation.

Allocation of variable consideration to future performance obligations

Similar to a series of distinct service periods, there may be situations when variable consideration is allocated entirely to performance obligations to be transferred in future periods. For example, if an entity entered into a contract to transfer 100 units of distinct goods transferred at a point in time and charges the customer based on the market price on the day of delivery, the entity may not need to estimate the total transaction price if the requirements on allocating variable consideration to each performance obligation are met.

License of IP

Consideration for a license of IP based on sales- or usage-based royalties qualifies for a recognition exception. However, that same exception does not apply to legal sales of IP; see section 10.2 for the scope of the licensing guidance. [606-10-55-65 – 55-65B]

In a license of IP, an entity is not required to estimate variable consideration upfront and then monitor and true up that estimate over the life of the contract.

Instead, the royalties are recognized at the later of: [606-10-55-65]

- when the subsequent sales or usage occurs; or
- the satisfaction or partial satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

If the entity needs to allocate the royalty to more than one performance obligation, it may need to estimate those amounts for purposes of allocating the transaction price to the performance obligations. However, it would not recognize any revenue until sales or usage occurs. [ASU 2016-10.BC75(a)]

Question 5.3.120

Can management use a method other than the 'expected-value' or 'most-likely-amount' methods when estimating variable consideration?

Interpretive response: No. The FASB considered, and ultimately rejected, allowing management to have a free choice to select a method to estimate variable consideration. Instead, it developed a framework for estimating variable consideration, requiring that an entity use either the expected-value method or the most-likely-amount method, depending on which is a better predictor given the specific facts and circumstances.The FASB thought that such a framework would ensure rigor in the estimation process. The FASB concluded that, without such a framework, the measurement of revenue might not be understandable to users and might lack comparability between entities. [ASU 2014-09.BC198]

When making disclosures about significant judgments made in applying Topic 606, an entity should ensure its disclosures about methods used to estimate variable consideration are consistent with the required framework described above. See section 15.8 for guidance about disclosing significant judgments in applying Topic 606.

Question 5.3.130

Is using relevant information from a portfolio of similar contracts to estimate variable consideration the same as applying the portfolio approach practical expedient?

Interpretive response: No. The TRG agreed that using a portfolio of data to develop estimates required to apply the revenue model in Topic 606, including estimates of variable consideration using the expected-value method, is not the same as applying the portfolio approach practical expedient. [TRG 07-15.38]

The portfolio approach practical expedient allows an entity to account for a portfolio of contracts collectively rather than individually. To qualify for the practical expedient, the entity must reasonably expect that the effects on the financial statements of applying this guidance to the portfolio will not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio. See section 2.5 for more discussion of the portfolio approach. [606-10-10-4]

This means that when entities apply the expected-value method and use data from a portfolio of similar contracts, the entity would not be required to undertake the analysis described in the paragraph above because the use of the expected-value method is not the same as the portfolio practical expedient.

Question 5.3.140

What does an entity consider in deciding whether it has a sufficient number of similar contracts to use the expected-value method?

Interpretive response: In some cases, an entity's ability to use the expected-value method will be clear. For example, entities that have substantially similar contracts with all customers obtaining the same goods or services will generally have a sufficient portfolio of data from which to use an expected-value method to estimate variable consideration.

However, an entity's contracts are often quite customer-specific. For example, for some entities, customers rarely obtain the exact same product, service or mix of products or services.

Use of the expected-value method does not require homogenous customer contracts; rather, it merely requires that there be common characteristics *relevant to the estimation of the variable consideration*.

For example, even if an entity never sells the same mix of goods or services to any two customers or has a wide variety of contract terms, certain goods and services may be substantially similar. This level of similarity may allow the entity to use an expected-value method to estimate the likelihood of earning performance bonuses or incurring penalties related to those goods or services. Similarly, even if the entity's customers enter into widely varied arrangements for different mixes of goods and services, the entity's goods and services may be generally consistent. Even though the actual good or service being provided may differ substantially between customers, the portfolio of customer contracts that include such goods and services may be sufficiently similar to provide relevant, predictive evidence about whether the entity will be required to provide service level credits or refunds to customers.

There are various attributes of an entity's customer contract portfolio that may provide similarities relevant to different types of variable consideration. The following are examples (not exhaustive) of attributes around which an entity may be able to develop a portfolio of data (even if the contracts are not substantially similar overall), relevant to estimating variable consideration.

— **Short-term versus long-term contracts.** It may be that customers under long-term contracts are more likely to be granted concessions (which are variable consideration – see Question 5.3.40) to keep that long-term contract in place and enhance the customer relationship.

— **Type or class of customer.** It may be that larger customers are granted concessions, but smaller customers are not; that larger customers have more stringent performance bonus/penalty provisions in their contracts than smaller customers; or that reseller customers (as compared to end-user customers) are more likely to return certain goods.

- **Payment terms.** It may be that customers with extended payment terms are more likely to be granted concessions (see Question 5.3.40).
- **Types of products or services.** It may be that the entity's performance record on performing certain services or producing certain products differs depending on the nature of those services and products.

Question 5.3.150

Does an entity need to consider all possible outcomes when applying the expected-value or the most-likely-amount method?

Interpretive response: No. Although in theory an entity using the most-likely-amount method considers all possible outcomes to identify the most likely one, in practice there is no need to quantify the less probable outcomes. [ASU 2014-09.BC201]

Similarly, in practice, estimating the expected value using a probability-weighted method does not require an entity to explicitly quantify probabilities for all possible outcomes using complex models and techniques. Using a smaller number of discrete outcomes might provide a reasonable estimate of the distribution of possible outcomes.

Regardless of the method used, an entity considers all the information (historical, current and forecasted) that is reasonably available when making its estimate.

Question 5.3.160

Does the transaction price in a contract with variable consideration have to equal a possible outcome of the contract?

Interpretive response: No. Some variable consideration arrangements have a limited number of possible outcomes. For example, an arrangement under which an entity provides services may include incentives or penalties for good or poor performance that have only a limited number of possible outcomes.

Consider a scenario in which on-time performance results in an entity earning $500. However, the entity stands to:

- earn potential bonuses of $300, $200 or $100 if a project is completed before specified dates; and
- incur penalties of $100, $200 or $300 if the project is completed after specified dates.

In this scenario the only possible outcomes for the transaction price are $200, $300, $400, $500, $600, $700 and $800.

This is a scenario that may occur in some large-scale implementation projects or construction projects. In scenarios such as this, entities with a sufficient volume of similar arrangements may determine that an expected-value method is the most appropriate basis on which to estimate the variable consideration.

The TRG discussed whether the transaction price must equal a possible outcome of the contract – e.g. in the scenario above, whether the estimated transaction price must be one of those possible outcomes. The TRG generally agreed that when using an expected-value method for estimating variable consideration, the estimated transaction price does not need to be an amount that is a possible outcome for an individual contract – i.e. in the scenario above, the estimated transaction price can be a number other than those listed. However, because of the transaction price reassessment requirements, at some point the transaction price will be trued up to the actual outcome achieved. [TRG 07-15.38]

Example 5.3.140

Transaction price is not a possible outcome of the contract

ABC Corp. enters into a contract for constructing a hospital with Customer. Customer wants to ensure the project is completed on a timely basis, and therefore has built into the contract penalties for not meeting the agreed-upon completion date.

The following table shows the agreed contract fee based on different scenarios.

Scenario	Contract fee
Project completed more than 3 months ahead of schedule	$150,000
Project deadline met	130,000
Project not completed within 3 months of deadline	120,000
Project not completed within 5 months of deadline	110,000
Project completed any time after 6 months	100,000

ABC concludes that the contract includes only a single performance obligation that is satisfied over time.

ABC decides that an expected-value method is the most appropriate to estimate the transaction price. This is because of the number of possible outcomes and the fact that ABC enters into a large number of similar construction projects.

Using the expected-value method, ABC assigns weighting to each possible outcome and estimates the transaction price as follows. This is before consideration of the constraint (see section 5.3.40).

Transaction price	Probability	Weighting
$100,000	5%	$ 5,000
110,000	10%	11,000
120,000	20%	24,000
130,000	50%	65,000
150,000	15%	22,500
Expected value		**$127,500**

Although $127,500 is not a possible outcome of the contract, ABC uses this amount as the transaction price at contract inception. ABC will continue to update the transaction price until the uncertainty associated with the project's completion is resolved.

Note: The result in this example does not consider the effects of the variable consideration constraint. ABC would also need to evaluate whether it was probable that a change in estimate would result in a significant revenue reversal and adjust the transaction price, if necessary. The variable consideration constraint is explained in section 5.3.40.

Question 5.3.170

Is an entity required to use a single method to estimate the transaction price consistently for all variable payment terms in the same contract?

Interpretive response: No. The use of different methods for different payment streams within the same contract is permissible, as long as the methods are consistently applied throughout the duration of the contract and that the methods used are the best predictors of the transaction price. The methods used should be applied consistently in contracts and among performance obligations with similar uncertainties.

For example, it would be permissible to apply a most-likely-amount method to a performance bonus under the contract while using an expected-value method to estimate the variable consideration for a right of return or in estimating the service level credits (see Question 5.3.80) in a service arrangement in the same contract. [ASU 2014-09.BC202]

Question 5.3.180

Can an entity change the estimation method during the course of the contract?

Interpretive response: No. As described in Question 5.3.170, an entity may use a different method for estimation for different variable payments in a contract. However, once an entity selects a method, it applies that method consistently throughout the contract's duration. Therefore, the entity either applies the expected-value method or the most-likely-amount method throughout the contract term to a variable element of the transaction price. [606-10-32-9]

Question 5.3.190

Is an entity required to apply the same method of estimating variable consideration to all similar variable fee terms within a portfolio of contracts with customers?

Interpretive response: We generally expect the same method of estimating a variable transaction price to be applied to similar variable fee terms across an entity's portfolio of contracts absent a change in circumstances or business practices – as the entity would be likely to reach the same conclusion as to the method that better predicts the transaction price in similar contracts. [ASU 2014-09.BC195]

However, the objective for each contract is to develop an estimate of the amount that is most predictive of the consideration to which the entity will be entitled. Therefore, if another method better predicts the amount of consideration due to specific circumstances of a contract with a particular customer that other method may be more appropriate.

Question 5.3.200

Is variable consideration included in the transaction price when the entity believes it is unlikely to earn the variable consideration?

Interpretive response: It depends. An entity's objective when determining the transaction price for a contract is to estimate the total amount of consideration to which it will be entitled under the contract, subject to the constraint on variable consideration.

If an entity concludes that using the most likely amount is the more appropriate approach and that amount is zero, then variable consideration would be excluded from the transaction price at contract inception. However, because the evaluation of variable consideration is an ongoing process, if the entity's estimate changes it would recognize an amount greater than zero in subsequent reporting periods.

In contrast, if an entity concludes that using the expected-value method is more appropriate, some amount of variable consideration (i.e. more than zero) will be included in the transaction price, unless application of the constraint results in a minimum amount of zero. This is the case even if the entity thinks it is unlikely to be entitled to any of the variable consideration.

5.3.40 Constraint on variable consideration

Excerpt from ASC 606-10

• • > Constraining Estimates of Variable Consideration

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.

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.

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.

• • > Example 23—Price Concessions

55-208 An entity enters into a contract with a customer, a distributor, on December 1, 20X7. The entity transfers 1,000 products at contract inception for a price stated in the contract of $100 per product (total consideration is $100,000). Payment from the customer is due when the customer sells the products to the end customers. The entity's customer generally sells the products within 90 days of obtaining them. Control of the products transfers to the customer on December 1, 20X7.

55-209 On the basis of its past practices and to maintain its relationship with the customer, the entity anticipates granting a price concession to its customer because this will enable the customer to discount the product and thereby move the product through the distribution chain. Consequently, the consideration in the contract is variable.

• • • > Case A—Estimate of Variable Consideration Is Not Constrained

55-210 The entity has significant experience selling this and similar products. The observable data indicate that historically the entity grants a price concession of approximately 20 percent of the sales price for these products. Current market information suggests that a 20 percent reduction in price will be sufficient to move the products through the distribution chain. The entity has not granted a price concession significantly greater than 20 percent in many years.

55-211 To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates the transaction price to be $80,000 ($80 × 1,000 products).

55-212 The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of $80,000 can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and determines that it has significant previous experience with this product and current market information that supports its estimate. In addition, despite some uncertainty resulting from factors outside its influence, based on its current market estimates, the entity expects the price to be resolved within a short time frame. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $80,000) will not occur when the uncertainty is resolved (that is, when the total amount of price concessions is determined). Consequently, the entity recognizes $80,000 as revenue when the products are transferred on December 1, 20X7.

• • • > Case B—Estimate of Variable Consideration Is Constrained

55-213 The entity has experience selling similar products. However, the entity's products have a high risk of obsolescence, and the entity is experiencing high volatility in the pricing of its products. The observable data indicate that historically the entity grants a broad range of price concessions ranging from 20 to 60 percent of the sales price for similar products. Current market information also suggests that a 15 to 50 percent reduction in price may be necessary to move the products through the distribution chain.

55-214 To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that a discount of 40 percent will be provided and, therefore, the estimate of the variable consideration is $60,000 ($60 × 1,000 products).

55-215 The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether some or all of the estimated amount of variable consideration of $60,000 can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and observes that the amount of consideration is highly susceptible to factors outside the entity's influence (that is, risk of obsolescence) and it is likely that the entity may be required to provide a broad range of price concessions to move the products through the distribution chain. Consequently, the entity cannot include its estimate of $60,000 (that is, a discount of 40 percent) in the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Although the entity's historical price concessions have ranged from 20 to 60 percent, market information currently suggests that a price concession of 15 to 50 percent will be necessary. The entity's actual results have been consistent with then-current market information in previous, similar transactions. Consequently, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur if the entity includes $50,000 in the transaction price ($100 sales price and a 50 percent price concession) and, therefore, recognizes revenue at that amount. Therefore, the entity recognizes revenue of $50,000 when the products are transferred and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved in accordance with paragraph 606-10-32-14.

Once an entity estimates variable consideration, it then applies the variable consideration constraint. The constraint's objective is to reduce the risk that the transaction price includes significant amounts that will be reversed as subsequent changes in the estimate occur. Therefore, the constraint introduces a downward bias into the estimate of variable consideration, requiring an entity to exercise prudence before it recognizes revenue – i.e. it makes a non-neutral estimate. This exception to the revenue recognition model, and to the FASB's conceptual framework requirement to make neutral estimates, reflects the particular sensitivity with which revenue reversals are viewed by many users and regulators. [ASU 2014-09.BC207]

When applying the constraint, an entity includes an estimated amount of variable consideration in the transaction price only if it is probable that a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal. A significant revenue reversal would occur if a subsequent change in the estimate of the variable consideration would result in a significant downward adjustment to the amount of cumulative revenue recognized from that contract when the change in estimate occurs. The term 'probable' is used in the same way as it is in Topic 450 – i.e. "the future event or events are likely to occur." Probable is not as high of a threshold as, for example, 'virtually certain'. As a result, downward adjustments may still occur even though the intent of the constraint is to reduce the likelihood of entities recognizing significant downward adjustments to previously recognized revenue. See Question 5.3.250. [ASU 2014-09.BC211]

The entity meets the objective of the constraint if it has sufficient experience or evidence to support that an amount of variable consideration does not risk a significant revenue reversal. Importantly, the lack of sufficient experience or evidence to support including the *entire* amount of variable consideration in the transaction price does not mean all the variable consideration should be excluded from the transaction price. If an entity expects that including some, but not all, of the estimated amount of variable consideration in the transaction price would not result in a significant revenue reversal, the entity includes that amount (and subsequent changes to that amount) in the estimate of the transaction price. This means that in most cases, even if there is significant uncertainty about variable consideration, the amount of variable consideration included in the transaction price will be greater than zero. [ASU 2014-09.BC206]

Determining whether its experience or other evidence is sufficient to support its assessment is a qualitative assessment. Specifically, an entity takes into consideration all relevant facts and circumstances associated with both:

— the likelihood of a downward adjustment in the estimate of variable consideration – e.g. the risk of such an adjustment arising from an uncertain future event; and

— the magnitude of the reversal if that uncertain event were to occur or fail to occur. An entity assesses the potential magnitude of a significant revenue reversal relative to the cumulative revenue recognized to date under the contract – i.e. for both variable and fixed consideration, rather than based only on a reversal of the variable consideration. The assessment of magnitude is relative to the transaction price for the *contract*, rather than the amount allocated to a specific *performance obligation*. [606-10-32-12]

If the risk of a downward adjustment in the estimate of variable consideration is low or the potential magnitude of the revenue reversal that would result from that downward adjustment is small, the constraint does not affect the estimated amount of variable consideration.

Circumstances indicating a possible significant revenue reversal include, but are not limited to: [606-10-32-12]

— the amount of consideration is highly susceptible to factors outside the entity's influence. Those factors 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;

— the uncertainty about the amount of consideration is not expected to be resolved for a long period of time;

— the entity's experience (or other evidence) with similar types of contracts is limited or that experience (or other evidence) has limited predictive value;

— 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; and/or

— the contract has a large number and broad range of possible consideration amounts.

An entity does *not* consider collectibility of the consideration (i.e. customer credit risk) when evaluating either its estimate of variable consideration or the applicability of the constraint. Rather, credit risk affects Step 1 of the revenue model, which contains an explicit collectibility threshold as a criterion to conclude that a contract exists within the Topic 606 revenue model (see section 3.3).

Even if an entity constrains variable consideration in its determination of the transaction price, it still recognizes all of the related costs to fulfill the promised good or service when control is transferred to the customer. This may result in an upfront loss until the constrained variable consideration (or a portion thereof) becomes unconstrained.

Question 5.3.210

Does an entity first estimate variable consideration and then apply the constraint to that estimate?

Interpretive response: Not necessarily. An entity isn't required to strictly follow the two-step process if its process for estimating variable consideration already incorporates the principles on which the guidance for constraining estimates of variable consideration is based.

For example, when an entity estimates revenue from sales of goods with a right of return, it might not practically need to estimate the expected revenue and then apply the constraint guidance to that estimate. This will be the case if its calculation of the estimated revenue incorporates its expectations of returns at a level at which it is probable that the cumulative amount of revenue recognized would not result in a significant revenue reversal. [ASU 2014-09.BC215]

If an entity decides not to strictly follow the two-step approach, it is nevertheless important that its estimated transaction price includes its expectations of the amount of variable consideration that is probable of not being subject to a significant reversal of the cumulative revenue recognized.

Question 5.3.220

Is the unit of account for determining the constraint at the contract or performance obligation level?

Interpretive response: Contract level. The unit of account for determining the transaction price, and therefore the constraint, is at the contract level – it is not at the performance obligation level. While this is not explicitly stated in the standard, the TRG agreed that the unit of account for applying the constraint is the contract. [TRG 01-15.14]

Question 5.3.230

Is a transaction price that is subject to variability due to market prices or volatility always constrained to zero?

Interpretive response: No. A contract with variable consideration based on market prices or subject to volatility does not necessarily mean the transaction price should be fully constrained. In certain circumstances, it may be appropriate to include variable amounts in the transaction price even if the realization of the variable consideration continues to be subject to market prices or volatility.

Although consideration being highly susceptible to factors outside an entity's influence is a factor that suggests an increased likelihood or magnitude of a revenue reversal, that factor is not determinative in concluding whether variable consideration could be recognized. [606-10-32-12]

Therefore, depending on an entity's evaluation of these factors, circumstances may exist in which an entity concludes that it is able to recognize some amount of revenue even when fees vary due to factors outside its control. An entity would need appropriate evidence to support that its estimate of the transaction price reflects the application of the constraint.

Example 5.3.150
Applying the constraint to a transportation agreement when there is market volatility

Pipeline Company has a transportation agreement whereby it will receive an incremental payment if the average price per barrel of oil over the three-year term of the agreement exceeds $40 per barrel. The average price over the first two years is $80 per barrel.

After considering factors such as the market volatility and global economics affecting the market price, Pipeline Company may be able to conclude that it is sufficiently likely that:

— the price per barrel will exceed the required average price over the remaining term of the agreement (the third year); and
— a subsequent significant reversal of any variable consideration in relation to cumulative revenue recognized is not probable.

If that is the case, Pipeline Company will include the estimated incremental amount in the transaction price before final resolution of the uncertainty.

Example 5.3.160
Applying the constraint to an investment management contract when there is market volatility

This example is adapted from Example 25 in Topic 606; see section 15.8 for a reproduction of the example.

Investment Manager enters into a two-year contract to provide investment management services to Fund, a non-registered investment partnership. Fund's investment objective is to invest in equity instruments issued by large publicly listed companies. Investment Manager receives the following fees payable in cash for its services.

Management fee	2% per quarter, calculated based on the fair value of the net assets at the end of each quarter.

Performance-based incentive fee	20% of the fund's return in excess of an observable market index over the contract period.

Investment Manager determines that the contract includes a single performance obligation (series of distinct services) that is satisfied over time, and identifies that both the management fee and the performance fee are variable consideration. Before including the estimates of consideration in the transaction price, Investment Manager considers whether the constraint applies to either the management fee or the performance fee.

Contract inception

At contract inception, Investment Manager determines that the cumulative amount of consideration is constrained because the promised consideration for both the management fee and the performance fee is highly susceptible to factors outside its own influence.

Subsequent reassessment

At each subsequent reporting date, Investment Manager makes the following assessment of whether any portion of the consideration continues to be constrained.

Management fee	The cumulative amount of consideration from the management fee to which it is entitled is not constrained, because it is calculated based on asset values at the end of each quarter. Therefore, once the quarter finishes, the consideration for that quarter is known. Investment Manager concludes that it should allocate the entire amount of the fee to the completed quarters, because the fee relates specifically to the service provided for those quarters. See section 6.6 for discussion of the variable consideration allocation guidance.
Performance-based incentive fee	The full amount of the performance fee is constrained, and therefore excluded from the transaction price. This is because: — the performance fee has a high variability of possible consideration amounts, and the magnitude of any downward adjustment could be significant; — although Investment Manager has experience with similar contracts, that experience is not predictive of the outcome of the current contract; this is because the amount of consideration is highly susceptible to volatility in the market (based on the nature of the assets under management); and — there are a large number of possible outcomes.

This determination is made each reporting date and could change toward the end of the contract period.

Assume that with three months left, Fund has achieved an annualized rate of return significantly in excess of the market index and as such, Investment Manager transfers the investments into a money market fund for the remainder of the contract term. Based on the annualized rate of return achieved to date compared to the market index, Investment Manager concludes that a subsequent significant reversal in relation to cumulative revenue recognized is not probable for the entire bonus given the risk of not achieving the rate of return has been mitigated by transferring the investments into the low-risk money market funds.

At that point, Investment Manager would include at least some of the estimated variable consideration in the transaction price.

If Investment Manager's fees included an incentive-based capital allocation in the form of a carried interest in a partnership or similar structure, it would make an accounting policy election to either apply Topic 606 to those fees or an equity ownership model using the guidance in Topic 323, Topic 810 or other relevant guidance. See Question 2.3.80 for a discussion of performance fees in the form of capital allocations.

Question 5.3.240

What factors influence the potential magnitude of a revenue reversal that would result from a downward adjustment to an entity's estimate of variable consideration?

Interpretive response: The constraint is intended to significantly reduce the likelihood that a *significant* reversal in the amount of *cumulative* revenue recognized *for the contract* will occur – i.e. it considers the magnitude of any potential revenue reversal.

The constraint is applied at the contract level and involves an analysis of the cumulative revenue recognized to date. Therefore, the nature and timing of when performance obligations are satisfied could affect a potential adjustment to the entity's most-likely-amount or expected-value method estimate of variable consideration. As such, the following factors affect (1) whether the constraint results in an adjustment to the entity's most-likely-amount or expected-value method estimate of variable consideration and, if so, (2) the amount of that adjustment.

- The identification of the performance obligations in the contract – e.g. whether goods or services are distinct.
- If there are multiple performance obligations in the contract, the order in which those performance obligations are satisfied.
- Whether some or all of the performance obligations in the contract are satisfied over time or at a point in time.

The following scenarios illustrate how these factors affect the analysis.

Scenario 1: Two performance obligations, one satisfied at inception

ABC Corp. enters into a contract with Customer that includes a machine and installation services that are separate performance obligations. The machine is transferred at contract inception and the installation services are provided over the subsequent 12 months.

The fixed consideration is $1,000,000; and ABC can earn up to a $200,000 bonus depending on when the installation services are completed. Based on the stand-alone selling prices of the machine and the services, the transaction price is allocated on an 80:20 ratio to the machine and installation services, respectively.

Using the most-likely-amount method, ABC concludes that it expects to be entitled to $150,000 of the performance bonus. However, the constrained amount that ABC expects to be entitled to is $50,000.

Suppose ABC does not constrain any of its estimate of variable consideration and includes $150,000 of variable consideration in the transaction price at contract inception. Further suppose that, at the end of the first reporting period, ABC has to revise its estimate to the constrained amount of $50,000.

In that scenario, ABC would record a revenue reversal of $80,000 relating to the machine ($100,000 ($150,000 – $50,000) × 80%). The reversal might be higher depending on progress toward satisfaction of the installation services at the time the estimate is revised.

Because the potential revenue reversal could be significant, ABC concludes that the variable consideration constraint should be applied.

Scenario 2: Single performance obligation, satisfied over time

ABC enters into a contract with Customer that includes a machine and significant customization and modification services that are a single, combined performance obligation. The combined performance obligation is satisfied over time and is expected to be satisfied 12-15 months after contract inception.

The fixed consideration is $1,000,000; and ABC can earn up to a $200,000 bonus depending on when the machine installation is completed.

On a most-likely-amount basis, ABC concludes that it expects to be entitled to $150,000 of the performance bonus. However, the constrained amount that ABC expects to be entitled to is $50,000.

Suppose that ABC includes $150,000 of variable consideration in the transaction price at contract inception, and later has to revise its estimate to the constrained amount of $50,000. In this scenario, ABC's revenue reversal at that point in time would be less than in Scenario 1 and would depend on ABC's progress toward satisfaction of the performance obligation. For example:

Percentage complete	Revenue reversal
10%	$10,000
25%	25,000
60%	60,000

Consequently, the magnitude of the revenue reversal that would result from a potential downward adjustment in ABC's estimate of variable consideration to which it expects to be entitled in this scenario is less significant throughout most of the contract period than in Scenario 1. ABC concludes that it does not need to constrain its estimate of the variable consideration to which it expects to be entitled and includes the entire $150,000 estimate in the contract inception transaction price.

Scenario 3: Single performance obligation, satisfied at a point in time

Assume the same facts as Scenario 2 except that the single, combined performance obligation is satisfied at a point-in-time upon completion of the customized machinery.

On a most-likely-amount basis, ABC concludes that it expects to be entitled to $150,000 of the performance bonus. However, it is only 'probable' that ABC will be entitled to $50,000.

In this scenario, the constraint would not result in an adjustment to the transaction price because no revenue will be recognized until the uncertainty giving rise to the variable consideration is resolved – i.e. because no revenue will be recognized until the performance obligation is completely satisfied, no cumulative revenue will have been recognized at the point in time of any downward adjustments to ABC's estimate of the variable consideration to which it expects to be entitled.

What the scenarios show

Based on the above, entities should be aware that the constraint is more likely to apply in arrangements for which a distinct good or service is transferred to the customer upfront and a significant portion of the variable amounts are allocated to that upfront good or service such that any changes to the variable amounts would result in a reversal of previously recognized revenue.

For example under Scenario 1, a change in the estimate of a performance bonus on distinct installation services would not only affect revenue recognized to date for the partially completed installation services, but also for the already transferred machine.

Question 5.3.245

When does a selling agent record revenue from trailing commissions that are contingent on events after its performance obligation is satisfied?

Interpretive response: It depends. Trailing commissions often occur when an agent brokers a sale to an end customer on behalf of a principal entity (the agent's customer) and receives subsequent payments from the principal entity based on factors outside of the agent's control – e.g. each time the customer renews the good or service. When the selling agent has no further obligations to the principal entity or the end customer after the initial sale, it determines the amount of trailing commissions to recognize as revenue when the initial sale occurs by applying the guidance on variable consideration. If the entity performs administrative tasks that occur after the initial sale, judgment will be required to determine whether those activities represent performance obligations and therefore may affect the allocation of the trailing commissions and the timing of revenue recognition. [606-10-32-11]

An agent estimates trailing commissions at contract inception and includes them in the transaction price, subject to the variable consideration constraint. An agent with a significant amount of history selling a particular product or service will likely recognize a portion of revenue related to anticipated trailing commissions at the point in time the performance obligation is satisfied (i.e. the original sale date). When there is a lack of history or the trailing commissions are based on other significant uncertainties (e.g. market volatility), the application of the variable consideration constraint guidance may be more difficult. However, in many circumstances we would expect an agent to be able to estimate at least some portion of the trailing commissions at the time the performance obligation is satisfied.

An agent reassesses its estimate of anticipated trailing commissions from customer renewals at each reporting date, and records revenue for those anticipated trailing commissions when it becomes probable that a significant reversal in cumulative revenue recognized related to those trailing commissions (or a portion thereof) will not occur. See section 15.7.10 for a discussion of the disclosure requirements when the transaction price is constrained and section 15.6.10 for the disclosure requirements for changes in transaction price.

Example 5.3.165
Trailing commissions

Scenario 1: Insurance agency – trailing commissions based on renewals

Insurance Agency sells a 20-year term life insurance policy to Insured on behalf of Insurance Provider. After brokering the sale, Insurance Agency has no further obligations to Insured or Insurance Provider related to that sale. Insurance Agency is not involved in policy renewal activities.

As payment for selling the life insurance policy on behalf of Insurance Provider, Insurance Provider:

— pays Insurance Agency 50% of the Year 1 policy premium of $500; and
— agrees to pay trailing commissions of 10% of the $500 fixed annual premium for as long as Insured continues to renew the policy.

Insurance Agency has a long history selling term life insurance products to the same demographic of customers and in the same geographical region as Insured. Insurance Agency has a significant amount of actuarially determined data that has shown to be predictive of future renewals. Its estimate considers life expectancy and the frequency in which policies lapse and are not renewed.

Insurance Agency satisfies its obligation when the initial policy is sold and no remaining performance is required for Insurance Agency to be entitled to renewal commissions. Because of its historical and actuarial information, Insurance Agency concludes that a significant portion of its estimated future commissions are not constrained. Therefore, it recognizes that amount of revenue when the initial policy is sold.

At each future reporting period, Insurance Agency reassesses its estimates of future policy renewals and recognizes additional revenue from further anticipated renewal commissions to the extent the recognition of those anticipated commissions does not result in it being probable that a significant reversal of cumulative revenue recognized will occur.

Scenario 2: Brokerage services – trailing commissions based on investor behavior and market prices

Broker sells 100 shares in recently formed Fund Y to Investor on behalf of its customer, Mutual Fund. After making the sale, Broker has no further obligations to Investor or Mutual Fund related to the sale.

As payment for selling the shares in Fund Y on behalf of Mutual Fund, Mutual Fund:

- pays Broker an upfront fee of $5/share; and
- agrees to pay trailing commissions of 0.1% of the quarter-end share price for each share in Fund Y that Investor continues to hold at each quarter-end thereafter.

Broker has a long history of selling investment shares, and on average investors with the same investor profile as Investor hold purchased shares from other Mutual Fund investment funds for four years. Even though Broker may have experience with similar contracts, that experience generally would be of little predictive value in determining the future performance of the market or investor behavior. Fund Y is a recently formed fund and has a different investment strategy than other investments Broker has historically sold. Also, the variable consideration has a broad range of possible amounts.

Broker evaluates all of the qualitative indicators that increase the likelihood and magnitude of potential reversal. Broker is unable to conclude that a significant reversal of revenue from trailing commissions in future quarters is not probable of occurring. Broker's conclusion is due to the uncertainty associated with the market price of Fund Y in future quarters and the uncertainty associated with investor behavior if Fund Y begins performing poorly under its investment strategy. Therefore, Broker calculates its transaction price to be $500 (100 shares × $5/share) and records $500 of revenue when its performance obligation is satisfied (i.e. the trade date of the shares).

At each future quarter-end, Broker recognizes revenue from current quarter commissions and determines what amount (if any) from the future trailing commissions should be recognized as revenue. Broker reassesses its expectation of future share ownership and predictability of Fund Y prices. Broker updates the transaction price and recognizes a portion of the future trailing commissions if it determines it is probable that a subsequent change in its estimate of those future trailing commissions would not result in a significant revenue reversal.

Question 5.3.248

How should entities apply the constraint to development-based milestone payments?

Interpretive response: It depends. A contingent milestone payment based on a non-sales metric such as a development-based milestone (e.g. obtaining regulatory approval to commercialize a drug compound) is considered variable consideration (see Question 10.11.50). A milestone payment that is variable consideration is estimated and included in the transaction price subject to the variable consideration constraint.

Applying the variable consideration constraint for development-based milestones is often challenging because of the uncertainty of developmental activities. We believe that entities should evaluate the individual facts and circumstances of development-based milestones to assess whether the revenue should be constrained. The constraint assessment should include a robust analysis of the key judgments and considerations used for each milestone.

Further, companies should consistently apply the judgments about the constraint across all of their arrangements with similar facts and circumstances, but also identify and account for differences when they exist. It would be inappropriate to simply elect a broad policy of constraining or not constraining a particular type of milestone until it is achieved.

In many, but not all cases, an entity may conclude that milestones for final regulatory approval are constrained until it receives notice from the regulator. This is due to the magnitude of the milestone payments, the lack of predictive historical experience, and the fact that the outcome is based on the judgments of a third party (e.g. the FDA). For example, this may occur when (not exhaustive):

- the drug candidate is based on new or novel medical science;
- the drug candidate is controversial; or
- the company (or partner) lacks extensive experience with the approval process or the past experience is not as relevant because of the unique circumstances of each drug candidate.

Notwithstanding the above, in other situations an entity may conclude that a regulatory approval milestone is not constrained at some point before approval. While these milestones will typically be constrained early in the process when there is lack of clinical data to support approval, the company might be able to release the constraint before approval when more relevant information about the likely or actual outcome of clinical trials or the application becomes available, there is less risk in the approval process, or historical experience is more relevant to the drug candidate. For example, when (not exhaustive):

- the approval for a generic drug is based on objective criteria (e.g. demonstrating biological equivalency) that the company can demonstrate before submitting the approval application; or
- a compound has previously been approved for other indications in the same therapeutic area or for use with other technologies making the company's historical experience more relevant to the assessment.

In contrast to milestone payments triggered on final regulatory approval, other development-based milestone payments may not be as dependent on the judgment or actions of a third party (e.g. a regulatory agency). Examples of these development-based milestone payments include payments triggered on first dosing in a clinical trial or on moving from one phase to the next in the clinical trial process. For these types of milestones, an entity may have relevant information that allows it to conclude that it is not probable that revenue attributable to a milestone will result in a significant reversal. Key considerations are the level of control the company has to achieve the milestone, the company's level of involvement and visibility into the process, and the company's assessments of the probability of success.

5.3.50 Reassessing variable consideration

Excerpt from ASC 606-10

• • > Reassessment of Variable Consideration

32-14 At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity shall account for changes in the transaction price in accordance with paragraphs 606-10-32-42 through 32-45.

An entity's estimate of variable consideration will frequently change after contract inception. For example, uncertainties will be resolved or new information will arise regarding remaining uncertainties. These types of events will require the entity to reassess its expectations about the amount of variable consideration to which it expects to be entitled.

To account for conditions that exist at each reporting date (and changes in conditions during the reporting period), an entity updates its estimates of variable consideration and amounts of that variable consideration that should be constrained throughout the contract. Any change in the estimate or amount constrained will result in a change to the contract's transaction price. See section 6.8 for more information on changes in transaction price. [606-10-32-14]

Question 5.3.250

How does an entity account for a change in estimate that results in a significant revenue reversal?

Interpretive response: While it was the standard's intention that in most cases, changes to variable consideration would be an upward (an increase in the transaction price) or an insignificant downward revision, there may be circumstances in which the change in estimate results in a *significant* reversal when compared to the cumulative revenue recognized. The threshold for determining whether a significant reversal would occur is 'probable' and not 'virtually certain', as such the standard allows for a reasonable possibility that a significant reversal will occur.

If the significant reversal is due to new facts or circumstances that were not available at the time of the initial estimate, the change is accounted for as a change in estimate just like any other change in the transaction price. This might be the case if an entity estimated a usage based fee in a service contract for which it had extensive experience with the customer (and similar customers) but unexpected circumstances subsequently led to the customer losing market share resulting in the usage of the service significantly declining.

Notwithstanding the paragraph above, an entity needs to evaluate whether the change is a change in estimate or the result of an error in accordance with Topic 250 (accounting changes and error corrections). If the change is a result of a misunderstanding of the facts and circumstances that were reasonably available when making the initial estimates, the entity would have an accounting error and need to assess the materiality and any related correction to current and prior periods to determine the appropriate process for correcting the error. See chapter 4 of KPMG Handbook, Accounting changes and error corrections, for additional information on how to identify, account for and present error corrections.

5.4 Sale with a right of return

Excerpt from ASC 606-10

• > Sale with a Right of Return

55-22 In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

a. A full or partial refund of any consideration paid
b. A credit that can be applied against amounts owed, or that will be owed, to the entity
c. Another product in exchange.

55-23 To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity should recognize all of the following:

a. Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for the products expected to be returned)
b. A refund liability
c. An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

55-24 An entity's promise to stand ready to accept a returned product during the return period should not be accounted for as a performance obligation in addition to the obligation to provide a refund.

5.4.10 Scope of the sales return guidance

A right of return is the right to return goods or obtain a refund for services. If a contract with a customer includes a return right, the contract's transaction price excludes the consideration related to products expected to be returned or amounts expected to be refunded. Because this consideration is not fixed at the contract's inception, a right of return gives rise to variable consideration in the determination of the transaction price. [606-10-55-22, 55-23]

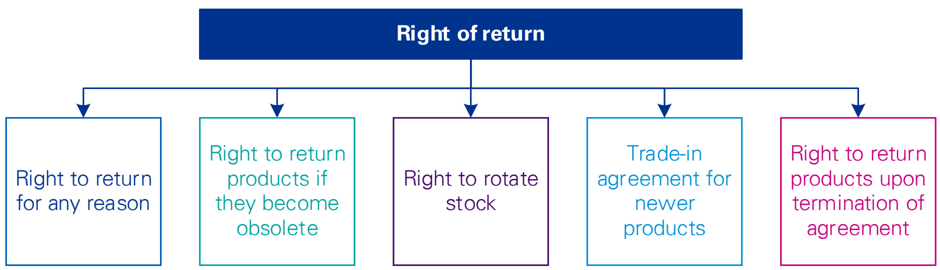
A right of return exists when an entity makes a sale in which its customer has a right to: [606-10-55-22]

— a full or partial refund of any consideration paid;

— a credit that can be applied against amounts owed, or that will be owed, to the entity; or

— another product in exchange – unless it is another product of the same type, quality, condition and price, such as exchanging a red sweater for a white sweater of the same kind.

Return rights can be explicitly stated in the contract or may be implied by an entity's business practices. They can take various forms, such as:



The sales return guidance does not apply to:

— exchanges by customers of one product for another of the same type, quality, condition and price;

— returns of faulty goods or replacements, which are instead evaluated under the guidance on warranties (see section 4.5);

— customer put options in which the customer has a significant economic incentive to exercise its option, which are accounted for as leases – see repurchase agreements in section 7.5.50; and

— customer put options in which the repurchase price is greater than the expected market value of the asset, which are accounted for as financing arrangements – see repurchase agreements in section 7.5.50. [606-10-55-28 – 55-29, 55-72, 55-75]

Question 5.4.10
Does Topic 606 distinguish between conditional and unconditional rights of return?

Interpretive response: Generally, no. Topic 606 does not distinguish between conditional and unconditional rights of return and both are accounted for similarly.

However, for a conditional right of return, the probability that the return condition will be met is considered in determining the expected level of returns. For example, a food production company may only accept returns of its products that are past a sell-by date. In that case, the food production company assesses the probability that the products will become past their sell-by date and estimates their return rate.

Question 5.4.20
Is the right to return a defective item a right of return or an assurance-type warranty?

Interpretive response: It depends. We believe the right to return a defective product for cash or credit generally should be accounted for the same way as a right of return for a non-defective product.

Specifically, when a right of return for cash or credit exists, revenue is not recognized for the portion of the sale that is expected to be returned. In contrast, when the right of return for a defective product is limited only to an exchange of the product (or return for repair), the return right is more like an assurance warranty. In this instance, the estimate of the cost to perform should be recognized as a liability and related expense when the sale is consummated (see section 4.5).

5.4.20 Accounting for a right of return

Excerpt from ASC 606-10

• • > Refund Liabilities

32-10 An entity shall recognize a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (that is, amounts not included in the transaction price). The refund liability (and corresponding change in the transaction price and, therefore, the contract liability) shall be updated at the end of each reporting period for changes in circumstances. To account for a refund liability relating to a sale with a right of return, an entity shall apply the guidance in paragraphs 606-10-

55-22 through 55-29.

• > Sale with a Right of Return

55-25 An entity should apply the guidance in paragraphs 606-10-32-2 through 32-27 (including the guidance on constraining estimates of variable consideration in paragraphs 606-10-32-11 through 32-13) to determine the amount of consideration to which the entity expects to be entitled (that is, excluding the products expected to be returned). For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity should not recognize revenue when it transfers products to customers but should recognize those amounts received (or receivable) as a refund liability. Subsequently, at the end of each reporting period, the entity should update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the transaction price and, therefore, in the amount of revenue recognized.

55-26 An entity should update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity should recognize corresponding adjustments as revenue (or reductions of revenue).

55-27 An asset recognized for an entity's right to recover products from a customer on settling a refund liability initially should be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity should update the measurement of the asset arising from changes in expectations about products to be returned. An entity should present the asset separately from the refund liability.

55-28 Exchanges by customers of one product for another of the same type, quality, condition, and price (for example, one color or size for another) are not considered returns for the purposes of applying the guidance in this Topic.

55-29 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 in paragraphs 606-10-55-30 through 55-35.

A return right affects a contract's transaction price; this is because the amount of consideration to which the entity is entitled for the goods or services transferred decreases when a customer exercises its return right. Because the entity initially calculates the transaction price at the contract's inception and does not know at that time whether and to what extent the customer will exercise its return right, the consideration related to the return right is not fixed. Therefore, it is variable consideration and the relevant guidance applies (see section 5.3). [606-10-55-25]

An entity does *not* account for a right of return as a stand-ready performance obligation. The FASB decided that the cost of accounting for the right of return as a separate performance obligation outweighs the benefits that such incremental information would provide to users of the financial statements. [606-10-55-24, ASU 2014-09.BC366]

When an entity makes a sale with a right of return, it initially recognizes the following.

Item	Measurement
Revenue	The gross transaction price, less the amount of the transaction price expected to be refunded (see section 5.3).
Refund liability	The expected refund – i.e. the difference between the consideration received or receivable and the revenue recognized.
Reduction in inventory	The carrying amount of the products transferred to the customer.
Asset for recovery	The carrying amount of the products expected to be returned, less the expected recovery costs.
Cost of goods sold	The carrying amount of the products transferred, less the asset for recovery.

The refund liability and asset for recovery are presented on a gross basis on the balance sheet; net presentation is not permitted. In addition, the asset for recovery is presented separately from inventory and is subject to its own impairment testing. [606-10-55-27, ASU 2014-09.BC367]

The entity updates its measurement of the refund liability and the asset for recovery at each reporting date for changes in expectations about the amount of the refunds. It recognizes adjustments to the refund liability as revenue, and adjustments to the asset for recovery as an expense. [606-10-32-10, 55-26, 55-27]

Example 5.4.10
Sale with a right of return

Retailer sells 100 products at a price of $100 each and receives a payment of $10,000. The sales contract allows Customer to return any undamaged products within 30 days and receive a full refund in cash. The cost of each product is $60. Retailer estimates that three products will be returned and a subsequent change in the estimate will not result in a significant revenue reversal.

Retailer estimates that the costs of recovering the products will not be significant and expects that the products can be resold at a profit.

Within 30 days, two products are returned.

Retailer records the following entries on:

- transfer of the products to Customer to reflect its expectation that three products will be returned;
- return of the two products; and
- expiration of the right to return products.

	Debit	Credit
Sales		
Cash	10,000	
Refund liability		300[1]
Revenue		9,700
To record sale excluding revenue on products expected to be returned.		
Asset (right to recover)	180[2]	
Cost of goods sold	5,820	
Inventory		6,000
To record COGS and right to recover products from customers.		
Two products returned		
Refund liability	200[3]	
Cash		200[3]
To record the refund for product returned.		
Inventory	120[4]	
Asset (right to recover)		120[4]
To record product returned as inventory.		
Right of return expires		
Refund liability	100	
Revenue		100
To record revenue on the expiration of the right of return.		
Cost of goods sold	60	
Asset (right to recover)		60
To record COGS on the expiration of the right to recover products from customers.		

Notes:

1. $100 × 3 (the price of the products expected to be returned).
2. $60 × 3 (the cost of the products expected to be returned).
3. $100 × 2 (the price of the products returned).
4. $60 × 2 (the cost of the products returned).

Question 5.4.30

Can an entity recognize revenue if it cannot reasonably estimate amount of returns?

Interpretive response: Yes. An entity recognizes revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. A sale with a right of return does not affect whether and when control transfers. Instead, it affects the measurement of revenue that the entity recognizes; this is because the uncertainty associated with the return right is treated in the same way as other types of variable consideration in determining the transaction price. In other words, an entity estimates what it expects to be returned and then constrains that estimate if necessary. For a discussion of estimating the transaction price, see section 5.3. [606-10-55-25]

An entity is required to make an estimate of the transaction price, and there are no instances in which an entity can assert it is unable to make an estimate and therefore be precluded on that basis from recognizing revenue. However, an entity is required to constrain its estimate to an amount that is probable that a significant reversal in the amount of cumulative revenue will not be recognized. The constraint's objective is to ensure the transaction price does not include amounts subject to the risk of a significant revenue reversal as a result of subsequent changes in estimates. When applying the constraint, an entity includes an estimated amount of variable consideration in the transaction price only if it is probable that a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal compared to the cumulative revenue recognized. [606-10-32-11]

While revenue could conceivably be constrained to zero for some rare right of return fact patterns, it is likely that most entities will have sufficient information to recognize consideration for an amount greater than zero. This is because revenue is recognized to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur and recognition does not necessarily default to zero.

The general factors to consider in applying the constraint are discussed in section 5.3.40. We believe that the following additional factors are relevant for a right of return:

- significant increases in or excess levels of inventory in a distribution channel – sometimes referred to as 'channel stuffing';
- lack of 'visibility' into or the inability to determine or observe the levels of inventory in a distribution channel and the current level of sales to end customers;
- expected introductions of new products that may result in the technological obsolescence, and larger than expected returns, of current products;
- the newness of a product;
- the introduction of competitors' products with superior technology or greater expected market acceptance; and
- other factors that affect market demand and changing trends in that demand for the issuer's products.

Question 5.4.40
How is the refund liability determined for partial rights of return?

Interpretive response: When a return right allows the customer to return a product for a partial refund, the refund liability (and the corresponding change in the transaction price) is measured based on the portion of the transaction price expected to be refunded.

For example, if a return right permits a refund of 95% of the sales price, the transaction price (before applying the constraint) is measured as the number of products expected to be returned multiplied by 95% of the selling price.

Question 5.4.50
How does an entity account for a restocking fee charged to customers when they return products?

Interpretive response: When an entity charges a customer a restocking fee for returning a product, it is generally intended to compensate the entity for either:

— costs associated with the product return – e.g. shipping costs and repackaging costs; or
— the reduction in the selling price that may occur when the entity resells the product to another customer.

The TRG discussed two issues related to restocking fees:

— how an entity accounts for restocking fees related to expected product returns; and
— how an entity accounts for restocking costs for expected product returns. [TRG 07-15.35]

The TRG agreed that restocking fees should be included as part of the transaction price. A right of return with a restocking fee is similar to a right of return for a partial refund. Therefore, the refund liability is based on the transaction price allocated to the goods expected to be returned less the restocking fee. [TRG 07-15.35]

Similarly, the entity's expected costs related to restocking are reflected in the measurement of the asset for recovery when control of the product transfers. This is consistent with the guidance in Topic 606 that any expected costs to recover returned products should be recognized by reducing the carrying amount of the asset recorded for the right to recover those products. [TRG 07-15.35]

Example 5.4.20
Restocking fees

Retailer sells 20 widgets to Customer for $30 each and the cost of each widget is $15. Customer has the right to return a widget but is charged a 10% restocking fee.

Retailer expects to incur restocking costs of $2 per widget returned, and estimates returns to be 5%.

When control of the widgets transfers to Customer, Retailer recognizes the following.

Item	What to include	Amount	Calculation
Revenue	Widgets estimated not to be returned plus restocking fee	$573	(19[1] × $30) + (1 × $3[2])
Refund liability	Widget expected to be returned less restocking fee	$27	(1 × $30) – $3[2]
Asset for recovery	Cost of widget expected to be returned less restocking cost	$13	($15 – $2)

Notes:

1. Widgets not expected to be returned: 20 widgets sold less 1 (20 × 5%) expected to be returned.
2. Restocking fee: $30 × 10%.

Retailer records the following journal entries.

	Debit	*Credit*
Cash	600	
Revenue		573
Refund liability		27
To recognize sale of widgets.		
Cost of goods sold	287[1]	
Asset for recovery	13	
Inventory		300[2]
To derecognize widgets sold from inventory.		

Notes:

1. Carrying amount of widgets transferred ($300) less asset for recovery (see above).
2. $15 × 20.

Question 5.4.60

Does estimating sales returns based on historical experience require an entity to evaluate whether it meets the conditions to apply the portfolio approach practical expedient?

Interpretive response: No. When estimating the amount of consideration expected to be received from a sales contract with a right of return, an entity may consider historical experience with similar contracts to make estimates and judgments. Using a group of similar transactions as a source of evidence is not itself an application of the portfolio approach (see section 2.5 and Question 5.3.130).

Example 22 in Topic 606 (see section 5.4.30) illustrates how to determine the transaction price for a portfolio of 100 individual sales with a right of return. In the example, the entity concludes that the contracts meet the conditions to be accounted for at a portfolio level, and determines the transaction price for the portfolio using an expected-value approach to estimate returns.

However, as explained above, an entity could achieve the same accounting outcome by using the portfolio as a source of data, rather than assessing whether the contracts meet the conditions to be accounted for at a portfolio level. If an entity concludes that it is using a portfolio of data rather than using the portfolio approach, it does not need to evaluate whether the accounting for individual transactions is materially the same as accounting for the portfolio, as required under the portfolio approach.

When the entity elects to estimate the transaction price using the expected-value method and uses a portfolio of data to determine the expected value of an individual contract, the estimated amount might not be a possible outcome for an individual contract (see Question 5.3.160).

5.4.30 FASB example on right of return

Excerpt from ASC 606-10

• • > Example 22—Right of Return

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.

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.

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.

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).

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.

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

5.5 Significant financing component in a contract

Excerpt from ASC 606-10

• > The Existence of a Significant Financing Component in the Contract

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.

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.

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.

5.5.10 Overview

A contract's transaction price is adjusted for the effect of a financing component (time value of money) if the financing component is significant to the contract. The requirement to adjust for a significant financing component reflects the fact that: [606-10-32-15, ASU 2014-09.BC229]

- entities are not indifferent to the timing of cash flows in a contract – i.e. cash now is generally more valuable than cash later;
- exclusion of the financing component could misrepresent the profit in the contract. A payment made in arrears would result in full profit on transfer of the good or service, even though the entity bears ongoing cost of financing the customer; conversely, a payment made in advance would result in the financing cost that the entity incurs being included in gross profit from the sale of the good or service; and
- contracts with an explicitly stated interest rate should not be treated differently from contracts with an implied interest rate.

5.5.20 Identifying a financing component

Generally, a contract may have a financing component when either: [606-10-32-16]

- the promised amount of consideration differs from the cash selling price of the promised goods or services; or
- there is a significant timing difference between when control of the goods or services is transferred to the customer and when the customer pays for the goods or services.

The financing component may be explicit – i.e. a stated interest rate is charged. Alternatively, it may be implied – i.e. the amount of consideration would differ if the customer paid cash at the same time as it received the goods or services. [606-10-32-15]

However, even if a contract meets either of the above criteria, it does not contain a financing component if any of the following factors exist. [606-10-32-17]

Factor	Example
The entity receives an advance payment, and the timing of the transfer of goods or services to the customer is at the discretion of the customer.	A flexible spending arrangement in which the customer pays the entity a fixed amount upfront and draws down against that prepaid amount at its discretion over the term of the arrangement – e.g. prepaid phone card and loyalty points.
A substantial portion of the consideration is variable, and the amount or timing of the consideration is outside the customer's or entity's control.	A transaction whose consideration is a sales-based royalty.
The difference between the amount of promised consideration and the cash selling price of the promised goods or services arises for non-finance reasons.	Protection against the counterparty not completing its obligations under the contract.

Determining whether a difference between the amount of promised consideration and the cash selling price of the goods or services arises for reasons other than providing financing requires judgment. An entity considers all relevant facts and circumstances, including whether the difference is proportionate to any non-financing reason provided. In other words, the difference between the promised consideration and the cash selling price of the goods or services must be proportional to the non-financing reason for the difference. [606-10-32-17(c)]

A payment in advance or arrears on terms that are typical for the industry and jurisdiction *may* have a primary purpose other than financing. For example, a customer may withhold an amount of consideration after the entity transfers a good or service but prior to the completion of the contract or the achievement of a specified milestone – e.g. successful implementation or customization of software. The primary purpose of these payment terms may be to provide the customer with assurance that the entity will perform its obligations under the contract, rather than provide financing to the customer. Importantly, the fact that payment in advance or arrears is typical for an industry or in a jurisdiction is not determinative that such payment occurs for non-finance reasons – i.e. it does not *automatically* mean there is not a significant financing component in the contract. [ASU 2014-09.BC233(c)]

Excerpt from ASC 606-10

• • > Example 27—Withheld Payments on a Long-Term Contract

55-233 An entity enters into a contract for the construction of a building that includes scheduled milestone payments for the performance by the entity throughout the contract term of three years. The performance obligation will be satisfied over time, and the milestone payments are scheduled to coincide with the entity's expected performance. The contract provides that a specified percentage of each milestone payment is to be withheld (that is, retained) by the customer throughout the arrangement and paid to the entity only when the building is complete.

55-234 The entity concludes that the contract does not include a significant financing component. The milestone payments coincide with the entity's performance, and the contract requires amounts to be retained for reasons other than the provision of finance in accordance with paragraph 606-10-32-17(c). The withholding of a specified percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.

• • > Example 30—Advance Payment

55-244 An entity, a technology product manufacturer, enters into a contract with a customer to provide global telephone technology support and repair coverage for three years along with its technology product. The customer purchases this support service at the time of buying the product. Consideration for the service is an additional $300. Customers electing to buy this service must pay for it upfront (that is, a monthly payment option is not available).

55-245 To determine whether there is a significant financing component in the contract, the entity considers the nature of the service being offered and the purpose of the payment terms. The entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to maximize profitability, taking into consideration the risks associated with providing the service. Specifically, if customers could pay monthly, they would be less likely to renew, and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (that is, customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs). In addition, customers tend to use services more if they pay monthly rather than making an upfront payment. Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments.

55-246 In assessing the guidance in paragraph 606-10-32-17(c), the entity determines that the payment terms were structured primarily for reasons other than the provision of finance to the entity. The entity charges a single upfront amount for the services because other payment terms (such as a monthly payment plan) would affect the nature of the risks assumed by the entity to provide the service and may make it uneconomical to provide the service. As a result of its analysis, the entity concludes that there is not a significant financing component.

Example 5.5.05

Advance payment with no significant financing component

Service Co provides credit monitoring services for its customers' debt instruments. Customers have the option to pay a single nonrefundable upfront fee or pay for the services annually. The upfront fee is derived by calculating the net present value based on a market index for all future annual fees through the term of the contract.

The contract term typically corresponds with the term of the debt instrument. If a customer terminates the contract before its original term, Service Co. keeps any fees previously received, including the entire upfront fee. The customer can terminate the contract at its discretion. Due to the nature of the services, a significant amount of all contracts are terminated before the original term (e.g. when a customer extinguishes its debt early).

Service Co's intent for charging an advance payment is primarily to accommodate a particular class of customers that generally prefer to pay fully for these services at the time the debt instrument is issued. These customers require monitoring services over a long period and prefer to establish and complete administrative activities upfront. The majority of these customers pay the fees upfront, which is the preferred business practice for that class of customers. The upfront payment also locks the customer into paying for the full term rather than providing the option to renew.

Service Co and Customer A enter into a contract to provide credit monitoring services of a debt instrument over a stated term of 10 years. Customer A elects to pay the upfront fee. There is a difference between the upfront fee and the price Customer A would pay if it instead paid over the 10-year service period. Therefore, Service Co evaluates the factors that indicate a financing component does not exist as follows.

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

In this contract, Service Co is providing an ongoing service to Customer A and not waiting for Customer A to exercise an option. Service Co continues to provide a service until Customer A terminates the contract. Customer A has no discretion to receive the service one month and not the next, and the timing of transfer is known (i.e. the service is transferred over time). Therefore, Service Co does not meet this factor. [ASU 2014-09, BC233(a)]

b. A substantial portion of the consideration is variable, and the amount or timing of the consideration is outside the customer's or entity's control

The consideration in this contract is fixed, and therefore this factor is not applicable.

c. The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance

Service Co considers the following examples where an advance payment may not be for financing.

- The payment is typical for an industry or jurisdiction. [ASU 2014-09.BC233(b)]
- The entity can avoid higher administration costs, such as costs related to administering renewals and collecting monthly payments. [606-10-55-246]
- The entity is locking in customers' purchase of services upfront rather than giving them an opportunity to renew monthly. [606-10-55-245]

Consistent with the first two examples, the upfront payment is typical for the class of customers and it reduces administrative burdens for both Service Co and its customers. The difference between the amounts received upfront versus receiving the fees over time is proportional to reduced administrative costs. Further, Service Co notes that most of the class of customers opt for the upfront pricing arrangement and the discount in these arrangements is uniformly applied and not based on the customers' credit risk.

As for the third example, Service Co is locking in the payment from Customer A rather than giving them the option to renew. Due to the nature of the services, in many cases customers terminate before the end of the stated term. In those cases, the upfront fee likely would be greater than what Service Co would receive over the same period if Customer A paid in annual installments – i.e. because the customer would not have to pay the remaining fees after termination. This also indicates that the upfront fee is not for the purpose of financing.

Based on the totality of the facts described above, Service Co concludes that the payment is for reasons other than finance and does not identify a significant financing component in the contract.

Question 5.5.10

Do extended payment terms result in a significant financing component?

Interpretive response: It depends. The existence of extended payment terms generally means there is a financing component in the contract. Contract-specific facts and circumstances will affect whether that financing component is *significant* to the contract. However, as a result of a practical expedient (see section 5.5.30), entities need not consider whether extended payment terms beyond an entity's customary payment terms, but less than one year include a significant financing component.

If the entity expects to provide a refund or other concession to the customer as a result of the extended payment terms, the entity accounts for the expected concession as outlined in Question 5.3.60.

Question 5.5.20

Can third-party financing by the customer constitute a significant financing component?

Interpretive response: No. An entity does not have to determine whether the contract contains a significant financing component solely because of how its customer obtains funds to pay the fees to which the entity is entitled under the contract.

Question 5.5.30

If the entity participates in the customer's third-party financing does it affect the transaction price?

Interpretive response: In circumstances where the customer of the entity obtains external financing but the entity participates in that financing (e.g. provides financial guarantees or indemnifications to the financing party, or establishes the creditworthiness of the customer to the financing party), the entity would first evaluate whether any guarantee is in the scope of Topic 460 (Guarantees) and should, therefore, be accounted for as an element of the contract outside the scope of Topic 606.

However, if a guarantee is not in the scope of Topic 460, or the entity's participation is in a form other than providing a guarantee to the financing party, there is an inherent risk that the entity may provide a concession either to the customer or the financing party. Questions 5.3.40 and 5.3.60 (as well as Question 4.2.20) address the issue of potential concessions, including those resulting from extended payment terms.

Question 5.5.35

Can a significant financing component exist because of a material right?

Interpretive response: Yes. When a contract contains a material right, an entity needs to consider whether a significant financing component exists as a result of the material right just like any other performance obligation. [TRG 03-15.32]

A significant financing component does not exist if a customer pays for a good or service in advance and the timing of the transfer of those goods or services is at the discretion of the customer. In many cases, a material right will meet this exception because the customer chooses when to exercise that right. However, in some cases the customer may lack discretion and therefore the material right would not meet the exception. [606-10-32-17(a)]

Entities should also consider the practical expedient for when, at contract inception, the entity does not expect the period between payment and transfer of the promised goods or services to exceed one year (see section 5.5.30).

5.5.30 Practical expedient to avoid adjusting for a financing component

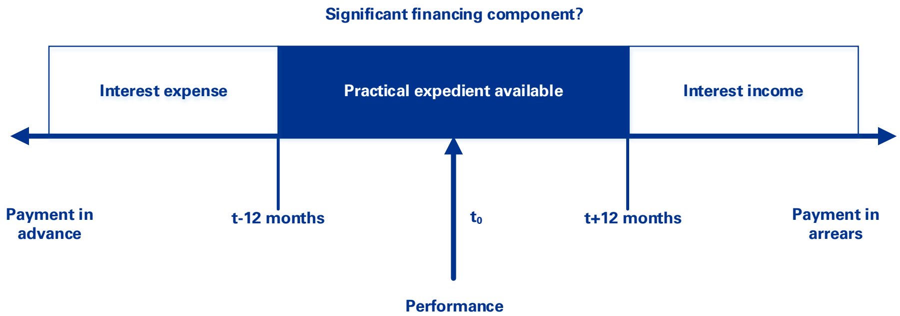
Excerpt from ASC 606-10

• > The Existence of a Significant Financing Component in the Contract

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.

No adjustment for a significant financing component is necessary if, at contract inception, the entity does not expect the period between customer payment and transfer of control of the promised goods or services to the customer to exceed one year. This exception applies regardless of whether control of goods or services occurs before or after payment is made by the customer. [606-10-32-18]

For contracts with an overall duration greater than one year, the practical expedient applies if the period between performance and payment for that performance is one year or less. [606-10-32-18]



In a contract with two or more performance obligations, identifying the period between customer payment and the transfer of goods or services may present challenges, especially when the performance obligations are satisfied at different points in time and consideration is paid over time or all at once. The TRG discussed how an entity should evaluate whether the practical expedient applies in these situations and concluded that each payment should be allocated to the various performance obligations on a relative selling price basis in order to determine the length of time between payment and transfer of the goods or services (see Question 5.5.70). [TRG 03-15.30]

Question 5.5.40

What is the accounting if an entity applies the one-year practical expedient but subsequently changes its expectations?

Interpretive response: An entity is not required to adjust the transaction price for a significant financing component if, at contract inception, the entity *does not expect* the period between payment by the customer of the consideration promised and the transfer of control of the promised good or service to the customer to exceed one year. However, it is possible that the entity's expectation of payment by the customer, or transfer of control of the promised goods or service, within one year may not be achieved. [606-10-32-18]

For example:

— A customer prepays an equipment manufacturer to customize equipment and the manufacturer initially expects to complete that customization service in less than a year from receipt of the prepayment. Later, due to unforeseen circumstances, the equipment manufacturer concludes that it will not meet that expected timeline.

— The terms of a contract require the customer to pay for a suite of professional services only on completion and the entity expects to provide all of the services within a year from receipt of the customer's payment; the entity later concludes that it will not complete the services within one year. In that case, the customer will pay for some services performed shortly after contract inception more than one year after those services were provided.

The timing of the assessment (contract inception) is explicit. Unlike the guidance on collectibility (see section 3.3), the remainder of the guidance on significant financing components makes no mention of reassessing the applicability of the practical expedient except if there is a contract modification that is not accounted for as a separate contract (see chapter 11). Nonetheless, we do not believe that the guidance precludes an entity from doing so when there are significant changes in the timing of either the cash consideration or the transfer of control of goods or services in the arrangement. [606-10-32-18]

However, facts and circumstances may arise that indicate that the earlier conclusion that the practical expedient applied was due to a misunderstanding of the facts and circumstances that existed at contract inception and were reasonably available to management at that time – leading to the entity inappropriately ignoring a significant financing component. In that case, the entity treats the change as an accounting error under Topic 250 (accounting changes and error corrections).The entity would then need to assess the materiality of the error and any related correction to current and prior periods to determine the appropriate process for correcting the error. See chapter 4 of KPMG Handbook, Accounting changes and error corrections, for additional guidance on error corrections.

Question 5.5.50

Does a multi-year contract with annual prepayments qualify for the one-year practical expedient?

Interpretive response: It depends. If a long-term contract (e.g. a three-year contract for professional services) requires the customer to pay for each year of service in advance, the contract will generally qualify for the practical expedient. This is *as long as* the prepayment relates solely to goods or services that will be provided over the year following the prepayment. The one-year practical expedient applies because the difference between when the payment is made and transfer of the goods or services to which the payment relates is one year or less. [606-10-32-18]

In contrast, if a prepayment relates to both a service to be provided over the year following the payment *and* another service that will be provided to the customer over a longer period, the practical expedient cannot be applied. An example is when a prepayment relates to both (1) construction of equipment that will be constructed and installed over the first six months and (2) three years of maintenance on that equipment.

Question 5.5.60

Does a contract with a payment due more than one year before, or one year after, delivery of the related goods or services qualify for the one-year practical expedient?

Interpretive response: No. If payment for a good or service is *due* more than one year before or one year after the complete transfer of the goods or services to the customer, the entity cannot apply the practical expedient because the time between the transfer of the goods or services and the expected payment date exceeds one year. For example, the entity has the right to invoice the customer one year from the date the customer receives the goods or services and the invoice has 30-day payment terms.

An entity is also not able to use the practical expedient if the performance obligation to which the payment relates is satisfied over time and no payments are due until more than one year after some or all of the services have been performed. For example, if professional services transferred to a customer over time will be provided over a six-month period and no payments are due until nine months after the services are completed, the practical expedient does not apply. In that case, the entity is transferring services to the customer during months 1-3 of the six-month service period that will not be paid for until more than one year after those services are performed.

Example 5.5.10
Application of the practical expedient

ABC Corp. enters into a contract with Customer to transfer equipment and provide implementation services. Customer will pay ABC in full for the equipment and the implementation services ($1 million) upon transfer of the equipment.

The equipment and the implementation services are separate performance obligations. The implementation services are expected to take approximately 15 months to complete. The equipment is transferred to Customer at a point in time, and the implementation services performance obligation will be satisfied over time as the services are performed.

The practical expedient does not apply because the payment relates to services that will be provided more than one year after the payment from Customer is received.

As discussed in Question 5.5.80, it is also not appropriate to exclude the financing effect applicable to the first year of the implementation services period when either:

— determining if a significant financing component exists; or
— calculating the accounting effect of the significant financing component (if there is one) on the transaction price for the contract.

Question 5.5.70
How are payments allocated to multiple performance obligations when determining whether a significant financing component exists or the one-year practical expedient is applicable?

Interpretive response: In a contract with two or more performance obligations, identifying the period between customer payment and the transfer of goods or services may present challenges, especially when the performance obligations are satisfied at different points in time and consideration is paid over time or all at once.

In some contracts that include consideration paid over time, one performance obligation is completed in the early stages of a contract, while a second performance obligation continues for a longer period. In such cases, the entity will generally allocate each payment received to both performance obligations in the contract on a pro rata basis (using relative stand-alone selling prices) to calculate the financing component and determine whether the practical expedient applies. Allocating payments as they are made to a single performance obligation (e.g. a product or license that is the first performance obligation transferred to the customer under the contract) until it has been fully paid (i.e. a first-in first-out, or FIFO, allocation method) would generally *not* be appropriate under Topic 606. [TRG 03-15.30]

Example 5.5.20
Allocation of customer payments

Service Provider enters into a three-year, non-cancellable service arrangement with Customer. In addition to providing three years of service, Service Provider will also provide various implementation services, which will be completed over a four to six month period before the commencement of the ongoing services. The ongoing service and the implementation are determined to be separate performance obligations that will both be satisfied over time.

In return for the service and the implementation services, Customer will make three payments of $120, the first of which is due at the commencement date and the remaining two payments are due on the first and second anniversaries of the go-live date.

The stand-alone selling price for the three years of service is $360, and the stand-alone selling price of the implementation is $40. Therefore, the relative stand-alone selling prices for the service and services are $324 (($360 / $400) × $360) and $36 (($40 / $400) × $360), respectively.

In determining whether the contract contains a significant financing component and whether the practical expedient applies, Service Provider allocates the annual payments following Method 1 below (rounded).

	Method 1: Appropriate		Method 2: Not appropriate	
	Service	Implement.	Service	Implement.
Pmt 1 (at go-live)	$108	$12	$ 84	$36
Pmt 2 (1 year after go-live)	108	12	120	-
Pmt 3 (2 years after go-live)	108	12	120	-

Based on the appropriate allocation of the customer payments (Method 1), the practical expedient does not apply. The implementation services will be paid for by Customer over a period of more than two years. Because there is a difference in timing between performance of the implementation and payment for those services – i.e. the services will be provided in the first four to six months after contract inception, but will be paid for over 24 months after the completion of those services, the contract includes a financing component.

Service Provider still needs evaluate whether the financing component is significant. See section 5.5.40 for further discussion of determining if a financing component is significant.

5.5.40 Determining if a financing component is significant

Two factors are considered in determining whether a financing component is significant to the contract, both of which require judgment.

Relevant facts and circumstances

— Difference between the amount of promised consideration and the cash selling price	+	Combined effect of: — Expected length of time between when the entity transfers the promised goods or services and when the customer pays — Prevailing interest rates in the relevant market

Therefore, if a financing component exists due to a difference between the amount of promised consideration and the cash selling price, the magnitude of that difference is relevant when determining if the financing component is significant. Moreover, if a financing component exists due to a difference between the time the entity is to receive consideration and when it transfers the promised goods and services, then both the length of time between these two events and the prevailing interest rates are relevant in determining if the financing component is significant. [606-10-32-16]

Even if a financing component is not significant, an entity is not precluded from accounting for that component following the significant financing guidance. [TRG 03-15.30]

Question 5.5.75●

At what level is the significance of a financing component determined?

Interpretive response: At the contract level only. It is not determined for each performance obligation or at an aggregated portfolio level – i.e. an entity does not evaluate whether the combined effects of individually insignificant financing components would be material to a portfolio of contracts or to the entity as a whole. [ASU 2014-09.BC234]

Question 5.5.80

When determining whether a financing component is significant to the contract, can an entity exclude the effect of payments made within one year from the transfer of the related goods or services?

Interpretive response: No. We do not believe it is appropriate to exclude the effect of payments for goods or services that are made within one year from the transfer of those goods or services when additional payments for those goods or services will not be made within one year from their transfer. Although Topic 606 includes a practical expedient to ignore the effects of the financing component if the period between when the entity transfers a good or service and when the customer pays for that good or service is less than one year, that relief does not extend to portions of a contract once it is determined the practical expedient does not apply.

For example, if a three-year service contract is entirely prepaid, it would be inappropriate to ignore any financing provided by that prepayment during the first year of the contract.

Question 5.5.90

Is the assessment of whether a financing component is 'significant' to a contract a quantitative or qualitative assessment?

Interpretive response: Once a financing component is determined to exist, it may or may not be significant.

Neither Topic 606, nor the basis for conclusions to any of the related ASUs, explicitly address how to determine whether a financing component is significant. However, the term 'material' in the context of other aspects of Topic 606 generally takes both qualitative and quantitative factors into consideration – e.g. in determining whether a customer option provides the customer with a material right or whether a promised good or service is 'immaterial in the context of the contract'. [TRG 10-14.6, ASU 2016-10.BC12]

Therefore, because 'significant' was the threshold selected for assessing financing components, it indicates an intent to depart from the qualitative and quantitative nature of the term 'material'. Consequently, we believe that 'significant', at least in the context of determining whether a financing component is significant, is principally a quantitative analysis.

Further, because the Boards did not provide guidance on what quantitative amounts would be significant, judgment will be required to determine at what point a financing component becomes significant to the contract.

Example 5.5.30
Calculation of the financing component

ABC Corp. enters into a contract with Customer to transfer equipment and provide maintenance of that equipment. In return for the equipment and the service in this contract, Customer will make 36 monthly payments in advance of $100 each. ABC concludes that the equipment and maintenance are separate performance obligations.

The relative stand-alone selling prices for the equipment and the maintenance service are $2,160 and $1,440, respectively. Consequently, each monthly payment is allocated $60 to the equipment (($2,160 / $3,600) × $100) and $40 (($1,440 / $3,600) × $100) to the maintenance service for purposes of determining whether the practical expedient applies and whether a significant financing component exists (see Question 5.5.70).

Control of the equipment is transferred at contract inception, but will be paid for over 36 months. Because of this difference in timing, the contract includes a financing component. ABC concludes that the practical expedient does not apply because payments related to the equipment (for which control is transferred to Customer at contract inception) extend beyond one year.

In calculating whether the financing component is significant to the contract, ABC imputes an interest rate of 14%. ABC calculates the significance of the financing component in the contract on the basis of an interest element of $384 (10.7% of the total contract price of $3,600), calculated as the difference between:

— the relative stand-alone selling price for the equipment of $2,160; and
— the present value of 36 monthly payments of $60 ($1,776).

ABC concludes that the contract includes a significant financing component. ABC considers the following in reaching its conclusion.

— The present value of the promised consideration *had payment occurred concurrently with transfer of control* ($3,126) is less than the promised consideration in the contract ($3,600).

— The length of time between ABC transferring control of the equipment and Customer paying for the equipment is 36 months.

— The interest element calculated is consistent with prevailing interest rates in the relevant market considering Customer's credit standing.

— The consideration is not variable and the nature of the arrangement does not contain any non-finance reasons for the difference in the amount of promised consideration and the cash selling price of the equipment and services in the contract.

Consequently, ABC recognizes $1,776 in revenue at the point in time it transfers control of the equipment and recognizes $384 in interest income over the 36-month term of the contract.

In calculating the financing component, it would be inappropriate for ABC to exclude from the interest element determination the first-year effect – i.e. the difference between $720 ($60 × 12) and the present value of those payments.

5.5.50 Accounting for a significant financing component

When a contract includes a significant financing component as a result of an advance payment to the entity, the customer is essentially providing financing to the entity. As a result, the entity increases the amount of revenue recognized from the contract and increases interest expense by a corresponding amount. Examples where this may occur include construction contracts and long-term service contracts that require payments at the contract's inception or in the contract's early stages. [606-10-32-20]

Conversely, when a contract includes a significant financing component because the entity receives payments in arrears, the entity is providing financing to the customer. As a result, the entity decreases the amount of revenue recognized and increases interest income by a corresponding amount. [606-10-32-20]

The effects of a significant financing component are reflected in the entity's estimate of the transaction price as either an increase (for advanced payments) or a decrease (for payments in arrears) using a discount rate that reflects the credit standing of the party receiving the financing – i.e. the entity's credit standing for advance payments and the customer's credit standing for payments in arrears. [606-10-32-19]

Determining the effect of the time value of money for a contract with a significant financing component can be complex for long-term or multiple-element arrangements. In these contracts:

— goods or services are transferred at various points in time;
— cash payments may be made throughout the contract; and
— there may be a change in the estimated timing of the transfer of goods or services to the customer.

If additional variable elements are present in the contract (e.g. contingent consideration) then these calculations can be even more complicated.

Question 5.5.100

Does a prepayment in advance of scheduled payments result in a change to the transaction price for a contract that contains a significant financing component?

Interpretive response: No. The objective in Topic 606 when adjusting the transaction price for a significant financing component is for the entity to recognize revenue at an amount that reflects what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that they are transferred to the customer. Therefore, despite any customer prepayments in advance of contractual payment dates, the time value of money adjustment determined at contract inception based on the stated payment terms continues to reflect the economic substance of the transaction. [606-10-32-16]

Topic 606 effectively presumes that the total consideration in the contract would have been less had the stated payment terms reflected an earlier payment date. The fact that the customer decided to prepay its obligation to the entity does not alter the financing component in the contract because that financing component still provided the same value to the customer. As a consequence, any difference between the transaction price and the amount paid by the customer is reflected in the income statement in the same manner as the significant financing component would be presented absent the prepayment.

Frequently, a customer decision to prepay the scheduled payments will be accompanied by a contract modification. That modification may involve either of the following.

— Solely a change in the total amount of cash the customer will pay – i.e. a modification to the note receivable. In this case, a modification to a receivable -- e.g. decreasing the total cash to be paid in exchange for the prepayment – would generally follow the guidance in Topic 310 (receivables) applicable to creditors upon the modification or extinguishment of a customer debt instrument.
— Additional changes to the performance obligations in the contract – e.g. in return for the prepayment, the customer may receive additional goods or services. In this case, the entity would likely have to consider both the guidance in Topic 310 and the contract modification guidance in Topic 606 (see section 11.2).

Sometimes the contract is *not* modified – i.e. the terms of the contract permit customer early payment. In that case, in general the effect of a customer prepayment of scheduled amounts will be to eliminate any remaining receivable from the customer, with the difference between the balance of the receivable and the cash received recognized as some form of 'other income'. We believe, it would not be appropriate to recognize additional product or service revenue from the prepayment because the customer's prepayment does not alter the financing that was provided to the customer when entering into the contract.

Determining the discount rate

Excerpt from ASC 606-10

• > The Existence of a Significant Financing Component in the Contract

32-19 To meet the objective in paragraph 606-10-32-16 when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

• • > Example 28— Determining the Discount Rate

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

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).

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. <u>The entity accounts for the receivable in accordance with Topic 310 on receivables and Subtopic 835-30 on the imputation of interest.</u>

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

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.

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. <u>The entity accounts for the loan receivable in accordance with Topic 310 on receivables and Subtopic 835-30 on the imputation of interest.</u>

• • > Example 29—Advance Payment and Assessment of Discount Rate

55-240 An entity enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (that is, the performance obligation will be satisfied at a point in time). The contract includes 2 alternative payment options: payment of $5,000 in 2 years when the customer obtains control of the asset or payment of $4,000 when the contract is signed. The customer elects to pay $4,000 when the contract is signed.

55-241 The entity concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

55-242 The interest rate implicit in the transaction is 11.8 percent, which is the interest rate necessary to make the 2 alternative payment options economically equivalent. However, the entity determines that, in accordance with paragraph 606-10-32-19, the rate that should be used in adjusting the promised consideration is 6 percent, which is the entity's incremental borrowing rate.

55-243 The following journal entries illustrate how the entity would account for the significant financing component.

a. Recognize a contract liability for the $4,000 payment received at contract inception.

Cash	$4,000	
Contract liability		$4,000

b. During the 2 years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration (in accordance with paragraph 606-10-32-20) and accretes the contract liability by recognizing interest on $4,000 at 6 percent for 2 years.

Interest expense	$494[(a)]	
Contract liability		$494

(a) $494 = $4,000 contract liability × (6 percent interest per year for 2 years).

c. Recognize revenue for the transfer of the asset.

Contract liability	$4,494	
Revenue		$4,494

Pending Content

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* ¦ Transition Guidance: 326-10-65-1

55-237 … The entity accounts for the receivable in accordance with Topic 310 on receivables, Subtopic 326-20 on financial instruments measured at amortized cost, and Subtopic 835-30 on the imputation of interest.

55-239 … The entity accounts for the loan receivable in accordance with Subtopic 310-10 on receivables, Subtopic 326-20 on financial instruments measured at amortized cost, and Subtopic 835-30 on the imputation of interest.

Excerpt from ASC 606-10

• • > Example 26—Significant Financing Component and Right of Return

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.

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.

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.

55-230 The contract includes a significant financing component, in accordance with paragraphs 606-10-32-15 through 32-17. This is evident from the difference between the amount of promised consideration of $121 and the cash selling price of $100 at the date that the goods are transferred to the customer.

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.

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.

Pending Content

Transition Date: *(P) December 16, 2019; (N) December 16, 2020* ¦ Transition Guidance: 326-10-65-1

55-231 …

(b) The receivable recognized would be measured in accordance with Subtopic 326-20. This Example does not consider the credit loss accounting for the receivable.

The discount rate to be used in accounting for a significant financing component: [606-10-32-19]

— is determined at contract inception and is not updated for changes in interest rates or changes in facts or circumstances, such as the customer's or the entity's credit standing. However, the discount rate is updated if there is a contract modification not accounted for as a separate contract and a significant financing component is determined to exist in the modified contract; and

— is the rate that would be reflected in a separate financing transaction between the entity and the customer, reflecting the credit characteristics of the party (i.e. the entity or the customer) receiving the financing.

For payments received in advance of the transfer of the goods or services to the customer, the discount rate used reflects the entity's creditworthiness. Conversely, for payments received in arrears, or after the transfer of the goods or services to the customer, the discount rate used reflects the customer's creditworthiness and any effect on the rate (presumably downward) if collateral or other security is provided by the customer. [606-10-32-19]

Question 5.5.110
Can an entity use a discount rate derived from a portfolio of contracts?

Interpretive response: Yes. An entity may use a discount rate that is not entity- or customer-specific when it applies the portfolio approach to account for the significant financing component of a group of similar contracts.

The portfolio approach (see section 2.5) allows an entity to apply the guidance in Topic 606 to a portfolio of contracts (or performance obligations) that have similar characteristics if by doing so the entity reasonably expects that the result of applying the guidance at the portfolio level would not differ materially from applying the guidance at the individual contract level. [606-10-10-4]

The entity may, for example, apply a discount rate to a portfolio of contracts with similar characteristics – e.g. duration, credit quality. The entity would need to ensure that new contracts are assigned to the appropriate portfolio based on common characteristics, including discount rates and payment structures. The entity would also need to support its conclusion that the results are not expected to be materially different from applying the guidance to individual contracts.

Question 5.5.120

Is it appropriate to use a risk-free rate as the discount rate?

Interpretive response: Generally, no. The Boards decided that using a risk-free rate would not result in useful information because the resulting interest rate would not reflect the characteristics of the parties to the contract – i.e. if the entity provides the customer financing, the entity likely would charge more for the financing when the customer's creditworthiness is lower. However, if the contract is with a customer where the risk-free rate reflects the characteristics of the parties, it could be an appropriate rate (e.g. a contract with the US government). [ASU 2014-09.BC239]

Question 5.5.130

Is using an interest rate that is explicitly specified in the contract appropriate?

Interpretive response: Not always. It may not be appropriate to use an interest rate that is explicitly specified in the contract, because the entity might offer below-market financing as a marketing incentive. Consequently, an entity applies the rate that would be used in a separate financing transaction between the entity and its customer (e.g. a financing transaction where the entity does not transfer goods or services to the customer). [606-10-32-19]

This can lead to practical difficulties for entities with large volumes of customer contracts or multinational operations, because they will have to determine a specific discount rate for each customer, class of customer or geographical region of customer when a contract contains a significant financing component.

Question 5.5.140

How should an entity account for an explicitly stated interest rate it charges a customer when the contract does not include a significant financing component?

Interpretive response: Generally, we believe that charging an explicit interest rate in contracts with customers might indicate that the financing component is significant from a qualitative stand-point. In this case, an entity should consider whether the quantitative aspects outweigh the qualitative evidence when determining whether the financing component is significant.

However, based on other quantitative measures, it is possible for a contract that includes an explicitly stated interest rate to not include a significant financing component (see Question 5.5.90).

For such a contract, we believe it would be acceptable to recognize and present the interest component in a manner similar to when the contract has a significant financing component (see section 5.5.50) as interest income separate from revenue from customers. In doing so, either of the following rates could be used to determine the amount of interest income:

— the interest rate that would be used if the contract had a significant financing component (i.e. imputed rate); or
— the explicitly stated interest rate.

Notwithstanding the above, if the fee is more akin to variable consideration – e.g. the balance is expected to be paid over a relatively short period of time or the interest is akin to a prompt payment discount discussed in Question 5.3.70 – it may also be acceptable to include the amount in the transaction price.

Entities should apply its approach consistently to similar contracts.

Question 5.5.150

Could a contract with an implied interest rate of zero contain a financing component?

Interpretive response: Yes. When the consideration to be received for a good or service with extended payment terms is the same as the cash selling price, the implied interest rate is zero. However, a significant financing component may still exist. The difference between the promised consideration for a good or service and the cash selling price is only one factor to consider in making this determination. [TRG 03-15.30]

For example, retailers sometimes offer a promotional incentive that allows customers to buy items such as furniture and pay the cash selling price two years after delivery. Judgment is required to evaluate whether in these circumstances the entity is offering a discount or other promotional incentive for customers who pay the cash selling price at the end of the promotional period that equals the financing charge that would otherwise have been charged in exchange for financing the purchase.

If the entity concludes that significant financing has been provided to the customer, then the transaction price is reduced by the implicit financing amount and interest income is accreted. The implicit financing amount is calculated using the rate that would be used in a separate financing transaction between the entity and its customer.

Presenting the effects of a significant financing component

Excerpt from ASC 606-10

• > The Existence of a Significant Financing Component in the Contract

32-20 An entity shall present the effects of financing (interest income or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income (statement of activities). Interest income or interest expense is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer. In accounting for the effects of the time value of money, an entity also shall consider the subsequent measurement guidance in Subtopic 835-30, specifically the guidance in paragraphs 835-30-45-1A through 45-3 on presentation of the discount and premium in the financial statements and the guidance in paragraphs 835-30-55-2 through 55-3 on the application of the interest method.

An entity presents the effects of the financing component as interest income or interest expense – i.e. separately from revenue from customers. The unwinding of the premium or discount is also not an element of revenue from customers because contracts with significant financing components have two separate economic features: one relating to the transfer of goods or services (revenue from customers) and the other relating to the financing component (interest income or expense). The Boards noted that if an entity regularly enters into financing transactions, it is not precluded from presenting interest as a type of revenue when the interest represents income from the entity's ordinary activities. See Question 14.7.20. [ASU 2014-09.BC246 – BC247]

Question 5.5.160

Can a significant financing component be allocated entirely to one or more, but not all, performance obligations?

Interpretive response: Yes, in some cases. The TRG agreed that in some circumstances a significant financing component could be allocated to one or more, but not all, of the performance obligations in the contract. This is a different question from that in Question 5.5.70, which concludes that, for purposes of determining *whether a significant financing component exists*, an entity generally allocates each payment received to all of the performance obligations in the contract on a pro rata basis to calculate the financing component and determine whether the practical expedient applies. [TRG 03-15.30]

Topic 606 only provides examples of a significant financing component in contracts with a single performance obligation; therefore, it was unclear if a significant financing component could be allocated entirely to one or more, but not all, performance obligations. The TRG generally agreed that allocating a significant financing component entirely to one or more performance obligations may be consistent with the allocation objective in some cases. While no specific conclusions were reached by the TRG on when this would be appropriate, the TRG indicated that the considerations about whether a significant financing component can be allocated entirely to one or more, but not all, of the performance obligations in a contract may be similar to those an entity considers in determining whether variable consideration or a bundled discount relates to only one or some of the performance obligations in a contract, but not all. Sections 6.5 and 6.6 provide guidance on the discount allocation exception and variable consideration allocation exception, respectively. [TRG 03-15.30]

Question 5.5.170

Is interest cost from a significant financing component capitalizable?

Interpretive response: No.The FASB clarified that interest expense from revenue contracts with a significant financing component are not in the scope of Subtopic 835-20 in ASU 2020-10. Therefore, an entity cannot capitalize the interest that is imputed from a significant financing component of a revenue contract in which a customer pays for a good or service in advance of the entity's satisfaction of the performance obligation. [835-30-15-3]

Examples

The following examples illustrate the principles regarding significant financing components.

Example 5.5.40

Time value of money in a single performance obligation arrangement

Large Equipment Manufacturer (LEM) enters into a contract to sell Product P to Customer for an upfront cash payment of $300,000. At contract inception, LEM expects to deliver Product P to Customer in two years.

Due to the length of time between the payment and delivery of the goods, LEM determines that the contract has a significant financing component. LEM uses a discount rate of 5%, which represents the rate that would be used in a separate financing transaction between LEM and Customer, including consideration of LEM's creditworthiness.

LEM records the following journal entries.

	Debit	*Credit*
Cash	300,000	
Contract liability		300,000
To recognize cash received at contract inception.		

	Debit	Credit
Interest expense	15,000[1]	
Contract liability		15,000
To recognize Year 1 interest accrual.		
Interest expense	15,750[2]	
Contract liability		15,750
To recognize Year 2 interest accrual.		
Contract liability	330,750	
Revenue		330,750[3]
To recognize revenue when control of equipment transferred.		

Notes:
1. $300,000 × 5% = $15,000.
2. ($300,000 + $15,000) × 5% = $15,750.
3. $300,000 + $15,000 + $15,750.

Example 5.5.50
Time value of money in a multiple-element arrangement

ABC Corp. enters into a contract with Customer to deliver Product X and Product Y for $150,000 payable upfront. Product X will be delivered in two years and Product Y will be delivered in five years.

ABC determines that the contract contains two performance obligations that are satisfied at the points in time at which the products are delivered to Customer. ABC allocates $37,500 (25%) to Product X and $112,500 (75%) to Product Y based on their relative stand-alone selling prices.

ABC concludes that the contract contains a significant financing component and uses an interest rate of 6%, which represents the rate that would be used in a separate financing transaction between ABC and Customer, including consideration of ABC's creditworthiness.

ABC records the following journal entries.

	Debit	Credit
Cash	150,000	
Contract liability		150,000
To recognize cash received at contract inception.		
Interest expense	18,540[1]	
Contract liability		18,540
To recognize interest accruals in Years 1 and 2.		

	Debit	Credit
Contract liability	42,135[2]	
Revenue		42,135
To recognize revenue when control of Product X transferred.		
Interest expense	24,145[3]	
Contract liability		24,145
To recognize interest accruals in Years 3–5.		
Contract liability	150,550	
Revenue		150,550[4]
To recognize revenue when control of Product Y transferred.		

Notes:

1. ($150,000 × 6%) + ($159,000 × 6%).
2. $37,500 + $4,635 (interest of $18,540 × 25%).
3. Contract liability at the start of Year 3 ($126,405) at 6% interest for three years: $7,584 + $8,039 + $8,522.
4. $112,500 + $24,145 interest Years 3 - 5 + $13,905 interest Years 1 and 2 (interest of $18,540 × 75%).

Example 5.5.60

Payment in advance performance obligation satisfied over time

Hosting Company signs a three-year, non-cancellable agreement with Customer to provide hosting services. Customer may elect to either pay:

a. $140 per month (total payment of $5,040); or
b. $4,200 at the beginning of the contract term, with no additional monthly payments.

Customer elects to option (b) and pays in advance. The contract includes a financing component based on the following.

— The difference in pricing between options (a) and (b), together with the timing difference between when Customer will pay the consideration and Hosting Company's provision of hosting services under option (b), indicates that the contractual payment terms under option (b) have the primary purpose of providing Hosting Company with financing.

— The cash selling price is the monthly fee of $140 because it reflects the amount due when the monthly hosting services are provided to Customer. A comparison of the payment terms between options (a) and (b) indicates total cumulative interest of $840 ($5,040 – $4,200) and an implied discount rate of 13%.

— Hosting Company further determines that the financing component is significant because the interest of $840 is 20% of the financed amount of $4,200. Therefore, an adjustment to reflect the time value of money will be needed if Customer elects option (b) to pay at the beginning of the contract term.

— Hosting Company concludes that none of the factors in paragraph 606-10-32-17 – indicating that a significant financing component does not exist – are present.

Hosting Company evaluates whether the implied discount rate of 13% is consistent with the interest rate that would be used in a separate financing transaction between itself and Customer, including consideration of its creditworthiness. Assuming that it is, Hosting Company recognizes revenue of $5,040 ratably over the contract term as the performance obligation is satisfied and interest expense of $840 using the effective interest method. The amount of interest expense to recognize each period is based on the contract liability, which decreases as services are provided and increases for the accrual of interest.

The following is a sample interest calculation under the effective interest method.

Month	Contract liability at beginning of month	Transaction price/delivery of service	Interest expense (13% / 12)	Contract liability at end of month
	A	B	(A-B) × 1.083% = C	A – B + C
1	$4,200	$140	$44	$4,104
2	4,104	140	43	4,007
3	4,007	140	42	3,909
4	3,909	140	41	3,810
5	3,810	140	40	3,710
Continue for each month…				
36	$ 140	$140	$ 0	$ 0

If the implied discount rate of 13% is determined to be too high or too low, then the transaction price would be adjusted to reflect a rate that would be used in a separate financing transaction between Hosting Company and Customer, based on Hosting Company's creditworthiness; this is because it is the party receiving the financing in this contract. The difference between the implied discount rate and the rate charged in a separate financing component would represent a discount granted to Customer for purposes other than financing.

Example 5.5.70
Payment in arrears

Manufacturer enters into a contract to provide equipment to Customer priced at $2 million. Although control of the equipment is transferred at contract inception, Manufacturer agrees that Customer will pay for the equipment over two years in monthly installments of $92,000.

The contract includes a financing component based on the following.

- The difference in pricing between the selling price of $2 million and the total of the monthly payments of $2,208,000 ($92,000 × 24) indicates that the contractual payment terms have the primary purpose of providing Customer with financing.
- The cash selling price is $2 million because it reflects the amount due at the point the equipment is transferred to Customer. A comparison of the cash selling price and the total payments to be received indicates total cumulative interest of $208,000 ($2,208,000 – $2,000,000) and an implied interest rate of 9.7%.
- Manufacturer further determines that the financing component is significant because the interest of $208,000 is approximately 10% of the financed amount of $2,208,000. Therefore, an adjustment to reflect the time value of money is needed.
- Manufacturer concludes that none of the factors indicating that a significant financing component does not exist in paragraph 606-10-32-17.

Manufacturer evaluates whether the implied interest rate of 9.7% is consistent with the interest rate charged in a separate financing transaction between itself and Customer, including consideration of Customer's creditworthiness. Assuming that it is, Manufacturer recognizes revenue of $2 million upon delivery of the equipment – i.e. as the performance obligation is satisfied – and interest income on a monthly basis using the effective interest method. The amount of interest income for each month is based on the balance of the receivable for equipment sold, which decreases as payments are received.

The following is a sample interest calculation under the effective interest method.

Month	Receivable at beginning of month	Payment at month-end	Interest income (9.7% / 12)	Receivable at end of month
	A	B	A × 0.81% = C	A – B + C
1	$2,000,000	$92,000	$16,143	$1,924,143
2	1,924,143	92,000	15,531	1,847,674
3	1,847,674	92,000	14,913	1,770,587
4	1,770,587	92,000	14,291	1,692,878
5	1,692,878	92,000	13,664	1,614,542
Continue for each month…				
24	$ 91,263	$92,000	$ 737	$ 0

If the implied interest rate of 9.7% is determined to be too high or too low, then the transaction price would be adjusted to reflect a rate that would be used in a separate financing transaction between Manufacturer and Customer, based on Customer's creditworthiness because Customer is receiving the financing. The difference between the implied interest rate and the rate charged in a separate financing component would represent a discount granted to the customer for purposes other than financing, reducing the amount of revenue recognized for the equipment and increasing the amount of interest income to reflect an appropriate rate of interest.

5.6 Noncash consideration

Excerpt from ASC 606-10

• > Noncash Consideration

32-21 To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the estimated fair value of the noncash consideration at contract inception (that is, the date at which the criteria in paragraph 606-10-25-1 are met).

32-22 If an entity cannot reasonably estimate the fair value of the noncash consideration, the entity shall measure the consideration indirectly by reference to the standalone selling price of the goods or services promised to the customer (or class of customer) in exchange for the consideration.

32-23 The fair value of the noncash consideration may vary after contract inception because of the form of the consideration (for example, a change in the price of a share to which an entity is entitled to receive from a customer). Changes in the fair value of noncash consideration after contract inception that are due to the form of the consideration are not included in the transaction price. If the fair value of the noncash consideration promised by a customer varies for reasons other than the form of the consideration (for example, the exercise price of a share option changes because of the entity's performance), an entity shall apply the guidance on variable consideration in paragraphs 606-10-32-5 through 32-14. If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, an entity shall apply the guidance in paragraphs 606-10-32-5 through 32-14 on variable consideration only to the variability resulting from reasons other than the form of the consideration.

32-24 If a customer contributes goods or services (for example, materials, equipment, or labor) to facilitate an entity's fulfillment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as noncash consideration received from the customer.

• • > Example 31—Entitlement to Noncash Consideration

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).

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.

55-250 To determine the transaction price (and the amount of revenue to be recognized), the entity measures the estimated fair value of 5,200 shares at contract inception (that is, on January 1, 20X1). The entity measures its progress toward complete satisfaction of the performance obligation and recognizes revenue as each week of service is complete. The entity does not reflect any changes in the fair value of the 5,200 shares after contract inception in the transaction price. However, the entity assesses any related contract asset or receivable for impairment. Upon receipt of the noncash consideration, the entity would apply the guidance related to the form of the noncash consideration to determine whether and how any changes in fair value that occurred after contract inception should be recognized.

Noncash consideration received from the customer is part of the transaction price. It could be in the form of goods or services, but it could also be in the form of a financial instrument or property, plant and equipment. For example, an entity might receive shares of the customer's stock in exchange for providing goods or services. [606-10-32-21, ASU 2014-09.BC248]

Noncash consideration is reflected in the transaction price at its fair value measured at contract inception. If an entity cannot make a reasonable estimate of fair value, then it refers to the estimated selling price of the promised goods or services. [606-10-32-21 – 32-22, ASU 2016-12.BC39]

The fair value of noncash consideration can change after contract inception. In that case, the entity determines whether the change in fair value is due to: [606-10-32-23]

- the form of the consideration – e.g. variations due to changes in the price per share if the noncash consideration is an equity instrument; or
- other than the form of the consideration – e.g. change in the number of equity instruments to be issued to the entity due to the entity's performance.

When the fair value of noncash consideration varies due to the form of the consideration, the transaction price is not adjusted and therefore the variable consideration constraint does not apply. Further, any changes in the fair value of noncash consideration due to the form of the consideration that are recognized would be reported outside of revenue from customers. [606-10-32-23]

In contrast, when the fair value of noncash consideration varies for reasons other than the form of the consideration, the change is reflected in the transaction price and is subject to the guidance on constraining variable consideration. Because changes in noncash consideration for reasons other than form are part of the transaction price, these changes are included in revenue from customers. The determination of whether a change in fair value is caused by the form of the noncash consideration or other reasons, and the determination of how to allocate the fair value changes between those affecting the transaction price and those that do not, may be challenging in some situations. [606-10-32-23]

In contrast to noncash consideration for the transfer of goods or services, noncash consideration to facilitate an entity's fulfillment of the contract (e.g. materials or equipment) is measured when the entity obtains control of those contributed goods or services. [606-10-32-24]

5.7 Consideration payable to a customer

Excerpt from ASC 606-10

• > Consideration Payable to a Customer

32-25 Consideration payable to a **customer** includes:

a. 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)
b. 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)
c. Equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments).

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.

32-25A Equity instruments granted by an entity in conjunction with selling goods or services shall be measured and classified under Topic 718 on stock compensation. The equity instrument shall be measured at the grant date in accordance with Topic 718 (for both equity-classified and liability-classified share-based payment awards). Changes in the measurement of the equity instrument (through the application of Topic 718) after the **grant date** that are due to the form of the consideration shall not be included in the transaction price. Any changes due to the form of the consideration shall be reflected elsewhere in the grantor's income statement. See paragraphs 606-10-55-88A through 55-88B for implementation guidance on equity instruments granted as consideration payable to a customer.

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.

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.

• > Equity Instruments Granted as Consideration Payable to a Customer

55-88A Paragraph 606-10-32-25A requires that equity instruments granted in conjunction with an entity selling goods or services be measured and classified under Topic 718 on stock compensation. If the number of equity instruments promised in a contract is variable due to a **service condition** or a **performance condition** that affects the vesting of an **award**, an entity should estimate the number of equity instruments that it will be obligated to issue to its customer and update the estimate of the number of equity instruments until the award ultimately vests in accordance with Topic 718. When measuring each instrument, the entity should include, in accordance with Topic 718, the effect of any market conditions and service or performance conditions that affect factors other than vesting. Examples of factors other than vesting are included in paragraph 718-10-30-15. Changes in the grant-date fair value of an award due to revisions in the expected outcome of a service condition or a performance condition (both those that affect vesting and those that affect factors other than vesting) are not deemed to be changes due to the form of the consideration (as described in paragraph 606-10-32-23) and, therefore, should be reflected in the transaction price.

55-88B Paragraph 606-10-32-25A requires that equity instruments granted by an entity in conjunction with selling goods or services be measured and classified under Topic 718 at the **grant date** of the instrument. When an estimate of the fair value of an equity instrument is required before the grant date in accordance with the guidance on variable consideration in paragraph 606-10-32-7, the estimate should be based on the fair value of the award at the reporting dates that occur before the grant date. An entity should change the transaction price for the cumulative effect of measuring the fair value at each reporting period after the initial estimate until the grant date occurs. In the period in which the grant date occurs, the entity should change the transaction price for the cumulative effect of measuring the fair value at the grant date rather than the fair value previously used at any prior reporting date.

• • > Example 32—Consideration Payable to a Customer

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.

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.

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).

5.7.10 Overview

Payments to a customer may relate to goods or services received from the customer, a discount or refund for the goods or services provided to the customer, or a combination of both. As such, the entity needs to evaluate the substance of the payment.

Consideration payable to a customer includes cash amounts that an entity pays or expects to pay to the customer. It includes credits or other items (e.g. a coupon or voucher) that can be applied by the customer against the amount owed to the entity or to other parties that purchase the entity's goods or services from the customer. Consideration payable to a customer also includes equity-based instruments (liability- or equity-classified) granted to customers. [606-10-32-25]

Entities will also need to evaluate payments made to other parties in the direct chain of distribution. This is because payments to customers include cash payments 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. Additionally, in some cases an entity may conclude that it is appropriate to apply the guidance more broadly to payments made to entities outside the direct distribution chain. [606-10-32-25]

Question 5.7.05

Are payments outside the contract with the customer or direct distribution chain evaluated as consideration payable to a customer?

Interpretive response: It depends. Determining how broadly to evaluate payments within and outside a distribution chain is a matter of judgment.

Payments made to a customer that are not specified in the contract may still represent consideration payable to a customer. An entity should have a process for evaluating whether any other payments made to a customer are consideration payable that requires further evaluation under Topic 606. However, an entity need not always identify and assess all amounts ever paid to a customer to determine if they represent consideration payable to a customer. [TRG 03 -15.28]

Payments within the direct distribution chain – i.e. payments to other parties that purchase the entity's goods or services from the customer – are accounted for as consideration payable to a customer. However, the evaluation of payments to parties outside a direct distribution chain requires judgment and a determination as to whether those incentives represent payments on behalf of the entity's customer. The consideration payable to a customer guidance may apply to these payments in some circumstances.

For example, an entity may have transactions or a business model that results in payments to a customer's customer who is not in the direct distribution chain because that party does not purchase the entity's goods or services. This is common in arrangements in which the entity is an agent connecting its customer to the end user of the customer's goods or services – e.g. a platform or marketing company that connects buyers and sellers may provide incentives to the buyer to increase the buyer's purchases with the seller. Depending on the facts and circumstances, the platform or marketing company may conclude either the buyer or the seller or both are the entity's customers. In these types of business models, the analysis of whether to apply the consideration payable to a customer guidance begins with the entity's conclusion about whether it has more than one customer among the various parties. [TRG 03 -15.28]

However, even when an entity concludes that the party to which it makes incentive payments is not its customer and is not within the direct distribution chain, the entity still evaluates those payments to determine whether they represent payments made on behalf of the entity's customer and, if so, the consideration payable to a customer guidance is applied. [TRG 03 -15.28]

This evaluation considers not only contractual obligations to the customer but also any implied promises to provide incentives to the entity's customer's customer. We understand that the SEC staff believes, in general, that an implied promise for an entity to make payments (i.e. fund discounts) to buyers (i.e. end users) that purchase from the entity's customers exists if the entity's incentive promotion or program is reasonably knowable to the entity's customers. Based on discussions with the SEC staff, an incentive promotion or program may be reasonably knowable to a customer when the benefit is visible to the customer (e.g. via a platform app, website, e-mails, or other forms of communications that are accessible by the customer) such that the customer is reasonably aware that end users of the entity's platform are receiving benefits on purchases and therefore has a reasonable expectation that incentives will be provided to the entity's customer. See Example 5.7.10.

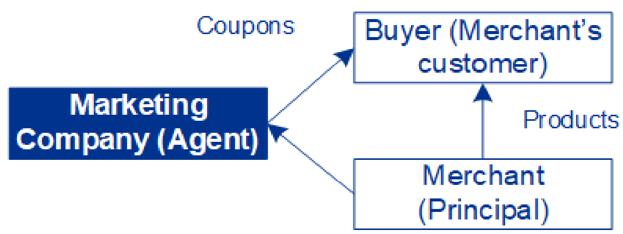
An entity may also make payments to a third party outside the distribution chain on behalf of a customer. The consideration payable to a customer guidance may also apply to these payments in some circumstances (see Question 5.7.45).

Example 5.7.10

Payments to customers – payments outside the distribution chain

Marketing Company (agent) markets and incentivizes the purchase of Merchant's (principal) products by providing coupons to Merchant's end customer. Marketing Company's service fee is based on the number of Merchant products sold.

The following diagram depicts this arrangement.



Depending on the facts and circumstances, Marketing Company might conclude that:

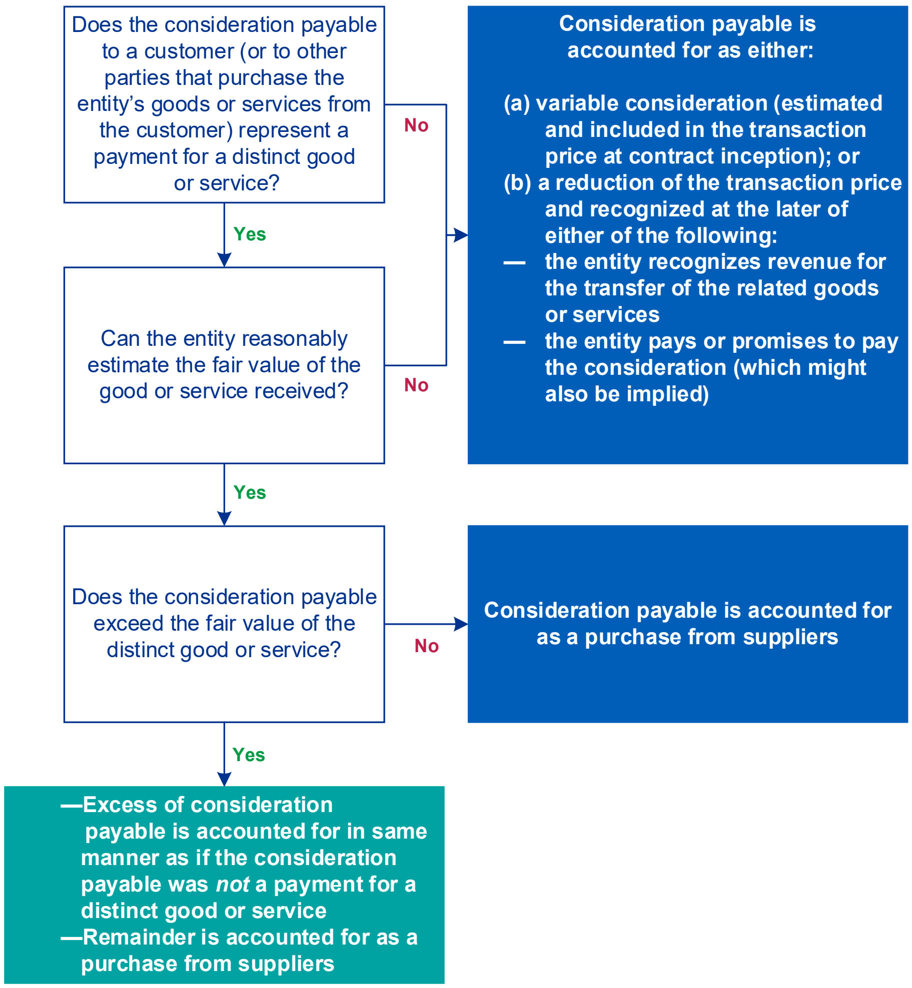
— both Merchant and Buyer are its customers. In that case, Marketing Company applies the consideration payable to a customer guidance to determine whether the coupon payment is accounted for as a reduction of revenue or as an expense if it is payment for a distinct good or service; or

— only Merchant is its customer. In that case, Marketing Company performs an additional evaluation to determine whether the coupon payment represents the fulfillment of a promise (contractual or implied) to the Merchant to provide coupons to its customer (i.e. a payment made to Buyer on behalf of the Merchant customer). If a contractual obligation or an implied promise exists, the payments are accounted for as a reduction of revenue. If no contractual or implied promise to the Merchant exists, then the coupon payment is generally recorded as sales and marketing expense.

See Question 5.7.05 for additional considerations when the entity is making a payment to a third party that is its customer's customer.

5.7.20 Accounting for consideration payable to a customer

The following decision tree summarizes how an entity would distinguish between a reduction of transaction price or a payment for goods or services.



Payments for a distinct good or service

When a payment to a customer is for a distinct good or service, an entity accounts for the payment in the same way as for other purchases from suppliers. An entity evaluates whether a good or service received from the customer is distinct using the same criteria in Step 2 to identify performance obligations. See section 4.3 for further discussion of the distinct criteria. [606-10-32-26]

If the entity does not receive a distinct good or service in exchange for the payment, the payment is considered a reduction of the transaction price.

Fair value of the payment

The amount of consideration received from a customer for goods or services and the amount of consideration paid to that customer for goods or services could be linked even if they are separate events. For example, a customer may pay more for goods or services from an entity than it otherwise would have paid if it were receiving a payment from the entity. [606-10-32-26]

As such, any amount paid to a customer for goods or services is limited to their fair value. The amounts in excess of fair value are recorded as a reduction of the transaction price. [606-10-32-26]

If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it accounts for all of the consideration payable to the customer as a reduction of the transaction price. [606-10-32-26]

Payment accounted for as a reduction of the transaction price

Consideration payable to a customer that is a reduction of the transaction price is either accounted for as variable consideration and included in the transaction price at contract inception or subject to the 'later of' guidance. [606-10-32-25, 32-27]

If the consideration payable to a customer includes a variable amount it estimates the amount at contract inception and includes that amount in the transaction price. The transaction price is recognized as revenue when (or as) control of the goods or services is transferred. [606-10-32-25]

However, if the amounts are subject to the 'later of' guidance, the payments are recognized as a reduction of revenue as the later of the date when the related revenue is recognized or the entity promises to pay such considerations (which can be implied). [606-10-32-27]

As a result, because the accounting could be different the entity will need to distinguish between when the payments are accounted for as variable consideration or under the 'later of' guidance (see Question 5.7.10).

Question 5.7.10

Does an entity include variable consideration in the transaction price or follow the 'later of' guidance on consideration payable to a customer?

Interpretive response: It depends. Amounts payable to a customer could be both variable consideration and consideration payable to a customer. However, the accounting for variable consideration and consideration payable to a customer could be different.

— **Variable consideration.** The entity estimates the variable consideration at contract inception and this estimate affects the transaction price. The transaction price is recognized as revenue as control of the goods or services is transferred.

— **Consideration payable to a customer ('later of' guidance).** Amounts are recognized as a reduction of revenue at the *later of* when the related revenue is recognized or the entity promises to pay such considerations (which can be implied).

To determine whether to account for the payment as variable consideration or follow the 'later of' guidance, an entity evaluates its past practice and other activities that could give rise to an expectation at contract inception that the transaction price includes a variable amount. For example, in the case of a customer incentive, at contract inception an entity evaluates whether it intends to provide an incentive or if the customer has a reasonable expectation that an incentive will be provided even though it may be in the form of consideration payable to a customer. If yes, then the incentive constitutes variable consideration. The incentive reduces the transaction price and revenue will be affected when the entity transfers control of the good or service.

The 'later of' guidance applies only if the entity concludes at contract inception that the contract does not have variable consideration in the form of an incentive to the customer or if the contract at inception includes a fixed payment to a customer. An example of a fixed payment is a nonrefundable upfront payment to a customer (see Questions 5.7.40 to 5.7.80).

Example 5.7.20
Payments to customers – variable consideration

Manufacturer delivers goods to Retailer on December 15, Year 1 pursuant to a contract between the parties. On January 20, Year 2, Manufacturer offers coupons in a newspaper to encourage retail sales of the goods sold to Retailer. Manufacturer agrees to reimburse Retailer for coupons redeemed. Manufacturer offered similar coupons in prior years.

Because Manufacturer has a history of offering similar coupons, and at contract inception expects to continue offering similar coupons, it will account for these as variable consideration. The variable consideration resulting from the uncertainty of coupon redemption will be estimated at contract inception.

Conversely, if Manufacturer had not offered coupons in prior years and does not expect, at contract inception, to make reimbursements to Retailer, then it would recognize estimated reimbursements as an adjustment to revenue when it communicates to Retailer its intention to reimburse it for any redeemed coupons following the 'later of' guidance.

Example 5.7.30
Credits to a new customer – reduction in the transaction price

Customer cancels its existing contract with Telco B and signs a two-year contract with Telco D for $80 per month. Because Customer must pay an early termination penalty to Telco B, Telco D promises at contract inception to give Customer a one-time credit of $200 (a 'port-in credit'). The port-in credit is not refundable if the customer cancels the contract or based on a required amount of usage.

Telco D determines that it should account for the port-in credit as consideration payable to a customer, because the credit will be applied against amounts owing to Telco D. Telco D does not receive any distinct goods or services in exchange for this credit and accounts for the credit as a reduction of the transaction price (i.e. $80 × 24 months – $200). The consideration payable to Customer is fixed and is not variable consideration.

The reduction in the transaction price is recognized as the promised goods or services in the entire contract are transferred.

Question 5.7.20

Are payments to customers in the form of equity-based instruments, instead of cash, considered 'consideration payable to a customer'?

Interpretive response: Yes. Topic 606 states that consideration payable to a customer includes equity-based instruments (liability- or equity-classified) granted to customers in conjunction with selling goods or services. Therefore, these instruments are recognized as a reduction of revenue unless they represent a fair value payment for a distinct good or service under Topic 606. [606-10-32-25]

When the equity-based instruments are accounted for as a reduction of revenue, the grant date fair value is recognized as a reduction of revenue in the same manner as if the entity made a cash payment to the customer. However, Topic 606 states that the equity-based instruments are measured and classified under Topic 718 (share-based payments). Therefore, it is important to consider the applicable guidance in both Topic 718 and Topic 606 for these transactions. [606-10-32-25A]

The following are some of the key aspects to consider when evaluating an equity-based instrument issued to a customer accounted for as a reduction of revenue.

Grant date fair value

The grant-date fair value of an equity-based instrument (as determined under Topic 718) is ultimately recorded as a reduction of revenue. However, if an entity promises or intends to provide an equity-based instrument to a customer and the grant date has not occurred, the entity follows the transaction price guidance in Topic 606 and estimates the fair value of the equity-based instrument. The estimate of fair value is adjusted each reporting date until the grant date(s) is achieved. See section 4 of KPMG Handbook, Share-based payment, for further discussion on determining the grant date. [606-10-32-25A, 606-10-55-88B]

Fully vested shares

If the equity-based instruments are fully vested (e.g. not subject to future customer purchases), the entity evaluates the payment in the same way it would a cash incentive payment to determine when and how to record it. This evaluation may be similar to the accounting for nonrefundable upfront cash payments to a customer as discussed in Question 5.7.50 and require the entity to assess whether to recognize an asset. Therefore, depending on the facts and circumstances, even though the equity-based instruments are immediately vested they may not be immediately recognized as a reduction of revenue but instead recorded as an asset and recognized as a reduction of revenue as future revenue is recognized. See Questions 5.7.50 to 5.7.90 and Examples 5.7.50 to 5.7.70 on upfront payments to customers.

Vesting conditions

An entity may grant equity-based instruments to the customer with vesting conditions. When the vesting is based on a service condition or performance condition, the amount that ultimately is recorded as a reduction of revenue depends on the number of shares that actually vest according to those conditions. Each reporting date, the transaction price is reduced by the grant-date fair value of the number of equity-based instruments expected to vest (subject to the entity's forfeiture policy discussed below) in accordance with Topic 718. The amounts are adjusted each period until the equity-based instrument ultimately vests. [606-10-55-88A]

When vesting is based on a market condition (e.g. the entity achieving a target share price), the existence of that condition affects the grant-date fair value of the award and not whether it is recorded. Therefore, the existence of a market condition does not change the number of equity-based instruments that are recorded as a reduction of revenue but rather the grant-date fair value of those equity-based instruments.

Judgment is required to evaluate and distinguish between different types of vesting conditions. See section 4 of KPMG Handbook, Share-based payment, for further discussion on vesting conditions. The following are additional considerations related to service and performance conditions.

Service condition

A service condition includes nonemployees rendering services to the grantor. We believe it also includes vesting based on a customer purchasing a volume of goods or services. [718-10-20]

Determining the number of equity-based instruments with a service condition that are expected to vest depends on the entity's policy election for estimating forfeitures.

— If an entity's policy is to estimate expected forfeitures, it reduces the transaction price by the number of equity-based instruments that are expected to vest and adjusts that estimate each reporting date.

— If an entity's policy is to record forfeitures only when they occur, it reduces the transaction price for the full number of equity-based instruments that could vest regardless of probability and would only increase the transaction price if the equity-based instruments are forfeited.

An entity's forfeiture policy is an entity-wide accounting policy election that applies to all nonemployee equity-based instrument transactions, including arrangements with customers. Entities should carefully evaluate their policy decision because the timing and amount of revenue recognized may significantly differ, may not align with the economics of the transaction and may differ from a cash incentive. See section 4 of KPMG Handbook, Share-based payment, for a discussion of the entity's forfeiture policy for nonemployee awards. [718-10-35-1D]

Performance condition

A performance condition includes achieving a target solely based on the grantor's own operations (or activities) or the grantee's performance related to the grantor's own operations (or activities). Examples of a performance condition include equity-based instruments that vest upon a grantor's liquidity event (e.g. change of control or IPO) or the grantor achieving a specified milestone (e.g. FDA approval) or level of profitability. [718-10 Glossary]

Equity-based instruments granted to a customer with a performance condition are only estimated and included as a reduction in the transaction price when the performance condition is probable of being achieved. While assessing the probability of service or performance condition vesting is similar to estimating variable consideration under Topic 606 (subject to the constraint), the variability in revenue associated with vesting conditions is measured under Topic 718. [718-10-25-20]

Classification

An equity-based instrument issued to customers is equity-classified or liability-classified in accordance with Topic 718. An equity-classified award is measured at grant-date fair value and is not remeasured. A liability-classified award is measured at grant-date fair value and then remeasured each period. Nonpublic entities can make a policy election to measure all liability-classified instruments in Topic 718 either at fair value or at intrinsic value. See section 3 of KPMG Handbook, Share-based payment, for guidance on determining classification.

For both equity-classified and liability-classified instruments granted to customers, the grant-date fair value is ultimately what is recorded as a reduction of revenue. The subsequent remeasurement of the liability for liability-classified instruments is recorded elsewhere in the entity's income statement. [606-10-32-25A]

Modifications

If an entity modifies the equity-based instrument granted to a customer and that modification changes the fair value, vesting conditions or classification of the equity-based instrument, it evaluates the modification under Topic 718, which could impact the value that is recorded as a reduction of revenue. Additionally, the entity needs to evaluate the impact of the modification under Topic 606 to determine how any changes resulting from the modification are recorded as a reduction of revenue.

Assessing modifications can be complex under both Topic 718 and Topic 606. See section 5 of KPMG Handbook, Share-based payment, for guidance on modifications under Topic 718 and see chapter 11 for guidance on modifications under Topic 606.

Example 5.7.35

Payments to customers in the form of equity-based instruments

Scenario 1: Equity-based instruments issued for each purchase

On January 1, Year 1, ABC Corp. executes an MSA with Customer to deliver custom widgets for one year. Enforceable rights and obligations that meet Topic 606's contract existence criteria only exist after Customer issues a purchase order for a custom widget.

The MSA specifies that each custom widget is priced at $1,000, and ABC agrees to grant Customer 500 fully vested shares (equity-based instruments) as a sales incentive for each widget purchased. On March 1, Year 1, Customer issues a purchase order for three widgets. ABC's stock price was $1.00 on January 1, Year 1, and $1.40 on March 1, Year 1.

ABC determines there is a mutual understanding of the equity-based instruments' terms and conditions (i.e. grant date) under Topic 718 at the date the MSA is executed – even though there is not a Topic 606 contract until purchase orders are submitted.

Therefore, ABC measures the equity-based instruments granted to Customer on January 1, Year 1, using the stock price on the date of the MSA (i.e. the grant date). This results in a $1,500 reduction (3 widgets × 500 shares × $1.00 per share) in the transaction price for the purchase order issued, and not a $2,100 reduction (3 widgets × 500 shares × $1.40 per share).

Scenario 2: Equity-based instruments issued upon achievement of volume threshold (service condition)

On October 1, Year 1, ABC enters into a contract with Customer to set a price of $1,000 per widget for each widget purchased during Year 2. The contract includes a provision that Customer will earn 4,000 shares of ABC stock if Customer purchases at least 10 widgets in Year 2. On October 1, Year 1, ABC's stock price is $1.00. ABC determines there is a mutual understanding of the equity-based instruments' terms and conditions (i.e. grant date) under Topic 718 on October 1, Year 1.

The volume requirement is a service condition and ABC's policy is to estimate forfeitures for nonemployee awards. ABC estimates that it is probable the volume threshold will be met and calculates the reduction in purchase price for the first 10 widgets to be $4,000 (4,000 shares × $1.00 per share). This results in net revenue of $6,000 for the first 10 widgets sold (($1,000 × 10 widgets) – $4,000).

As sales of the first 10 widgets in Year 2 occur, ABC recognizes $600 of revenue when control of each widget transfers. ABC updates its estimate of whether the volume threshold will be met under Topic 718 each reporting period and adjusts the transaction price accordingly.

Scenario 3: Equity-based instrument issued upon achievement of financial target (performance condition)

On January 1, Year 1, ABC enters into a contract with Customer to set a price of $1,000 per widget purchased during Year 1. The contract includes a provision that Customer will earn 200 shares of ABC stock that vest for each widget purchased if ABC achieves an annual EBITDA target during the year. On January 1, Year 1, ABC's stock price is $1.00. ABC determines there is a mutual understanding of the equity-based instruments' terms and conditions (i.e. grant date) under Topic 718 on January 1, Year 1.

At contract inception, ABC estimates based on its projections that it is probable that it will achieve the annual EBITDA target. Therefore, ABC calculates the reduction in purchase price per widget in Year 1 to be $200 (200 shares × $1.00 per share). This results in net revenue for each widget sold in Year 1 of $800, which would be recognized when control of each widget transfers. Each reporting period, ABC updates its estimate of whether the financial target will be met under Topic 718 and adjusts the transaction price accordingly.

Scenario 4: Equity-based instrument issued upon a change in control event (performance condition)

On January 1, Year 1, ABC enters into a contract with Customer to set a price of $1,000 per widget purchased during Year 1. The contract includes a provision that Customer will receive 800 shares of ABC stock that vest for each widget purchased if ABC has a change in control event during the year. On January 1, Year 1, ABC's stock price is $1.00.

ABC determines there is a mutual understanding of the equity-based instruments' terms and conditions (i.e. grant date) under Topic 718 on January 1, Year 1. ABC calculates the reduction in purchase price per widget in Year 1 to be $800 (800 shares × $1.00 per share) if a change in control event occurs.

Topic 805 states that liabilities triggered by a business combination are recorded only when the business combination is consummated. ABC applies this guidance in Topic 805 to determine when a change in control is probable of occurring. ABC determines that it is not deemed probable until the change in control event occurs. Therefore, ABC recognizes revenue of $1,000 for each widget until a change in control occurs. [805-20-55-50, 55-51]

Upon a change in control, ABC would recognize a cumulative reduction of revenue of $800 for each widget sold between January 1 and the date of the change in control event, and revenue would be reduced by $800 for each subsequent widget sold.

Question 5.7.30

Are payments by a manufacturer to a retailer for advertising a reduction of the transaction price or a distinct service?

Interpretive response: It depends. The manufacturer considers the facts and circumstances of the arrangement to determine if (1) the service is distinct (particularly whether it is distinct within the context of the contract) and (2) if so, whether it can reasonably estimate the fair value of the service.

Many marketing arrangements with retailers do not provide distinct services because the arrangements do not create an enforceable right by the manufacturer to receive a distinct good or service that it controls. Therefore, these payments or discounts are typically a reduction of the transaction price. For example, if a retailer provided advertising in an in-store circular (i.e. not circulated outside of the store), the advertising services generally would not be distinct within the context of the contract. This is because the products would not be displayed in a circular unless the products are also sold by the retailer, and the manufacturer does not control the advertising.

However, there may be situations in which the advertising is widely distributed outside of the retailer's location (e.g. an advertisement in a newspaper, television or radio) and therefore might be a distinct service provided by the retailer. If the advertising provides (1) a benefit consistent with an advertising service that another entity would (or typically does) provide and (2) an external benefit (e.g. advertising that reaches customers independent of the retailer), then the advertising service could be a distinct service and payments or discounts given to customers are treated as an expense. In these cases, the manufacturer should also be able to reasonably estimate the fair value of the advertising services.

Question 5.7.40

Are slotting fees paid to a customer a payment in exchange for goods or services or a reduction of the transaction price?

Interpretive response: Generally, a reduction in transaction price. Topic 606 does not define slotting fees but the definition in legacy US GAAP in 605-50-20 provides an explanation of these types of fees.

Excerpt from ASC 605-50

20 Glossary

Slotting Fees

Consideration from a vendor to a reseller to obtain space for the vendor's products on the reseller's store shelves, whether those shelves are physical (that is, in an actual building in which the store is located) or virtual (that is, space in an Internet reseller's online catalog). The term slotting fees also includes vendor consideration for other types of product placement arrangements between a vendor and a reseller such as brand development or new product introduction arrangements. Brand development fees and new product introduction fees involve consideration from a vendor to a reseller for that reseller to display the vendor's products in a number of ways—for example, favorable in-store positioning, end-cap placement (placement at the end of an aisle), or additional shelf space. Those arrangements are the same as slotting arrangements in that the vendor incurs a fee with the reseller in return for the reseller displaying or offering that vendor's products in the store.

Slotting fees may be incurred by a vendor at any of the following times:

1. Before the vendor sells any of the related products to the reseller
2. On a regular schedule (for example, monthly) to maintain shelf space

allocation or to be a continuing vendor of the reseller
3. Periodically as negotiated (for example, each payment is separately negotiated and is not based on a schedule).

In return for those fees, the vendor may or may not receive stated rights, such as the display of the vendor's products on a specified amount of linear shelf space for a specified period of time or in a specified physical location within the reseller's store.

Under Topic 606, an entity determines whether slotting fees are:

— paid in exchange for a distinct good or service that the customer transfers to the entity, and therefore recognized as an expense by the entity; or
— sales incentives granted by the entity, and therefore recognized as a reduction of the transaction price by the entity.

Topic 606 is silent on its application to slotting fees. However, we believe that in most circumstances slotting fees generally result in a reduction of the transaction price and are not paid in exchange for distinct goods or services. Nevertheless, because this analysis requires significant judgment, an entity needs appropriate internal controls and documentation to support its judgment.

Certain payments that may be characterized as slotting fees could provide a distinct benefit and be classified as an expense. For example, if a retailer requests a donation from the consumer products company to the retailer's charity, the company may be able to conclude that the payment is distinct from its product sales and record the payment as an expense. Therefore, the appropriate accounting depends on an evaluation of each contract and the relevant facts and circumstances.

If a slotting fee is paid to the customer upfront, the entity should evaluate whether that payment meets the definition of an asset (see Question 5.7.50).

Example 5.7.40

Payments to customers – reduction in the transaction price

Manufacturer enters into a one-year contract with Retailer to sell goods. Retailer commits to buy at least $1,500 worth of the products during the year. Manufacturer also makes a nonrefundable payment of $15 to Retailer at contract inception to compensate Retailer for the changes that it must make to its shelving to accommodate Manufacturer's products.

Manufacturer concludes that the payment to Retailer is not in exchange for a distinct good or service, because Manufacturer does not obtain control of the rights to the shelves and does not receive a benefit beyond the goods sold to Retailer. Consequently, Manufacturer determines that the payment of $15 is a reduction of the transaction price, which it recognizes through reduced revenue as it transfers the promised goods (see Question 5.7.50).

Question 5.7.45

Are payments to a third party evaluated as consideration payable to a customer?

Interpretive response: Yes, in some cases. While incentives are often paid directly to a customer or a customer's customer, there are cases in which payments are made to a third party outside the direct chain of distribution. For example, an entity may agree to make a payment directly to a third-party vendor on the customer's behalf.

Determining if such a payment is consideration payable to a customer requires an evaluation of the nature of the payment. We believe the direction of the cash payment by the entity (i.e. whether directly to the customer or to a third party) should not, on its own, drive the accounting conclusion. Instead, an entity considers whether the payment is, in substance, an incentive to the customer under the contract. Incentive payments could occur before or after an entity enters into a contract with the customer.

An entity should have a process for evaluating whether payments made to third parties represent consideration payable to a customer. An entity also needs to consider whether it obtains control of a distinct good or service from the third party.

The payment to a third party is evaluated as consideration payable to a customer and recognized as a reduction of revenue when:

— the entity does not obtain control of a distinct good or service provided by the third party; and
— the payment to the third party is for the customer's benefit.

If the entity obtains control over a distinct good or service from the third party, it accounts for the payment in the same way as other purchases. If that good or service is subsequently transferred to the customer, it represents the satisfaction of a performance obligation under the contract.

See Question 5.7.05 for additional considerations when the entity is making a payment to a third party that is its customer's customer.

Example 5.7.45

Customer incentive paid to a third party (1)

ABC Corp. supplies renewable natural gas to customers who are commercial vehicle operators. ABC plans to grow its business by offering an incentive to its customers to use a natural gas powered vehicle instead of a diesel powered vehicle.

The incentive program is structured as follows.

— Customer signs a 5-year lease for a natural gas powered vehicle with an unrelated third-party lessor (Lessor).

— The terms of the lease require a lease payment by Customer to Lessor equal to the market rent for a diesel powered vehicle, which is less than the market rent for a natural gas powered vehicle.
— ABC agrees to make payments directly to Lessor to cover the rent differential so Lessor will be made whole with respect to the market rent for a natural gas powered vehicle.
— Customer contemporaneously executes a separate natural gas supply contract with ABC that commits Customer to purchase a minimum volume of natural gas from ABC.

ABC does not take possession of or operate the natural gas powered vehicle at any time, does not have any control over how it is used, and is not obligated to make lease payments for the vehicle in the event Customer defaults under the lease agreement. Therefore, ABC determines that it is not receiving a distinct good or service in exchange for its payments to Lessor.

ABC's cash payment is an incentive that is contractually required based on an agreement with Customer and is not for a distinct good or service the entity is receiving. Therefore, ABC accounts for the cash payment to Lessor as consideration payable to a customer. The payments represent a reduction to the transaction price under the natural gas supply contract and are recognized as ABC transfers the natural gas to Customer.

Example 5.7.46
Customer incentive paid to a third party (2)

Franchisor grants Franchisee a license to operate its retail brand. The franchise agreement entitles Franchisee to a certain number of tablet computers to be used in checkout lines at the store when a new franchise store is opened. These tablets are paid for by Franchisor as an incentive for Franchisee to enter into the arrangement or to obtain additional licenses to open new stores. Franchisor has a relationship with a supplier of tablets through which it can obtain substantial price discounts.

Scenario 1: Franchisor does not obtain control of the goods

Franchisee places the tablet order with the agreed-upon supplier directly. Franchisee can select the color and style of the tablets and designate the location to which they will be shipped. Franchisor does not take possession of the tablets. Franchisor subsequently makes a payment directly to the supplier to settle the purchase.

The nature of this payment to the supplier is, in substance, an incentive for the Franchisee to open a new store. Franchisor does not receive a distinct good or service from the supplier because at no point does Franchisor control the tablets or direct their use. Therefore, the payment is accounted for as consideration payable to a customer and a reduction of the transaction price in the franchise agreement. Because a franchise license is symbolic IP that transfers to the Franchisee over time (see section 10.7.30), the payment reduces revenue over the term of the franchise license based on an appropriate measure of progress (e.g. straight-line over the term).

Scenario 2: Franchisor obtains control of the goods

Franchisor makes bulk purchases of tablets and separately provides them to franchisees when a new store is opened. Franchisor receives shipment of the tablets and bears the risk of loss until they are delivered to Franchisee.

In this scenario, Franchisor receives a distinct good or service in exchange for the payment to the supplier. While the purpose of the tablets is to incentivize Franchisee to open new stores, Franchisor determines that it has control over the tablets and can direct their use for other purposes as it chooses. For example, it could choose to resell the tablets or use them in Franchisor-owned stores. Therefore, procurement of the tablets from the supplier is accounted for as a purchase rather than consideration payable to a customer.

The tablets are determined to be distinct goods from the franchise right. Therefore, when the tablets are controlled by the Franchisor before they are transferred to the Franchisee, they are accounted for as performance obligations under the franchise agreement.

Example 5.7.47
Fees paid to provide zero or low-interest financing to a customer

Retailer is offering promotional 0% financing for six months to customers purchasing over $2,000 using their store credit card. The store credit card is underwritten and issued by third-party Bank.

Under normal terms in its existing contract with Bank, Retailer pays Bank a 2% transaction processing fee for every purchase at Retailer that a customer makes using their Retailer store card. To finance the promotion, Retailer agrees to pay Bank an additional 1.5% of the purchase price of the merchandise to fund the financing benefit to eligible customers during the promotional period.

Retailer does not have control over Bank's underwriting process and is only able to pay interest on behalf of customers if those card transactions are approved by Bank. Retailer's 1.5% payment to Bank is a customer incentive and is accounted for as consideration payable to a customer. Retailer does not receive a distinct good or service in exchange for the 1.5% fee.

Therefore, the 1.5% interest payments represent a reduction to the transaction price under eligible customer contracts. As a result, Retailer records its normal 2% processing transaction fee as an operating expense and the incremental 1.5% interest fee as a reduction of revenue at the time of the retail sale.

Example 5.7.48
Commission paid to a third party

ABC Corp. provides its customers with access to its proprietary online database of resumes, which customers use to fill personnel positions. Most customers enter into an arrangement directly with ABC for access to its online database.

However, certain customers (Customers) are referred to ABC through a recruitment agency (Agency) that assists Customers with their larger recruitment efforts. Agency provides Customers with a suite of services and also suggests that Customers use ABC's platform as a tool to identify qualified candidates.

ABC has an arrangement with Agency that obligates ABC to pay Agency a commission when Customers sign up for access to ABC's database. Agency does not commit to a quantity of referrals but when Customers want to purchase access to ABC's database, Agency collects the full list price of ABC's services from Customers and remits the amount due to ABC net of their commission.

ABC considers the following facts when determining how to present the amounts retained by Agency.

— The contracts between Agency and Customers typically empower Agency to act on behalf of Customers when they choose to use ABC's services. Agency will often execute the contracts with ABC on Customers' behalf.

— The licenses to access ABC's database are in the Customers' name and not the Agency's name. Likewise, order forms and invoices are in the names of Customers (not Agency), but reference the right of the end-customers to have their enrolled agent execute or fulfill on their behalf.

— Agency does not control the license to access ABC's database before it is provided to Customers and Customers can cancel their arrangement with Agency without affecting their ability to use and benefit from ABC's database.

Agency is performing a service for both ABC and Customers under separate arrangements. Agency is not a reseller of ABC's database but rather acts in the capacity of a sales agent for ABC. The nature of the payments made to Agency is commissions to obtain contracts with customers. Although the amounts collected from Customers are net of the commission payments when remitted by Agency, the commission payments do not represent payments to a customer and are therefore presented as costs to obtain a contract and do not reduce revenue.

Question 5.7.50

How should an entity account for a nonrefundable upfront payment to a customer or potential customer?

Interpretive response: It depends. Entities may make nonrefundable upfront payments to customers or potential customers to motivate that (potential) customer to enter into a contract. Often these are characterized as 'pay to play' or 'exclusivity' payments, but they can also be made to reimburse the customer for costs associated with entering into the contract – new vendor costs, termination fees on previous contract, etc.

When the upfront payments are not in exchange for a distinct good or service, entities account for the cost as a reduction of the transaction price. However, many times entities may make these payments even if there is no enforceable contract with the customer or the contract term is very short (e.g. a month-to-month contract). In those scenarios, recognizing an upfront payment immediately as a reduction of revenue or as an expense could result in an upfront loss.

The TRG discussed two potential approaches to accounting for nonrefundable upfront payments to customers. [TRG 11-16.59]

View A: Expected purchases	Payments to customers are capitalized and amortized as a reduction of revenue over expected purchases, including purchases under potential future contracts.
View B: Contract period	Payments to customers are recognized as a reduction of revenue over the existing contract. If no contract exists, the payment is immediately recognized in the income statement.

The TRG agreed that View A is appropriate when the payment meets the definition of an asset and is recoverable from future cash flows (including cash flows from anticipated renewals or new contracts). View B would only be appropriate when the payment only relates to the existing contract. [TRG 11-16.59]

In addition, Ruth Uejio, Professional Accounting Fellow, Office of Chief Accountant, discussed this topic in a speech given during the 2016 AICPA National Conference on Current SEC and PCAOB Developments.

> "From my perspective, a company must first determine what the payment was made for. The following are some of the questions that OCA staff may focus on to understand the nature and substance of the payment:
>
> 1. What are the underlying economic reasons for the transaction? Why is the payment being made?
> 2. How did the company communicate and describe the nature of the payment to its investors?
> 3. What do the relevant contracts governing the payment stipulate? Does the payment secure an exclusive relationship between the parties? Does the payment result in the customer committing to make a minimum level of purchases from the vendor?
> 4. What is the accounting basis for recognizing an asset, or recognizing an upfront payment immediately through earnings?
>
> Once a company has determined the substance of the payment, I believe a company should account for the payment using an accounting model that is consistent with the identified substance of the payment and relevant accounting literature. Additionally, companies should establish accounting policies that are consistently applied. I'd highlight that there should be a neutral starting point in the accounting evaluation for these types of arrangements. I believe that registrants must carefully evaluate all of the facts and circumstances in arriving at sound judgments, and should perform the analysis impartially. Additionally, in my view 'matching' is not a determinative factor to support asset recognition." [2016 AICPA Conf]

Concepts Statement 8 defines an asset as "a present right of an entity to an economic benefit." As such, based on the SEC speech, the TRG discussion, the definition of an asset and framework in Subtopic 340-40, we believe the following are factors (not exhaustive) that may indicate that View A is appropriate.

1. **The payment is recoverable through the initial contract and/or future anticipated renewals.** In order to meet the definition of an asset, the entity must be able to recover the asset through future cash flows. Further, the entity needs to obtain or control those particular benefits. By entering into the initial contract, the entity obtained the control of an asset. However, in some instances the entity may only expect to recover the payment through future anticipated contracts. If the payment relates to initial and future anticipated contracts, the asset could be recoverable through cash flows related to both. While payments to customers are not in the scope of Subtopic 340-40, this concept is similar to the notion underlying costs to obtain contracts with customers. As such, we believe entities could look to both the initial and future anticipated renewals to assess the recoverability of the asset.
2. **The entity secures an exclusivity agreement and it is probable that the customer will make purchases sufficient to recover the payment.** If the payment secures an exclusive relationship between the entity and its customer and it is probable the customer will order a sufficient number of goods or services to recover the payment, the payment would meet the definition of an asset as the entity has obtained a right that it controls and would benefit from that relationship.
3. **History of renewals/average customer life.** If the entity has a history of renewals with similarly situated customers, an average customer life longer than the initial contract term might indicate the payment relates to future expected renewals. Unless, as noted in (1) below, the payment only relates to the current contract.
4. **Underlying reason for the payment.** An entity should also consider its customary business practices and reason for making the payment. If the payment is a one-time expenditure at the beginning of a new contract (new customer, new product line, etc.) to secure a relationship, that payment may meet the definition of an asset because the payment obtained the contract with the customer.

In contrast, we believe the following may indicate that View B is appropriate.

1. **The payments are recurring and commensurate with the subsequent payments upon renewal.** If the entity makes payments at the beginning of each contract and subsequent renewal, it would indicate that the payment only relates to the current contract.
2. **The entity does not obtain any contractual assurance (e.g. exclusivity or a customer contract) that future contracts will be obtained.** If the entity does not obtain any contract (even if short-term) or exclusivity agreement, the entity may not have an asset that it controls.
3. **The entity is entering into a new market or selling new products or services.** If the entity does not have a history to suggest that it will be successful in recovering the payment through the current or future anticipated contracts, it may be inappropriate to defer and amortize the payment longer than the current contract.

See Questions 5.7.70 and 5.7.80 for a discussion of the amortization period and impairment model for these assets.

Example 5.7.50
Nonrefundable upfront payment to a customer – IT outsourcing

ABC Corp. agrees to make a $1 million nonrefundable upfront payment to Customer to help offset transition costs for an IT outsourcing contract. The contract term is five years but is cancellable each month without penalty. Therefore, the contract term is only one month under Topic 606 (see Question 3.8.10). ABC expects the customer to purchase services for the full five years with estimated fees of $6 million based on its experience with similar customers and its customary business practice of making similar payments. ABC expects to earn margins of at least 25%.

In order to determine the appropriate accounting, ABC performs the following evaluation.

— **The payment is recoverable through the cash flows from the initial contract and anticipated future renewals.** The payment is expected to be recoverable from future net cash flows totaling $1.5 million ($6 million × 25% profit margin).

— **History of renewals/average customer life.** ABC expects a customer life beyond the initial five-year term based on its history with similar customers and making similar payments.

— **Underlying reason for the payment.** The purpose of the payment is to incentivize Customer to enter into the contract and use ABC as its IT outsourcer for a number of years. ABC has a customary business practice of making these payments at the beginning of a new customer relationship and does not generally make additional payments when the customer renews the contract.

Based on its overall evaluation of these factors, ABC concludes that the payment should be capitalized and amortized as a reduction of revenue over the anticipated future purchases (see Question 5.7.70).

Example 5.7.60
Nonrefundable upfront payment to a customer – Supply arrangement

Supplier makes a $1 million nonrefundable upfront payment to Customer as part of the negotiations in a three-year exclusive supply contract to provide specialized parts to Customer that are a component in one of Customer's main products.

The supply contract stipulates a price of $100 per part. Customer provides a non-binding forecast of its supply requirements, which forecasts probable purchases of 100,000 parts over the contract period (for a total of $10 million). Supplier's profit margins for these specialized parts is 20%. However, under Topic 606 there is no enforceable contract until Customer submits a purchase order.

Supplier considers the following relevant factors to evaluate the accounting for the payment to Customer.

— **The entity secures an exclusivity agreement and it is probable that the customer will make purchases in order to recover the payment.** Supplier secured an exclusivity agreement and the payment is expected to be recoverable from probable future purchases $10 million, earning the entity $2.0 million ($10 million × 20% profit margin).

— **Underlying economic reason for the payment.** The primary purpose of the fee is to secure an exclusive relationship as well as to incentivize Customer to switch vendors. Supplier customarily makes similar payments at the beginning of the customer relationship.

Based on its overall evaluation of these factors, Supplier concludes that the payment should be capitalized and amortized as a reduction of revenue over the anticipated future purchases (see Question 5.7.70).

Example 5.7.70

Nonrefundable upfront payment to a customer – New product

Manufacturer has recently launched a new product in a developing field with a high risk of technological obsolescence. In order to incentivize Reseller to buy and sell this product to its end customers, Manufacturer makes a $1 million nonrefundable upfront payment to enter into an MSA that sets the pricing of future product purchases. Reseller does not agree to exclusively sell Manufacturer's products or commit to a minimum quantity.

Reseller requires this payment to cover the cost of attempting to sell the product to its end customers if it is not successful in the market. Given that this is a new product, Manufacturer does not have historical experience with this product or similar customers.

Manufacturer considers the following to evaluate the accounting for the payment to Reseller.

— **The entity secures an exclusivity agreement and it is probable that the customer will make purchases in order to recover the payment.** Manufacturer did not obtain a contract for a minimum purchase or exclusivity agreement from Reseller. While the MSA is a legal contract, Reseller did not commit to a minimum quantity.

— **History of renewals/average customer life.** The payment could be viewed as obtaining a customer relationship; however, the lack of historical experience and risk of obsolescence indicate that the payment may not be recoverable through future purchases.

— **Underlying economic reason for the payment.** Manufacturer made the payment to Reseller in order to get its product into the market. However, due to the uncertainty and experience related to the product it is uncertain whether the payment will be recoverable.

Based on its overall evaluation of the factors, Manufacturer concludes that this payment does not represent an asset. Therefore, it accounts for the payment as a reduction of revenue (or expense) when the payment is made.

Question 5.7.60

Are upfront payments to customers that are capitalized classified as a contract asset?

Interpretive response: Generally, no. When an entity makes an upfront payment to a customer and does not receive distinct goods or services in exchange for the payment, the payment generally reduces the transaction price and is recognized either over the current contract term or estimated future purchases (see Question 5.7.50). If the payment is deferred and recognized over a future period, the entity records an asset.

This asset typically does not meet the definition of a contract asset. Contract assets are rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time. When an entity makes an upfront payment to a customer, it has not yet transferred goods or services, which is why the asset created by the upfront payment does not meet the definition of a contract asset. As a consequence, the asset would not be presented with contract assets and would be presented separately in other assets or another appropriate financial statement line item.

However, we believe it is also acceptable to present an asset created by a payment to a customer that reduces the transaction price as a contract asset (or net contract liability) when the asset relates only to the current contract – i.e. the amortization period does not include future contracts. This is because a contract asset or contract liability reflects the relationship between the entity's performance and the customer's payments for a current contract. In other words, when the payment reduces the transaction price, it could be viewed similar to consideration received from the customer and therefore included in the net position of the contract.

It would not be appropriate to reflect an asset that relates to multiple contracts as a contract asset because the unit of account for a contract asset and contract liability is a single contract with a customer (see Question 14.2.10).

For a discussion of the amortization and impairment of assets resulting from payments to customers, see Questions 5.7.70 and 5.7.80.

Question 5.7.70

What is the amortization period for a nonrefundable upfront payment capitalized as an asset?

Interpretive response: The TRG agreed that the assessment of the amortization period should be based on an evaluation of expected cash flows from a customer and an entity could make this determination in the same way it does for other assets. For example, the guidance for determining the useful life of intangible assets in Subtopic 350-30 or determining the useful life of a cost to obtain a contract with a customer in Subtopic 340-40 could be useful as a framework for determining the amortization period. [TRG 11-16.59]

We believe multiple approaches may be acceptable as long as they consider the period of expected cash flows from the customer contracts to which the payment relates. However, we believe the most relevant analogy is the guidance in Subtopic 340-40, because the payments to a customer are typically akin to a cost of obtaining a contract. As a result, the amortization period could include both the current and anticipated contract renewals. See section 12.7 for further details on determining the amortization period in Subtopic 340-40.

Question 5.7.80

How should an entity test a nonrefundable upfront payment that has been deferred for impairment?

Interpretive response: The TRG agreed that in the absence of explicit guidance, applying the principles behind other impairment tests in US GAAP would be a supportable approach to testing a capitalized upfront fee for impairment. In general, we believe multiple approaches may be acceptable as long as they only take into account the recoverability of the asset from contracts with the customer to which the payment relates. [TRG 11-16.59]

We believe the most relevant analogy would be for an entity to use the impairment model in Subtopic 340-40 related to costs capitalized for obtaining contracts with customers. That impairment model takes into account cash flows from both current and future anticipated contracts to which the asset relates. Under that guidance, an impairment loss is recognized for the difference between the carrying amount of the asset and: [340-40-35-3]

— consideration (in exchange for the goods or services to which the asset relates) expected to be received in the future or received but not yet recognized as revenue, less

— the costs that relate directly to providing those goods or services and that have not been recognized as expenses.

However, the TRG did not include the contract asset impairment model as a potential alternative. Paragraph 606-10-45-3 states that an impairment of a contract asset should be measured, presented and disclosed in accordance with Topic 310 (or Subtopic 326-20 upon adoption). We do not believe Topic 310 (or Subtopic 326-20) would be an appropriate model for this asset because there is no credit risk involved with the payment to a customer.

For guidance on and interpretation of Subtopic 326-20, see KPMG Handbook, Credit impairment. See section 12.9 for further details on the impairment model in Subtopic 340-40.

Question 5.7.90

How should an entity present consideration payable to a customer that results in 'negative revenue'?

Interpretive response: Unless a payment to a customer is in exchange for a distinct good or service, an entity accounts for the payment as a reduction of the transaction price and, therefore, of revenue. In some situations, the amount of consideration payable to a customer could exceed the cumulative amount of consideration the entity expects or has received from a customer resulting in 'negative revenue'. Topic 606 does not explicitly address whether it is appropriate to reclassify negative revenue to expense. [606-10-32-25]

We believe an entity will typically record consideration payable to a customer as a reduction of revenue even when it results in negative revenue. However, there may be limited circumstances in which reclassifying negative revenue to an expense is also acceptable. The following are examples in which recognizing an expense would be acceptable.

— An entity makes an upfront payment to a potential new customer in relation to a new product. However, the entity cannot conclude that the payment represents an asset related to expected purchases because there is no committed contract and a high degree of uncertainty of obtaining future contracts. See Question 5.7.50 and Example 5.7.70.

— A customer relationship is terminated such that it is unlikely that there will be future anticipated contracts, and the payment exceeds cumulative revenue recognized during the customer relationship, possibly because of threatened litigation.

There may be other limited circumstances in which there is negative revenue in a period, and determining whether it is appropriate to reclassify the payments to expense will require significant judgment based on an evaluation of the facts and circumstances.

5.8 Nonrefundable upfront fees

Excerpt from ASC 606-10

• > Nonrefundable Upfront Fees (and Some Related Costs)

55-50 In some **contracts**, an entity charges a **customer** a nonrefundable upfront fee at or near contract inception. Examples include joining fees in health club membership contracts, activation fees in telecommunication contracts, setup fees in some services contracts, and initial fees in some supply contracts.

55-51 To identify **performance obligations** in such contracts, an entity should assess whether the fee relates to the transfer of a promised good or service. In many cases, even though a nonrefundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfill the contract, that activity does not result in the transfer of a promised good or service to the customer (see paragraph 606-10-25-17). Instead, the upfront fee is an advance payment for future goods or services and, therefore, would be recognized as **revenue** when those future goods or services are provided. The revenue recognition period would extend beyond the initial contractual period if the entity grants the customer the option to renew the contract and that option provides the customer with a material right as described in paragraph 606-10-55-42.

55-52 If the nonrefundable upfront fee relates to a good or service, the entity should evaluate whether to account for the good or service as a separate performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.

55-53 An entity may charge a nonrefundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks as described in paragraph 606-10-25-17). If those setup activities do not satisfy a performance obligation, the entity should disregard those activities (and related costs) when measuring progress in accordance with paragraph 606-10-55-21. That is because the costs of setup activities do not depict the transfer of services to the customer. The entity should assess whether costs incurred in setting up a contract have resulted in an asset that should be recognized in accordance with paragraph 340-40-25-5.

• • > Example 53 – Nonrefundable Upfront Fee

55-358 An entity enters into a contract with a customer for one year of transaction processing services. The entity's contracts have standard terms that are the same for all customers. The contract requires the customer to pay an upfront fee to set up the customer on the entity's systems and processes. The fee is a nominal amount and is nonrefundable. The customer can renew the contract each year without paying an additional fee.

55-359 The entity's setup activities do not transfer a good or service to the customer and, therefore, do not give rise to a performance obligation.

55-360 The entity concludes that the renewal option does not provide a material right to the customer that it would not receive without entering into that contract (see paragraph 606-10-55-42). The upfront fee is, in effect, an advance payment for the future transaction processing services. Consequently, the entity determines the transaction price, which includes the nonrefundable upfront fee, and recognizes revenue for the transaction processing services as those services are provided in accordance with paragraph 606-10-55-51.

5.8.10 Overview

Nonrefundable upfront fees are nonrefundable consideration paid by the customer at or near contract inception. These types of fees are often characterized as initiation, membership, joining, activation or set-up fees. For example, such fees may be joining fees for health club membership, activation fees for telecommunications contracts or set-up fees for outsourcing contracts. [606-10-55-50]

A nonrefundable upfront fee is included in the transaction price and allocated to the performance obligations in the contract in the same manner as other consideration in the contract. However, the presence of an upfront fee often raises questions about whether any activities performed by the entity at or near contract inception transfer a good or service to the customer. To answer these questions, this section discusses how the contract should be analyzed, although this is conceptually the same process as a contract with no nonrefundable upfront fee.

The first step is to determine whether the upfront fee is for the transfer of a good or service or for the transfer of future goods or services under the contract.

— **For a transferred good or service.** If the upfront fee relates to a good or service transferred to the customer, the entity needs to determine whether the good or service is a separate performance obligation. For example, some implementation services transfer goods or services to the customer. For further discussion of identifying performance obligations, see section 4.2. [606-10-55-51]

— **For future goods or services.** If the upfront fee does not relate to a specific good or service transferred to the customer – e.g. the fee is for set-up activities or administrative tasks – it is an advance payment for future goods and services. See Question 4.2.70 for how to distinguish between goods and services transferred to a customer and set-up activities. [606-10-55-51]

If a nonrefundable upfront fee represents an advance payment for future goods or services, the entity would also evaluate whether the fee provides a material right to the customer. A fee could provide a material right when the contract includes a customer option to purchase additional goods or services. For example, entities such as telecoms, cable service providers and health clubs may enter into monthly contracts with customers that include nonrefundable upfront fees to be paid by the customer at or near contract inception. Such arrangements may provide the customer with the right to optional discounted services in future periods because the upfront fee does not need to be paid in subsequent months.

— If the fee provides the customer with a material right, that right is a performance obligation that receives an allocation of the transaction price. The entity then recognizes revenue from that performance obligation when the entity transfers the goods or services underlying the option or the option expires (see chapter 8).

— In contrast, if the fee does not provide a material right, it is allocated to the existing performance obligations and recognized as those goods or services are transferred.

Therefore, the period over which a nonrefundable upfront fee is recognized depends, in part, on whether the fee provides a material right, and if so, for how long. When the contract includes a material right, the nonrefundable upfront payment may be recognized over a period longer than the contract term. [TRG 03-15.32]

Question 5.8.10

How should an entity evaluate whether a nonrefundable upfront fee provides the customer with a material right?

Interpretive response: The objective of evaluating whether an upfront fee provides a material right is to identify the periods that the customer benefits from not having to pay another fee upon exercising a renewal option. The period the customer benefits from the renewal includes only those periods that the fee influences the customer's decision to exercise its option. See chapter 8 for further discussion of identifying a material right. [TRG 03-15.32]

The entity considers both quantitative and qualitative factors to evaluate the presence of a material right. We believe the following factors should be considered to identify the periods (if any) for which a nonrefundable upfront fee provides a material right.

- **The renewal price compared with the price in the initial contract with the upfront fee.** The significance of the upfront fee and amounts paid for the initial services compared to renewals could influence a customer's decision to renew. The customer may be economically compelled to renew based on its initial investment.
- **The availability and pricing of service alternatives.** For example, if the customer could readily obtain similar services without having to pay an upfront fee, the initial payment may not be an incentive for the customer to renew because it could easily obtain services elsewhere at prices similar to the renewal price.
- **History of renewals.** If the entity has a strong history of renewals, it might indicate that the upfront fee provides an incentive for the customer to exercise its renewal option. For example, an entity might look at the average customer life or periods where the customers renew at a high rate.

If the fee provides a material right, the period the customer benefits from the fee may be shorter than the average customer life. This is because there may be many factors other than the upfront fee that influence a customer to renew a contract. For example, the quality of service and convenience of not changing providers could influence the customer to renew, but those renewals would not mean the customer was provided a material right when it paid the upfront fee. As a consequence, significant judgment will be required to determine the period for which a material right is present.

Example 5.8.10
Nonrefundable upfront fees – annual contract

Cable Provider enters into a one-year contract to provide cable television to Customer. In addition to a monthly service fee of $100, Cable Provider charges a one-time upfront fee of $50.

Cable Provider has determined that its set-up activity does not transfer a promised good or service to Customer, but is instead an administrative task. Therefore, it concludes that the $50 upfront fee is an advance payment for future cable services. Next, Cable Provider needs to determine whether this advance payment represents a material right to the customer.

At the end of the year, Customer can renew the contract on a month-to-month basis at the then-current monthly rate, or can commit to another one-year contract at the then-current annual rate. In either case, Customer will not be charged another fee upon renewal. The average life of similar contracts is three years.

Cable Provider considers both quantitative and qualitative factors to determine whether the upfront fee provides an incentive for Customer to renew the contract beyond the stated contract term to avoid another upfront fee. If the incentive is important to Customer's decision to enter into the contract, then the upfront fee represents a material right.

First, Cable Provider compares the upfront fee of $50 with the total transaction price of $1,250: the upfront fee of $50 plus the service fee of $1,200 ($100 × 12). It concludes that the nonrefundable upfront fee is not quantitatively material.

Second, Cable Provider considers the qualitative reasons Customer might renew. Cable Provider notes that the average customer life is three years, and therefore the history of renewals indicates that Customer is likely to renew. However, Cable Provider also considers other reasons why Customer might renew, including the overall quality of the service provided, the services and related pricing provided by competitors, and the inconvenience to Customer of changing service providers – e.g. returning equipment to Cable Provider, scheduling installation by the new provider.

Cable Provider concludes that although avoiding the upfront fee on renewal is a consideration to Customer, this factor alone does not influence Customer's decision. Cable Provider concludes based on its customer satisfaction research data that the quality of service provided and its competitive pricing are the key factors underpinning customer renewal decisions. Based on this quantitative and qualitative analysis, Cable Provider concludes that the upfront fee of $50 does not convey a material right to Customer.

As a result, the upfront fee is treated as an advance payment on the contracted one-year cable services and is recognized as revenue over the one-year contract term. This results in monthly revenue of $104 ($1,250 / 12) for the one-year contract.

Example 5.8.15
Nonrefundable upfront fees for set-up activities

ABC Corp. is a SaaS provider of digital advertising services. ABC enters into a statement of work (SOW) with Customer whereby Customer pays ABC a $10 million nonrefundable fee for activities to substantially increase Customer's ability to use ABC's SaaS platform. The activities relate to ABC expanding capacity at its own data center and increasing its employee headcount. The contract does not contain a lease.

At the same time, ABC and Customer enter into a master service agreement (MSA) that outlines the terms for future arrangements into which ABC and Customer may enter, including required service levels. ABC would not be able to serve Customer at the desired scale set forth in the MSA and Customer would not contract with ABC for the data center build out if Customer was not also contracting for the ongoing services in the MSA. The MSA is not a contract under Topic 606 because it does not create enforceable rights and obligations until a subsequent purchase order is consummated (see Question 3.2.30). However, the SOW and MSA are evaluated together because they are entered into at or near the same time and negotiated with a single commercial objective; see section 3.7 for considerations on when to combine contracts.

The activities in the SOW represent tasks required to fulfill future contracts with Customer under the MSA. Therefore, ABC considers whether the activities in the SOW transfer goods or services to the customer or are set-up activities. ABC concludes that the activities are set-up activities because they relate to its own assets (build out of the data center) and operations (hiring of employees) and therefore those items are not transferred to Customer. Further, because they relate to ABC's own assets, the activities do not provide *incremental* benefit to Customer beyond any future SaaS services under the MSA. As a result, ABC also concludes that the fees are in effect nonrefundable fees associated with future contracts under the MSA.

Because the MSA only represents options for additional services, ABC concludes that the nonrefundable upfront fees and optional purchases in the MSA convey a 'material right'. ABC will allocate the upfront fee to the customer options to which it relates. See chapter 8 for further discussion of identifying a material right. [TRG 03-15.32]

Example 5.8.20
Nonrefundable upfront fees – material right

Customer enters into a month-to-month contract with Telco for a voice and data plan. Customer agrees to pay $50 per month plus a nonrefundable upfront activation fee of $60; this is consistent with the fees charged to customers in the same class during the year.

Customer has no obligation to renew the contract in the subsequent month. If Customer does renew, then no activation fee will be charged in the second or subsequent months. Telco's average customer life for month-to-month contracts is two years.

Telco determines that its activation activity does not transfer a good or service to Customer, but is instead an administrative task. Telco then assesses whether the option to renew the contract without paying the activation fee on renewal represents a material right.

Telco considers the following.

- **The renewal price compared with the price in the initial contract inclusive of the upfront fee.** Telco notes that Customer pays $110 in Month 1 and would pay $50 in each subsequent month for which renewal occurs. Therefore, the 'discount' on the renewal rate is quantitatively significant.
- **The availability and pricing of service alternatives.** Telco notes that competitors typically charge a similar activation fee.
- **History of renewals.** Telco notes that the average customer life is two years, which extends significantly beyond the initial one-month contract term.

Based on these factors, Telco concludes the initial contract has a material right. Telco then considers all qualitative and quantitative factors that influence Customer's renewal decisions in order to determine the number of renewal options or periods for which a material right is present. These factors include average customer life, qualitative factors (e.g. the quality of the service compared to viable service alternatives) and significance of the activation fee. When making this assessment, Telco would likely conclude that the period for which there is a material right is less than the average customer life as the significance of the activation fee in relation to total consideration decreases each month the customer renews.

Telco would then allocate the transaction price in the initial contract to the service and each material right identified. The amounts allocated to the material rights are recognized either when Telco provides the underlying service or when the options expire unexercised.

For guidance on estimating the stand-alone selling price in a contract with an upfront fee that gives rise to a material right, see Question 5.8.40 and Example 5.8.40.

Question 5.8.20

If a nonrefundable upfront fee relates to a separate performance obligation, should it be allocated entirely to that performance obligation?

Interpretive response: Not necessarily. Even when a nonrefundable upfront fee relates to a separate performance obligation, the amount of the fee may not equal the relative stand-alone selling price of that performance obligation. Therefore, some of the fee could be allocated to other performance obligations in the contract. See section 6.4 for further details on allocating the transaction price to performance obligations.

Example 5.8.25
Nonrefundable upfront fees – discount club

Discount Club operates a membership-only retail business and sells memberships for a nonrefundable upfront annual fee of $100. In return, Customer gains access to shop at Discount Club's stores. There are no minimum purchase requirements associated with the membership, and there are no limits on the amount of purchases Customer can make during the year.

Discount Club determines that its nonrefundable upfront fee creates a material right for the annual membership period. This is because it grants Customer the ability to purchase goods at discounted prices not otherwise available without the membership.

In this example, we believe there may be two acceptable alternatives to define the nature of the material right created by the upfront fee. These two alternatives may result in different recognition patterns of the upfront fee over the annual membership period.

Alternative 1: Time-based material right

The nature of the material right is Customer's daily opportunity to purchase discounted goods. Discount Club allocates the upfront fee evenly to each daily material right and recognizes the $100 upfront annual fee as revenue ratably over the annual period. As each day passes, Discount Club recognizes the portion of the material right allocated to that day because the option either was exercised or expired unexercised.

Alternative 2: Options to make discounted purchases

The nature of the material right is Customer's options to purchase discounted goods throughout the year. Discount Club allocates the $100 upfront annual fee in proportion to anticipated discounts realized by Customer during the membership period. As each day passes, Discount Club recognizes the portion allocated to each day because the option was exercised or expired unexercised. As a consequence, Discount Club recognizes the fee in a pattern that reflects the anticipated discounts realized by Customer.

To determine the allocation, Discount Club estimates the pattern of forecasted sales using a portfolio of data (see Question 5.3.130), which approximates the forecasted discounts to be realized by Customer during the year. If Discount Club has seasonal patterns to its sales, this method results in a larger portion of the upfront fee being recognized as revenue during peak sales periods.

See further discussion on the accounting for material rights in chapter 8.

Question 5.8.30

When an upfront fee gives rise to a material right, but the renewal price is not specified in the initial contract, can the alternative approach be applied?

Background: Topic 606 provides an alternative approach to estimating the stand-alone selling price of a customer option when certain criteria are met. Under this alternative, the entity allocates the transaction price to the optional goods or services it expects to provide and the corresponding consideration it expects to receive. If an entity is either unable or chooses not to elect this alternative, it has to separately calculate the stand-alone selling price for each good or service, which entails estimating the likelihood that the customers will renew in each subsequent period. For further discussion on estimating the stand-alone selling price of a customer option, including the alternative approach, see section 8.5.10. [606-10-55-45]

Interpretive response: Generally, yes. One of the criteria to apply the alternative approach is that the optional goods or services are provided in accordance with the terms of the original contract. Sometimes an entity may provide the customer with an option to renew at a price negotiated at the time of the renewal, or at the then market rate, or the contract may be silent on renewals but there is a reasonable expectation by the customer that it has the right to renew the service.

When a renewal option or price is not specified in the original contract, we believe the alternative approach can be applied if a nonrefundable upfront fee conveys a material right and the entity's past practice creates a reasonable expectation that the customer:

- will avoid paying an upfront fee upon renewal; and
- will pay a renewal price consistent with renewal pricing given to a similar class of customer.

However, the optional good or service expected to be provided needs to be similar to the good or service in the original contract.

We believe this conclusion is consistent with the FASB's intent. This is because the criteria to apply the alternative approach are intended to distinguish between renewal options and other types of material rights such as loyalty points and discount vouchers. The criterion that requires additional goods and services to be provided under the original contract's terms makes this distinction for loyalty points and discount vouchers. Because an entity can change the pricing of the additional goods or services under those programs beyond the parameters specified in the original contract, the alternative approach cannot be applied in those scenarios. For example, an airline can change the number of points that must be redeemed to obtain a flight, thereby changing the discount (e.g. the value of the points) that was given in the original contract. [ASU 2014-09.BC394 – BC395]

Although an entity could change the price of the renewals in the renewal option scenario, we believe the contract terms that convey the material right (i.e. the upfront fee) should be the terms that are evaluated under this criterion. If the customer has a reasonable expectation that it will avoid an additional upfront fee when the contract is renewed, the terms that create the material right are implied in the original contract. In contrast, the discount provided in a voucher or loyalty point scenario is determined at the time the option is exercised.

Example 5.8.30
Nonrefundable upfront fees – alternative approach

Customer enters into a one-year service contract with ABC Corp. The terms of the contract require Customer to pay a fixed monthly fee of $100, plus a nonrefundable upfront fee of $4,000. The contract does not specify a renewal option or pricing, but ABC has a history of renewing these types of contracts at prices consistent with similar customers without requiring payment of the upfront fee again upon renewal.

The nonrefundable upfront fee relates to set-up activities and not a promised good or service. ABC concludes that the upfront fee gives rise to a material right because Customer would not have to pay the upfront fee if the service is renewed at the end of the one-year term.

ABC also concludes that the alternative approach can be applied to estimate the stand-alone selling price of the renewal option. This is because the renewal services will be substantially the same as the services provided under the original contract and the renewal price will be determined consistent with the renewal pricing given to similar customers.

See Question 5.8.40 and Example 5.8.40 for guidance on how ABC may determine the amount of services it expects to provide and the corresponding consideration it expects to receive in applying the alternative approach.

Question 5.8.40
How should an entity determine the expected goods or services under the alternative approach when an upfront fee gives rise to a material right?

Interpretive response: When a contract includes an upfront fee that conveys a material right, an entity has two potential approaches to allocate consideration to the material right: [606-10-55-44, 55-45]

— determine the stand-alone selling price of the right and allocate based on a relative stand-alone selling price basis; or

— the alternative approach, which allocates the transaction price to the optional goods or services it expects to provide by reference to those expected goods or services and the corresponding expected consideration (see section 8.5.10).

If an entity qualifies for and elects to apply the alternative approach (see Question 5.8.30), it estimates the goods or services it expects to provide and the corresponding consideration it expects to receive. However, Topic 606 does not provide detailed guidance on how to make this determination. As discussed in Question 8.5.50, we believe that entities can apply a method based on a portfolio of data or a method based on an individual contract. [606-10-55-45]

We believe the following are acceptable methods for applying the alternative approach when an upfront fee conveys a material right. Under either of these methods, the expected goods or services are limited to the period a material right exists. See Question 5.8.10 for guidance on determining the period the material right exists.

Method 1: Portfolio of data basis incorporating estimates of breakage with adjustments for changes in estimate

Method 1 is similar to Example 51 in Topic 606 (reproduced in section 8.5.10) whereby the entity estimates the expected renewals and corresponding expected consideration for a portfolio of similar contracts.

Under this method, an entity estimates breakage using the portfolio of data. For example, if the portfolio comprises 100 contracts and there is a material right for a single renewal period, the entity estimates how many of the 100 contracts will be renewed. The entity then allocates the expected consideration between the original contract and expected renewals.

If the actual renewals are different from the original estimate, the entity adjusts the number of expected goods or services, transaction price and revenue recognized. See Example 8.5.20. [606-10-55-352]

Based on discussions with the FASB staff, we believe it is acceptable to adjust the number of expected goods or services on a cumulative catch-up or prospective basis.

Method 2: Portfolio of data basis amortizing upfront fee over weighted-average expected renewal period

Under Method 2, an entity amortizes the upfront fee over the period of expected renewals in a pattern consistent with the measure of progress for that performance obligation. This method allocates the consideration to the expected renewal periods rather than to the expected goods or services.

Method 2 takes into account a portfolio of data similar to Method 1; however, this method sets a weighted-average amortization period for the upfront fee rather than calculating a specific number of renewals each period. Both Methods 1 and 2 incorporate an estimate of breakage.

This method differs from Method 1 because an entity does not track actual versus estimated renewals for a particular portfolio (e.g. contracts entered into in a single month/quarter) and make an adjustment to true up to actual renewals. The monitoring of the renewal experience is done at a higher level. An entity monitors its weighted-average expected renewal period for similar customers and updates the revenue recognized for the change in estimate using either a cumulative catch-up or prospective adjustment.

However, we believe an approach where an entity establishes an amortization period with no monitoring for subsequent changes in actual results would not be appropriate.

Method 3: Contract-by-contract basis

Under Method 3, an entity includes the expected goods or services and corresponding consideration for a specific contract rather than calculating breakage using a portfolio of contracts. We believe this method is consistent with the FASB's intent for the alternative approach to allow entities to avoid the complex calculations needed to estimate the likelihood of a series of renewal periods. [ASU 2014-09.BC392 – BC393]

Under this method, the entity includes each option that provides the customer with a material right in the contract to be a 'good or service that is expected to be provided' unless it expects the right to expire unexercised – e.g. it is likely that the right will expire unexercised.

If the actual renewals are different from the original estimate, the entity adjusts the number of expected goods or services using either a cumulative catch-up or prospective adjustment. In the event a renewal option is not exercised, any remaining contract liability is recognized as revenue. This method requires an entity to monitor each of its contracts separately to make an adjustment based on actual renewals.

Example 5.8.40 further illustrates these methods when applying the alternative approach.

Example 5.8.40

Allocating the transaction price in a contract with an upfront fee that gives rise to a material right – comprehensive example

ABC Corp. enters into a one-year service contract with Customer for a fixed fee of $4,000, which is billed upfront. In addition, ABC charges a one-time nonrefundable upfront fee of $1,000. Customer can renew the service for 10 annual time increments at a rate of $4,000 per year.

ABC concludes that the nonrefundable upfront fee relates to set-up activities that do not result in the transfer of goods or services to Customer. Further, ABC concludes that the upfront fee gives rise to a material right because it is significant and Customer would not have to pay another upfront fee upon renewal. Further, ABC has a strong history of renewals, and competitors with comparable service quality are priced similarly and charge upfront fees.

ABC considers various data points to determine the period over which the entity has a material right (see Question 5.8.10). Those data points include the average customer life, the significance of the upfront fee and other qualitative factors to determine the period Customer benefits from not having to pay the upfront fee (i.e. the number of periods not having to pay the upfront fee influences Customer's renewal decision). Based on this analysis, ABC concludes that Customer only has a material right for two renewal periods.

ABC also concludes that the services are satisfied over time and a time-elapsed measure of progress is appropriate.

ABC considers the various methods of allocating the transaction price to the performance obligations -- one year of service and two material rights.

Approach 1: Estimate the stand-alone selling price of each option

To estimate the stand-alone selling price of each material right, ABC calculates the discount Customer would receive from exercising the option adjusted for the probability of renewal for each option. ABC concludes the discount is $1,000, which is the nonrefundable upfront fee that would not need to be paid upon exercising renewal option 1 and renewal option 2.

ABC expects 85% of customers to renew at the end of Year 1 and 72% of the original customers to renew at the end of Year 2 (i.e. 85% of the customers that renewed in Year 1 will renew in Year 2 (85% × 85% = 72%)).

ABC estimates the stand-alone selling price for each material right as follows.

Option	Discount	Probability of renewal	Stand-alone selling price
Renewal option 1	$1,000	85%	$850
Renewal option 2	$1,000	72%	$720

ABC then allocates the transaction price on a relative stand-alone selling price basis as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Service contract Year 1	$5,000	76.1%	$3,805
Material right – renewal option 1	850	12.9%	645
Material right – renewal option 2	720	11.0%	550
Total	**$6,570**	**100.0%**	**$5,000**

ABC records the following journal entries, assuming that Customer exercises the renewal options.

	Debit	*Credit*
Cash/trade receivables	5,000	
Contract liability		5,000
To recognize a contract liability when upfront billing occurs at beginning of Year 1.		
Contract liability	3,805	
Revenue		3,805
To recognize revenue ratably as service contract performance obligation is satisfied over Year 1.		

	Debit	Credit
Cash/trade receivables Contract liability *To recognize a contract liability when upfront billing occurs at beginning of Year 2.*	4,000	 4,000
Contract liability Revenue *To recognize revenue ratably after renewal option 1 is exercised and service performance obligation satisfied over Year 2.*	4,645	 4,645
Cash/trade receivables Contract liability *To recognize a contract liability when upfront billing occurs at beginning of Year 3.*	4,000	 4,000
Contract liability Revenue *To recognize revenue ratably after renewal option 2 is exercised and service performance obligation satisfied over Year 3.*	4,550	 4,550

If Customer does not exercise an option, ABC recognizes as revenue the amounts allocated to all remaining options.

Note: There may be other methods to estimate the stand-alone selling price of a material right as long as they are consistent with the allocation objective and material rights guidance. We believe the above illustrates an acceptable approach.

Approach 2: Apply the alternative approach

ABC allocates the transaction price by reference to the services expected to be provided and corresponding expected consideration. To apply the alternative approach, it could estimate the transaction price using any of the following methods described in Question 5.8.40.

Method 1: Portfolio of data basis incorporating estimates of breakage

Based on its estimates of expected renewals for a portfolio of contracts, ABC allocates the transaction price to each performance obligation per contract as follows.

Performance obligation	Contract price	Expected renewals	Expected consideration	Stand-alone selling price	Selling price ratio	Price allocation
Service contract Year 1	$ 5,000[1]	n/a	$ 5,000	$ 5,000	38.9%	$ 4,388
Renewal option 1	4,000	85%	3,400[2]	4,250[4]	33.1%	3,734

Performance obligation	Contract price	Expected renewals	Expected consideration	Stand-alone selling price	Selling price ratio	Price allocation
Renewal option 2	4,000	72%	2,880[3]	3,600[5]	28.0%	3,158
Total	**$13,000**		**$11,280**	**$12,850**	**100.0%**	**$11,280**

Notes:
1. Calculated as $4,000 + 1,000.
2. Calculated as $4,000 × 85%.
3. Calculated as $4,000 × 72%.
4. Calculated as $5,000 × 85%.
5. Calculated as $5,000 × 72%.

In Year 1, ABC recognizes $4,388 as it satisfies the related service performance obligation. The difference between the amount recognized as revenue ($4,388) and consideration received ($5,000) is recognized as a contract liability ($612).

If, at the beginning of the first renewal period, the actual number of renewals is different, ABC updates the transaction price and revenue recognized accordingly through either a cumulative catch-up or prospective adjustment approach, pursuant to paragraph 606-10-55-32.

For example, if 95% of customers exercise their renewal option upon completion of the one-year service contract, ABC updates the transaction price and reallocates the consideration to each performance obligation as follows.

Cumulative catch-up adjustment approach

Performance obligation	Contract price	Expected renewals	Expected consideration	Stand-alone selling price	Selling price ratio	Price allocation
Service contract Year 1	$ 5,000[1]	n/a	$ 5,000	$ 5,000	35.7%	$ 4,356
Renewal option 1	4,000	95%	3,800[2]	4,750[4]	33.9%	4,136
Renewal option 2	4,000	85%[6]	3,400[3]	4,250[5]	30.4%	3,708
Total	**$13,000**		**$12,200**	**$14,000**	**100.0%**	**$12,200**

Notes:
1. Calculated as $4,000 + 1,000.
2. Calculated as $4,000 × 95%.
3. Calculated as $4,000 × 85%.
4. Calculated as $5,000 × 95%.
5. Calculated as $5,000 × 85%.
6. Assume ABC's updated estimate of expected renewals for Option 2 is now 85%.

Under the cumulative catch-up adjustment approach, ABC records the following journal entry at the beginning of Year 2 to take into account the change in expectation.

	Debit	*Credit*
Revenue	32[1]	
Contract liability		32
To reverse revenue from Year 1 at the start of Year 2, based on adjustment to allocation of consideration.		
Note:		
1. Calculated as $4,388 – $4,356.		

Prospective adjustment approach

Under a prospective adjustment approach, ABC does not adjust the contract liability when the estimate changes but updates the allocation on a prospective basis as follows.

Performance obligation	Contract price	Expected renewals	Remaining expected consideration	Stand-alone selling price	Selling price ratio	Price allocation
Service contract Year 1	$ 5,000[1]	n/a	n/a	n/a	n/a	n/a
Renewal option 1	4,000	95%	$3,800[2]	$4,750[4]	52.8%	$4,125
Renewal option 2	4,000	85%	3,400[3]	4,250[5]	47.2%	3,687
Contract liability	n/a	n/a	612[6]	n/a	n/a	
Total	**$13,000**		**$7,812**	**$9,000**	**100.0%**	**$7,812**

Notes:

1. Calculated as $4,000 + 1,000.
2. Calculated as $4,000 × 95%.
3. Calculated as $4,000 × 85%.
4. Calculated as $5,000 × 95%.
5. Calculated as $5,000 × 85%.
6. Contract liability after Year 1.

ABC records the following journal entry as it satisfies the related service performance obligation in Year 2, which takes into account the change in estimate.

	Debit	*Credit*
Cash/trade receivables	3,800	
Contract liability	325	
Revenue		4,125

To recognize revenue as the related service performance obligation is satisfied in Year 2, while adjusting for the change in estimate for renewals.	

At the end of year 2 the contract liability is $287 ($612 – $325).

Method 2: Portfolio of data basis amortizing over a weighted-average expected renewal period

Assume ABC determines that the weighted-average expected renewal period for similar customers is 30 months. For an individual customer that exercises all of its options, ABC calculates revenue to be recognized as follows.

Performance obligation	Actual service revenue per contract	Upfront fee	Revenue recognized
Service Year 1	$ 4,000	$ 400[1]	$ 4,400
Renewal option 1	4,000	400[1]	4,400
Renewal option 2	4,000	200[2]	4,200
Total	**$12,000**	**$1,000**	**$13,000**

Notes:
1. Calculated as ($1,000 / 30 months) × 12 months.
2. Calculated as ($1,000 / 30 months) × 6.

In Year 1, ABC recognizes $4,400 as it satisfies the related service performance obligation. The difference between the amount recognized ($4,400) as revenue and consideration received ($5,000) is recognized as a contract liability ($600).

ABC monitors its weighted-average expected renewal period for similar customers and updates the revenue recognized with either a cumulative catch-up or prospective adjustment, if necessary.

Method 3: Contract-by-contract basis

ABC does not expect the material right to expire unexercised and therefore includes all of the material right periods as expected services. This results in effectively amortizing the upfront fee ratably over the hypothetical contract because the entity uses a time-elapsed measure of progress.

Performance obligation	Contract price	Expected consideration	Selling price ratio	Price allocation
Service contract Year 1	$ 5,000	$ 5,000	33.3%	$ 4,333
Renewal option 1	4,000	4,000	33.3%	4,333
Renewal option 2	4,000	4,000	33.4%	4,334
Total	**$13,000**	**$13,000**	**100.0%**	**$13,000**

In Year 1, ABC recognizes $4,333 as it satisfies the related service performance obligation. The difference between the amount recognized as revenue ($4,333) and consideration received ($5,000) is recognized as a contract liability ($667).

If Customer does not exercise an option, ABC recognizes as revenue the amount allocated to the remaining renewal options.

6. Step 4: Allocate the transaction price to performance obligations

Detailed contents

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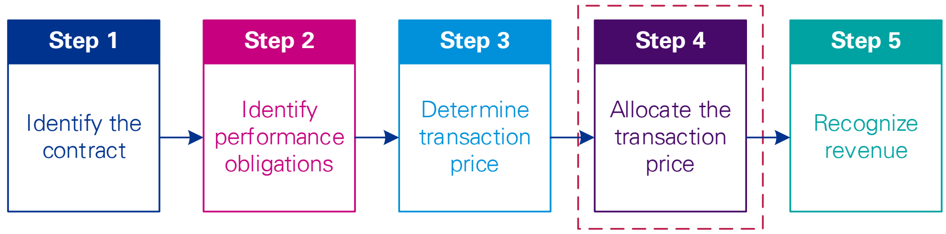
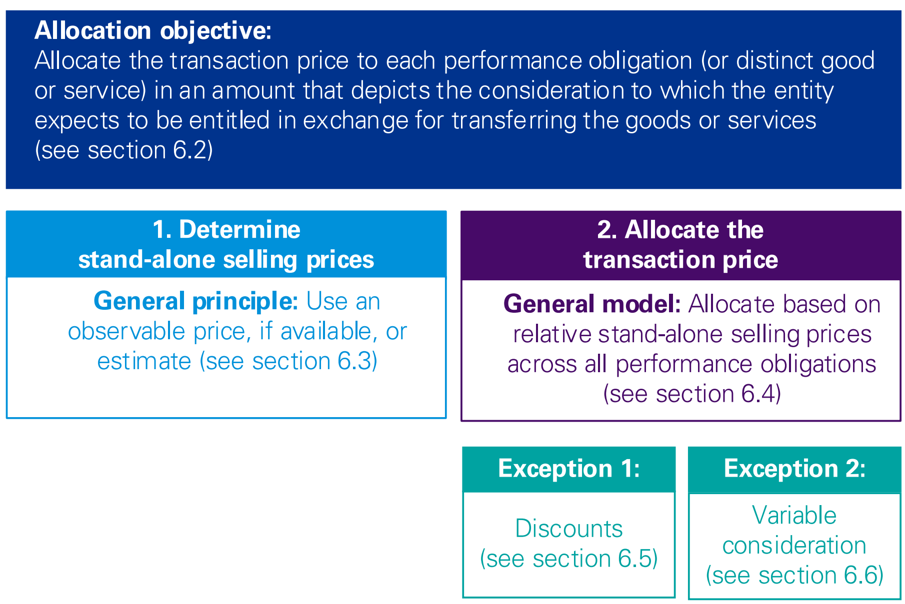
Examples

6.1 How the standard works



Step 4 requires an entity to allocate the transaction price (determined in Step 3) to each performance obligation (identified in Step 2) in a manner that depicts the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer (the 'allocation objective').

The following chart summarizes this process, which is explained in more detail in this chapter.



If the transaction price changes (e.g. a change in estimate for variable consideration after contract inception), the entity allocates those changes on the same basis as it allocated the original estimate of the transaction price (see section 6.8).

6.2 The allocation objective

Excerpt from ASC 606-10

> Allocating the Transaction Price to Performance Obligations

32-28 The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

32-29 To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).

32-30 Paragraphs 606-10-32-31 through 32-41 do not apply if a contract has only one performance obligation. However, paragraphs 606-10-32-39 through 32-41 may apply if an entity promises to transfer a series of distinct goods or services identified as a single performance obligation in accordance with paragraph 606-10-25-14(b) and the promised consideration includes variable amounts.

6.2.10 Overview

The allocation objective is a critical concept in Step 4. That objective is to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled for transferring the promised goods or services to the customer. [606-10-32-28]

Generally, an entity accomplishes this objective by allocating the transaction price to each performance obligation on a relative stand-alone selling price basis. This method is often referred to as the general allocation model. However, there are exceptions to the general allocation model related to discounts and variable consideration. [606-10-32-29]

The general allocation model is discussed in section 6.4, the discount allocation exception in section 6.5 and the variable consideration allocation exception in section 6.6. Before an entity applies the general allocation model, it determines the stand-alone selling prices of a contract's performance obligations, which is discussed in section 6.3.

6.3 Determine stand-alone selling prices of performance obligations

Excerpt from ASC 606-10

• > Allocation Based on Standalone Selling Prices

32-32 The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service.

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.

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).

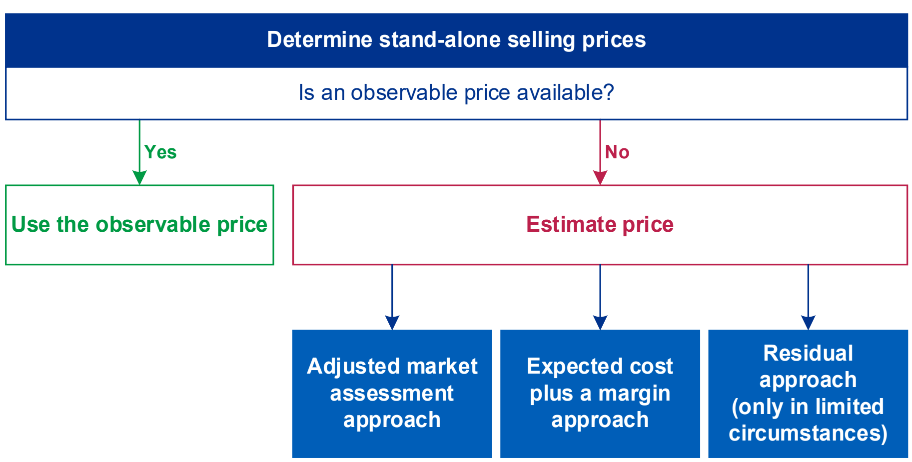
32-35 A combination of methods may need to be used to estimate the standalone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain standalone selling prices. For example, an entity may use a residual approach to estimate the aggregate standalone selling price for those promised goods or services with highly variable or uncertain standalone selling prices and then use another method to estimate the standalone selling prices of the individual goods or services relative to that estimated aggregate standalone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the standalone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated standalone selling prices would be consistent with the allocation objective in paragraph 606-10-32-28 and the guidance on estimating standalone selling prices in paragraph 606-10-32-33.

6.3.10 Overview

The first step in applying Step 4 is to determine each performance obligation's stand-alone selling price.

A performance obligation's stand-alone selling price is the price at which an entity would sell the good or service separately to a customer. The best evidence of this is an observable price from stand-alone sales (which includes stand-alone renewals) of the performance obligation to similarly situated customers. A contractually stated price or list price could be the stand-alone selling price, but this is not presumed to be the case and would need to be supported by other evidence. [606-10-32-32]

If the stand-alone selling price is not directly observable, the entity estimates the amount using a suitable method. In limited circumstances, an entity may estimate the amount using the residual approach. [606-10-32-33, 32-34(c)]



6.3.20 Estimating stand-alone selling prices

An entity considers all information that is reasonably available when estimating a stand-alone selling price – e.g. market conditions, entity-specific factors and information about the customer or class of customer.

While Topic 606 does not preclude or prescribe any particular method for estimating the stand-alone selling price when observable prices are not available, entities are required to maximize the use of observable inputs and apply consistent methods to estimate the stand-alone selling price of other performance obligations with similar characteristics. [606-10-32-33, ASU 2014-09.BC276]

Topic 606 does describe the following estimation methods as possible approaches. [606-10-32-34]

Adjusted market assessment approach	Evaluate the market in which the performance obligation is sold and estimate the price that customers in the market would be willing to pay
Expected cost plus a margin approach	Forecast the expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service
Residual approach (limited circumstances)	Subtract the sum of the observable stand-alone selling prices of other performance obligations in the contract from the total transaction price

Often, there will not be observable stand-alone selling prices for all of the performance obligations in a contract with a customer. As a result, significant judgment is often necessary in estimating a stand-alone selling price. As a result, entities should have processes with appropriate internal controls for estimating stand-alone selling prices of performance obligations that are not typically sold separately.

Reasonably available information that may be considered in developing these estimates includes the following. [ASU 2014-09.BC269]

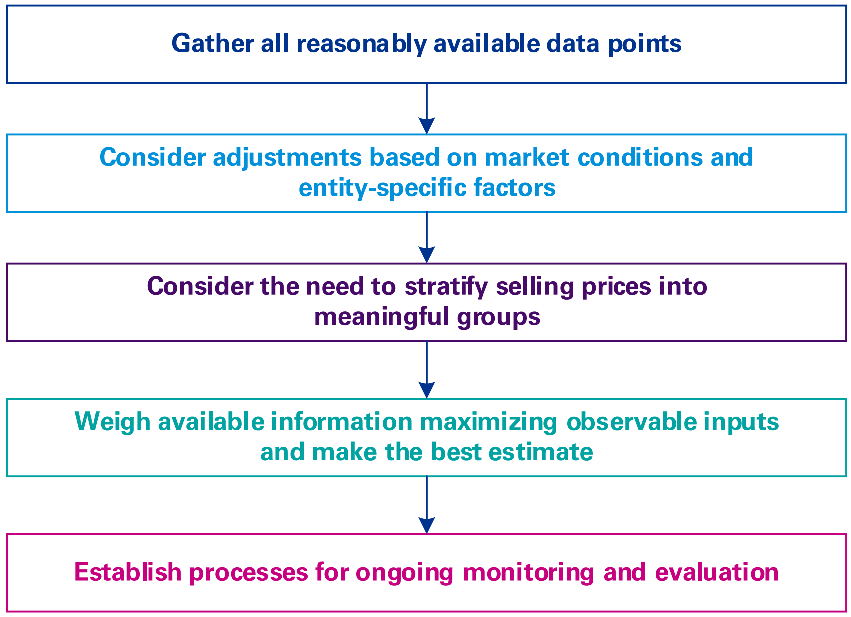
— **Reasonably available data points.** For example, costs incurred to manufacture or provide the performance obligation, profit margins, supporting documentation to establish price lists, third-party or industry pricing, and contractually stated prices.

— **Market conditions.** For example, market demand, competition, market constraints, awareness of the product and market trends.

— **Entity-specific factors.** For example, pricing strategies and objectives, market share and pricing practices for bundled arrangements.

— **Information about the customer or class of customer.** For example, type of customer, geography or distribution channels.

Regardless of the approach selected, the following actions may be useful for estimating and documenting the stand-alone selling price.



Question 6.3.10
Is an entity required to establish a stand-alone selling price for each performance obligation?

Interpretive response: Yes. The stand-alone selling price is determined at contract inception for each performance obligation.

Topic 606 does not require that the amount can be reliably estimated, nor does it prescribe another threshold. An entity is required to maximize the use of observable inputs when estimating the stand-alone selling price, but in all circumstances it will need to arrive at a stand-alone selling price for each performance obligation and allocate the transaction price to each performance obligation in the contract. [606-10-32-33]

There are no circumstances in which revenue recognition is postponed because the determination of a stand-alone selling price is difficult or highly subjective.

Question 6.3.20

Does an entity need to revise the stand-alone selling price if it changes before the entity satisfies all performance obligations?

Interpretive response: No. The stand-alone selling price for a previously allocated arrangement is not revised even if it changes after contract inception but before satisfying all of the performance obligations in a contract. However, in the case of a contract modification that is not accounted for as a separate contract, the entity uses stand-alone selling prices at the date of the modification to account for the modified contract (see Question 11.3.10). [606-10-32-43]

Question 6.3.30

How often does an entity need to establish a stand-alone selling price for a particular performance obligation?

Interpretive response: It depends. The stand-alone selling price is determined for each performance obligation at contract inception and should reflect currently available information, including shifts in pricing, customer base, product offerings or technology. Practically, the frequency of updating the estimated stand-alone selling prices for the purposes of accounting for new contracts will vary based on the nature of the performance obligations, the markets in which the goods or services are being sold and various entity-specific factors.

For example, when an entity has a new product offering, enters a new geographical market, sells goods or services in a highly competitive market or is experiencing high rates of technological change, it may have to make more frequent updates to the estimated stand-alone selling price as market awareness and demand change.

In contrast, when the products, markets and customer base are more stable, some entities may reasonably conclude that the stand-alone selling price of a performance obligation does not change frequently.

Depending on the particular facts and circumstances some entities may reasonably be able to conclude that stand-alone selling prices established on a monthly, quarterly or annual basis reflect the stand-alone pricing for that entire period. Entities should have a monitoring process to ensure that the stand-alone selling prices used appropriately reflect current circumstances at the inception of each contract.

Question 6.3.40

Can a single good or service have more than one stand-alone selling price?

Interpretive response: Yes. The best evidence of stand-alone selling price is the price when the good or service is sold separately in similar circumstances and to similar customers. As such, the stand-alone selling price of a particular good or service could vary based on the circumstances and type or class of customer. [606-10-32-32]

When determining the stand-alone selling price for a good or service, an entity should consider stratifying stand-alone selling prices into meaningful groups and identifying a different stand-alone selling price for each group. The groups could be based on customer type, volume of sales to customers, geography, distribution channel or other relevant groupings.

Question 6.3.45

Can the same performance obligation have more than one stand-alone selling price within a single contract?

Interpretive response: It depends. Generally, the same performance obligation within a single customer contract will have the same stand-alone selling price. However, there could be circumstances in which the stand-alone selling price for the same performance obligation may be expected to change based on the expected timing of delivery.

An entity may expect changes in market price or production costs over a long period of time. Those changes could affect the price at which an entity would be willing to commit to transfer control of the performance obligation in the future. Different stand-alone selling prices may be appropriate if the same performance obligations are provided over a long period of time and an entity has evidence to support that stand-alone sales of those performance obligations will be priced differently when they are transferred at a future point in time.

Example 6.3.05

Different stand-alone selling price for the same performance obligation within a single contract

ABC Corp. enters into a three-year contract with Customer to provide non-customized widgets. The widgets are transferred at a point in time and do not represent a series of distinct goods that would be accounted for as a single performance obligation. Customer is obligated to purchase a minimum number of widgets in each of the three years.

The observable price per widget is $500 at the outset of the contract and this is determined to be the stand-alone selling price. ABC has a consistent history of annual price increases that the market has borne when these widgets are sold separately. ABC's pricing committee has approved 5% annual increases for this product and the anticipated annual increases are communicated to customers.

Based on the expected changes in market price, the stand-alone selling price for these widgets in this simple fact pattern increases 5% in Years 2 and 3. Therefore, ABC Corp. accounts for the widget sales in the three-year contract using the stand-alone selling prices as follows.

	Stand-alone selling price per widget
Year 1	$500.00
Year 2	$525.00
Year 3	$551.25

ABC will continue to monitor market and pricing conditions as it enters into new contracts with similar terms. If there is a disruption in market prices or its pricing practices that make its historical experience less predictive to evaluating the stand-alone selling price expected to exist for the widgets in the future, it may be necessary for ABC to reconsider whether its accounting for such contracts should be different.

Question 6.3.50

Is the stand-alone selling price required to be a point estimate or can it be a range?

Interpretive response: Although a point estimate is required to allocate the transaction price to the performance obligations for a given contract, it may be acceptable for a point estimate to be drawn from a range of prices when that range is sufficiently narrow. Using a range is most appropriate when stand-alone selling prices are expected to vary somewhat for similar types of customers. A range should be (1) narrow and (2) based on an analysis that maximizes observable inputs and supports an assertion that any price within that range would be a valid pricing point if the performance obligation were sold on a stand-alone basis.

Topic 606 does not discuss ranges of prices. Accordingly, an entity needs to exercise judgment in establishing that its range of prices is sufficiently narrow under the circumstances. One approach that maximizes observable inputs is a bell-shaped curve approach. Under this approach, an entity evaluates whether stand-alone prices during recent periods are sufficiently clustered within a narrow range.

When the dispersion in stand-alone prices is so wide that a relevant price is not determinable from the observable transactions, an entity uses another method to estimate the stand-alone selling price. The entity could estimate the stand-alone selling price using the adjusted market assessment, expected cost plus a margin or residual approach (see Question 6.3.90). However, the observable prices would still be used as data points in the estimate of the stand-alone selling price of the performance obligation.

It is not appropriate to establish a range of observable transactions and then arbitrarily expand the range by a certain percentage on either side of the observable range to create a range of estimated stand-alone selling prices.

Similarly, it is not appropriate to derive a point estimate – i.e. a stand-alone selling price that is not based on observable selling prices – and arbitrarily add a range of a certain percentage on either side of the point estimate.

Question 6.3.60

Can the stated contractual price be the stand-alone selling price?

Interpretive response: It depends. A contractually stated price may be (but is not presumed to be) the stand-alone selling price of that good or service. To that end, contractually stated prices may provide a relevant data point when determining the estimated stand-alone selling price of a good or service in some cases. [606-10-32-32]

If the stated price in the contract is developed using methods and assumptions consistent with an entity's normal pricing processes and practices for stand-alone sales of the good or service, the contract price may be useful in the analysis. This is particularly the case if:

— the stated prices for the good or service are reasonably consistent across similar customers regardless of what other goods or services are bundled in the arrangement; or

— the good or service is sold separately and the cash consideration tied to the delivery of the good or service is consistent with its stated price.

When the stated contract price is the stand-alone selling price or is a price within a sufficiently narrow range of observable stand-alone selling prices, the entity may use the stated contract price to allocate the transaction price. However, if the stated contract price for any of the performance obligations in the arrangement is not within a range of stand-alone selling prices, the entity needs to make a relative allocation based on the appropriate stand-alone selling price for each performance obligation. See Question 6.3.70 and Examples 6.3.10 and 6.3.20.

Example 6.3.10

Allocating the transaction price based on stated contract prices

ABC Corp. sells a medical imaging device bundled with one year of maintenance service and 10 days of training to a customer. ABC determines that the medical imaging device, maintenance service and training are separate performance obligations. There is no variable consideration or discounts that are required to be allocated entirely to one or more but not all of the performance obligations (see sections 6.5 and 6.6).

The stated contract prices for the goods and services are as follows.

Performance obligation	Contract price
Medical imaging device	$505,000
One year of maintenance service	50,000
Training	9,900
Total	**$564,900**

ABC has established a narrow range of stand-alone selling prices for each of the goods and service identified as separate performance obligations.

Performance obligation	Range of stand-alone selling prices
Medical imaging device	$500,000 – $525,000
One year of maintenance service	$50,000 – $52,500
Training	$960 – $990 per day

Because all of the stated contract prices fall within the narrow ranges, ABC concludes that the stated contract price may be used to allocate the transaction price to the performance obligations. No further allocation is required.

Question 6.3.70

When the stand-alone selling price is a range, what point in the range should be used when the stated contract price is outside that range?

Interpretive response: An entity should develop policies for estimating stand-alone selling prices that are consistent with the allocation objective (see section 6.2) and are applied consistently.

This may also include a policy to determine which price in the range of stand-alone selling prices should be used as the stand-alone selling price for purposes of allocating the transaction price. For example, an entity may consider a policy of using either (1) the midpoint of the range or (2) the outer limit of the range nearest to the stated contract price for that performance obligation.

Example 6.3.20

Contract prices are not at stand-alone selling price

Assume the same facts as Example 6.3.10 except that the total fee for the arrangement is $551,000, allocated between the performance obligations as shown in the table.

ABC's policy is to use the midpoint of its narrow range of observable stand-alone selling prices when stated contract prices fall outside the established ranges when performing the relative stand-alone selling price allocation.

Because the stated prices for the maintenance and training fall outside their respective estimated selling price ranges, consistent with its policy, ABC allocates the transaction price using the midpoints of the ranges, as follows.

Performance obligation	Contract price	Stand-alone selling price	Selling price ratio	Price allocation
Medical imaging device (stated price within range)	$520,000	$520,000[1]	89.5%	$493,145
One year of maint. (midpoint of range)	26,000	51,250[2]	8.8%	48,488
Ten days of training (midpoint of range)	5,000	9,750[3]	1.7%	9,367
Total	**$551,000**	**$581,000**	**100%**	**$551,000**

Notes:

1. Stated contract price is used because it falls within the narrow range.
2. Midpoint of range $50,000 – $52,500 is used because stated contract price is outside the narrow range.
3. Midpoint of range $960 – $990 per day × 10 days is used because stated contract price is outside the narrow range.

Question 6.3.80

Is an entity required to use an observable stand-alone selling price if one exists?

Interpretive response: Yes. If observable stand-alone selling prices can be obtained those prices must be used. While the FASB did not specify a hierarchy of evidence to determine the stand-alone selling price of a good or service, Topic 606 requires an entity to use observable prices when a good or service is sold separately. However, stand-alone historical sales may not on their own be determinative. [ASU 2014-09.BC276]

The best evidence of stand-alone selling price is the observable price when the entity sells that good or service separately (including the price of actual contract renewals) in similar circumstances and to similar customers. However, if the entity is selling the good or service in a new market, to a new customer type or under different circumstances – e.g. market factors have affected the pricing for the particular good or service – then other data points may be more relevant. In that situation, the historical sales should be used as an observable input in developing an estimate of the stand-alone selling price for that new circumstance. We would expect an entity to use the most relevant stand-alone sales prices and make adjustments based on other relevant factors to determine the stand-alone selling price. [606-10-32-32]

However, when the historical stand-alone sales are not within a sufficiently narrow range, those sales may not provide evidence of an observable stand-alone selling price; this is because the range is so wide that an appropriate

pricing point is not observable. In that situation, an entity will need to estimate the stand-alone selling price using another method that maximizes the use of observable inputs (that would include those historical sales as inputs).
See Question 6.3.50 on determining an observable stand-alone selling price that is a range.

An entity may sell a good or service separately, but only on occasion. In this situation, the entity evaluates whether the historical sales for that good or service when it is sold separately are indicative of the price the entity would charge in a similar situation. For example, if the entity has not sold a good or service on a stand-alone basis within a reasonable period of time before the current transaction (e.g. six months to one year), the previous sales price for that good or service may not be indicative of the stand-alone selling price in the current contract. In that situation, the entity may not have an observable stand-alone selling price and should estimate the stand-alone selling price. However, the historical sales should be considered as a data point in the estimate.

Question 6.3.90

If a performance obligation does not have an observable stand-alone selling price, does an entity have a free choice in selecting a method to estimate it?

Interpretive response: No. Topic 606 includes an implicit hierarchy. If a performance obligation does not have an observable stand-alone selling price, the entity needs to select the estimation method that maximizes the use of observable inputs.

Otherwise, Topic 606 does not preclude or prescribe any particular method for estimating a stand-alone selling price as long as the estimate is a faithful representation of the price at which the entity would sell the distinct good or service as if it were sold separately to the customer. However, the residual approach is restricted to limited situations (see Question 6.3.100). [606-10-32-33 – 32-34, ASU 2014-09.BC268]

Because an entity is required to maximize the use of observable inputs, it looks first at estimation techniques that rely on observable inputs before using techniques more heavily reliant on non-observable inputs.

Consider the following scenarios.

- Assume an entity has observable inputs available such as stand-alone sales that are not sufficiently clustered around a narrow range and third-party sales of a similar good or service. However, its cost and margin data (see Question 6.3.150) does not provide relevant data points. In this example, the entity uses the adjusted market assessment approach rather than the cost plus a margin approach because the adjusted market assessment approach maximizes the use observable inputs.
- In contrast, assume an entity has observable, reliable historical cost data for similar goods or services, but observable third-party pricing for similar goods or services is not consistent. In this scenario, the entity would likely

conclude that the expected cost plus a margin approach is more appropriate. However, if the entity has observable market data, such as competitor pricing or stand-alone sales, it still considers those data points when evaluating the appropriateness of the expected cost plus margin estimate.

— If an entity has either observable market data or observable cost plus margin data and either of those approaches provides a faithful representation of the stand-alone selling price, the entity should not use the residual approach because those other approaches maximize the use of observable inputs.

— If an entity does not have direct observable market inputs or cost data for a particular good or service, the residual approach may maximize observable inputs (i.e. by using the observable inputs from the other goods or services in the contract). However, the residual approach may only be applied in certain circumstances (see Question 6.3.100).

Question 6.3.100

When can an entity use the residual approach to estimate stand-alone selling price?

Interpretive response: The residual approach is appropriate only if the stand-alone selling price of one or more goods or services is highly variable or uncertain, and observable stand-alone selling prices exist for the other goods or services promised in the contract.

Selling price is …	… if …
Highly variable	The entity sells the same good or service to different customers at or near the same time for a broad range of prices.
Uncertain	The entity has not yet established the price for a good or service and the good or service has not previously been sold on a stand-alone basis. See Question 6.3.120.

If two or more goods or services in a contract have highly variable or uncertain stand-alone selling prices, an entity may need to use a combination of methods to estimate the stand-alone selling prices of the performance obligations in the contract. For example, an entity may use:

— the residual approach to estimate the aggregate stand-alone selling prices for all of the promised goods or services with highly variable or uncertain stand-alone selling prices; and then

— another technique to estimate the stand-alone selling prices of the individual goods or services in the bundle that was determined by the residual approach.

Application of the residual approach is not limited to delivered items – i.e. a reverse residual approach is allowed if the requirements for its use are met for an undelivered performance obligation.

The residual approach may be the appropriate approach for estimating the stand-alone selling price of IP when, and only when, the selling price is highly variable or uncertain. That is because there is often little or no incremental cost to the IP (so an expected cost plus a margin approach would be inappropriate) and the IP may not have substantially similar market equivalents from which to derive a market assessment. As a consequence, for IP the residual approach will frequently be the method that maximizes the use of observable inputs.

However, another approach may be more appropriate for other goods or services even if the criteria to use the residual approach are met. Topic 606 requires that the method used to estimate stand-alone selling price maximize the use of observable inputs (see Question 6.3.90); when there are observable inputs such as third-party pricing or cost and margin data from selling similar goods or services another approach may be more appropriate.

The residual approach should be used only when the criteria are met and the approach results in an estimated selling price at which the entity would sell the promised good or service separately. See also Question 6.3.110.

Example 6.3.30

Estimating stand-alone selling price – residual approach

Software Vendor enters into a contract to provide rights to use Licenses S and T for three years, as well as technical support services for both licenses. The contract price is $100,000.

Software Vendor has identified four performance obligations in the contract: License S; technical support for License S; License T; and technical support for License T. Software Vendor determines that the licenses and the related technical support are each distinct, and therefore separate performance obligations.

A stand-alone observable price of $12,500 is available for the technical support for the Licenses S and T, based on renewals that are sold separately at that price. However, the prices at which Software Vendor has sold licenses similar to Licenses S and T to similar customers in other bundled transactions have been in a broad range – i.e. selling prices of the licenses are highly variable and not directly observable. Also, the level of discounting in the bundled arrangements varies based on negotiations with individual customers.

Software Vendor determines the stand-alone selling prices of the performance obligations in the contract as follows. The residual approach is used to estimate the stand-alone selling price for the bundle of products (Licenses S and T) together.

Product	Stand-alone selling price	Approach
Licenses S and T	$ 75,000	Residual approach: $100,000 – $12,500 – $12,500
Technical support for License S	12,500	Directly observable price
Technical support for License T	12,500	Directly observable price
Total	**$100,000**	

Because Licenses S and T will transfer to the customer at different points in time, Software Vendor then estimates the stand-alone selling price of each license. It does this by allocating the $75,000 to Licenses S and T based on the average residual stand-alone selling price in other contracts for each license over the past year.

Product	Average residual selling price	Selling price ratio	Price allocation	Calculation
License S	$ 40,000	40%	$30,000	$75,000 × 40%
License T	60,000	60%	45,000	$75,000 × 60%
Total	**$100,000**		**$75,000**	

The approach used by Software Vendor to estimate the stand-alone selling prices of Licenses S and T is an example of one approach that may be acceptable; however, other approaches may be acceptable – e.g. estimating the stand-alone price based on the entity's internal pricing practices – if they are consistent with the allocation objective (see section 6.2) and maximize the use of observable inputs.

Question 6.3.110

Can the residual approach result in zero or very little consideration allocated to a good or service?

Interpretive response: No. If applying the residual approach results in zero or very little consideration being allocated to a good or service, or to a bundle of goods or services, then this approach may not be reasonable.

If an entity has determined that a good or service is distinct, then by definition the good or service has value to the customer on a stand-alone basis. In this case, an entity considers all reasonably available data and whether the stand-alone selling price of that good or service should be estimated using another method.

Note: The issue in this question is different from allocating consideration between items that are in the scope of Topic 606 and items that are in scope of other Topics, which may result in little or no consideration being allocated to the aggregate of the items that are in the scope of Topic 606 (see Question 2.4.20).

Question 6.3.120

How should an entity evaluate whether the selling price of a good or service is uncertain when it has not yet sold that good or service separately?

Interpretive response: To apply the residual approach, the selling price of the good or service must be highly variable or uncertain. The selling price of a good or service is uncertain if "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)." [606-10-32-34(c)(2)]

Even when an entity has not sold a good or service on a stand-alone basis, it may still have established a price for the good or service. For example, the entity may have established an internal list price or made an offer to a customer at that price.

A price could be an 'established price' for purposes of evaluating the residual approach when an entity has set a price for a good or service based on its customary business practices, if the entity expects that the good or service will be regularly sold separately at that price. That is because the price may not be substantive without the expectation of entering into separate sales at that price.

In some situations, it may be difficult to demonstrate that an entity has established a price until a good or service has been sold separately on a regular basis. However, simply selling the good or service separately does not automatically mean the selling price is not uncertain if those sales are infrequent or not current.

When evaluating whether a price has been established before stand-alone sales occur, an entity needs to apply significant judgment and should consider the following (not exhaustive).

- **Other observable inputs provide evidence that the price has been established.** For example, if third-party pricing for similar products is consistent with the price set by the entity, it would indicate that the price is not uncertain.
- **The length of time between when the price is set and when the entity expects to sell the good or service.** The greater the length of time until, or uncertainty about when, the good or service will be sold, the higher the likelihood that the price is uncertain.
- **The entity's historical experience of selling previously released goods or services for the price set by management.** A history of setting a price and then changing that price prior to selling the good or service separately indicates that the price is uncertain.
- **The frequency with which the entity expects to sell the good or service on a stand-alone basis.** Not expecting to sell the good or service separately on a regular basis indicates that the price is uncertain because an expectation of regular stand-alone sales might change how an entity sets the price for the good or service.
- **The entity has offered customers a contractually stated renewal price and has a history of customers exercising the option at that stated**

price for similar goods and services. If a customer has not yet exercised an option to renew, the price may still be uncertain if the entity has a history of customers renegotiating the contract to purchase a renewal at a different price.

— **The nature of the good or service and the entity's experience with similar products.** If the goods or services are based on a new technology or service offering and the entity lacks historical experience to demonstrate that a price established will be used in stand-alone sales, the selling price may be uncertain. In contrast, if the new good or service is similar to existing goods or services provided by the entity or goods or services sold by competitors, there might be more certainty in the selling price.

Even if the selling price is considered uncertain, an entity is required to maximize the use of observable inputs in estimating the stand-alone selling price of a good or service. For example, the presence of contractually stated prices for renewal options, stand-alone sales of similar products or third-party sales of similar goods or services would likely be considered observable data points that an entity would need to consider in its estimation process. Therefore, the entity might conclude that a method other than the residual approach should be used in estimating the stand-alone selling price.

Question 6.3.130

Is it acceptable to use an entity-published price list as evidence to estimate a stand-alone selling price?

Interpretive response: It depends. Similar to contractually stated prices for goods or services in a contract containing multiple performance obligations, a published price listing cannot be presumed to represent an appropriate estimate of stand-alone selling price. However, a published list price may be a relevant data point that should be considered. [606-10-32-32]

In many cases, a published price list serves as a starting point for price negotiations for a good or service. An entity may sell certain goods or services included on the price list on a stand-alone basis. Analyzing the discounting practices for similar goods or services sold on a stand-alone basis can provide observable data points that are relevant and useful in corroborating the estimated selling price for the goods or services that are not sold on a stand-alone basis.

Question 6.3.140

What costs should an entity consider when estimating a stand-alone selling price using the expected cost plus a margin approach?

Interpretive response: Under the expected cost plus a margin approach, an entity could forecast its expected costs of satisfying a performance obligation. [606-10-32-34(a)]

Subtopic 340-40, which provides guidance on the accounting for costs to fulfill a contract, provides that the costs eligible for capitalization are costs that are directly related to the contract. As such, we believe it would be consistent with the requirements of Subtopic 340-40 to consider the types of costs that relate directly to a contract when estimating costs to fulfill (satisfy) a performance obligation. Those costs are summarized in the following table. [340-40-25-7 – 25-8]

Direct costs to be included in the estimate ✓	**Costs to be excluded from the estimate** ✗
Direct labor – e.g. employee wages	General and administrative costs – unless explicitly chargeable under the contract
Direct materials – e.g. supplies	Costs that relate to satisfied performance obligations
Allocation of costs that relate directly to the contract – e.g. depreciation and amortization	Costs of wasted materials, labor or other contract costs
Costs that are explicitly chargeable to the customer under the contract	Costs that do not clearly relate to unsatisfied performance obligations
Other costs that were incurred only because the entity entered into the contract – e.g. subcontractor costs	

When fulfillment costs are directly in the scope of other guidance (e.g. Topic 330 on inventory), an entity's determination of cost should be consistent with the requirements under the guidance for those goods or services. For example, if an entity manufactures equipment but does not sell the equipment on a stand-alone basis, we would expect the entity to consider only inventoriable costs when developing its measure of expected costs plus margin to estimate stand-alone selling price. However, R&D costs in the scope of other guidance would typically be excluded from the estimate of costs to fulfill a performance obligation because they are not related to fulfillment of a contract.

See Question 6.3.150 for further details on the margin used under this approach.

Question 6.3.150

How does an entity determine what margin to use when developing a cost plus margin data point to estimate a stand-alone selling price?

Interpretive response: Determining the margin to use when developing an expected cost plus margin estimate requires the exercise of significant judgment, particularly when historical profit data has not been tracked on a disaggregated product-by-product grouping basis.

It may be necessary for an entity to gather reasonably available margin data points and make adjustments for market conditions and entity-specific factors to arrive at the best estimate of a reasonable profit margin. It may also be necessary to establish separate margins for different classes of sales transactions based on different geographical markets, customer classes or other meaningful groups. The profit margins used should also be consistent with costs used in the estimate (see Question 6.3.140) to reflect the expected margin on those particular costs.

Consideration of the following factors may be appropriate when estimating a reasonable margin to be reflected in a cost plus margin data point.

- **Average profit margins** within an entity's product or service lines can provide evidence of the margin it can expect to achieve if the product or service were sold separately. Adapting this margin to a specific good or service within the group could be necessary, particularly if there are specific items expected to have different margins.
  - The nature of the good or service should be considered to determine whether it warrants a premium or a discount from the average profit margin. For example, some items might be sold in high volumes or might not have significant value-added attributes, even though the entity considers them to be in the same product group.
- **A competitor's profit margins** realized for similar goods or services may provide relevant data points.
  - The competitive position of an entity's goods or services relative to competitors' goods or services may help determine a profit margin that the market would be willing to pay. For example, best-in-class goods or services or those with enhanced functionality or sold by an entity with a dominant market share likely will have higher profit margins than a competitor's margins. Similarly, if a competitor has goods or services with enhanced functionality, or benefits from being best in class, an entity may not expect to be able to attain a similar margin in the same market.
  - It may be necessary to consider a competitor's cost structure to determine whether its profit margins require adjustment relative to the entity's expected margin.
  - It may be necessary to consider how long the competitor has sold the product compared to the entity's product. If the entity is developing a new product that will compete with a long-standing product offering of a competitor, the entity may expect to have lower profit margins as it obtains market share.
- **Third parties and industry trade groups** may publish average profit margin data for goods and services in a particular industry. This external pricing data may provide a relevant data point when determining a reasonable margin for certain goods and services. An entity should consider the effect of market conditions and entity-specific factors on an entity's estimated margin when using such external data.

— **An entity may have established processes**, for example through a pricing committee, for establishing reasonable margins for certain goods and services sold on a stand-alone basis. How margins are determined for goods and services similar to those not sold on a stand-alone basis may provide a relevant and useful data point for determining a reasonable margin.

No one individual data point is likely to be determinative of a margin that should be used in an expected cost plus margin assessment, and the weight given to each data point in determining an entity's best estimate will vary depending on facts and circumstances. However, any estimate will need to maximize the use of observable inputs.

6.4 Allocate the transaction price

Excerpt from ASC 606-10

> Allocation Based on Standalone Selling Prices

32-31 To allocate the transaction price to each performance obligation on a relative standalone selling price basis, an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those standalone selling prices.

• • > Example 33—Allocation Methodology

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.

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**	

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	($25 ÷ $150 × $100)
Product C	50	($75 ÷ $150 × $100)
Total	**$100**	

6.4.10 Overview

At contract inception, the transaction price is generally allocated to each performance obligation on the basis of relative stand-alone selling prices – i.e. the general allocation model. In most cases, an allocation based on stand-alone selling prices faithfully depicts the amount of consideration to which an entity is entitled for satisfying a performance obligation and the relative stand-alone selling price allocation should be the general model for allocating the transaction price. [606-10-32-31]

However, there are situations when a relative allocation may not faithfully depict the amount of consideration to which the entity is entitled. Topic 606 includes exceptions to the general model for the following scenarios:

— observable evidence that a discount relates entirely to one or more, but not all, performance obligations (see section 6.5); and
— variable consideration is attributable to one or more, but not all, distinct goods or services (see section 6.6).

Example 6.4.10
Relative allocation – Illustrative example

ABC Corp. enters into a contract to sell Products A, B and C to Customer for $800, which is a discount of $200 from the sum of the stand-alone selling prices. ABC allocates the transaction price of $800 based on the products' relative stand-alone selling prices as follows.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	Calculation
Product A	$ 200	20%	$160	$800 × 20%
Product B	300	30%	240	$800 × 30%
Product C	500	50%	400	$800 × 50%
Total	**$1,000**	**100%**	**$800**	

Question 6.4.05●

Is the allocation of consideration limited to non-contingent amounts?

Interpretive response: No. Topic 606 does not have a limitation on the allocation of arrangement consideration to amounts of revenue that are non-contingent. Therefore, the transaction price is estimated and allocated on a relative stand-alone selling price basis to each performance obligation without limitation. The transaction price includes all amounts, including contingent amounts, to which the entity expects to be entitled (see chapter 5 on estimating the transaction price).

Question 6.4.10

Can the sum of the stand-alone selling prices in a contract be less than the total transaction price?

Interpretive response: Generally, no. We generally expect that the sum of the stand-alone selling prices of the individual goods and services will be equal to or greater than the bundled contract fee. Customers typically are not willing to pay a premium for a bundle of goods or services when they could purchase the goods or services for less on a stand-alone basis.

If the sum of the stand-alone selling prices is less than the total transaction price, entities should reconsider whether they have identified all of the items that Topic 606 requires to be identified in the contract (e.g. promised goods and services, significant financing components) and whether the stand-alone prices have been properly determined. In particular, they should evaluate whether the premium is in substance a nonrefundable upfront fee that provides the customer with a material right to purchase additional goods or services or renew the existing contract. See section 8.3 for a discussion of material rights and section 5.8 for a discussion of nonrefundable upfront fees.

If a premium remains after reconsideration of the points in the preceding paragraph, the premium generally is allocated on a relative stand-alone selling price basis with the rest of the transaction price unless there is observable evidence that the premium relates to one or more, but not all, performance obligations. For example, an entity could also consider the guidance on allocating a discount to one or more performance obligations to determine whether there is observable evidence that a premium relates entirely to a bundle of distinct goods or services, but not all of the performance obligations in the contract (see section 6.5).

6.5 Discount allocation exception

Excerpt from ASC 606-10

> Allocation of a Discount

32-36 A customer receives a discount for purchasing a bundle of goods or services if the sum of the standalone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract. Except when an entity has observable evidence in accordance with paragraph 606-10-32-37 that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract. The proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the transaction price to each performance obligation on the basis of the relative standalone selling prices of the underlying distinct goods or services.

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.

32-38 If a discount is allocated entirely to one or more performance obligations in the contract in accordance with paragraph 606-10-32-37, an entity shall allocate the discount before using the residual approach to estimate the standalone selling price of a good or service in accordance with paragraph 606-10-32-34(c).

6.5.10 Overview

Generally, when a customer receives a discount for purchasing a bundle of goods or services, that discount is allocated proportionately among the performance obligations using the relative stand-alone selling price method (i.e. the general allocation model). However, in some situations the discount can be allocated entirely to one or more, but not all, performance obligations in a contract. This exception exists because in some cases a proportional allocation of a discount may not depict the amount of consideration to which an entity is entitled for satisfying a particular performance obligation. For example, in a bundled arrangement consisting of high margin and low margin products, a relative allocation of a discount could result in a loss on one part of a contract although the contract as a whole is profitable. [ASU 2014-09.BC 277]

To apply the discount allocation exception all of the following criteria need to be met. [606-10-32-37]

Allocate discounts to some, but not all, performance obligations if:

Criterion (a)		Criterion (b)		Criterion (c)
The entity regularly sells each distinct good or service (or each bundle thereof) that are in the contract on a stand-alone basis.	+	The entity also regularly sells, on a stand-alone basis, a bundle(s) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle.	+	The discount attributable to each bundle is substantially the same as the discount in the contract, and an analysis of each bundle provides observable evidence of the performance obligation(s) to which the entire discount in the contract belongs.

The discount allocation exception typically applies to contracts with at least three performance obligations. That is because the discount for the good or service (or bundle of goods or services) has to be substantially the same as the discount in the contract. As a result, an entity may be able to demonstrate that the discount relates to two or more performance obligations, but it will be difficult to have sufficient evidence to allocate the discount entirely to a single performance obligation. [ASU 2014-09.BC283]

Question 6.5.10
Is the discount allocation exception optional?

Interpretive response: No. The guidance on allocating a discount is not optional. However, practically, this analysis is required only if the entity regularly sells each distinct good or service (or distinct bundle) on a stand-alone basis. Therefore, if the entity regularly sells only some of the distinct goods or services in the contract on a stand-alone basis, the criteria for allocating the discount entirely to one or more, but not all, of the performance obligations are not met and further analysis is generally not required.

Some arrangements involve several different goods or services that may be sold in various bundles. In this case, an entity may need to consider numerous possible combinations of products to determine whether the entire discount in the contract can be allocated to a particular bundle.

Topic 606 does not provide specific guidance on how to evaluate whether a good or service (or bundle) is regularly sold on a stand-alone basis. Entities should have a policy to define 'regularly sells' for different bundles of goods or services. This may include considering both volume and frequency.

Example 6.5.10
Allocating a discount in a bundle of products

Manufacturer enters into a contract with Customer to sell Products A, B and C for $3,600. Manufacturer frequently sells Products A, B and C on a stand-alone basis, as follows.

Product	Stand-alone selling price
A	$ 900
B	1,100
C	2,000
Total	**$4,000**

Customer receives a $400 ($4,000 – $3,600) discount for buying the three products as a bundle. Manufacturer regularly sells Products A and B as a bundle for $1,600 ($400 discount) and regularly sells Product C for $2,000. This provides Manufacturer with observable evidence that the discount of $400 relates entirely to Products A and B and not Product C. As a result, the entire discount of $400 is allocated to Products A and B.

Manufacturer uses the observable selling prices of Products A and B when sold on a stand-alone basis to allocate the discount.

Product	Stand-alone selling price	Selling price ratio	Price allocation	Calculation
A	$ 900	45%	$ 720	$1,600 × 45%
B	1,100	55%	880	$1,600 × 55%
	2,000	100%	1,600	
C			2,000	
Total			**$3,600**	

Question 6.5.20

Can an entity allocate a discount entirely to one or more performance obligations when the stand-alone selling price of one or more of the other performance obligations is highly variable or uncertain?

Interpretive response: It depends. Paragraph 606-10-32-38 states that if a discount is allocated entirely to one or more performance obligations in the contract based on the discount allocation exception criteria, an entity allocates the discount before using the residual approach. [606-10-32-38]

However, a literal reading of the discount allocation exception criteria may suggest that an entity would rarely, if ever, be able to allocate a discount to one or more, but not all, performance obligations in the contract when the entity uses the residual approach. This is because:

— the discount allocation exception criteria require that the entity regularly sell each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis and that the entity can quantify the total discount in the contract; and

— to use the residual approach the selling price of that good or service needs to be highly variable or uncertain, which typically means that those items are not sold on a stand-alone basis and it may not be possible to quantify the total discount in the contract.

This raises a potential conflict in the guidance because it appears that an entity would not be able to apply the discount allocation exception when the criteria to apply the residual method are met. As such, it is unclear when the guidance in paragraph 606-10-32-38 would apply.

Example 34 (Case B and Case C) in Topic 6 (reproduced below) illustrates scenarios in which the residual approach can or cannot be applied to a performance obligation in the contract when there is a directly observable discount on a bundle of goods in a contract. In Case B, before using the residual approach, the entity allocated a discount directly to a bundle of goods or services even though the discount in the entire contract was not objectively determinable due to the highly variable or uncertain nature of one of the performance obligations.

Based on discussions at public FASB meetings and from informal discussions with the FASB staff, we believe that the Examples indicate that before using a residual approach, an entity should evaluate whether it is appropriate to allocate a discount based on observable evidence. In Case B, the entity has evidence that allocating the discount entirely to a bundle is appropriate because the amount allocated to the performance obligation estimated under the residual approach is in the range of the stand-alone selling prices estimated under the residual approach in other contracts. In contrast, Case C illustrates that the discount in the contract should be allocated under the general allocation model if allocating a discount entirely to other performance obligations results in an allocation that is inconsistent with the allocation objective.

This approach ensures that the discount in the contract is not allocated entirely to that residual good or service. Even if it appears that the discount allocation criteria are not met, observable prices of a bundle of goods or services in a contract provide better evidence on which to allocate a discount than the residual approach does. In other words, the residual approach may more appropriately depict the stand-alone selling price of a good or service *after* taking into account observable prices for the other performance obligations in the contract.

In any case, the entity needs to have observable evidence that supports the allocation of the discount to one or more, but not all, performance obligations, which often may be difficult for many entities to establish.

Excerpt from ASC 606-10

• • > Example 34—Allocating a Discount

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**

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

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.

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.

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.

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

• • • > Case B — Residual Approach Is Appropriate

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.

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.

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)
Products B and C	$60	Directly observable with discount (see paragraph 606-10-32-37)
Product D	$30	Residual approach (see paragraph 606-10-32-34(c))
Total	**$130**	

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

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 $105 to Products A, B, C, and D using the relative standalone selling prices of those products in accordance with paragraphs 606-10-32-28 through 32-35.

6.6 Variable consideration allocation exception

Excerpt from ASC 606-10

• > Allocation of Variable Consideration

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).

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.

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.

6.6.10 Overview

In general, variable consideration is allocated under the general allocation model similar to the rest of the transaction price. However, in some situations variable consideration can be allocated entirely to one or more, but not all distinct goods or services in a contract.

This exception exists because variable consideration may not relate to all of the performance obligations (or distinct goods or services) in a contract. For example, a contract with multiple performance obligations may include a bonus that relates specifically to satisfying one or more, but not all, of the performance obligations. In those situations, it may not be appropriate to allocate variable consideration to all of the performance obligations because such an allocation would not depict the amount of the consideration to which the entity was entitled for a particular performance obligation. [ASU 2014-09.BC278]

Variable consideration may be attributable to:

— all of the performance obligations in a contract;

— one or more, but not all, of the performance obligations in a contract – e.g. a bonus that is contingent on transferring a promised good or service within a specified time period; or

— one or more, but not all, of the distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation (see section 6.7). [606-10-32-39]

When an entity meets the following criteria, the variable amount (and subsequent changes to that amount) is allocated entirely to one or more performance obligations, or to one or more distinct goods or services that form part of a series. [606-10-32-40]

Allocate variable consideration to a performance obligation (or distinct good or service) if:

Criterion (a)		Criterion (b)
The terms of a variable payment relates specifically to the entity's efforts to satisfy the performance obligation (or transfer the distinct good or service).	+	The allocation is consistent with the allocation objective (see section 6.2).

6.6.20 Criterion (a) – The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct goods or services

Assessing this criterion may often be relatively straightforward because the contract terms specifically identify how the variable amounts are resolved and the transfer of goods or services required to earn that amount. However, when variable consideration is contingent on satisfying multiple distinct goods or services (including multiple distinct service periods) or the terms of the payment are dependent on prior periods, the variable amounts typically relate to all of the distinct goods or services required to earn that consideration (see Question 6.6.30). [606-10-32-40(a)]

6.6.30 Criterion (b) – Allocation is consistent with the allocation objective

When assessing this criterion, an entity evaluates whether the allocation objective (see section 6.2) is met for the entire contract – i.e. not just the distinct goods or services to which the variable consideration relates. A relative stand-alone selling price allocation is not required to meet the allocation objective. However, an entity could use stand-alone selling prices to support the reasonableness of the allocation. As a result, significant judgment will be required to evaluate when this criterion is met (see Questions 6.6.40, 6.6.50, 6.7.30, 6.7.40 and 6.7.60 to 6.7.80). [606-10-32-40(b)]

Additionally, when concluding on criterion (b), an entity may need to estimate the variable consideration at contract inception (see chapter 5 on determining the transaction price, including further discussion on estimating variable consideration).

Question 6.6.10
Is the guidance on allocating variable consideration optional?

Interpretive response: No. An entity must evaluate whether variable consideration in its contracts meets the requirements to allocate the amounts entirely to one or more, but not all, distinct goods or services in the contract.

As a result, determining whether the distinct goods or services are part of a series that forms a single performance obligation is an important evaluation when the contract includes variable consideration; this is because an entity might be required to allocate variable consideration entirely to one or more distinct goods or services (or distinct service periods) within the performance obligation. For a discussion of when to recognize a series as a performance obligation, see section 4.4; and for a discussion of how to allocate variable consideration among goods or services in a series, see section 6.7.

Question 6.6.20

Is the variable consideration allocation guidance or the discount allocation guidance applied first?

Interpretive response: Topic 606 includes an allocation hierarchy: the variable consideration allocation guidance is applied before the guidance on allocating discounts in section 6.5 or the general allocation model in section 6.4.

In some cases, a contract may contain both variable consideration and a discount. For example, an entity may sell products in a bundle at a discount to the aggregate stand-alone selling prices of the products in the bundle. In addition, the transaction price may include a variable element.

When a contract contains both variable consideration and a discount, applying the discount allocation guidance first may result in an incorrect allocation of the transaction price. [606-10-32-41, TRG 03-15.31]

Some contracts contain features that could be either variable consideration or a discount – e.g. a refund resulting from a service level guarantee. In these cases, an entity evaluates the nature of the feature.

— If the service level guarantee causes the transaction price to be variable – e.g. exceeding a guaranteed percentage of down-time during a period results in a refund – then the entity follows the hierarchy and applies the guidance on allocating variable consideration first.

— Conversely, if a rebate is fixed and not contingent – e.g. the refund is simply a fixed discount against the aggregate stand-alone selling prices of the items in a bundle – then an entity applies the guidance on allocating discounts or the general allocation model and does not consider the guidance on allocating variable consideration.

Question 6.6.30

What factors identify whether a variable payment relates specifically to the entity's efforts to transfer a distinct good or service?

Interpretive response: The first criterion to allocate variable consideration to one or more, but not all, distinct goods or services states, "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)." [606-10-32-40(a)]

This criterion is generally met when the variability is solely attributed to and resolved as a result of the transfer of one or more but not all goods or services. This is the case when the amount paid by the customer is independent of the transfer of past or future goods or services (including efforts in previous periods). In other words, the amount paid is resolved entirely as a result of transferring one or more but not all goods or services.

In contrast, this criterion is not met when:

— the variable amount could change based on the transfer of future goods or services. This would mean the variable amounts are attributable to both the current and future goods or services; and

— the variable amount depends on distinct goods or services previously transferred. This would mean that the variable amounts are attributable to not only the final good or service but all of the goods or services transferred before it.

The following are examples of when this criterion is met.

— **Out-of-pocket reimbursements.** Reimbursements of variable amounts related to distinct implementation or installation services but not the subsequent good or service – e.g. outsourcing, software-as-a-service, telecom services.

— **Performance bonuses.** A performance bonus associated entirely with successfully completing a specified performance obligation.

— **Market-based pricing.** A contract to transfer a distinct commodity where the price charged is based on the prevailing market rate at the time.

— **Transaction- or user-based fees.** Transaction- or user-based fees that are resolved and linked entirely to the distinct good transferred or performance within a service period, as long as the price per transaction or user does not change as a result of transferring future goods or services. See Question 6.7.40 for further details on the transaction-based pricing related to a series of distinct services.

If this criterion is met, the entity also evaluates whether the other criterion (i.e. meeting the allocation objective) is met to allocate the variable amounts entirely to that distinct good or service.

Question 6.6.40

Can variable consideration be allocated entirely to one performance obligation and zero consideration allocated to another?

Interpretive response: No. Allocating zero consideration in a contract to a performance obligation would not be consistent with the allocation objective (see section 6.2). This view is consistent with the FASB view that an allocation of the transaction price should not result in an allocation of zero to a performance obligation because, by definition, a distinct good or service has value to the customer on a stand-alone basis. See Question 6.3.110.

To meet the allocation objective and therefore criterion b (see section 6.6.30) of the variable consideration allocation exception, an entity considers all of the payment terms and performance obligations in the contract. Therefore, the evaluation could become more complex when there are multiple performance obligations.

For example, if an entity has a contract with two performance obligations (e.g. equipment and maintenance services) but the only fee in the contract is a variable fee based on usage of one of the performance obligations (e.g. a usage-based fee for the equipment), it would be inappropriate to allocate the variable amounts entirely to only the one performance obligation on which the variable amount is based.

Question 6.6.50

Can variable consideration be allocated entirely to one performance obligation and fixed consideration be allocated entirely to another performance obligation?

Interpretive response: Yes, as long as the criteria to allocate the variable consideration entirely to that performance obligation are met. The entity evaluates whether allocating variable fees entirely to one performance obligation results in amounts allocated to each performance obligation that reasonably depict the amount of consideration that the entity expects for satisfying that performance obligation. [606-10-32-40]

Example 35 Case A in Topic 606 (reproduced below) illustrates a fact pattern in which variable consideration is allocated entirely to one performance obligation and the remaining fixed consideration is allocated entirely to another performance obligation. In that example, the fixed amount of consideration approximates the stand-alone selling price of one performance obligation and the variable amount approximates the stand-alone selling price of another performance obligation.

In contrast, Example 35 Case B in Topic 606 (reproduced below) illustrates a fact pattern in which the variable amounts cannot be allocated entirely to one performance obligation because it would result in more than stand-alone selling price allocated to one performance obligation and less than stand-alone selling price being allocated to the other performance obligation.

As discussed in Question 6.6.20, the entity first applies the guidance on allocating variable consideration and then allocates the remaining consideration. However, the evaluation of whether the allocation objective is met should consider the resulting allocation of both the fixed and variable consideration in the contract.

Based on Example 35, the presence of variable prices in a contract incremental to what the entity would normally charge for a performance obligation indicates that the variable amounts relate to more than one performance obligation. However, if the variable amounts are equal to or less than the price the entity would normally charge for a performance obligation, the variable amounts could still be entirely allocated to a single performance obligation if the allocation of the other consideration in the contract reflects a reasonable allocation for the entire contract.

For example, if a contract with two performance obligations includes usage-based fees at a price per use less than the price normally charged and fixed fees that are incremental to the stand-alone selling price of the other performance obligation, the following may be consistent with the allocation objective:

— allocating the variable amount entirely to one performance obligation; and
— allocating the fixed consideration between the two performance obligations.

Also see Examples 6.7.90 and 6.7.100.

Excerpt from ASC 606-10

• • > Example 35 — Allocation of Variable Consideration

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

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.

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.

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.

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

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.

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.

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).

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.

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.

Question 6.6.60

If a contract contains different types of variable consideration, does all of the variable consideration need to be allocated in the same manner?

Interpretive response: No. An entity applies the guidance to each type of variable consideration within a contract. It is common to have multiple variable payment streams in an individual contract. Depending on the facts and circumstances, an entity could conclude that some variable amounts meet the requirements to be allocated to one or more, but not all, distinct goods or services while other variable amounts in the same contract are attributable to all of the distinct goods or services. Example 6.7.110 illustrates this type of allocation.

Question 6.6.70

How does the variable consideration allocation exception apply to market-priced commodity sales contracts?

Interpretive response: When an entity enters into a contract to transfer a specified quantity of commodities in exchange for market- or index-based pricing at the time the goods are transferred, the contract contains variable consideration; this is because the ultimate amount the entity will be entitled to is not known at contract inception.

In these situations, the entity needs to consider whether the variable consideration allocation exception is met.

— If the exception criteria are met for all of the variable consideration, the entity does not need to estimate the variable consideration and generally recognizes the variable amounts as the related uncertainty is resolved and the entity transfers control of the goods.

— If the exception criteria are not met, the entity estimates the total transaction price and allocates it to each performance obligation under the general allocation model.

Commodity supply contracts that contain only market- or index-based pricing will generally meet the two required criteria to qualify for the allocation exception.

— Criterion (a) in section 6.6.20 will generally be met because the terms of the variable payment relate specifically to the entity's efforts to deliver the commodity – i.e. the variability is solely attributed to and resolved as a result of the market price upon transfer to the customer. [606-10-32-40(a)]

— Criterion (b) in section 6.6.30 will generally be met because the market price depicts the amount of consideration to which the entity expects to be entitled upon transfer of each distinct commodity. [606-10-32-40(b)]

When contracts include other consideration (either fixed or variable), further consideration of all of the payment terms is required to understand if both of the criteria are met.

This analysis is the same regardless of whether the specified amount of distinct commodities is transferred at a point in time or over time as part of a series.

Example 6.6.10

Variable consideration allocated entirely to barrels delivered at the associated spot rate

Upstream Energy Co. (UEC) enters into a four-year non-cancellable contract with Customer to sell 10,000 BBLs/day of Light Sweet crude oil. The oil is priced at the NYMEX WTI spot rate on the day it is delivered to Customer. As a result, the contract includes variable consideration.

UEC concludes that its contract with Customer contains 10,000 separate performance obligations per day because each barrel of oil is capable of benefiting Customer on its own and is separately identifiable. UEC also concludes control of each barrel transfers at a point in time because the commodity is not simultaneously received and consumed by Customer (see Question 7.3.30).

UEC concludes it should allocate the variable consideration to each BBL based on the following.

— Criterion (a) in section 6.6.20 is met because the variable payment (i.e. the daily spot rate) relates specifically to its efforts to satisfy the performance obligation.

— Criterion (b) in section 6.6.30 is met because the market-based pricing reflects the amount to which UEC would expect to be entitled in exchange for transferring the oil.

As a result, UEC recognizes revenue equal to the barrels of oil delivered times the spot rate on the day of delivery.

Example 6.6.20

Variable consideration plus a fixed differential allocated entirely to barrels delivered at the associated spot rate

Assume the same facts as in Example 6.6.10, except that the oil quality and location of delivery is different and the contract is priced at:

— the NYMEX WTI spot rate on the day it is delivered to Customer; plus

— a fixed differential of $3/BBL to compensate UEC for quality and location differences from the crude oil used as the basis for the market-based rate. This differential is considered fixed consideration in the contract.

Despite the presence of a fixed differential, UEC concludes that the variable amounts should be allocated to each BBL based on the following.

- Criterion (a) in section 6.6.20 is met because the variable payment (i.e. the daily spot rate) relates specifically to its efforts to satisfy the performance obligation.
- Criterion (b) in section 6.6.30 is met because allocating the variable amount entirely to the oil delivered is consistent with the allocation objective. This is because the market-based pricing plus the differential reflects the amount to which UEC would expect to be entitled in exchange for transferring the oil given its quality and location.

As a result, UEC recognizes the variable consideration when the barrels of oil are delivered. In addition, UEC allocates the fixed consideration on a relative stand-alone selling price basis to each BBL. UEC considers the fixed differential when developing its 'backlog' disclosure (see section 15.7.10).

6.7 Allocate variable consideration to distinct goods or services within a series

6.7.10 Overview

The variable consideration allocation exception applies not only to the allocation between the performance obligations in a contract but also to portions of a performance obligation that is considered a series. That is, when the criteria are met (see section 6.6), variable consideration is allocated entirely to a distinct good or service that is part of a series (single performance obligation). As a result, to apply the allocation guidance it is critical in Step 2 to determine if a performance obligation is a series (see section 4.4).

The following excerpt explains the FASB's rationale for allocating variable consideration to portions of a single performance obligation – i.e. distinct goods or services that comprise a single performance obligation.

Excerpt from ASU 2014-09

BC285. The Boards clarified in paragraph 606-10-32-39(b) that variable consideration can be allocated to distinct goods or services even if those goods or services form a single performance obligation. The Boards made this clarification to ensure that an entity can, in some cases, attribute the reassessment of variable consideration to only the satisfied portion of a performance obligation when that performance obligation meets the criterion in paragraph 606-10-25-14(b). Consider the example of a contract to provide hotel management services for one year (that is, a single performance obligation in accordance with paragraph 606-10-25-14(b)) in which the consideration is variable and determined based on two percent of occupancy rates. The entity provides a daily service of management that is distinct, and the uncertainty related to the consideration also is resolved on a daily basis when the occupancy occurs. In those circumstances, the Boards did not intend for an entity to allocate the variable consideration determined on a daily basis to the entire performance obligation (that is, the promise to provide management services over a one-year period). Instead, the variable consideration should be allocated to the distinct service to which the variable consideration relates, which is the daily management service.

The excerpt above describes a performance obligation for hotel management services that is a series of distinct days. In that example, the entity charges its customer a variable daily amount based on a percentage of occupancy fees. Without the variable consideration allocation exception for a series, the daily fees would be allocated to the entire performance obligation and recognized as that performance obligation is satisfied using a single measure of progress. [ASU 2014-09.BC285]

Instead, the FASB stated that it did not intend for entities to allocate the variable consideration to the entire performance obligation in situations such as this. Rather, when the variable consideration allocation criteria are met, the entity should allocate the variable amounts to the days to which they relate. For example, if sales occupancy fees were $1,000 on Day 1 and $2,000 on Day 2, based on the 2% rate charged, the entity would allocate $20 to Day 1 and $40 to Day 2 and so forth. Practically, the entity does not have to estimate the amounts because they are known each day and are also recognized as revenue that day. [ASU 2014-09.BC285]

Similarly, a performance bonus related to a specific period that meets the variable consideration allocation criteria could be allocated to that period rather than the entire performance obligation. Example 25 in Topic 606 (see section 15.8 for a reproduction of the example) illustrates the allocation of a variable quarterly management fee to each quarter within a five-year contract. In that scenario, the fee is estimated during and recognized over the period to which the fee relates rather than the entire five-year contract. Similar to the hotel management example, practically an entity would not need to estimate the fee related to future quarters to account for the current quarter. [606-10-55-221 – 55-225]

Another potential result of allocating variable consideration to portions of a series is that different payment streams could be recognized over different time periods. Although an entity cannot use multiple measures of progress for a single performance obligation (see Question 7.4.10), if consideration is allocated to different distinct goods or services in a series, those amounts can be recognized over different time periods. This is acceptable because it is a result of the allocation guidance and not of applying multiple measures of progress. By definition, each distinct good or service within a series has to have the same measure of progress. Example 25 in Topic 606 illustrates this outcome because the quarterly management fee is recognized in each quarter while the five-year performance fee is allocated to the entire performance obligation. [606-10-55-221 – 55-225]

The TRG discussed the allocation of variable consideration in a long-term service contract with a single performance obligation and expanded on the discussion of when it is appropriate to allocate variable amounts to distinct services within a series. The TRG agreed on the following. [TRG 07-15.39]

— The variable consideration allocation guidance is an exception to the general allocation model, and therefore a relative stand-alone selling price allocation is not required. However, an entity could use stand-alone selling prices to support the reasonableness of the allocation.

— Judgment is necessary to determine when the criteria in section 6.6.10 have been met. In particular, criterion (b) could be challenging because Topic 606 does not provide prescriptive guidance on how to make that determination (see Questions 6.6.40, 6.6.50, 6.7.30, 6.7.40 and 6.7.60).

The TRG discussed several fact patterns where an entity could meet the criteria to allocate variable consideration and recognize that variable consideration in the same period. Those examples included fact patterns related to IT outsourcing, transaction processing, hotel management and licenses of symbolic IP. See Question 6.7.30 for further discussion of evaluating the requirements.

However, the TRG did not discuss all fact patterns in which the variable consideration allocation guidance could or could not be applied. For example:

— The fact patterns discussed represent simplified pricing structures. Entities need to carefully evaluate their own facts and circumstances before concluding that the criteria to allocate variable consideration have been met (see Questions 6.7.10 to 6.7.60).

— The TRG only discussed fact patterns with a single performance obligation and did not discuss allocating variable consideration between multiple performance obligations (see Questions 6.7.70 and 6.7.80).

— The TRG only discussed performance obligations that were a series of distinct service periods (i.e. time periods) while other performance obligations could be a series of distinct quantities (see Question 6.7.100).

Question 6.7.10

Is the same amount (absolute value) required to be allocated to each distinct good or service within a series?

Interpretive response: No. The TRG agreed that the allocation of variable consideration to a distinct service period within a stand-ready obligation that is a series would not need to result in the same amount (absolute value) being allocated to each service period within the performance obligation. [TRG 07-15.39]

For example, an annual contract to perform services may consist of daily distinct service periods and the allocation is not required to result in each day having the same amount of variable consideration allocated to each day. [TRG 07-15.39]

Question 6.7.20

Does the presence of a fixed fee affect the analysis of whether variable amounts can be allocated entirely to a distinct good or service within a series?

Interpretive response: It depends. In a contract with a single performance obligation, the presence of a fixed fee generally will not affect the analysis of whether the variable amounts can be allocated entirely to a distinct good or service within the single performance obligation. That is because a fixed fee is recognized as the entire performance obligation and cannot be specifically allocated to a distinct good or service within that performance obligation. Therefore, the same amount of the fixed fee is allocated to each distinct good or service and the analysis of the variable fee would be the same with or without the fixed fee.

However, in a contract with multiple performance obligations, an entity considers the allocation of the fixed fee in order to determine whether the allocation objective is met (see Questions 6.7.70 and 6.7.80).

Question 6.7.30

How does an entity evaluate whether the allocation objective has been met when allocating variable consideration to a distinct good or service in a series?

Interpretive response: The TRG discussed several fact patterns in which an entity could meet the criteria to allocate variable consideration to distinct time increments (e.g. day, month, year) within a series. Those examples included fact patterns related to IT outsourcing, transaction processing, hotel management and licenses of symbolic IP. [TRG 07-15.39]

In those examples, the performance obligation was a series of time increments and the variable consideration was in some cases a usage-based fee (e.g. IT outsourcing, transaction processing, monthly hotel occupancy fees), a bonus (annual bonus for the hotel management fee) or sales-based royalties (e.g. for the symbolic IP). [TRG 07-15.39]

Based on the TRG discussion, the following factors (not exhaustive) may be helpful in evaluating whether variable amounts can be allocated to a distinct good or service period within a series and, in particular, whether the allocation objective (criterion 606-10-32-40(b)) has been met. [TRG 07-15.39]

— **Consistency in prices.** When the variable pricing is based on a per unit amount or formula and that pricing is consistent throughout the contract, that may indicate that the variable pricing depicts the amount of consideration to which the entity would expect to be entitled for providing services each distinct service period. Because each distinct service period is substantially the same, we would expect the entity to price each period in a similar manner unless the entity can support the reasons for changing prices. However, this factor may not be relevant when evaluating an allocation between two performance obligations. See Question 6.7.40 for further information on a contract with a consistent price per transaction.

— **Price is commensurate with the price charged separately.** The entity (or other entities) charging a commensurate price per transaction or per user (or using another formula on a stand-alone basis) might indicate that the price charged depicts the amount to which the entity would expect to be entitled for transferring a distinct service. For example, regularly charging a similar price per user per month to a customer class might indicate that the pricing for each distinct period may depict the price that the entity would expect to sell each increment of service on a stand-alone basis. This factor is particularly relevant when evaluating the allocation of variable fees in contracts with multiple performance obligations. For example, in a contract to provide two distinct performance obligations with transaction-based pricing, an allocation based on the contractual prices would not satisfy the allocation objective if the price for one service includes amounts attributable to the other service.

— **Consideration is commensurate with the value or benefit to the customer.** A variable fee that reflects the value or benefit transferred to the customer during a distinct service period may indicate that the allocation objective is met. For example, a fee based on usage that is resolved each day – e.g. a hotel management contract fee that is based on a percentage of daily room fees – may reflect the value to the customer in that period because the customer used or benefitted from the service more frequently in that period. Similarly, each annual performance bonus in a multi-year contract may reflect the performance of the entity and value delivered to the customer in that annual period. In the case of an annual bonus, the bonus would be allocated entirely to the annual period and recognized over that time period based on the measure of progress for the performance obligation.

— **Consideration is commensurate with the entity's efforts to fulfill the service.** A variable fee that reflects the entity's efforts to fulfill the service may indicate that the allocation objective is met. For example, the TRG discussed a contract for hotel management services and noted that reimbursement of variable fulfillment costs (e.g. labor costs) in each distinct period is consistent with the allocation objective (see section 6.2). That is because an entity typically expects to be entitled to a different amount for each distinct service period based on the costs incurred during that time period.

— **Pricing is consistent with the entity's customary pricing practices.** Similar to how an entity establishes stand-alone selling price for a good or service, an entity should evaluate its customary pricing practices to evaluate whether a variable amount depicts the amount to which the entity expects to be entitled for transferring the goods or services. An entity should evaluate all reasonably available data points, market conditions, entity-specific factors and information about the class of customer.

— **Changing prices.** Additional considerations are required when the variable prices change over the contract period even if those changes are consistent with the entity's customer pricing practices. The price may change based on prior usage such as volume rebates, or simply based on the passage of time. See Question 6.7.50 for considerations with tiered pricing and Question 6.7.60 for prices that change over time.

Question 6.7.40

What are the key factors to consider when evaluating whether a consistent per transaction or per usage fee meets the variable consideration allocation guidance in a contract with a single series?

Interpretive response: When a performance obligation comprises a series of distinct service periods – e.g. a series of distinct daily, monthly or annual periods of service (see section 4.4) – allocating the transaction- or usage-based fees to the distinct service period in which the fee is earned is appropriate when both criteria to allocate variable consideration are met. [606-10-32-40]

Criterion (a) – Variable payment relates specifically to the entity's efforts to transfer the distinct good or service

When per transaction or per usage pricing is consistent throughout the contract term, this criterion (see section 6.6.20) is typically met. That is because this criterion is met when the fee is:

— linked to the usage of the service (e.g. transactions processed) by the customer during a distinct service period or a result of the entities efforts (e.g. a percentage of hotel revenues during the period); *and*

— resolved as to its ultimate amount within a distinct service period (e.g. the fee is not dependent upon past performance or subject to change based on future usage).

For example, if a contract for transaction processing establishes a fee of $1 per transaction processed that does not change based on the level of usage, criterion (a) is met for each day of service provided because the fees relate specifically to the customer's usage during that distinct service period. That is, the pricing is not dependent upon transferring past or future distinct services.

In contrast, if the $1 fee changes retrospectively based on usage during an entire annual period or the pricing is tiered such that the price of future usage decreases, criterion (a) is *not* met for each day. For example, this would be the case if the $1 fee is retroactively adjusted to $0.90 per transaction or the fees are $1 for first 100 transactions and $0.90 for next 100 transactions. That is because in those scenarios the variable amounts in each day are dependent upon usage or performance in future (in the retrospective example) or past (in the tiered example) distinct service periods. However, the variable amounts could meet the criteria to be allocated to the *year* of the performance obligation, rather than each day. This may be the case if the cumulative pricing resets each year. See Question 6.7.50 for further discussion of cumulative discounts and rebates.

Criterion (b) – Allocation is consistent with the allocation objective

When per transaction or per usage pricing is consistent throughout the contract term, criterion (b) (see section 6.6.30) is typically met. That is because the focus of this criterion is on the per transaction pricing structure throughout the contract rather than the estimated transaction or usage volumes for each distinct service period (e.g. each day, month, quarter or year). That is, during each distinct period the entity expects to be entitled to a different amount of consideration based on the customer's varying usage of the services (e.g. 100,000 transactions processed in Month 1; 107,000 processed in Month 2; 98,500 in Month 3). As a consequence, it is generally the transaction pricing structure that determines whether this criterion is met.

When the transaction-based pricing structure remains consistent among the distinct service periods that comprise a series, the varying amounts of consideration to which the entity expects to be entitled each period, which are driven by the transaction volume, generally meet the allocation objective. This is because those changing amounts each period reflect changes in the value to the customer.

As discussed in Question 6.7.20, the presence of a fixed fee generally does not affect the analysis of whether the variable amounts can be allocated entirely to a distinct service period within the single performance obligation. However, contracts will often be more complex and the analysis can become more challenging in contracts with multiple performance obligations or more complex pricing structures and there may be cases in which this criterion is not met as a result. See Questions 6.7.50 to 6.7.80.

It is also possible an entity would be able to recognize revenue for an arrangement that includes transaction- or usage-based pricing using the 'as-invoiced' practical expedient. Questions 7.4.60 to 7.4.110 discuss when the 'as-invoiced' practical expedient can be applied.

Example 6.7.10
Transaction-based fees allocated to the period they were earned

Transaction Processor enters into a contract with Customer to process an unlimited amount of Customer's transactions for one year. The arrangement consideration consists of a fixed upfront fee of $1,000 and $5 per transaction processed. The quantity of transactions that will be processed is not known and will be billed on a monthly basis.

Transaction Processor concludes the following:

— The contract consists of a single performance obligation satisfied over time to provide Customer with continuous access to the transaction processing platform.

— The performance obligation is a series of distinct days of service and that a time-based measure of progress is appropriate for the performance obligation (see section 4.4).

— The variable amounts per transaction should be allocated to the distinct service period (each day) in which the transaction is processed because:
  – criterion (a) in section 6.6.20 is met. The variable amounts relate specifically to the customer's usage of the transaction processing service that day; and
  – criterion (b) in section 6.6.30 is met. Allocating the transaction-based fees to each day is consistent with the allocation objective – each day has a similar pricing structure and the fixed fee is allocated to all of the days in the contract.

— The fixed fee is attributable to the entire performance obligation and is recognized ratably over the contract period.

Customer processes the following transactions during the year.

Quarter	Transactions processed	Transaction-based amount billed
Q1	100	$500
Q2	75	$375
Q3	150	$750
Q4	125	$625

Because the variable amounts are attributed entirely to each day within a given quarter, the following revenue is recognized each quarter by Transaction Processor.

Quarter	Fixed fee[1]	Variable fees	Total revenue
Q1	$ 250	$ 500	$ 750
Q2	250	375	625
Q3	250	750	1,000
Q4	250	625	875
Total	**$1,000**	**$2,250**	**$3,250**

Note:

1. The total $1,000 fixed fee is recognized ratably over the year using a time-based measure of progress.

As discussed in Question 7.4.10, an entity cannot use multiple measures of progress for a single performance obligation. In this example, the variable fees are allocated to each quarter and the fixed fees are allocated to the entire performance obligation. However, because those fees are only allocated to a quarter rather than to the entire performance obligation, they are recognized only over the distinct period to which the fees are allocated. The variable and fixed fees being recognized over a different period is a result of the allocation guidance and not applying multiple measures of progress to a single performance obligation.

Question 6.7.50

How do volume-based discounts and rebates affect the allocation of variable consideration within a series?

Interpretive response: Pricing arrangements that include volume-based discounts or rebates sometimes apply to an entire contract term or to distinct periods within the contract that has variable consideration. For example, a tiered-pricing or volume rebate/credit structure may apply to each month, quarter or year within a longer-term service arrangement and reset at the beginning of the next distinct period.

There are many different transaction- and usage-based pricing structures that exist and they frequently co-exist with varied fixed price components. The following are examples of tiered pricing in arrangements with variable consideration.

— Per transaction pricing that decreases *prospectively* as the customer makes greater use of the provider's service. For example, the customer is required to pay $0.10 per transaction for the first 100 transactions; $0.09 per transaction for the next 100; and $0.075 per transaction for those above 200.

— Per transaction pricing that decreases as the customer makes greater use of the provider's service on a *retrospective* basis. For example, the customer is required to pay $0.10 per transaction for the first 100 transactions; if the customer reaches that milestone, it will pay $0.09 on all transactions going forward *and* receive a rebate (or credit toward future transaction fees) of $0.01 on each of the first 100 transactions processed.

When a service contract has these types of pricing structures, an entity generally will not be able to allocate usage-based fees to a distinct period shorter than the contractual period over which the pricing is resolved or reset because the criterion in paragraph 606-10-32-40(a) would not be met. That is, because when the price per transaction is dependent on a previous purchase, the variable amount relates to multiple periods. However, just because the variable amounts relate to multiple periods does not necessarily mean the fees must be allocated to the entire performance obligation.

For example, assume that a contract has a single performance obligation to provide three years of transaction processing, with transaction-based pricing.

— If a discount or rebate is earned over the entire three-year period (e.g. based on three-year cumulative transaction volumes), then the variable consideration is attributable to the entire performance obligation. When considering the criterion in paragraph 606-10-32-40(a), the variable consideration (such as transaction-based fees) earned on any given day relates to the entire performance obligation because those amounts are dependent on previous or future transactions processed throughout the entire three-year period.

— If the measurement period for a discount or rebate resets during the performance obligation period – e.g. resets each quarter or year of the three-year term – the variable amounts earned each measurement period relate specifically to that period and are allocated entirely to that measurement period assuming the other criterion in paragraph 606-10-32-40(b) is met.

Example 6.7.20
Tiered pricing

Transaction Processor enters into a contract with Customer to process an unlimited amount of Customer's transactions for one year. The arrangement consideration consists of a fixed upfront fee and tiered per transaction pricing that resets on a quarterly basis. The per transaction pricing, which resets each quarter, is as follows.

Quantity processed	Price per transaction
0 – 1,000	$10
1,001 – 5,000	$8
> 5,000	$5

Transaction Processor concludes the following.

— The contract consists of a single performance obligation to provide continuous access to the transaction processing system that is simultaneously provided to and consumed by Customer.

— The performance obligation is a series of distinct days of service.

— Because of the upfront fee and tiered pricing, it does not qualify to apply the as-invoiced practical expedient (see Questions 7.4.70 and 7.4.90) and determines that a time-based measure of progress is appropriate for the performance obligation.

Next, Transaction Processor concludes that it should apply the variable consideration allocation exception.

— Criterion (a) in section 6.6.20 is met for each quarter. The pricing resets each quarter such that the variable amounts earned from each transaction processed relate specifically to Transaction Processor's efforts to provide the service in the quarter in which the transaction is processed. In its analysis of criterion (a), Transaction Processor considered whether to allocate the variable consideration to a shorter period, such as each distinct day of service. However, because the amount earned on each transaction is dependent on the previous purchases during the quarter, the variable consideration relates to the entity's efforts to transfer distinct services for all of the days in the quarter.

— Criterion (b) in section 6.6.30 is met for each quarter. Allocating the amounts to each quarter meets the allocation objective because each quarter has a consistent price structure throughout the term of the contract (see Question 6.7.40).

Transaction Processor needs to estimate the variable amounts (and update that amount until the end of the contractual quarter) that will be earned each quarter and recognize those amounts using a time-based measure of progress. If the contractual quarters are aligned with the entity's quarterly reporting periods, then practically Transaction Processor could recognize the amounts as the transactions are billed and achieve the same outcome for the reporting period.

However, often the contractual quarterly periods will not align with the entity's quarterly reporting periods. In that case, Transaction Processor will need to estimate the transaction volumes for the contractual quarterly periods and update the estimate each reporting period. This would be the case even though Transaction Processor will not need to estimate transaction volumes for the full one-year term. The requirement to update the estimate could result in a cumulative-catch adjustment during the quarter.

Question 6.7.55

How do guaranteed minimums affect the allocation of usage-based fees within a series?

Interpretive response: It depends. It is common for service providers that charge customers variable consideration in the form of usage- or transaction-based fees to require a customer to pay for a guaranteed amount of usage. For example, an entity may charge a customer $5 per transaction, but require the customer to pay for a minimum of 1,000 transactions per year. Substantive minimums represent fixed consideration.

When a performance obligation comprises a series of distinct service periods – e.g. distinct daily, monthly or annual periods of service (see section 4.4) – and a minimum is a substantive term in the contract, the entity needs to evaluate the variable consideration allocation criteria to determine if the amounts in excess of the minimum should be allocated to a distinct service period. The variable consideration allocation criteria are detailed in sections 6.6.20 and 6.6.30.

An exception exists if an entity meets the 'as-invoiced' practical expedient criteria and chooses to apply the expedient. In that case, it does not need to evaluate the variable consideration allocation guidance. Questions 7.4.60 to 7.4.110 discuss when the as-invoiced practical expedient can be applied, including when it can be applied if the arrangement includes a minimum guarantee.

Practically, there are other scenarios when an entity may not need to evaluate the variable consideration allocation criteria because the accounting outcome would not be significantly affected. For example, when an output-based measure of progress based on usage is appropriate, applying that measure would achieve the same result as allocating the variable amounts to each period if:

- the price per use or transaction is the same for the minimum and excess quantities; and
- there are no other significant fees other than fixed fees that would be allocated to the performance obligation and recognized using the same output-based measure of progress.

If such a scenario does not exist and an entity does need to evaluate the variable consideration criteria, the following are relevant considerations for its analysis.

Criterion (a) – Variable payment relates specifically to the entity's efforts to transfer the distinct good or service

When a contractual minimum exists, the contract will generally meet criterion (a) for the entire period covered by the contractual minimum but not for distinct periods within the larger period covered by the contractual minimum. A contract will generally meet criterion (a) for the entire period covered by the contractual minimum because the amounts in excess of the minimum relate to either the entity's efforts in transferring the distinct service, or an outcome (e.g. usage) of transferring the service over the entire contractual minimum service period. For example, when a contract has an annual minimum, any amounts in excess of the minimum during the year will generally meet criterion (a) to be allocated to the year.

However, criterion (a) will generally not be met for distinct periods within the larger period covered by the substantive contractual minimum. That is because the variable amounts are triggered only after usage in previous periods and therefore relate to the usage in the entire period rather than a specific day or month (see Question 6.6.30). For example, when a contract has a substantive annual minimum, any amounts in excess of the minimum will generally not meet criterion (a) to be allocated to the month when the minimum is exceeded; this is because the excess variable amounts relate to cumulative usage for all preceding months within that year.

If criterion (a) is met, the entity still needs to consider whether allocating the variable amount in excess of the minimum to a distinct good or service is consistent with the allocation objective.

Criterion (b) – Allocation is consistent with the allocation objective

To assess criterion (b), an entity needs to consider all the performance obligations and payment terms in the contract, including the minimum guaranteed amount. If allocating the amounts in excess of the minimum to one or more, but not all, distinct service periods does not reflect what an entity expects to be entitled to for those service periods, the allocation objective is not met.

In general, the same considerations discussed in Question 6.7.30 – involving whether the allocation objective has been met when allocating variable consideration to a distinct good or service in a series – apply to contracts with a minimum. In addition, the following are also relevant to the analysis of criterion (b) and are illustrated in Example 6.7.25 below:

- the considerations discussed in Question 6.7.60 involving whether changes in variable pricing during the contract term preclude allocating variable consideration to distinct time increments, which may apply if the minimum changes from period to period; and
- how the measure of progress used to recognize the fixed fees (including the minimum) affects the total amounts recognized in each period and whether those results are consistent with the allocation objective.

Conclusion

If both criteria are met for the period with a substantive contractual minimum, an entity allocates the variable amounts to that period and recognizes the variable amounts using the same measure of progress as the fixed fees. As a result, the entity estimates excess variable amounts for the entire contractual minimum period and recognizes those amounts over that period. However, if the contractual minimum period is a month or a quarter that does not cross reporting periods, then practically the entity will not need to estimate because the amounts will be known for the reporting period.

Example 6.7.25
Allocating variable consideration with a guaranteed minimum

ABC Co. enters into a contract with Customer to provide a single stand-ready service for three years that is a series of distinct days of service. ABC charges Customer a usage-based fee that is considered variable consideration. In addition, ABC charges a nonrefundable upfront fee of $5,000 in exchange for set-up activities that do not transfer a good or service to the customer. ABC concludes that there is no material right as a result of the upfront fee.

ABC concludes that it cannot apply the as-invoiced practical expedient as a result of the upfront fee (see Question 7.4.70). Further, ABC concludes that a time-elapsed measure of progress is appropriate for the stand-ready performance obligation; this is because ABC expects its costs and effort of standing ready to be consistent regardless of transaction volume.

Note that ABC would recognize contractual minimums and variable fees differently than the scenarios below if an output-based measure of progress were determined to be appropriate.

Scenario 1: Annual minimum

ABC charges a usage-based fee of $5 per transaction and the contract requires Customer to pay a guaranteed minimum of 1,000 transactions for each annual period (i.e. 3,000 transactions are guaranteed for the entire contract) and this minimum is substantive. Customer's usage above 1,000 transactions in any annual period results in additional consideration of $5 per transaction to ABC.

ABC concludes that variable amounts in excess of the minimum should be allocated to the annual period in which they are earned under the contract because both variable consideration allocation criteria are met for the annual period.

— Criterion (a) in section 6.6.20 is met for the annual period. The variable amounts relate specifically to Customer's usage of the service during the annual period because the excess amounts earned in the annual period are not dependent on transactions in a previous or future annual period.

— Criterion (b) in section 6.6.30 is met. The allocation of excess variable amounts to the annual period in which they are earned under the contract is consistent with the allocation objective; this is because the excess amounts earned are commensurate with the benefit to Customer (i.e. transactions processed) during that annual period and the pricing is consistent in each annual period.

However, ABC cannot allocate the excess fees earned in an annual period entirely to the day, month or quarter in which the excess fees are earned under the contract because criterion (a) in section 6.6.20 is not met with respect to those shorter periods. For example, if Customer exceeds 1,000 transactions for Year 1 in Month 9, the excess variable amounts that ABC earns under the contract in Month 10 cannot be allocated solely to Month 10; this is because those excess amounts depend on the cumulative transactions in Months 1–9.

At the beginning of each annual period in the contract, ABC estimates the variable amounts for the annual period subject to the constraint and recognizes that amount on a time-elapsed basis over the annual period. At each reporting date within an annual period, ABC reassesses its estimate of the excess variable amounts for the annual period and updates the amount recognized during the annual period on a time-elapsed basis.

The entire fixed consideration in the contract of $20,000 (upfront fee of $5,000 + guaranteed amount of $15,000 (3,000 transactions × $5 per transaction)) is recognized on a time-elapsed basis over the three-year contract term. In any given month during the contract period, ABC recognizes 1/36th of the fixed consideration of $20,000 plus 1/12th of the estimated excess variable amounts for the respective annual period. ABC allocates changes in estimates of the excess variable amounts for an annual period evenly to each month within that annual period and recognizes a cumulative catch-up adjustment for previous months in an annual period in the month its estimate changes.

Scenario 2: Monthly minimum

Assume the same facts as Scenario 1, except that the substantive minimum is based on monthly usage of 100 transactions that resets each month – i.e. 3,600 transactions are guaranteed for the entire three-year contract.

ABC concludes that variable amounts in excess of the minimum should be allocated to each monthly period in which they are earned under the contract because both variable consideration allocation criteria are met for each monthly period.

— Criterion (a) in section 6.6.20 is met for the monthly period. The variable amounts relate specifically to Customer's usage of the service during the monthly period because the excess amounts earned in the monthly period are not dependent on transactions in a previous or future month.

— Criterion (b) in section 6.6.30 is met. The allocation of excess variable amounts to the monthly period in which they are earned under the contract is consistent with the allocation objective; this is because the excess amounts earned are commensurate with the benefit to Customer (i.e. transactions processed) during that month and the pricing in each period is consistent.

ABC allocates any excess variable amounts to the months in which they are earned under the contract. The entire fixed consideration in the contract of $23,000 (upfront fee of $5,000 + guaranteed amount of $18,000 (3,600 transactions × $5 per transaction)) is recognized on a time-elapsed basis over the three-year contract term.

Scenario 3: Changing minimums – allocation objective not met

Assume the same facts as Scenario 1, except that the annual minimum increases over time:

— 1,000 transactions in Year 1;
— 2,000 transactions in Year 2; and
— 3,000 transactions in Year 3.

Additionally, ABC expects at contract inception that it will process a similar amount of transactions each year (about 3,000) and does not anticipate a change in the costs of providing the service over the contract period.

ABC concludes that the variable amounts relate to the entire contract and that it cannot allocate variable amounts to the annual period in which they are earned because criterion (b) in section 6.6.30 is not met. ABC concludes that criterion (b) is not met because each year is not priced consistently and the change in minimums over the period is not commensurate with a change in value to the customer, effort or cost.

In reaching this conclusion, ABC considered the allocation that would result from allocating variable amounts in each period along with the other consideration. ABC expects Customer's usage to be approximately 3,000 transactions each year; because fixed consideration is recognized evenly over each annual period, allocating the variable amounts to each year would result in the following amount of revenue recognized in each annual period.

Hypothetical allocation – allocation objective not met

Annual period	Expected usage	Variable amounts	Fixed fees recognized	Allocate to each annual period
Year 1	3,000	$ 10,000[1]	$ 11,667[3]	$ 21,667
Year 2	3,000	5,000[2]	11,667[3]	16,667
Year 3	3,000	0	11,666[3]	11,666
Total	**9,000**	**$ 15,000**	**$ 35,000**	**$ 50,000**

Notes:

1. 2,000 transactions (3,000 expected usage – 1,000 minimum) × $5/transaction.
2. 1,000 transactions (3,000 expected usage – 2,000 minimum) × $5/transaction.
3. $35,000 fixed fees ($5,000 upfront fee + $30,000 guaranteed minimum (6,000 transactions × $5/transaction)) / 3 years.

By allocating variable amounts to the annual period in which they are earned, ABC would recognize decreasing revenue (i.e. $21,667 in Year 1, $16,667 in Year 2 and $11,667 in Year 3) despite providing the same level of stand-ready service to Customer (with consistent expected costs). Therefore, ABC concludes that the allocation objective is not met.

Instead, ABC estimates total variable consideration for all three years in the contract subject to the constraint and includes that amount in the transaction price. The total transaction price (both variable and fixed) is recognized on a time-elapsed basis over the three-year contract period. At each reporting date, ABC reassesses its estimate of the excess variable amounts for the entire contract and updates the transaction price.

Scenario 4: Changing minimums – allocation objective met

Assume the same facts as Scenario 3, except that ABC expects Customer's usage to increase each year in an amount that is commensurate with the increasing annual minimums. The result in this fact pattern is different from Scenario 3 in which Customer's usage is estimated to remain constant despite increasing annual minimums.

ABC concludes that variable amounts in excess of the minimum should be allocated to the annual period in which they are earned under the contract because both variable consideration allocation criteria are met for the annual period.

- Criterion (a) in section 6.6.20 is met for the annual period. The variable amounts relate specifically to Customer's usage of the service during the annual period because the excess amounts earned in the annual period are not dependent on transactions in a previous or future annual period.
- Criterion (b) in section 6.6.30 is met for the annual period. While the minimums increase each year, the increase is commensurate with the expected value to the customer and expected usage. When considering all of the payment terms, ABC observes that it would recognize a consistent amount of revenue in each annual period based on expectations of usage that is commensurate with the entity's time-elapsed measure of progress.

Allocation objective is met

Annual period	Expected usage	Variable amounts	Fixed fees recognized	Allocate to each annual period
Year 1	2,000	$ 5,000[1]	$ 11,667[4]	$ 16,667
Year 2	3,000	5,000[2]	11,667[4]	16,667
Year 3	4,000	5,000[3]	11,666[4]	16,666
Total	**9,000**	**$ 15,000**	**$ 35,000**	**$ 50,000**

Notes:

1. 1,000 transactions (2,000 expected usage – 1,000 minimum) × $5/transaction.
2. 1,000 transactions (3,000 expected usage – 2,000 minimum) × $5/transaction.
3. 1,000 transactions (4,000 expected usage – 3,000 minimum) × $5/transaction.
4. $35,000 fixed fees ($5,000 upfront fee + $30,000 guaranteed minimum (6,000 transactions × $5/transaction)) / 3 years.

Based on this conclusion, ABC:

- estimates the variable amounts subject to the constraint for each annual period in the contract at the beginning of each annual period, and recognizes that amount on a time-elapsed basis over the respective annual period;

- at each reporting date within an annual period, reassesses its estimate of the excess variable amounts for that annual period and updates the amount recognized on a time-elapsed basis. Changes in estimates of the excess variable amounts for the annual period are allocated evenly to each month within that annual period, and a cumulative catch-up adjustment is recognized for previous months in an annual period in the month the estimate changes; and
- recognizes the fixed consideration in the contract of $35,000 (upfront fee of $5,000 + guaranteed amount of $30,000 (6,000 transactions × $5 per transaction)) on a time-elapsed basis over the entire three-year contract term ($11,667 per year).

Question 6.7.60

Do changes in variable pricing during the contract term (other than volume-based discounts/rebates) preclude an entity from allocating a variable amount to the period in which it is earned?

Interpretive response: Not necessarily. Service arrangements that include variable fees may have rates or formulas that increase or decrease over the contract term and those changes are not based on either the entity's or customer's performance – i.e. the contract price or formula changes based on factors outside of either party's control, such as the passage of time or changes in market prices or other relevant indices. For example, a contract could include per transaction pricing that changes in each year, such as $0.10 per transaction for Year 1, $0.09 per transaction for Year 2 and $0.075 per transaction for Year 3. In contrast to volume-based discounts or rebate scenarios described in Question 6.7.50, the change in price is not dependent on either the customer's usage or the entity's performance in prior or future periods.

The TRG agreed that in some facts and circumstances an entity could allocate variable amounts entirely to the distinct service period in which they are earned when the price charged per transaction decreases each year and the change is not dependent on either the entity or customer's performance in the prior period. The TRG specifically discussed an example of IT outsourcing in which the price decrease is consistent with market terms and is linked to changes in costs to fulfill the service. [TRG 07-15.39]

In addition to the factors discussed by the TRG (linkage to market terms or changes in cost structure), there may be other factors that would allow an entity to meet the allocation objective. However, an entity would need evidence to support that the pricing in the period depicts the amount to which it would expect to be entitled in exchange for transferring the distinct good or service. Therefore, together with the discussion by the TRG, the following additional factors may be helpful in assessing whether the allocation objective is met when there are changing prices or formulas.

- **Whether the change in price is commensurate with a change in value to the customer.** The market price of goods or services may change over time due to technological advances, market competition or increased efficiencies. When market prices change, the value received by the customer for the services could also change and the amount to which the entity expects to be entitled for providing the services may change. An entity should support this consideration by evaluating the following (not exhaustive).

  – ***The entity's historical pricing practices and trends.*** Historical pricing trends showing that stand-alone pricing changes in a similar manner may indicate that the pricing reflects what the entity expects to be entitled to in those periods. For example, a history of price decreases in annual contracts may support a similar decrease from Year 1 to Year 2 in a two-year contract.
  – ***Prices charged by competitors for similar services.*** Prices decreasing over time because competition in the marketplace makes the goods or services less expensive each year may indicate that the rates in future periods are consistent with what the entity would expect to charge for the services in the future period.
  – ***The changes in price are commensurate with changes in the effort or cost of fulfilling the service.*** Changes in the entity's cost could also reflect a change in market value. See the discussion below for further considerations about changes in cost or effort required to fulfill the services.

— **Whether the changes are commensurate with (or based on) a market index.** For example, price increases each year based on a relevant market index indicate that the price in each period depicts what the entity would charge in those periods. Allocating a change in price based on an inflation index is consistent with the allocation objective. [606-10-32-40(b)]

— **Whether the change in price is commensurate with the effort or cost required to fulfill the services.** Decreases over time in the entity's cost of performing the services may indicate that the price charged in future years depicts the amount to which the entity expects to be entitled for services in those periods. For example, the TRG discussed an IT outsourcing contract in which the rate charged for the activities underlying the IT service obligation reflects the increased complexity of the underlying activities that will be performed earlier in the contract period versus later in the contract period, requiring more experienced (i.e. more costly) personnel to perform the activities at the outset.

Notwithstanding the above, if prices change because of an incentive for the customer to enter into the contract or pricing in one period reflects value attributable to another period, the allocation objective likely is not met.

Example 6.7.30
Changing prices – allocation objective is met

Outsourcer provides IT outsourcing to customers for which customers pay a fixed upfront fee and variable amounts based on millions of instructions per second of computing power (MIPs) and the number of employees supported.

Outsourcer enters into a contract with Customer to use Outsourcer's services for three years. Outsourcer concludes that the contract consists of a single performance obligation satisfied over time. Outsourcer also concludes that the performance obligation is a series of distinct days of service (see Example 4.4.10) and that a time-elapsed measure of progress is appropriate for the performance obligation.

The arrangement consideration consists of a fixed upfront fee of $1,000 and the following prices per transaction.

- Year 1 – $1.00 per MIP and $100 per employee supported
- Year 2 – $0.80 per MIP and $90 per employee supported
- Year 3 – $0.60 per MIP and $80 per employee supported.

The price at the beginning of the contract reflects market pricing. The price decreases each period because Outsourcer expects (1) the level of ongoing service effort to decrease over the three-year period as the level of effort to implement the outsourcing decreases and (2) to use less expensive personnel in later years as the level of effort to provide the service decreases. The contract also includes a price benchmarking clause, which requires Outsourcer to prospectively adjust contract prices to current prices at the end of each year.

Outsourcer concludes that variable amounts should be allocated to the distinct service period (each day) in which the outsourcing service is provided because:

- criterion (a) in section 6.6.20 is met. The variable amounts relate directly to the customer's usage of the service because the amount earned in each period is not dependent on past or future transactions; and
- criterion (b) in section 6.6.30 is met. The allocation is consistent with the allocation objective because the prices charged in Years 1, 2 and 3 depict what the entity would expect to be entitled to in those periods as demonstrated by the changes being commensurate with market trends and the entity's cost of fulfilling the service.

The fixed fee is attributable to the entire performance obligation and is recognized ratably over the contract period. Because the variable amounts are allocated entirely to the periods in which they are earned, Outsourcer recognizes the variable fees in the months the service is provided.

Example 6.7.40
Changing prices – allocation objective is not met

Assume the same facts as Example 6.7.30 except that the prices per transaction are as follows.

- Year 1 – $0.50 per MIP and $50 per employee supported
- Year 2 – $1.00 per MIP and $100 per employee supported
- Year 3 – $0.80 per MIP and $90 per employee supported.

Outsourcer offered Customer a significant discount on the usage-based pricing in Year 1 as an inducement to enter into the contract, and then charges Customer an amount higher than what it normally charges in Years 2 and 3 to recover some of the shortfall in Year 1.

Outsourcer concludes that variable amounts per transaction should not be allocated to the distinct service period (each day or the year) in which the transaction is processed because:

— criterion (a) in section 6.6.20 is met. The variable amounts relate specifically to the customer's usage of the service because the amount earned in each period is not dependent on past or future transactions.

— criterion (b) in section 6.6.30 is *not* met. Allocating the transaction-based fees to each day is inconsistent with the allocation objective. Outsourcer priced the first year significantly below what it would price similar services to its customers, and the prices in Years 2 and 3 are incremental to what the entity would normally charge customers in future periods. This pricing structure indicates that some of the price in Year 2 and Year 3 relates to services provided in Year 1. As such, allocating the fees based on the contractual rates would not be consistent with the allocation objective because the amounts per usage would not depict the amount to which the entity would expect to be entitled for providing those distinct services.

Outsourcer estimates the transaction price for the entire three-year period, which includes the fixed fees and the total usage-based fees and recognizes the transaction price ratably over the three-year period. Outsourcer updates the transaction price each period and makes corresponding adjustments to the transaction price and the revenue recognized.

Example 6.7.50
Per user pricing – allocation objective is met

Health Care enters into a contract with Customer to provide a single distinct service of healthcare managed services for three years. Health Care charges Customer a 'per member per month fee' (PMPM) during the period and a fixed monthly fee. Health Care concludes that its performance obligation is to provide a single continuous service of distinct time periods.

Health Care is required to perform significant set-up activities that do not provide an incremental benefit to Customer and are not a promised good or service in the contract (see Question 4.2.70).

Health Care further concludes that the PMPM fee is variable consideration rather than an option to acquire incremental services (see section 5.3 and Example 5.3.60). The PMPM fee changes during the three years as follows.

— Year 1 – $8 per member
— Year 2 – Year 1 price × (lesser of 1.03 of Year 1 pricing or 1+ increase in CPI)
— Year 3 – Year 2 price × (lesser of 1.03 of Year 2 pricing or 1+ increase in CPI).

Health Care concludes that the per member amounts should be allocated entirely to each month because:

— criterion (a) in section 6.6.20 is met. The variable amounts relate directly to the customer's usage of the service in that time period and the amount per member is not dependent on past or future performance; and

- criterion (b) in section 6.6.30 is met. The allocation is consistent with the allocation objective because the price charged in each month depicts the amount the entity would charge for those services in those periods. While the price increases each year because that amount is based on an inflation index, the change is commensurate with the market value for the services.

Health Care concludes that a time elapsed measure of progress best depicts its performance and the fixed fees are recognized ratably over the three years. As a result of the allocation, Health Care recognizes the PMPM amount it bills Customer on a monthly basis.

Example 6.7.60

Per user pricing – allocation objective is not met

Assume the same facts as Example 6.7.50 except that Health Care incurs significant costs for its set-up activities and prices its subsequent services in a manner in which it expects to recover the costs in the first year of service. Health Care and its competitors typically do not charge customers separately for the set-up activities and price those costs into the first year of service.

The per member per month fee changes during the three years as follows.

- Year 1 – $10 per member
- Year 2 – $8 per member
- Year 3 – $8 per member.

Health Care concludes that the per member amounts should not be allocated entirely to each month. While the variable amounts relate directly to Customer's usage of the service, allocating the usage-based fees to each day is inconsistent with the allocation objective.

While the pricing is consistent with its customary pricing practices and relates to recovering the set-up costs, Health Care concludes that the change in price from Year 1 to Year 2 is not commensurate with changes in value or efforts in fulfilling the services transferred to Customer. The per member fees in Year 1 are incremental to what Health Care would normally charge for those services. Health Care does not consider the cost of the set-up activities because that cost is not a fulfillment cost of the distinct service to which it would allocate the fee. In other words, the set-up activities do not justify the incremental Year 1 fee because they do not transfer a good or service to Customer. The value to Customer of the service is the same each year of the three-year term.

Health Care estimates the transaction price for the entire three-year period and recognizes the transaction price using a time-elapsed measure of progress.

Question 6.7.70

Can the allocation objective be met if all variable consideration is allocated to a series and zero consideration is allocated to another performance obligation in the contract?

Interpretive response: No. As discussed in Question 6.6.40, allocating zero consideration to a performance obligation would not be consistent with the allocation objective (see section 6.2) even if the entity would otherwise be able to allocate the variable amounts entirely to a distinct time period within a series. To meet the allocation objective, an entity needs to consider all of the payment terms and performance obligations in the contract. Therefore, the evaluation could become more complex in scenarios that involve multiple performance obligations.

For example, suppose an entity has a contract with two performance obligations (software-as-a-service and implementation services) but only charges a variable amount based on usage of one of the performance obligations (a transaction-based fee for the SaaS). It would be inappropriate to allocate the variable amounts entirely to only the one performance obligation on which the variable amount is based.

Example 6.7.70

Upfront professional services and SaaS

Software Host provides a hosted software solution to customers for which customers generally pay a usage-based fee based on the number of transactions processed. Customers are not permitted to take possession of Software Host's software. Software Host and Customer enter into a contract for Customer to use Software Host's SaaS for three years and charges $10 per transaction processed.

As part of the contract, Software Host agrees to perform professional services before Customer goes live with Software Host's hosted solution. Software Host concludes that the contract contains two performance obligations: the SaaS and the professional services, both of which are satisfied over time.

Software Host also concludes that the SaaS is a single performance obligation comprising a series of distinct daily service periods. Software Host typically charges $100 per hour for professional services and estimates that the upfront professional services will take 200 hours to complete. Software Host charges similar customers $10 per transaction for its hosted solution when sold separately.

Software Host evaluates whether the variable amounts should be allocated entirely to one or more, but not all, of the performance obligations in the contract.

— Criterion (a) in section 6.6.20 is met because the per transaction amounts relate specifically to the usage of the hosted solution.

— Criterion (b) in section 6.6.30 is *not* met because a reasonable amount of consideration is not allocated to the professional services.

As a result, Software Host does not apply the variable consideration allocation exception, but rather allocates the transaction price to the performance obligations on a relative stand-alone selling price basis under the general allocation model.

Software Host estimates that the stand-alone selling price of the professional services is $20,000 ($100 per hour × 200 estimated hours) and $180,000 for the hosted solution – i.e. the price charged per transaction is consistent with prices charged to similarly situated customers on a stand-alone basis.

Software Host estimates a transaction price of $180,000 ($10 × 18,000 estimated transactions) and concludes that the amount does not need to be constrained because of extensive experience with other similar contracts; and the likelihood of a significant reversal is diminished because the performance obligation is satisfied over time (see Question 5.3.240).

At contract inception, Software Host allocates the transaction price as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Professional services	$ 20,000	10%	$ 18,000
SaaS	180,000	90%	162,000
Total	**$200,000**	**100%**	**$180,000**

Software Host recognizes the $18,000 as it satisfies its performance obligation for the professional services over time. After the professional services are completed, but before the SaaS period begins, Software Host records the following cumulative amounts.

	Debit	*Credit*
Contract asset	18,000	
Revenue – professional services		18,000

Software Host also evaluates whether the variable amounts allocated to the SaaS performance obligation (90% of each dollar of variable consideration) can be further allocated to the distinct service periods to which the variable amount relates. Software Host concludes that the requirements to allocate the variable consideration are met:

— Criterion (a) in section 6.6.20 is met. The variable amounts relate specifically to Customer using the SaaS.

— Criterion (b) in section 6.6.30 is met. Allocating the remaining variable amounts to each day would be consistent with the allocation objective because Software Host typically prices similar services on a similar per transaction basis and the amounts are consistent across the contract period.

As a result, as each transaction is processed, 10% of the consideration reduces the contract asset and 90% is allocated to the distinct service period and recognized as revenue. If the estimated transaction price changes, Software Host adjusts only the amount recognized for professional services because changes in variable amounts for the SaaS are allocated entirely to the period in which the variability is resolved (see section 6.8).

Year 1

Customer processed 8,000 transactions and Software Host billed Customer $80,000. Software Host records the following journal entry.

	Debit	*Credit*
Accounts receivable	80,000	
Contract asset		8,000[1]
Revenue – SaaS		72,000[2]

Notes:
1. $80,000 × 10%.
2. $80,000 × 90%.

At the end of Year 1, Software Host adjusts its estimate of the transaction price to $200,000 because it anticipates processing 2,000 more transactions than originally estimated. As a result, Software Host allocates 10% of the change to the professional services in accordance with the relative allocation established at contract inception. Software Host records the following amounts.

	Debit	*Credit*
Contract asset	2,000	
Revenue – professional services		2,000[1]

Note:
1. $200,000 × 10% – $18,000.

Year 2

Customer processed 9,000 transactions resulting in additional billings of $90,000. Software Host records the following journal entry.

	Debit	*Credit*
Accounts receivable	90,000	
Contract asset		9,000[1]
Revenue – SaaS		81,000[2]

Notes:
1. $90,000 × 10%.
2. $90,000 × 90%.

At the end of Year 2, Software Host adjusts its estimate of the transaction price to $240,000 because it anticipates processing 4,000 more transactions than its previous estimate. Software Host concludes that because both performance obligations have already been allocated an amount of consideration equal to its stand-alone selling price at contract inception, the excess variable consideration should be allocated entirely to the SaaS. This is because the excess relates specifically to Customer's usage of that service and the per transaction price is consistent with a per transaction stand-alone selling price. As a result, the change in estimate does not affect revenue previously recognized but only the period the variable amount is allocated to in the future.

Year 3

Customer processed the remaining 7,000 transactions and Software Host billed Customer $70,000. Software Host records the following journal entry.

	Debit	*Credit*
Accounts receivable	70,000	
Contract asset		3,000[1]
Revenue – SaaS		67,000[2]

Notes:
1. $20,000 – $8,000 – $9,000.
2. $70,000 – $3,000.

Alternative approach to allocation of variable amounts

The example above illustrates one approach and is dependent on facts and circumstances and the appropriate application of judgment. Other approaches may be acceptable if it can be demonstrated that they are consistent with the allocation objective.

If in the example above, the stand-alone selling prices for the professional services and the SaaS (a daily stand-ready obligation) are ranges, then it may be less apparent that the excess variability in transaction price should be allocated entirely to the SaaS. Consequently, when the stand-alone selling prices are ranges, an entity could estimate the total discount in the contract ($20,000 of the 'free' implementation services) and allocate that amount on a relative basis between the performance obligations using the most recent estimate of volumes to be processed. Under this approach, in each period an entity updates its estimate of the total expected per transaction fees and allocates the discount on a proportionate basis between the implementation and SaaS.

Under both approaches, changes in estimates of the transaction price are allocated in the same manner as the original allocation (see section 6.8).

Year 1

Customer processed 8,000 transactions and Software Host billed Customer $80,000. Software Host records the following amounts.

	Debit	*Credit*
Accounts receivable	80,000	
Contract asset		8,000[1]
Revenue – SaaS		72,000[2]

Notes:
1. $80,000 × 10%.
2. $80,000 × 90%.

Software Host adjusts its estimate of the transaction price to $200,000 because it anticipates processing 2,000 more transactions than originally estimated. As a result, Software Host reallocates the discount based on the updated transaction price.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Professional services	$ 20,000	9.09%	$ 18,181
SaaS	200,000	90.91%	181,819
Total	**$220,000**	**100%**	**$200,000**

Software Host records the following journal entry to adjust the professional services revenue.

	Debit	Credit
Contract asset	181[1]	
Revenue – professional services		181

Note:
1. $18,181 – $18,000.

Year 2

Customer processed 9,000 transactions resulting in additional billings of $90,000. Software Host records the following journal entry.

	Debit	Credit
Accounts receivable	90,000	
Contract asset		8,182[1]
Revenue – SaaS		81,818[2]

Notes:
1. $90,000 × 9.09%.
2. $90,000 × 90.91%.

Software Host adjusts its estimate of the transaction price to $240,000 because it anticipates processing 4,000 more transactions than its previous estimate. As a result, Software Host reallocates the discount based on the updated transaction price.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Professional services	$ 20,000	7.69%	$ 18,461
SaaS	240,000	92.31%	221,539
Total	**$260,000**	**100%**	**$240,000**

Software Host records the following journal entry to adjust the professional services revenue.

	Debit	*Credit*
Contract asset	280[1]	
Revenue – professional Services		280

Note:
1. $18,461 – $18,181.

Year 3

Customer processed the remaining 7,000 transactions and Software Host billed Customer $70,000. Software Host records the following amounts.

	Debit	*Credit*
Accounts receivable	70,000	
Contract asset		2,279[1]
Revenue – SaaS		67,721[2]

Notes:
1. $18,461 – $8,000 – $8,182.
2. $70,000 – $2,279.

Example 6.7.80
Upfront professional services and SaaS – tiered pricing

Software Host provides a hosted software solution for which customers generally pay a usage-based fee based on the number of transactions processed. Customers are not permitted to take possession of Software Host's software. Software Host and Customer enter into a contract for Customer to use Software Host's SaaS for three years at the following per transaction amounts that reset each year.

Quantity processed	Price per transaction
0 – 1,000	$10
1,001 – 5,000	$8
> 5,000	$6

As part of the contract, Software Host agrees to perform professional services before Customer goes live with Software Host's hosted solution. Software Host concludes that the contract contains two performance obligations: the SaaS and the professional services, both of which are satisfied over time.

Software Host also concludes that the SaaS is a single performance obligation that comprises a series of distinct daily service periods and the usage-based fee is variable consideration. Software Host typically charges $100 per hour for professional services and estimates that the upfront professional services will take 200 hours to complete. Software Host charges similar customers the same per transaction pricing for its hosted solution when sold separately.

Software Host evaluates whether the variable amounts should be allocated entirely to one or more, but not all, of the performance obligations in the contract.

- Criterion (a) in section 6.6.20 is met because the per transaction amounts relate specifically to the usage of the hosted solution.
- However, criterion (b) in section 6.6.30 is *not* met because a reasonable amount of consideration is not allocated to the professional services.

As a result, Software Host does not apply the variable consideration allocation exception, but rather allocates the transaction price to the performance obligations on a relative stand-alone selling price basis under the general allocation model.

Software Host concludes that the stand-alone selling price of the professional services is $20,000 ($100 per hour × 200 estimated hours) and $180,000 for the hosted solution. The pricing structure is consistent with prices charged to similarly situated customers on a stand-alone basis, and Software Host estimated the stand-alone selling price for the hosted solution based on an estimate of 8,000 transactions processed in each year or $60,000 per annual period as follows.

Quantity processed	Price per transaction	Transactions per year	Total price
0 – 1,000	$10	1,000	$10,000
1,001 – 5,000	8	4,000	32,000
> 5,000	6	3,000	18,000
Total		**8,000**	**$60,000**

Software Host estimates a transaction price of $180,000 ($60,000 per year × 3 years) and concludes that the amount does not need to be constrained because of extensive experience with other similar contracts; and the likelihood of a significant reversal is diminished because the performance obligation is satisfied over time (see Question 5.3.240).

At contract inception, Software Host allocates the transaction price as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Professional services	$ 20,000	10%	$ 18,000
SaaS	180,000	90%	162,000
Total	**$200,000**	**100%**	**$180,000**

Software Host also evaluates whether the variable amounts allocated to the SaaS performance obligation (90% of each dollar of variable consideration) can be further allocated to the distinct service periods to which the variable amount relates. Software Host concludes that the fee relates specifically to the annual periods due to the tiered pricing (see Question 6.7.50) and that allocating the variable amount to each annual period is consistent with the allocation objective. This is because Software Host typically prices similar services on a similar basis and the pricing structure is consistent in each annual period.

As a result, Software Host estimates the number of transactions that will be processed in each annual period and recognizes that amount over each annual period based on an appropriate measure of progress. If the estimated transaction price changes, Software Host adjusts the amount recognized for professional services. Further, for the portion of the change in transaction price related to a change in the expected number of transactions in the current annual period, Software Host adjusts revenue recognized for the SaaS. However, for any portion of the transaction price change related to an estimate of transactions to be processed in future annual periods, Software Host adjusts only the amounts recognized for professional services because the portion of the change allocated to the SaaS is allocated entirely to the period in which the variability is resolved.

Year 1

Software Host recognizes the $18,000 as it satisfied its performance obligation for the professional services. After the professional services are completed, but before the SaaS period begins, Software Host records the following cumulative amounts.

	Debit	*Credit*
Contract asset	18,000	
Revenue – professional services		18,000

Software Host concludes that a time-elapsed measure of progress is appropriate for the SaaS performance obligation and recognizes the $54,000 ($60,000 × 90%) allocated to Year 1 ratably over the year. At the end of June of Year 1, Software Host adjusts its estimate of transactions to be processed in each year to 9,000 transactions or $66,000 per year. As such, the total transaction price increases to $198,000.

Software Host records the following amount of revenue for the first half of Year 1, and adjusts the revenue allocated to professional services ($18,000 already recognized) based on the change in transaction price.

	Debit	*Credit*
Contract asset	31,500	
Revenue – professional services		1,800[1]
Revenue – SaaS		29,700[2]

Notes:
1. ($198,000 × 10%) – $18,000.
2. ($198,000 × 90%) / 3 × 50%.

Through the first six months, Customer had processed 5,000 transactions and Software Host billed Customer $42,000 ((1,000 × $10) + (4,000 × $8)).

Software Host records the following journal entry.

	Debit	Credit
Accounts receivable	42,000	
Contract asset		42,000

At the end of Year 1, Customer has processed an additional 4,000 transactions for which it was billed $24,000 (4,000 × $6). Software Host records the following journal entry.

	Debit	Credit
Accounts receivable	24,000	
Contract asset	5,700	
Revenue – SaaS		29,700[1]
Note:		
1. (((\$198,000 × 90%) / 3) × 100%) – \$29,700.		

Year 2

Customer processes 9,000 transactions resulting in additional billings of $66,000. Software Host records the following amounts as of the end of the year.

	Debit	Credit
Accounts receivable	66,000	
Contract asset		6,600[1]
Revenue – SaaS		59,400[2]
Notes:		
1. \$66,000 × 10%.		
2. \$66,000 × 90%.		

Year 3

Customer processes the remaining 9,000 transactions and is billed $66,000. Software Host records the following amounts as of the end of the year.

	Debit	Credit
Accounts receivable	66,000	
Contract asset		6,600[1]
Revenue – SaaS		59,400[2]
Notes:		
1. \$66,000 × 10%.		
2. \$66,000 × 90%.		

Question 6.7.80

Can variable consideration be allocated entirely to one performance obligation and fixed consideration entirely to another performance obligation in a contract that contains a series?

Interpretive response: Yes, as discussed in Question 6.6.50, as long as the criteria to allocate the variable consideration entirely to one performance obligation are met.

In contrast to the discussions in Question 6.7.40 to 6.7.60 and the related examples, when the contract has multiple performance obligations, the entity considers whether the allocation objective is met with respect to all of the performance obligations in the contract. As such, the entity evaluates whether allocating variable fees entirely to one performance obligation would result in amounts allocated to each performance obligation that reasonably depict the amount of consideration that the entity expects for satisfying that performance obligation.

Example 6.7.90

Variable consideration allocated entirely to one performance obligation

Software Host provides a hosted software solution to customers for which customers generally pay a usage-based fee based on the number of transactions processed. Customers are not permitted to take possession of Software Host's software. Software Host and Customer enter into a contract for Customer to use Software Host's SaaS for three years and charges $10 per transaction processed plus a fixed upfront fee of $20,000.

As part of the contract, Software Host agrees to perform professional services before Customer goes live with Software Host's hosted solution. Software Host concludes the contract contains two performance obligations: the SaaS and the professional services, both of which are satisfied over time.

Software Host also concludes that the SaaS is a single performance obligation comprising a series of distinct daily service periods.

Software Host estimates that the stand-alone selling price of the professional services is $20,000. It charges similar customers $10 per transaction for its hosted solution on a stand-alone basis.

Software Host allocates the variable fees entirely to the SaaS because:

— criterion (a) in section 6.6.20 is met because the variable payment relates specifically to Customer's usage of the SaaS; and

— criterion (b) in section 6.6.30 is met because allocating the variable amounts charged entirely to the SaaS and the fixed amount to the professional services depicts what the entity would expect to be entitled to for each service on a stand-alone basis.

Software Host allocates the fixed amounts entirely to the professional services and recognizes that amount as it satisfies the performance obligation. The variable amounts are allocated to the SaaS performance obligation. Software Host could either apply the as-invoiced practical expedient to recognize the variable amounts as it has the right to bill (see Questions 7.4.60 to 7.4.110) or allocate the fees to each distinct service period. Both methods would provide the same result.

Example 6.7.100

Fixed consideration allocated to multiple performance obligations and variable consideration allocated entirely to one performance obligation

Consider the same facts as Example 6.7.90 except for the following.

— The price stated in the contract for professional services is a fixed amount of $30,000, while the stand-alone selling price is $20,000.

— The price stated in the contract for the transaction-based fees is $9 per transaction processed, while Software Host normally charges similar customers $10 per transaction on a stand-alone basis.

Software Host estimates that it will be entitled to variable consideration of $90,000 based on its estimate of processing 10,000 transactions. On an absolute dollar basis, the estimated stand-alone selling price of the SaaS is $100,000, which results in a difference of $10,000 from the contractually stated rate and estimated volumes.

Software Host allocates the variable fees entirely to the SaaS because:

— criterion (a) in section 6.6.20 is met because the variable payments relate specifically to usage of the SaaS; and

— criterion (b) in section 6.6.30 is met because the allocation of the remaining fixed consideration to the SaaS depicts the amounts the entity expects and normally charges for the SaaS and the professional services.

After the allocation of variable consideration, Software Host allocates the fixed consideration. The fixed consideration is allocated based on the general allocation model. However, to be consistent with the allocation objective Software Host reduces the stand-alone selling price of the SaaS by the estimated variable consideration allocated to the SaaS. In this example, the stand-alone selling price of the SaaS is $100,000, which is reduced by an estimate of $90,000 of variable consideration. As such, the fixed consideration of $30,000 is allocated as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Fixed consideration allocation
Professional services	$20,000	66.67%	$20,000
SaaS	10,000	33.33%	10,000
Total	**$30,000**	**100.00%**	**$30,000**

Question 6.7.90

For a contract that contains a series with different types of variable consideration, does all of the variable consideration need to be allocated in the same manner?

Interpretive response: No. As discussed in Question 5.5.160, an entity applies the variable consideration allocation guidance to each type of variable consideration within a contract. It is common to have multiple variable payment streams in an individual contract. Depending on the facts and circumstances, an entity could conclude that some variable amounts meet the requirements to be allocated to one or more, but not all, distinct goods or services while other variable amounts in the same contract are attributable to all of the distinct goods or services.

For example, the TRG discussed a fact pattern involving hotel management services with several variable payment streams and agreed that different payments could be allocated to different parts of the contract. In that example, a multi-year contract for daily distinct services included annual performance bonuses, monthly variable fees based on hotel occupancy and daily reimbursements of costs to fulfill the contract. The TRG agreed that in the fact pattern described, the variable consideration allocation criteria (see section 6.6.10) are met by allocating: [TRG 07-15.39]

— the performance bonuses to each annual period – i.e. the bonus would be recognized over the entire period;
— the monthly occupancy fees entirely to each month; and
— daily cost reimbursements to each day.

Example 6.7.110

Multiple variable payments in one contract allocated to the period they were earned

Hotel Manager enters into a two-year contract to provide hotel management services to Customer. Hotel Manager charges Customer 2% of monthly occupancy fees, reimbursement of labor costs incurred to perform the service and an annual incentive payment based on 5% of gross operating profit.

Hotel Manager concludes that the contract consists of a single performance obligation satisfied over time to provide hotel management services. Hotel Manager also concludes that the performance obligation is a series of distinct days of service and that a time-based measure of progress is appropriate for the performance obligation.

Hotel Manager concludes that the contract has three types of variable consideration:

1. fee based on monthly occupancy fees;
2. reimbursement of variable labor costs; and
3. annual incentive payment based on gross operating profit.

Hotel Manager evaluates whether those amounts should be allocated entirely to one or more distinct service periods.

1. **Monthly fee.** Hotel Manager concludes that the fee should be allocated entirely to each month. The variable amounts relate directly to Hotel Manager's efforts and the outcome from providing the services each month and are not dependent on prior or future month's services and meet criterion (a) in section 6.6.20. Further, criterion (b) in section 6.6.30 is met because percentage of rental revenue is consistent each month and would depict the amount the entity would charge to provide those services on a monthly basis.

2. **Reimbursement of variable labor costs.** Hotel Manager concludes that the fee should be allocated entirely to each day. The variable amounts relate directly to Hotel Manager's efforts to transfer the service in that time period and meet criterion (a) in section 6.6.20 because it is resolved each day (i.e. not dependent on past or future performance). Further, criterion (b) in section 6.6.30 is met because the reimbursement pricing structure remains consistent among the distinct daily service periods and depicts the varying amounts of consideration to which the entity expects to be entitled each day.

3. **Annual incentive payment.** Hotel Manager concludes the annual incentive payment relates directly to the benefit provided to the customer for the annual period and it is consistent with incentive fees that could be earned in other years. As such, Hotel Manager concludes the incentive payment should be allocated to each year.

Hotel Manager not only considers the allocation of the payments individually, but it also considers the allocation of all of the payment terms. As such, because the monthly reimbursement of variable labor costs and annual incentive payment relate to different service periods, Hotel Manager needs to consider whether allocating the fees to different periods is consistent with the allocation objective (see section 6.2). Hotel Manager concludes that allocating the monthly user fee, reimbursement of variable labor costs and annual incentive payment to different periods is consistent with the allocation objective because each day during the contract period is in effect allocated its proportion of the variable consideration. This conclusion is consistent with the TRG discussion noted in Question 6.7.90. [TRG 07-15.39]

Question 6.7.100

How does an entity evaluate the variable consideration allocation guidance for a series of distinct quantities?

Interpretive response: When a single performance obligation consists of a series of distinct quantities, the entity evaluates the criteria in section 6.6.10 to determine if it may allocate variable fees to each quantity rather than a time period.

For example, if a performance obligation consists of a promise to process 25 transactions rather than a series of distinct time periods (i.e., the service is not a stand-ready obligation), the entity evaluates whether it may allocate any variable amounts to each transaction instead of a time period.

Example 6.7.120
Variable consideration allocated in a series of distinct quantities

Transaction Processor enters into a contract with Customer to process one transaction each month for the following year. Transaction Processor charges the customer 5% of the total dollar amount processed in each transaction.

Transaction Processor concludes that the contract has a single performance obligation consisting of a series of distinct services and that the nature of the promise is to process 12 transactions rather than a service of standing ready (see section 4.2). Further, because the ultimate amount of consideration to be received is unknown, the contract has variable consideration.

Transaction Processor concludes that it should allocate the variable fees entirely to each transaction as it occurs because:

— criterion (a) in section 6.6.20 is met because the variable payment relates specifically to each transaction and the amount is not dependent on past or future transactions; and

— criterion (b) in section 6.6.30 is met because allocating the variable amounts to the transaction would depict what the entity expects to be entitled to for each on a stand-alone basis because each transaction is priced the same (i.e. the formula is the same) throughout the contract period and the changes in the dollar amount reflect the additional value to the customer for processing larger or smaller transactions.

Question 6.7.110
Can fixed consideration be allocated to one or more, but not all, distinct goods or services within a series?

Interpretive response: No. Fixed consideration cannot be allocated among the distinct goods or services within a single performance obligation (a series) using the variable consideration allocation guidance.

Instead, the fixed consideration allocated to the entire performance obligation is attributed to the distinct goods or services based on the single measure of progress (e.g., time-elapsed method, input method) used to determine progress towards complete satisfaction of the performance obligation. A measure of progress might approximate the effect of allocating fixed consideration to portions of a series. For guidance on selecting a measure of progress, see section 7.4.

6.8 Changes in transaction price

Excerpt from ASC 606-10

> Changes in the Transaction Price

32-42 After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

32-43 An entity shall allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Consequently, an entity shall not reallocate the transaction price to reflect changes in standalone selling prices after contract inception. Amounts allocated to a satisfied performance obligation shall be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

32-44 An entity shall allocate a change in the transaction price entirely to one or more, but not all, performance obligations or distinct goods or services promised in a series that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) only if the criteria in paragraph 606-10-32-40 on allocating variable consideration are met.

32-45 An entity shall account for a change in the transaction price that arises as a result of a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. However, for a change in the transaction price that occurs after a contract modification, an entity shall apply paragraphs 606-10-32-42 through 32-44 to allocate the change in the transaction price in whichever of the following ways is applicable:

a. An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 606-10-25-13(a).
b. In all other cases in which the modification was not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

6.8.10 Overview

After contract inception, the transaction price may change for various reasons, including the resolution of uncertain events or other changes in circumstances that affect the amount of consideration to which an entity expects to be entitled. [606-10-32-42]

In most cases, these changes are allocated to performance obligations on the same basis as at contract inception. For example, when using the relative stand-alone selling price model any change in the transaction price is similarly allocated on a proportional basis. Similarly, when variable consideration is allocated entirely to one or more, but not all, distinct goods or services in accordance with the variable consideration allocation exception, any changes in those variable amounts are allocated to those performance obligations or distinct goods or services. Any portion of a change in transaction price that is allocated to a satisfied or partially satisfied performance obligation is recognized as revenue (or as a reduction in revenue) in the period of the transaction price change (see Example 6.7.70). [606-10-32-43, 32-44]

A change in the transaction price resulting from a contract modification requires additional consideration. When the change in the transaction price is a result of a modification, the transaction price is allocated in accordance with the modification guidance (see section 11.2). When the change in transaction price occurs *after* a contract modification, the change is allocated to the performance obligations in the modified contract – i.e., those that were unsatisfied or partially unsatisfied immediately after the modification – unless the:

- change is attributable to an amount of variable consideration that was promised before the modification; and
- the modification was accounted for as a termination of the existing contract and creation of a new contract. [606-10-32-45]

How an entity allocates changes in the transaction price after a modification depends on whether the change is attributable to variable amounts promised before the modification. This is because a change in the expected amount of variable consideration and changes in the transaction price arising from a modification are the results of different economic events.

A change in the expected amount of variable consideration relates to a resolution of variable consideration identified and agreed upon at contract inception or contract modification, whereas a change in price arising from a modification is the result of a separate and subsequent negotiation between the two parties. As such, it may be appropriate to allocate changes in variable consideration that was promised before the modification to distinct goods or services that have been satisfied even if the modification is accounted for on a prospective basis as a termination of an existing contract and creation of a new contract. [ASU 2014-09.BC82]

The following example in Topic 606 illustrates a scenario in which the transaction price changes after a contract modification.

Excerpt from ASC 606-10

• • > Example 6 — Change in the Transaction Price after a Contract Modification

55-117 On July 1, 20X0, an entity promises to transfer two distinct products to a customer. Product X transfers to the customer at contract inception and Product Y transfers on March 31, 20X1. The consideration promised by the customer includes fixed consideration of $1,000 and variable consideration that is estimated to be $200. The entity includes its estimate of variable consideration in the transaction price because it concludes that it is probable that a significant reversal in cumulative revenue recognized will not occur when the uncertainty is resolved.

55-118 The transaction price of $1,200 is allocated equally to the performance obligation for Product X and the performance obligation for Product Y. This is because both products have the same standalone selling prices and the variable consideration does not meet the criteria in paragraph 606-10-32-40 that requires allocation of the variable consideration to one but not both of the performance obligations.

55-119 When Product X transfers to the customer at contract inception, the entity recognizes revenue of $600.

55-120 On November 30, 20X0, the scope of the contract is modified to include the promise to transfer Product Z (in addition to the undelivered Product Y) to the customer on June 30, 20X1, and the price of the contract is increased by $300 (fixed consideration), which does not represent the standalone selling price of Product Z. The standalone selling price of Product Z is the same as the standalone selling prices of Products X and Y.

55-121 The entity accounts for the modification as if it were the termination of the existing contract and the creation of a new contract. This is because the remaining Products Y and Z are distinct from Product X, which had transferred to the customer before the modification, and the promised consideration for the additional Product Z does not represent its standalone selling price. Consequently, in accordance with paragraph 606-10-25-13(a), the consideration to be allocated to the remaining performance obligations comprises the consideration that had been allocated to the performance obligation for Product Y (which is measured at an allocated transaction price amount of $600) and the consideration promised in the modification (fixed consideration of $300). The transaction price for the modified contract is $900, and that amount is allocated equally to the performance obligation for Product Y and the performance obligation for Product Z (that is, $450 is allocated to each performance obligation).

55-122 After the modification but before the delivery of Products Y and Z, the entity revises its estimate of the amount of variable consideration to which it expects to be entitled to $240 (rather than the previous estimate of $200). The entity concludes that the change in estimate of the variable consideration can be included in the transaction price because it is probable that a significant reversal in cumulative revenue recognized will not occur when the uncertainty is resolved. Even though the modification was accounted for as if it were the termination of the existing contract and the creation of a new contract in accordance with paragraph 606-10-25-13(a), the increase in the transaction price of $40 is attributable to variable consideration promised before the modification. Therefore, in accordance with paragraph 606-10-32-45, the change in the transaction price is allocated to the performance obligations for Product X and Product Y on the same basis as at contract inception. Consequently, the entity recognizes revenue of $20 for Product X in the period in which the change in the transaction price occurs. Because Product Y had not transferred to the customer before the contract modification, the change in the transaction price that is attributable to Product Y is allocated to the remaining performance obligations at the time of the contract modification. This is consistent with the accounting that would have been required by paragraph 606-10-25-13(a) if that amount of variable consideration had been estimated and included in the transaction price at the time of the contract modification.

55-123 The entity also allocates the $20 increase in the transaction price for the modified contract equally to the performance obligations for Product Y and Product Z. This is because the products have the same standalone selling prices and the variable consideration does not meet the criteria in paragraph 606-10-32-40 that require allocation of the variable consideration to one but not both of the performance obligations. Consequently, the amount of the transaction price allocated to the performance obligations for Product Y and Product Z increases by $10 to $460 each.

55-124 On March 31, 20X1, Product Y is transferred to the customer, and the entity recognizes revenue of $460. On June 30, 20X1, Product Z is transferred to the customer, and the entity recognizes revenue of $460.

Question 6.8.10

When is a change in transaction price accounted for as a contract modification?

Interpretive response: It depends. A contract modification is a change in scope and/or price that either creates new or changes existing enforceable rights and obligations. An evaluation of facts and circumstances for the change in price is required and not all changes in price are contract modifications. This distinction is important because it affects when the change in price is recognized. [606-10-25-10]

— **Resolution of variable transaction price.** The resolution of variability in the amount of expected consideration is accounted for as a change in transaction price and not a contract modification. Examples include the achievement of a performance bonus or resolution of an uncertainty that existed at contract inception that affects price.

— **Price concessions.** Pricing variability that is not explicitly stated in a contract is not presumed to be the result of a contract modification. It may instead be an implied term of the contract that could be inferred from the entity's historical business practices. If an entity has a history of granting price concessions or there is evidence of past performance issues or payment disputes, the resulting price changes would generally be attributed to the initial contract and not be accounted for as a contract modification. See Question 5.3.40.

— **External pressures on price.** Changes in market conditions, technological advances or competition in the marketplace could also cause an entity to change its pricing under an existing contract. When these types of changes are inconsistent with an entity's past practice, not anticipated at inception of the contract and are unrelated to performance issues, they would be accounted for as a contract modification.

For guidance on the accounting for contract modifications, see chapter 11. Examples 11.3.30 and 11.3.90 illustrate the consideration of past performance issues when evaluating a potential contract modification.

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

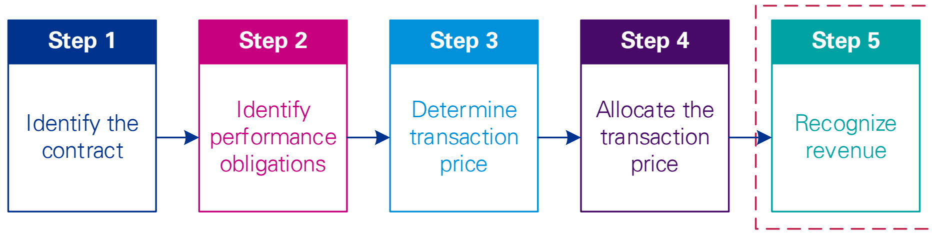
Detailed contents

New item added to this chapter: **
Item has been moved in this edition ●
Item significantly updated in this chapter: #

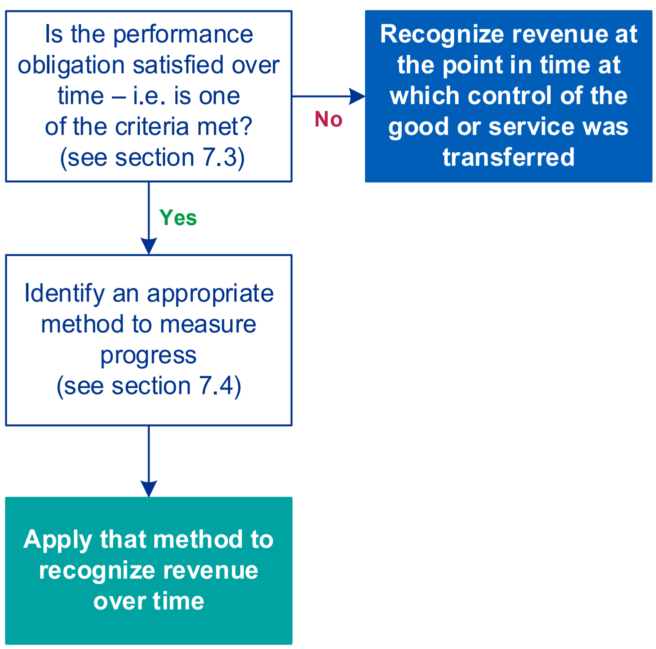
Examples

Examples

7.1 How the standard works



The final step in the revenue model is to recognize the transaction price allocated to a performance obligation when (or as) the performance obligation is satisfied. A performance obligation is satisfied when (or as) the customer obtains control of the promised goods or services. The following decision tree summarizes the key steps in applying the control model to a performance obligation.



7.2 Transfer of control

Excerpt from ASC 606-10

> Satisfaction of Performance Obligations

25-23 An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

25-24 For each performance obligation identified in accordance with paragraphs 606-10-25-14 through 25-22, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 606-10-25-27 through 25-29) or satisfies the performance obligation at a point in time (in accordance with paragraph 606-10-25-30). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

25-25 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

a. Using the asset to produce goods or provide services (including public services)
b. Using the asset to enhance the value of other assets
c. Using the asset to settle liabilities or reduce expenses
d. Selling or exchanging the asset
e. Pledging the asset to secure a loan
f. Holding the asset.

An entity recognizes revenue when or as it satisfies a performance obligation by transferring a good or service to a customer, either at a point in time (when) or over time (as). A good or service is 'transferred' when or as the customer obtains control of it. [606-10-25-23]

Control is assessed from the perspective of the customer. In developing the revenue standard, the FASB considered whether control should be applied from the perspective of the seller (i.e. when the seller surrenders control of a good or service) or customer (i.e. when the customer obtains control of that good or service) or a combination. The FASB observed that in many cases both perspectives lead to the same result; however, it concluded that control should be assessed from the perspective of the customer because that perspective minimizes the risk of an entity recognizing revenue from undertaking activities that do not coincide with the transfer of goods or services to the customer. [ASU 2014-09.BC121]

'Control' refers to the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. [606-10-25-23 – 25-25]

Control is …	
the ability	— the customer has a present right
to direct the use of	— the right enables it to: – deploy the asset in its activities; – allow another entity to deploy the asset in its activities; or – prevent another entity from deploying the asset.
and obtain the remaining benefits from	— the right also enables it to obtain potential cash flows directly or indirectly – for example, through: – use of the asset; – consumption of the asset; – sale or exchange of the asset; – pledging the asset; or – holding the asset.
… an asset (including services)	

Topic 606's transfer-of-control model applies equally to all arrangements, including service contracts. The FASB believes that goods and services are assets – even if only momentarily – when they are received and used by the customer. The FASB observed that it would be difficult to clearly define a service, and not all contracts that are commonly regarded as services result in a transfer of resources to customers over time. Consequently, the FASB decided to specify guidance that focuses on the attributes of when a good or service is transferred to a customer. [606-10-25-25, ASU 2014-09.BC122–BC123]

Accordingly, at contract inception, an entity first evaluates whether it transfers control of the good or service over time. If control is not transferred over time, it transfers control at a point in time.

There is specific implementation guidance on assessing whether revenue from the license of IP is recognized at a point in time or over time (see section 10.7).

7.3 Performance obligations satisfied over time

Excerpt from ASC 606-10

• > **Performance Obligations Satisfied Over Time**

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).

7.3.10 Overview

To determine if a performance obligation is satisfied over time, an entity evaluates whether it transfers control of the good or service over time. There are three criteria indicating that control is transferred over time.

— If one of these 'over-time' criteria are met, the entity recognizes revenue over time.
— If none of the criteria are met, control transfers to the customer at a point in time (see section 7.5). [606-10-25-24]

	Criterion	Example
1	The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs	Routine or recurring services – e.g. cleaning services
2	The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced	Building an asset on a customer's site
3	The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date	Building a specialized asset that only the customer can use, or building an asset to a customer's specifications that includes payment provisions for work completed to date

Question 7.3.10

Can an entity elect to recognize revenue at a point in time rather than over time?

Interpretive response: No. At contract inception, an entity evaluates the over-time criteria to determine if each performance obligation in the contract is satisfied over time or at a point in time. If one or more of the criteria are met, the entity recognizes revenue over time. If none of the criteria are met, the entity recognizes revenue at a point in time. [606-10-25-24]

Topic 606 also does not provide an exception for short-term contracts. However, an entity is not precluded from recognizing revenue at a point in time if the outcome of transferring a good or service over time is the same as recognizing revenue at a point in time. In that case, an entity needs appropriate controls in place to evaluate whether the outcomes are not materially different.

Question 7.3.20

Does a performance obligation to provide a service always meet the criteria to be satisfied over time?

Interpretive response: No. An entity needs to evaluate the nature of the promise and apply the over-time criteria to both goods and services and should not assume that a service is satisfied over time.

For example, when an entity is acting as a sales agent for a customer, the entity may satisfy its promise at a point in time. This is because the activities performed by the agent before sale typically do not transfer a good or service to a customer. If the customer receives any benefit from the entity's activities, then that benefit is limited unless the sale is completed. As such, these services typically do not meet the over-time criteria because:

— the customer does not simultaneously receive and consume benefits as the entity performs;
— the entity is not creating or enhancing an asset the customer controls; and
— the entity does not have an enforceable right to payment for performance to date. [606-10-25-27]

However, there may be sales agent arrangements that provide benefits to the customer over time before a sale is completed. For example, an entity enters into a written sale agent agreement and receives a significant nonrefundable upfront fee at the time of listing and a relatively small commission fee when a sale is completed. The large nonrefundable upfront fee indicates that the entity is providing the customer with a listing service and the customer is benefiting from that service over time. Moreover, Criterion 3 likely is met because the upfront fee compensates the entity for its performance to date (see Question 7.3.100) and its performance does not create an asset with alternative use to the entity (see Question 7.3.70).

Judgment and evaluation of the facts are necessary to determine whether a good or service is being transferred before the sale is completed.

Question 7.3.25

Over what time period should an entity recognize revenue when the performance obligation has an indefinite term?

Background: An entity may enter into a contract to provide an over-time performance obligation in perpetuity. For example, a gaming company may provide access to its web-based content for an indefinite term.

Interpretive response: Topic 606 does not explicitly address how an entity should determine the period of revenue recognition for an indefinite term. However, the underlying principle is that an entity recognizes revenue by measuring progress toward complete satisfaction in a manner that depicts its performance. This typically involves estimating the entity's progress toward completion. Therefore, we believe it is appropriate to estimate the period in which the entity expects to perform. [606-10-25-31]

When the contract includes an indefinite term, we believe the entity should consider all relevant factors to determine the appropriate period including, but not limited to the:

- customer life – e.g. average period of customer usage; and
- expected life of underlying technology, product or IP.

The period the entity estimates depends on the nature of the service, and facts and circumstances about the entity and the customer. The period should best depict the entity's performance in fulfilling its obligation to that customer.

- In some cases, it will be appropriate to recognize revenue over a period that is *less than* the life of the underlying technology, product or IP when an entity has reliable data to support that the entity is transferring control of the service over the customer life.
- In other cases, an entity may expect to provide services to the customer throughout the life of the underlying technology, product or IP, or it may not have reliable data to support a shorter customer life.

7.3.20 Criterion 1: Customer receives and consumes benefits as the entity performs

Excerpt from ASC 606-10

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

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.

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.

• • > Example 13 — Customer Simultaneously Receives and Consumes the Benefits

55-159 An entity enters into a contract to provide monthly payroll processing services to a customer for one year.

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.

Criterion 1 focuses on whether the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. In many typical service contracts, the entity's performance creates an asset only momentarily because that asset is simultaneously received and consumed by the customer. The simultaneous receipt and consumption of the asset that has been created means that the customer obtains control of the entity's output as the entity performs. For example, as an entity processes transactions on behalf of a customer, the customer simultaneously receives and consumes a benefit as each transaction is processed. [ASU 2014-09.BC125]

In some service-type contracts, it may be unclear whether the customer receives and consumes the benefit. To address this problem, Topic 606 clarifies that a customer obtains the benefits of an entity's performance as the entity performs if another party would not need to substantially reperform the work completed to date were that other party to fulfill the remaining performance obligation to the customer. [606-10-55-6, ASU 2014-09.BC126]

In evaluating this criterion, an entity disregards potential limitations (whether contractual or practical) that would prevent it from transferring a remaining performance obligation to another party. This is because the objective of the criterion is to determine whether control of the goods or services has already been transferred to the customer by using a hypothetical assessment of what another party would need to do were it to take over the remaining performance. [ASU 2014-09.BC127]

The FASB observed that the first criterion is not intended to apply to contracts in which the entity's performance is not immediately consumed by the customer, which is typical when the entity's performance results in an asset (e.g. work in process). Consequently, an entity that has a contract in which its performance results in an asset (either tangible or intangible) being created or enhanced should consider the other two criteria. [ASU 2014-09.BC128]

Example 7.3.10

Assessing if another entity would need to reperform the work completed

Trucker enters into a contract with Customer to transport equipment from Los Angeles to New York City. The contract contains a restriction in which Customer is not permitted to hire another company to transport the equipment, and Trucker cannot subcontract or assign the contract to another party.

Trucker concludes that Customer simultaneously receives and consumes the benefit of the services. This is because if Trucker delivers the equipment to Denver (i.e. only part of the way) then another entity could transport the equipment the remainder of the way to New York City without reperforming Trucker's performance to date – i.e. the other entity would not need to take the goods back to Los Angeles to deliver them to New York City. In arriving at this conclusion, Trucker ignores the contractual and practical restrictions that would allow it to transfer the remaining performance obligation to another entity.

As a result, Criterion 1 is met and transportation of the equipment is a performance obligation that is satisfied over time. [ASU 2014-09.BC126]

Question 7.3.30

Can a performance obligation to deliver commodities meet Criterion 1?

Interpretive response: It depends. An entity that agrees to deliver a commodity (e.g. gas, electricity, oil) to a customer considers the nature of its promise to determine whether to recognize revenue over time or at a point in time. In many contracts to deliver commodities, an entity has promised to transfer a storable good that the customer does not immediately consume. Therefore, the customer does not simultaneously receive and consume the benefits provided by the entity's performance. However, there may be scenarios in which an entity has promised to provide a service of delivering a commodity that the customer immediately consumes and therefore immediately receives the benefits.

For example, a contract to deliver natural gas to temporary storage may represent a promise to deliver a good that the customer does not immediately consume. In this instance, revenue is recognized at a point in time, likely upon delivery. In contrast, a contract to provide natural gas to the customer for on-demand consumption may represent a service that immediately benefits the customer. Such a contract meets Criterion 1 for over-time recognition.

To determine whether the customer immediately consumes the assets and receives the benefits as the performance obligation is satisfied, the TRG agreed that the entity evaluates the nature of the promise as well as:

— inherent characteristics of the commodity;
— contract terms;
— information about the infrastructure and other delivery mechanisms; and
— other relevant facts and circumstances. [TRG 07-15.43]

Criterion 1 generally is not met if a commodity is not immediately consumed when the entity creates it (i.e. work in process, finished goods inventory). This view is consistent with the FASB's observation that Criterion 1 is not met when the entity's performance creates an asset such as work in process. In other words, if the entity accounts for the commodity as inventory or a long-lived asset before delivery, this criterion generally will not be met. [ASU 2014-09.BC128]

7.3.30 Criterion 2: Entity's performance creates or enhances an asset the customer controls as the entity performs

Excerpt from ASC 606-10

• • > Customer Controls the Asset As It Is Created or Enhanced (paragraph 606-10-25-27(b))

55-7 In determining whether a customer controls an asset as it is created or enhanced in accordance with paragraph 606-10-25-27(b), an entity should apply the guidance on control in paragraphs 606-10-25-23 through 25-26 and 606-10-25-30. The asset that is being created or enhanced (for example, a work in process asset) could be either tangible or intangible.

Criterion 2 addresses situations in which a customer controls an asset that is being created or enhanced by the entity's performance. Because the customer controls any work in process, the customer is obtaining the benefits of the goods or services that the entity is providing. In evaluating whether a customer controls an asset during creation or enhancement, an entity considers the control principle and the indicators of when control transfers at a point in time (see section 7.5). [606-10-25-27(b), 55-7, ASU 2104-09.BC129]

For example, in the case of a construction contract in which the entity is building on the customer's land, the customer generally controls any work in process arising from the entity's performance. In many construction contracts, the entity has in effect agreed to sell its rights to the asset (work in process) as it performs. As such, the parties have agreed to a continuous sale that occurs as the work progresses. [ASU 2104-09.BC129–BC130]

7.3.40 Criterion 3: Entity's performance does not create an asset with alternative use and entity has an enforceable right to payment

Excerpt from ASC 606-10

• > Performance Obligations Satisfied Over Time

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 for 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 an entity.

25-29 An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 606-10-25-27(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Paragraphs 606-10-55-11 through 55-15 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.

Criterion 3 contains two specific requirements, both of which need to be met to satisfy the criterion:

— the entity's performance creates an asset that does *not* have an alternative use to the entity; and
— the entity has an enforceable right to payment at all times for performance completed to date (while expecting to fulfill the contract as promised). [606-10-25-28, 25-29]

The assessment of whether an asset has an alternative future use to the entity is performed at contract inception. A reassessment is not performed unless the parties modify the contract in a manner that substantively changes the performance obligation. [606-10-55-8]

Question 7.3.35●

How does an entity apply the over-time criteria for contract manufacturing arrangements to produce goods to a customer's specifications?

Interpretive response: In contract manufacturing arrangements to produce goods to a customer's specifications, the third over-time criterion is often the criterion that requires the most analysis and will determine whether revenue is recognized over time or at a point in time. To apply this criterion, a manufacturer that produces tangible goods to meet a customer's unique specifications evaluates the contract (including its right to payment) to determine whether it would have an alternative use for those goods. If it determines it would not and that it would have an enforceable right to payment for performance completed to date during the contract period, the third criterion is met and it recognizes the contract revenue over time. [TRG 11-16.56]

This is a very fact-dependent determination and different contract terms could result in different outcomes across a manufacturer's customer contracts. If the third criterion is not met, the manufacturer still has to consider the other two criteria.

A manufacturer recognizes revenue from contract manufacturing arrangements as follows:

— under the **over-time accounting model** if any of the over-time criteria are met, as manufacturing occurs; and
— under the **point-in-time accounting model** if none of the over-time criteria are met, as the goods are shipped or delivered.

7.3.50 Asset with no alternative use to the entity

Excerpt from ASC 606-10

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

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.

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.

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.

• • > Example 15 — Asset Has No Alternative Use to the Entity

55-165 An entity enters into a contract with a customer, a government agency, to build a specialized satellite. The entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differ substantially, on the basis of each customer's needs and the type of technology that is incorporated into the satellite.

55-166 At contract inception, the entity assesses whether its performance obligation to build the satellite is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.

55-167 As part of that assessment, the entity considers whether the satellite in its completed state will have an alternative use to the entity. Although the contract does not preclude the entity from directing the completed satellite to another customer, the entity would incur significant costs to rework the design and function of the satellite to direct that asset to another customer. Consequently, the asset has no alternative use to the entity (see paragraphs 606-10-25-27(c), 606-10-25-28, and 606-10-55-8 through 55-10) because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.

55-168 For the entity's performance obligation to be satisfied over time when building the satellite, paragraph 606-10-25-27(c) also requires the entity to have an enforceable right to payment for performance completed to date. This condition is not illustrated in this Example.

When an entity creates an asset with an alternative future use to the entity, the entity could readily direct the asset to another customer and therefore the customer would not control the asset as it is being created. For example, when an entity creates standard inventory-type items for which it has the discretion to substitute across different contracts, the customer cannot control the asset because it does not have the ability to restrict the entity from redirecting the asset. [ASU 2014-09.BC134]

An asset that is highly customized for a particular customer is less likely to have an alternative use to the entity. This is because the entity would incur significant costs to reconfigure the asset for sale to another customer or would need to sell the asset for a significantly reduced price. In these cases, the customer could be regarded as receiving the benefit of that performance and consequently as having control of the asset being created as the performance occurs. [ASU 2014-09.BC135]

Whether the asset is highly customized is not the only factor to consider. This assessment of an asset's alternative future use also includes an evaluation of both contractual restrictions and practical limitations that may prohibit an entity from redirecting the asset to another use. [606-10-55-8, ASU 2014-09.BC136]

Contractual restrictions

An asset may not have an alternative use to the entity due to contractual restrictions. In such cases, the contractual restrictions have to be substantive – i.e. an enforceable right. For example, an asset may be standardized (e.g. some real estate transactions) but substantive contractual restrictions may preclude the entity from directing the asset to another customer. This indicates that the customer controls the asset as it is created because it has the ability to restrict the entity from directing that asset to another customer. [606-10-55-9, ASU 2014-09.BC137]

A contract restriction that is a protective right may not limit the entity's practical ability to physically substitute or redirect an asset. Therefore, a protective right on its own is not sufficient to establish that an asset has no alternative use to the entity. For example, a contract might state that an entity cannot transfer a good or service because a customer has legal title to the goods in the contract. If the legal title to the goods is intended to protect the customer in the event of the entity's liquidation, and the entity can physically substitute and redirect the goods to another customer, the contractual restriction may merely be a protective right and does not indicate that control of the goods have transferred to the customer. [ASU 2014-09.BC138]

Practical limitations

An asset also may not have an alternative use to the entity due to practical restrictions or limitations. A practical limitation on an entity's ability to direct an asset for another use – e.g. design specifications that are unique to a customer – exists if the entity would:

— incur significant costs to rework the asset; or
— be able to sell the asset only at a significant loss. [606-10-55-10]

Example 7.3.20
Contractual restrictions in a customized manufacturing contract

Ship Builder enters into a contract with Customer to build a large cruise ship. Customer is able to make changes to the basic design of the ship, but cannot specify or alter major structural elements of the ship's design. The contract precludes Ship Builder from transferring the specific cruise ship to another customer and Ship Builder concludes that the provision is substantive. As a result of these contractual restrictions, Ship Builder determines that the ship does not have an alternative use to Ship Builder.

Question 7.3.40

In assessing whether an asset has no alternative use, should an entity consider the completed asset or the in-production asset?

Interpretive response: The analysis should focus on the asset in its completed form.

Practical limitations on the entity's ability to direct the asset for an alternative use include whether the entity would need to incur significant costs to rework the asset or be able to sell the asset only at a significant loss. When evaluating practical restrictions or limitations, an entity considers:

— the characteristics of the asset that will *ultimately* be transferred to the customer; and

— whether the asset, *in its completed form,* could be redirected without a significant cost of rework. [ASU 2014-09.BC136, TRG 11-16.56]

Often the asset can be redirected to another customer or for another purpose during the production process, up until the point at which customization of the asset begins to occur. However, in its completed form the asset may have no alternative use to the entity. For example, in some manufacturing contracts the basic design of an asset may be the same across many contracts, but the customization of the finished good may be substantial. Consequently, redirecting the asset in its completed state to another customer would require significant rework. [ASU 2014-09.BC127, TRG 11-16.56]

Therefore, the fact that the asset remains standardized and interchangeable up to a certain point in the production process does not mean Criterion 3 cannot be met. In this instance, if an entity determines that there will be no alternative use for the finished product, then Criterion 3 applies if the entity also has an enforceable right to payment for its performance from that point.

However, under such circumstances, revenue recognition begins only once customization begins. Before that point, the entity's performance does not transfer an asset to the customer but rather creates an asset for the entity – e.g. inventory.

Question 7.3.45

Does an asset have an alternative use when the entity can sell the parts to other customers in an aftermarket?

Interpretive response: It depends. The evaluation of whether an asset has an alternative use is done on a contract-by-contract basis at contract inception. At contract inception, an entity should determine if the asset in its completed state will have an alternative use to the entity at the time it is expected to be ready for use (see Question 7.3.40).

The existence of an aftermarket that would allow the entity to sell the asset to another customer at the time the asset is ready for use indicates that the asset has an alternative use to the entity. However, an entity may enter into a contract to produce a customized product for a customer that will be completed before a sufficient aftermarket exists. In the latter case, the asset does not have an alternative use even if the entity expects to be able to sell the product in the aftermarket at a future date. That is because the product being created to fulfill the *current* contract cannot be redirected to another customer.

An entity will need to exercise judgment to determine when a sufficient aftermarket exists for a new product that would allow the entity to realize the asset's economic benefits through sales to other customers. In some cases, it may be an extended period of time before a secondary market or aftermarket develops.

In general, when considering if there is an alternative use for products being sold to a customer, we believe the entity should consider whether there is a sufficient aftermarket such that it could practically redirect substantially all of the units in the contract to another customer without incurring a significant economic loss. For example, even if some of the units could be redirected to another customer, if the entity would have to warehouse many of the contract units for a significant period before a sufficient aftermarket exists, those long-term warehousing costs may result in a loss to sell the product to other customers. In that case, a sufficient aftermarket is deemed not to exist, and therefore no alternative use exists for the units being produced under that contract.

Example 7.3.25

Assessing the 'no alternative future use' criterion when an aftermarket may exist in the future

ABC Corp. enters into a contract to manufacture a new customized part exclusively for Original Equipment Manufacturer (OEM). OEM expects to incorporate the part into a product it is developing for end customers.

ABC anticipates that at some stage OEM's customers will need to replace the part that ABC manufactured, which will create an aftermarket for ABC's parts. However, at the time ABC expects the new part to be ready for use, it does not expect there to be other potential customers because OEM will not have begun selling its product to end customers.

Although ABC expects there will be an alternative use in the future, at the time it enters into the original contract with OEM, the parts do not have an alternative use to the entity.

Question 7.3.50

How should an entity evaluate if its costs to rework an asset would be significant?

Interpretive response: Topic 606 does not provide guidance to help evaluate whether the cost to rework an asset for an alternative use is significant.

Because Criterion 3 is assessing whether the performance obligation is satisfied over time, we believe the evaluation of whether the rework is significant should be done at the performance obligation level rather than the contract level. Further, consistent with Question 7.3.40, significance is assessed based on the costs to rework the completed asset rather than the cost during various phases of production. We also believe the evaluation should consider both quantitative and qualitative factors.

The following are some factors that an entity may consider when making this determination (not exhaustive):

— **Level and cost of customization.** If the customization itself is significant, the cost of rework may be significant. For example, if the customization of the asset occurs over a significant period of time and involves significant development and design activities or represents a significant cost of the finished product, then the cost to rework the asset for another customer may be significant. In contrast, if the customization occurs over a short period of time and does not represent a significant portion of the overall cost, the cost to rework may not be significant.

— **Incremental cost to rework versus the original costs.** If the cost to rework an asset and produce a finished product is commensurate with the original cost of customization, the cost to rework may be significant. In contrast, if the cost to rework the asset is insignificant compared to the original cost of the asset, the rework costs may not be considered significant.

— **Activities required to rework the asset.** If the activities required to rework the asset involve design and development activities, the cost of rework may be more significant. However, if the materials can be quickly converted into a raw material to be used in the entity's normal process, the cost may not be as significant. For example, an entity may produce glass materials customized to the size and shape for a particular customer but could easily melt the glass to be reused as a raw material.

— **Entity can sell the reworked asset at a reasonable profit margin.** While the profit margin would be expected to be less than if no rework occurred, if the entity expects to recover the costs plus a reasonable margin when compared to sales of similar goods then the cost of rework may not be significant. The entity should consider both the absolute dollar amount of margin to be recovered and profit margin percentage in evaluating whether it could expect to receive a reasonable profit margin. For example, if an entity produces a low cost, low margin product, any incremental cost may have a significant effect on margin percentage but not a significant effect on the absolute dollar amount expected to be recovered.

— **Amount of the asset that cannot be reworked.** An entity may be unable to rework the asset or a significant portion of the component parts – e.g. if the disassembly process would significantly damage the component parts so that they cannot be reused or the raw material cannot be worked into other products. That would be considered a significant economic loss, which is a practical limitation on alternative use of the asset.

Example 7.3.30
No alternative future use – practical limitations

Manufacturer enters into a contract with Customer to build a specialized satellite. Manufacturer builds satellites for other customers; however, the design and construction of each satellite differs substantially on the basis of each customer's needs and the type of technology that is incorporated into the satellite.

At contract inception, Manufacturer assesses whether the satellite will have an alternative use in its completed state. Although the contract does not preclude Manufacturer from directing the completed satellite to another customer because it is significantly customized, another customer cannot use it in its completed form. As such, Manufacturer performs an analysis to determine if the costs incurred to rework the satellite would be significant.

Factor	Analysis	Supports no alternative use conclusion
Level and cost of customization	The level and cost of customization is significant. Various types of engineers, designers and developers are engaged to design and build the customized satellite to the customer's specifications. The design and construction period takes significant time, and a significant portion of the satellite's overall cost is due to its customization.	Yes
Incremental cost to rework versus original costs	To rework the satellite to be used by another customer, Manufacturer would have to go through the design and development stage with a different customer to create a satellite to meet the new customer's needs. It is expected that the cost of these activities would be commensurate with the customization cost of the original satellite.	Yes
Activities required to rework the asset	Significant design and development is necessary to rework the asset. The components of the satellite cannot be quickly converted back into raw materials to be used in the entity's manufacturing process.	Yes
Entity can sell reworked asset at reasonable margin	Given the unique process to develop and build the satellite, the high costs of disassembly and incremental costs to rework the satellite, it is expected that the gross margin would be significantly lower for the reworked satellite than the original satellite. In addition, the satellite is a high dollar item and therefore from an absolute perspective the effect would be significant.	Yes
Amount of asset that cannot be reworked	Each satellite is different and may have at least some component parts made up of different raw materials. However, there are very few parts that would need to be scrapped.	No

Manufacturer evaluates these qualitative and quantitative factors in total. It determines it would incur significant costs to rework the design and function of the satellite given the level of effort and cost around designing the satellite specifically for Customer and the costs required to be able to redesign the satellite for another customer. The customer-specific design of the satellite restricts Manufacturer's practical ability to readily direct the satellite to another customer. Therefore, the satellite does not have an alternative use to Manufacturer.

Example 7.3.40
Alternative future use – no practical limitations

Bottle Maker enters into a contract with Customer to manufacture specialized bottles. The bottles are made out of standard glass used in all of Bottle Maker's bottles but are shaped in a mold to meet Customer's specifications. Bottle Maker manufactures bottles for various customers with some bottles having a shape customized based on customers' specifications and others having general shapes that Bottle Maker offers to all of its customers.

At contract inception, Bottle Maker assesses whether the bottles will have an alternative use in their completed state. Although the contract does not preclude Bottle Maker from directing the completed bottles to another customer, their shape is customized to customer-specific designs, so another customer cannot use them in their completed form. As such, Bottle Maker performs an analysis to determine if the costs incurred to rework the bottles would be significant and considers the following.

Factor	Analysis	Supports no alternative use conclusion
Level and cost of customization	The bottle is molded into a shape specified by Customer. However, the process does not include significant time and effort to develop and design the product; and the cost of the customization is relatively insignificant because the design process is homogenous and performed for a large number of bottles.	No
Incremental cost to rework versus original costs incurred	To rework the bottle to use in another contract, Bottle Maker would incur some direct labor and overhead associated with the product as the glass is melted and put back through the manufacturing process which is commensurate with the original cost of customization.	Yes
Activities required to rework asset	The bottles are produced in a highly automated manufacturing process in which a substantial number of bottles can be produced in a relatively short time. While the bottles are customized for a particular customer, the customization is done through a homogenous process and does not require incremental design or development.	No

Factor	Analysis	Supports no alternative use conclusion
Entity can sell reworked asset at reasonable margin	This is a high volume, low cost and low margin business. Even though Bottle Maker is able to use substantially all of the materials in the production process, the reworked asset may have a significantly lower gross margin percentage compared to non-reworked assets. However, the rework does not have a significant effect on the entity's absolute dollar profit margins when reworked into finished goods.	Mixed
Amount of asset that cannot be reworked	A significant portion of the customized asset is raw material (glass). As such, virtually all of the glass in the customized bottles can be melted down and reused in producing other bottles. There are no components of the bottle that have to be scrapped.	No

Bottle Maker evaluates these qualitative and quantitative factors in total. It determines that the cost of reworking the asset is not significant based on significance of the customization to the overall process. As such, although the bottles do not have alternative use to Bottle Maker in their completed state because they can be reworked for relatively little cost, Criterion 3 is not met. Accordingly, Bottle Maker recognizes the revenue for each bottle at a point in time rather than over time.

7.3.60 Enforceable right to payment

Excerpt from ASC 606-10

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

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.

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.

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 contract 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).

55-14 In assessing the existence and enforceability of a right to payment for performance completed to date, an entity should consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:

a. Legislation, administrative practice, or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer.
b. Relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect.
c. An entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

55-15 The payment schedule specified in a contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the payment schedule in a contract specifies the timing and amount of consideration that is payable by a customer, the payment schedule might not necessarily provide evidence of the entity's right to payment for performance completed to date. This is because, for example, the contract could specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract.

An entity that is creating an asset with no alternative use is effectively constructing the asset at the direction of the customer. The contract terms in these types of transactions may give an entity an enforceable right to payment for performance completed to date. This enforceable right provides economic protection against the risk of the customer (or another party) terminating the contract and leaving the entity with an asset of little or no value. The presence of an enforceable right to payment for performance completed to date indicates that the entity is transferring value to the customer over time as it performs – i.e. that it is satisfying its performance obligation over time. [606-10-25-29, ASU 2014-09.BC142]

In assessing whether an enforceable right to payment exists, the entity considers whether, throughout the contract, it is entitled to compensation for performance completed to date if the contract were terminated for reasons other than the entity's failure to perform as promised. In addition to evaluating contract terms, an entity would also consider the effect of Uniform Commercial Code (UCC) provisions and relevant case law in assessing whether an enforceable right to payment exists. When the payment terms upon termination are silent, see Question 7.3.75 for guidance. [606-10-55-11]

The entity's right to payment may not always be for the contract value in a prematurely terminated contract. However, the compensation should be based on a reasonable proportion of the entity's expected profit margin to date – e.g. a right to recover costs incurred plus a reasonable profit margin. The entity's determination of the expected profit margin is made at contract inception. The amount to which the entity is entitled does not need to equal the contract margin at all times during the arrangement – i.e. a pro rata amount directly proportional to the entity's completed performance to the date of termination. However, it must be based on either a reasonable proportion of the entity's expected profit margin for the contract based on the work performed to date or a reasonable return on the entity's cost of capital for similar contracts. If an entity would recover only its costs in an otherwise profitable contract, it does not have the right to payment for performance completed to date. When evaluating termination provisions in contracts priced at a loss, see Question 7.3.130 for guidance. [606-10-55-11, ASU 2014-09.BC144]

Other factors to consider include the following. [606-10-55-14 – 55-15]

Payment terms	— An unconditional right to payment is not required. Instead, an enforceable right to demand or retain payment for the performance completed to date if the contract is terminated by the customer for convenience may satisfy the enforceable right requirement.

Payment schedule	— A payment schedule does not necessarily indicate whether an entity has an enforceable right to payment for performance to date.
Contractual terms	— If a customer acts to terminate a contract without having a contractual right at that time to do so, the contract terms may entitle the entity to continue to transfer the promised goods or services and require the customer to pay the corresponding consideration promised.
Legislation or legal precedent	— If a right is not specified in the contract, jurisdictional matters such as legislation, UCC, administrative practice or legal precedent may confer a right to payment to the entity. For considerations when evaluating contracts that do not specify the payment terms at termination, see Question 7.3.75. — In contrast, legal precedent may indicate that rights to payment in similar contracts have no binding legal effect, or that an entity's customary business practice not to enforce a right to payment may result in that right being unenforceable in that jurisdiction.

Question 7.3.60

When evaluating Criterion 3, could an entity reach different conclusions for similar goods or services in different contracts?

Interpretive response: Yes. The TRG agreed that the analysis of whether a good is transferred over time or at a point in time should be made on an individual contract basis and for each performance obligation in each contract. The TRG observed that similar goods or services could have different patterns of recognition depending on the rights and obligations in each contract.

A different pattern of recognition could even arise for similar goods or services with similar contract terms if the relevant legal framework for each contract is different. In practice, a detailed understanding of the terms of the contract and local laws may be required to assess whether an entity has a right to payment for performance to date. For example, in some jurisdictions customer default may be infrequent and contracts may not include extensive detail on the rights and obligations that arise in the event of default. In such cases, a legal opinion may be necessary to determine an entity's legal right to payment (see Question 7.3.90). [TRG 11-16.56]

In other jurisdictions, entities may have a practice of not enforcing their contractual rights if a customer defaults, preferring instead to take possession of the property so they can sell it to a new customer. Again, evaluation of the specific facts and circumstances, including appropriate legal consultation, may be necessary to establish whether the contractual rights remain enforceable given an established pattern of non-enforcement.

Example 7.3.50
Applying the over-time criteria to sales of real estate – Criterion 3 is met

Property Developer is developing a multi-unit residential complex. Customer enters into a binding sales contract with Property Developer for Unit X, which is under construction. Each unit has a similar floor plan and is a similar size. The following facts are relevant.

— Customer pays a nonrefundable deposit on entering into the contract and will make progress payments intended to cover costs to date plus the margin percentage in the contract during construction of Unit X.

— The contract has substantive terms that preclude Property Developer from being able to direct Unit X to another customer.

— If Customer defaults on its obligations by failing to make the promised progress payments when they are due, Property Developer has 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 property developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

Based on these facts, Property Developer determines that Unit X does not have an alternative use to it because it is contractually prevented from transferring Unit X to another customer and it would have an enforceable right to all of the consideration promised under the contract upon Customer's default. Consequently, Criterion 3 is met and Property Developer recognizes revenue from the construction of Unit X over time.

Example 7.3.60
Applying the over-time criteria to sales of real estate – Criterion 3 is not met

Assume the same facts as Example 7.3.30 except for the following.

— Customer pays a nonrefundable deposit on entering into the contract, but is not required to make any progress payments that cover costs to date plus the margin percentage in the contract during construction of Unit X. Final payment is due when construction is complete and the unit is move-in ready.

— If Customer terminates the contract, neither the contractual terms nor legal framework would provide Property Developer an enforceable right to payment for performance completed to date.

At contract inception, Property Developer determines that because it is contractually prevented from transferring Unit X to another customer, Unit X does not have an alternative use to Property Developer. However, there is no enforceable right to payment. Consequently, Criterion 3 is not met and Property Developer recognizes revenue related to the sale of Unit X at the point in time when control of the unit transfers to Customer.

Question 7.3.70

Can Criterion 3 apply to a performance obligation to provide services?

Interpretive response: Yes. Criterion 3 can apply to contracts to provide services. The customer may not simultaneously receive and consume benefits as the entity performs the services (Criterion 1); however, the services may not create an asset with alternative use to the entity (Criterion 3). For example, an entity may perform a marketing study that the customer only benefits from by obtaining the end results and another party would need to reperform the work that the entity has completed to date.

In this instance, to determine if Criterion 3 is met and the service is satisfied over time, an entity evaluates the contract provisions to ascertain whether it has an enforceable right to payment for its performance completed to date.

Example 14 in Topic 606 (reproduced below) illustrates a fact pattern in which a service meets Criterion 3.

Excerpt from ASC 606-10

• • > Example 14 — Assessing Alternative Use and Right to Payment

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.

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.

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.

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.

Question 7.3.75

Does an entity have an enforceable right to payment if the contract does not explicitly state the entity's right to payment upon contract termination?

Interpretive response: Generally, no. We believe that when a contract's written terms do not specify the entity's right to payment upon contract termination, an enforceable right to payment is presumed not to exist. This is consistent with the FASB staff views discussed at the June 26, 2018 Private Company Council meeting. [PCC Memo June 26, 2018]

We believe this presumption (that an enforceable right to payment does not exist) also applies to non-cancellable contracts when there are no written terms to specify the entity's right to payment if the customer breaches the contract.

However, if the entity asserts that it has an enforceable right to payment for performance completed to date in these circumstances, to overcome this presumption, we would expect an entity to do the following.

— Support its assertion (that it has an enforceable right to payment) based on legislation, administrative practice or legal precedent that confers upon the entity a right to payment for performance completed to date. This analysis should demonstrate that an enforceable right to payment exists in the relevant jurisdiction. [606-10-55-14(a)]

— Assess whether relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect. [606-10-55-14(b)]

The fact that the entity may have a basis for making a claim against the counterparty in a court of law would not on its own be sufficient to support that there is an enforceable right to payment as discussed in Question 7.3.80.

Question 7.3.80

Does the entity's ability and intent to sue if the customer terminates the contract indicate that it has an enforceable right to payment?

Interpretive response: Not necessarily. The key evaluation is whether an entity has an enforceable right to payment. When a right to payment on termination is not specified in the contract with the customer, an entity may presume that the enforceable right does not exist (see Question 7.3.75). When evaluating whether an entity may still have a right to payment or whether a stated right is enforceable, an entity considers the relevant laws or regulations.

The fact that the entity may sue a customer who defaults or cancels a contract for convenience does not in itself demonstrate that the entity has an enforceable right to payment. However, in some circumstances an entity might need to go to court to enforce its existing right to payment.

Factors to consider when determining if an entity has a right to payment include: [606-10-55-14]

— relevant laws and regulations – laws and regulations can confer a right to payment even though such a right is not specified in a contract;

— customary business practices – an entity's intent not to enforce a right to payment provision typically does not negate the existence of the right; however, a customary practice of not enforcing similar rights may indicate that the right is not enforceable under the law in the appropriate legal jurisdiction;

— the legal environment;

— relevant legal precedents – legal precedent could indicate whether a right to payment clause in a contract has binding legal effect; and

— legal opinions on the enforceability of rights (see Question 7.3.90).

Each individual factor may not be determinative on its own. An entity needs to determine which factors are relevant for its specific set of circumstances. In cases of uncertainty – e.g. when the above factors are inconclusive or provide contradictory evidence about the existence of a right to payment – an entity considers all relevant factors and applies judgment in reaching its conclusion.

Question 7.3.90

Does an entity need to obtain a legal opinion to assess whether it has an enforceable right to payment?

Interpretive response: An entity may have an apparent right to payment described in its contract with the customer or under a relevant law or regulation, but there may be uncertainty over whether the right is enforceable. This may be the case when there is no legal precedent for the enforceability of the entity's right.

For example, in a rising property market an entity may choose not to enforce its right to payment in the event of customer default because it prefers to recover the property and resell it at a higher price. A practice of not enforcing an apparent right to payment may result in uncertainty over whether the contractual right remains enforceable.

In such cases, an entity may need a legal opinion to help it assess whether it has an enforceable right to payment. However, all facts and circumstances need to be considered in assessing how much weight (if any) to place on the legal opinion. This may include an assessment of:

— the quality of the opinion – i.e. strength of the supporting legal arguments;
— whether there are conflicting opinions provided by different legal experts; and
— whether there are conflicting legal precedents for similar cases.

Question 7.3.100

Does an entity have an enforceable right to payment when the customer pays in full upfront?

Interpretive response: It depends. An enforceable right to payment may exist based on an upfront payment in full if the entity's right to retain (and not refund) the payment is enforceable should the customer terminate the contract. [ASU 2014-09.BC146]

Question 7.3.110

Can an entity have an enforceable right to payment for performance completed to date when it is not entitled to costs plus a margin for standard materials before their integration into the manufacturing process?

Interpretive response: Yes. The inability to enforce payment from a customer for costs incurred before integration into the manufacturing process (e.g. raw materials or components usable in other arrangements or returnable to the supplier) does not mean Criterion 3 is not met.

'Costs incurred' refers to costs specifically incurred for that contract (i.e. that can no longer be used for other purposes) and does not include the manufacture or purchase of standard inventory items until such inventory is integrated into the manufacturing process.

Many contracts with customers to manufacture or construct goods with no alternative use to the entity require the manufacturer to use standard raw materials or components as inputs to the good being manufactured or constructed for the customer. In many cases, the inputs remain interchangeable with other products until actually deployed in the customer's good (see Question 7.3.40). In such cases, the entity may not have an enforceable right to payment based solely on the procurement or development of those standard raw materials or components. Instead, the incorporation into the customer's good triggers the enforceable right to payment and at that point the entity begins transferring the service over time.

Question 7.3.120

Can an enforceable right to payment for performance completed to date exist in a manufacturing contract when the contract only guarantees reimbursement of materials or work in process at cost?

Interpretive response: Not usually. In assessing whether an enforceable right to payment exists, the entity considers whether, throughout the contract, it is entitled to compensation for performance completed to date if the contract were terminated for reasons other than the entity's failure to perform as promised. The entity should be able to recover costs incurred plus a reasonable profit margin. [606-10-55-11]

Some manufacturing contracts include termination clauses that guarantee payment of finished goods at cost plus a margin. However, the customer is only obligated to reimburse the entity for materials and/or work-in-process at cost. Such a termination clause does not in itself preclude the performance obligation from being satisfied over time. All facts and circumstances and the overall contract provisions need to be analyzed in order to determine if the entity would still be allowed, in substance, to recover its costs plus a reasonable margin.

For example, a notice period may in effect give the entity the practical ability to turn work-in-process and outstanding materials into a finished product before termination. In that case, the entity would receive reimbursement on that finished good at cost plus margin. Therefore, the entity would conclude that it has an enforceable right to payment.

Similarly, it may also be useful to understand what 'cost' means in the context of the contract. Some contracts may provide an agreed-upon cost or list price methodology for reimbursing materials in case of termination. However this 'contractual cost' may not entirely reflect the actual cost of the materials to the entity. In fact, in some situations the contractual cost would provide actual cost plus a reasonable margin. This could happen if the actual cost to the entity includes volume discounts or purchasing efficiencies not reflected in the 'contractual cost'.

However, if the entity is truly only entitled to reimbursement for costs incurred to date (i.e. no margin), we would expect that it does not meet Criterion 3.

Question 7.3.130

Can an enforceable right to payment exist for a contract priced at a loss when an entity is not entitled to cost plus a margin for performance completed to date?

Interpretive response: Yes. We believe an entity can have an enforceable right to payment for performance completed when, at contract inception, the contract is priced at a loss.

In assessing whether an enforceable right to payment exists, the entity considers whether it would be entitled to an amount that at least compensates the entity for its performance completed to date in the event of contract termination. This includes an amount that approximates the selling price of the goods or services transferred to date – e.g. recovery of the costs incurred plus a reasonable profit margin. [606-10-55-11]

If the entity is entitled to a proportional amount of the contract price in a contract priced at a loss, we believe that proportional amount would approximate the selling price of the goods or services transferred to date even if that amount is less than costs incurred to date because it is a proportion of the expected price in the contract. We believe the guidance that states "for example, recovery of the costs incurred … plus a reasonable profit margin" does not preclude a loss contract from having an enforceable right to payment. That is, a 'reasonable profit margin' could be the loss margin intended at contract inception. [606-10-55-11]

Further, the basis for conclusions describes the right to payment criterion as providing economic protection to the entity from the risk of customer termination, which we believe is achieved if the customer is required to pay the relative proportion of the contract price for performance completed to date in the event of contract termination. [ASU 2014-09.BC142]

See section 13.2 for further discussion on recognizing losses from contracts with customers.

Question 7.3.140

Do contracts with the US government that have a 'termination for convenience' clause include an enforceable right to payment?

Interpretive response: Yes. As discussed in Question 3.8.25, it is common for contracts with the US federal government to be governed by Federal

Acquisition Regulations (FAR) and to include a 'termination for convenience' clause.

FAR 49.201(a) states that when contracts are terminated for reasons other than default, the US federal government "should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit." [FAR 49.201(a)]

We believe the termination for convenience clause is consistent with the requirements of Topic 606 and provides an entity with an enforceable right to payment on termination. [606-10-55-11]

Some FAR provisions allow the US government to direct the entity to sell work-in-process to other customers to mitigate the amount of the termination payment it may need to make. These provisions do not affect whether there is an enforceable right to payment, but may be relevant in an entity's evaluation of whether the asset created under the contract has an alternative future use. [606-10-25-27(c)]

If an entity concludes that an enforceable right to payment does not exist, it still evaluates whether its performance obligations in its contracts governed by FAR meet one of the other over-time criteria. [606-10-25-27]

7.3.70 FASB examples on assessing Criterion 3

Excerpt from ASC 606-10

• • > Example 16 — Enforceable Right to Payment for Performance Completed to Date

55-169 An entity enters into a contract with a customer to build an item of equipment. The payment schedule in the contract specifies that the customer must make an advance payment at contract inception of 10 percent of the contract price, regular payments throughout the construction period (amounting to 50 percent of the contract price), and a final payment of 40 percent of the contract price after construction is completed and the equipment has passed the prescribed performance tests. The payments are nonrefundable unless the entity fails to perform as promised. If the customer terminates the contract, the entity is entitled only to retain any progress payments received from the customer. The entity has no further rights to compensation from the customer.

55-170 At contract inception, the entity assesses whether its performance obligation to build the equipment is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.

55-171 As part of that assessment, the entity considers whether it has an enforceable right to payment for performance completed to date in accordance with paragraphs 606-10-25-27(c), 606-10-25-29, and 606-10-55-11 through 55-15 if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. Even though the payments made by the customer are nonrefundable, the cumulative amount of those payments is not expected, at all times throughout the contract, to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date. This is because at various times during construction the cumulative amount of consideration paid by the customer might be less than the selling price of the partially completed item of equipment at that time. Consequently, the entity does not have a right to payment for performance completed to date.

55-172 Because the entity does not have a right to payment for performance completed to date, the entity's performance obligation is not satisfied over time in accordance with paragraph 606-10-25-27(c). Accordingly, the entity does not need to assess whether the equipment would have an alternative use to the entity. The entity also concludes that it does not meet the criteria in paragraph 606-10-25-27(a) or (b), and, thus, the entity accounts for the construction of the equipment as a performance obligation satisfied at a point in time in accordance with paragraph 606-10-25-30.

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

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

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.

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

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.

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.

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.

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.

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

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.

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.

7.4 Measuring progress toward complete satisfaction of a performance obligation

Excerpt from ASC 606-10

• > Measuring Progress toward Complete Satisfaction of a Performance Obligation

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).

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

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.

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.

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.

• • > Reasonable Measures of Progress

25-36 An entity shall recognize revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress toward complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress.

25-37 In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognize revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

7.4.10 Overview

Revenue for a performance obligation that is satisfied over time is recognized using a single method of measuring progress toward complete satisfaction of the obligation. Once an entity chooses a method, it applies that method consistently to similar performance obligations and in similar circumstances. [606-10-25-32]

The objective in selecting a method of measuring progress is to choose one that depicts the entity's performance in transferring control of the promised goods or services that comprise a performance obligation. Therefore, there is no free choice of which method to apply to a given performance obligation. Rather, the appropriate method is based on the nature of the good or service that it promised to transfer to the customer. [606-10-25-31, 25-33, ASU 2014-09.BC159]

Although an entity updates its estimates related to the measure of progress selected in subsequent reporting periods, it cannot subsequently change the method. Rather, a performance obligation is accounted for under the method selected until it has been fully satisfied. [606-10-25-35]

Reasonable measure of progress

A requirement for recognizing revenue over time is the ability to reasonably measure progress toward complete satisfaction of the performance obligation. An entity cannot make a reasonable estimate if it lacks reliable information.

While it is expected to be rare that a reasonable estimate cannot be made, in the event that an entity cannot make a reasonable estimate of progress, it recognizes revenue to the extent of costs incurred. The entity stops using the cost incurred method once it can reasonably measure its progress, and recognizes a cumulative catch-up adjustment in the current period. Such a change is not a change in method because recognizing revenue as costs are incurred is not a measure of progress but rather an exception to the requirement of applying a reasonable measure of progress. [606-10-25-36, 25-37, ASU 2014-09.BC180]

A completed contract method where an entity defers revenue until the contract is complete or substantially complete would not be appropriate.

Regardless of whether revenue is recognized under a measure of progress method or as costs are incurred, the entity expenses its costs as they are incurred because the work-in-process is transferring continuously to the customer when the over-time criteria are met.

Question 7.4.10

Can an entity use multiple measures of progress for a single performance obligation?

Interpretive response: No. Each performance obligation can have only one method of measuring progress. This may be difficult when a single performance obligation contains multiple promised goods or services whose costs will be incurred over different periods of time or transferred in different patterns. For example, this might occur when a performance obligation combines a license and a service arrangement, or a sale of goods and design or installation services. [606-10-25-32]

Understanding the nature of the overall promise to the customer is key to selecting a reasonable measure of progress. The TRG generally agreed that entities should not default to recognize revenue under a final deliverable model, but should instead evaluate the nature of the overall promise when selecting a measure of progress. In determining the nature of the combined performance obligation, an important consideration may be the reasons why the goods or services were combined into a single performance obligation. The following are examples.

— They were combined because they are inputs into a combined output (i.e. the promises are not separately identifiable): a measure of progress that depicts the progress toward completing the combined output may be more appropriate than one that is based on an individual good or service within the contract.

— They were combined because one or more goods or services are not capable of being distinct (i.e. the customer cannot benefit from that good or service): a measure of progress that recognizes revenue when only one of those goods or services has been performed would not be appropriate. This is because to transfer control of a good or service, the customer needs to be able to obtain substantially all of the benefits from the good or service. When a good or service is not capable of being distinct, by definition the customer cannot obtain the benefit from that item alone and therefore no revenue should be recognized. [TRG 07-15.41]

Similarly, we believe it is important to consider the reasons why the performance obligation is satisfied over time (and which of the three criteria was met) because those criteria may indicate how control is transferring to the customer. For example, if the performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits provided by the entity's performance (Criterion 1), the method used to measure progress should reflect the pattern of when benefits are provided to the customer.

If the determination of a single method of progress is challenging, an entity may need to reconsider whether it should have combined two or more goods or services into a single performance obligation. In this instance, perhaps there are multiple distinct performance obligations. On the other hand, just because the identification of a single measure of progress is challenging does not necessarily mean that the promised goods or services are not a single performance obligation. [TRG 07-15.41]

Example 7.4.10
SaaS and nondistinct services

Software Host enters into a contract with Customer to provide Customer with access to its hosted research application for three years on a software-as-a-service (SaaS) basis – i.e. Customer does not have the right to take possession of the hosted software.

Customer needs access to a research tool that can meet certain specifications before it can migrate from its legacy research tool. As part of the contract, Software Host agrees to develop and implement the necessary additional search functionality to its hosted application before Customer goes live with the research tool in six months. Software Host begins the customization efforts immediately after contract inception.

Software Host frequently sells access to its SaaS on a stand-alone basis. It concludes that its performance obligation to provide SaaS is satisfied over time because Customer receives and consumes benefits from the hosted application as Software Host provides that access – i.e. Customer benefits from having the research tool available to it whenever needed during the arrangement period.

Software Host also concludes that the customization services, which involve proprietary knowledge of and access to its existing software code, and the SaaS offering in this contract are not distinct from each other – i.e. they constitute a single, combined performance obligation.

Software Host further concludes that the combined performance obligation is satisfied over time on the same basis as it had previously concluded its SaaS offering, when sold on a stand-alone basis, is satisfied over time. Software Host then selects a time-based measure of progress, with recognition of revenue commencing at go-live, for the following reasons.

— Even with the customization services being part of the contract, the fundamental nature of Software Host's promise to Customer is to provide Customer with access to its SaaS that meets Customer's needs, which Customer consumes and receives benefit from on a generally equal basis throughout, and only *during*, the three-year period following the go-live date.

— Customer will not begin to consume and receive benefit from the SaaS before the go-live date – i.e. if go-live never came, Customer would have consumed and received no benefit from the contract, even if Software Host had successfully customized the hosted application to Customer's specifications.

— From the go-live date, Software Host's efforts to give Customer access to its hosted research application are expected to be even throughout the three years. [TRG 07-15.41]

Example 7.4.20
Equipment and customization services

ABC Corp. enters into a contract with Customer to provide equipment and services that will substantially customize and add significant new functionality that enables the equipment to have functionality specific to the Customer.

ABC concludes that the equipment is not separately identifiable from the service and should be combined into a single performance obligation. Although the equipment and the services are capable of being distinct, the equipment and services are inputs that ABC uses to produce the combined output (customized equipment). As such, the nature of the single performance obligation is developing the customized equipment.

ABC concludes that the performance obligation is satisfied over time because it is developing customized equipment that does not have an alternative use and it has an enforceable right to payment for performance completed to date. As such, ABC uses a measure of progress that depicts the performance of completing the customized equipment, such as an input method based on labor hours or costs (see section 7.4.30).

Although the equipment would be recognized at a point in time if it were a separate performance obligation, in this instance all of the revenue is recognized over the period the customization services are performed. This is because the equipment is not distinct from the service in the contract.
[TRG 07-15.41]

Question 7.4.15
Can an entity with a vertically integrated supply chain measure progress for each sub-component of a single performance obligation at the individual facility level?

Interpretive response: No. A manufacturer may vertically integrate its supply chain such that one facility produces sub-components (e.g. WIP), which are shipped to another facility where integration occurs and production is finalized. When control transfers to the customer over time, progress is measured from a consolidated reporting entity perspective; therefore, the amount and timing of revenue recognition at each facility is based on the single performance obligation at the consolidated reporting entity level.

For example, an entity manufactures a customized widget for a customer, which consists of sub-components that are manufactured at different facilities in different countries. The customized widget is transferred to the customer over time. When sub-component A is complete, it is shipped to a US facility to be integrated into the customized widget. The amount of revenue recognized related to sub-component A is based on the determination of control and a single measure of progress for the customized widget and not the individual sub-component.

Revenue related to sub-component A is not based solely on the efforts of the manufacturing facility that produced it. For example, if a cost-to-cost input method is used to measure progress, the identification of all incurred and estimated costs across the manufacturing facilities involved is required to determine the amount of revenue recognized related to the efforts to manufacture sub-component A.

In some cases, control of the sub-component may not transfer to the customer until it is integrated into the customized widget if the sub-component has an alternative use before integration begins. Before that point, the entity's performance does not transfer an asset to the customer but rather creates an asset for the entity – e.g. inventory. In those cases, revenue is not recognized as the sub-component is manufactured or upon shipment of the sub-component but rather based on when control of the customized widget is transferred. See also Question 7.3.40.

Methods for measuring progress toward complete satisfaction of a performance obligation over time

Excerpt from ASC 606-10

• > Methods for Measuring Progress toward Complete Satisfaction of a Performance Obligation

55-16 Methods that can be used to measure an entity's progress toward complete satisfaction of a performance obligation satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29 include the following:

a. Output methods (see paragraphs 606-10-55-17 through 55-19)
b. Input methods (see paragraphs 606-10-55-20 through 55-21).

To recognize revenue from performance obligations that are satisfied over time, an entity selects a measure of progress that depicts the transfer of control of the goods or services to the customer. A measure of progress is either an output method or an input method. [606-10-25-33]

Method	Description	Examples
Output	Based on direct measurements of the value to the customer of goods or services transferred to date, relative to the remaining goods or services promised under the contract	— Surveys of performance to date — Appraisals of results achieved — Milestones reached — Time elapsed
Input	Based on an entity's efforts or inputs toward satisfying a performance obligation, relative to the total expected inputs to the satisfaction of that performance obligation	— Resources consumed — Costs incurred — Time elapsed — Labor hours expended — Machine hours used

7.4.20 Output methods

Excerpt from ASC 606-10

• • > Output Methods

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.

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.

Output measures 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 promised goods or services. There are several types of output methods, such as units produced, units delivered, time elapsed and milestones reached. The FASB believes that conceptually output measures are the most faithful depiction of an entity's performance because they directly measure the value of the goods or services transferred to the customer. [606-10-55-17, ASU 2014-09.BC164]

However, output methods are not always appropriate. In some cases, such a method may not provide a faithful depiction of performance if the output method selected fails to measure some of the goods or services for which control has transferred to the customer. In other situations, the outputs may not be directly observable or the output method is costly to apply. [606-10-55-17, 55-19]

For example, if at the reporting date an entity's performance has produced work-in-process or finished goods that are controlled by the customer, then using an output method based on units produced or units delivered would distort the entity's performance. This is because the entity would not recognize revenue for the assets that are created before delivery or before production is complete but that are controlled by the customer. [ASU 2014-09.BC165]

Question 7.4.20

Is the milestone method an acceptable measure of progress?

Interpretive response: It depends. If control transfers to the customer over time, a measure of progress based on milestones needs to reflect the pattern of entity's performance. The TRG agreed that while milestones are listed as an example of an output method, it remains necessary to consider whether milestones faithfully depict performance, particularly if they are widely spaced. This is because control generally transfers continuously as the entity performs rather than at discrete points in time. Normally, a milestone method would need to incorporate a measure of progress between milestone achievements to faithfully depict an entity's performance. [TRG 04-16.53]

The presence of a significant amount of work-in-process that the customer controls between milestones indicates that the entity has performed and another measure of progress should be used.

Work-in-process as discussed above refers to the costs to produce an asset or otherwise fulfill a performance obligation satisfied over time and therefore controlled by the customer as the entity performs. This could include the cost of inventory used in production. When satisfying an over-time performance obligation, work-in-process is generally expensed when it is incurred because control of the work-in-process transfers to the customer as it is produced and not at discrete intervals.

However, an entity that satisfies performance obligations over time can still have inventory recorded. For example, inventory to support multiple contracts that has an alternative use is recognized as an asset until it is dedicated to a specific contract.

Question 7.4.30

Can a measure of progress based on a units-of-delivery or units-of-production method be appropriate for a single performance obligation that provides both design and production services?

Interpretive response: Generally, no. A units-of-delivery or units-of-production method usually would not be appropriate when the contract provides both design and production services that constitute a single performance obligation. In this case, each item produced or delivered may not transfer an equal amount of value to the customer. These contracts are common in the aerospace and defense, contract manufacturing, engineering, and construction industries.

For example, if at the reporting date an entity's performance has produced work-in-process or finished goods that are controlled by the customer, using an output method based on units produced or units delivered would distort the entity's performance. This is because the entity would not recognize revenue for the assets that are created and controlled by the customer before delivery or production is complete. [606-10-55-17]

7.4.30 Input methods

Excerpt from ASC 606-10

• • > Input Methods

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.

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).

Although the FASB thought that conceptually an output measure is the most faithful depiction of an entity's performance, it observed that an input method could be appropriate if it is less costly and provides a reasonable proxy for measuring progress. [ASU 2014-09.BC164]

Input methods recognize revenue based on the entity's efforts or inputs to satisfy a performance obligation. There are several types of input methods, such as resources consumed, labor hours expended, costs incurred, time elapsed and machine hours used. [606-10-55-20]

In some contracts there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to the customer. Therefore, an entity that uses an input method may need to adjust the measure of progress for uninstalled materials and significant inefficiencies in its performance that are not reflected in the price of the contract – e.g. wasted materials, labor or other resources. [606-10-55-21]

For example, if a single performance obligation consists of combined goods and services, transfer of control of a good may occur at a different time from transfer of control of the services – e.g. the customer obtains control of the goods before they are installed. In such cases, faithfully depicting performance may entail recognizing revenue only to the extent of the cost incurred for uninstalled materials when:

— the good is not distinct;
— the customer is expected to obtain control of the good significantly earlier than it receives services related to the good;
— the cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation; and
— the entity is acting as the principal, but procures the good from a third party and is not significantly involved in designing and manufacturing the good. [606-10-55-21(b)]

Generally, some level of inefficiency, rework or overrun is assumed in a service or construction contract and contemplated in the arrangement fee. Although Topic 606 specifies that unexpected amounts of wasted materials, labor or other resources should be excluded from a cost-to-cost measure of progress, it does not provide additional guidance on how to identify unexpected costs. Judgment is therefore necessary to distinguish normal wasted materials or inefficiencies from those that do not depict progress toward completion. [606-10-55-21, ASU 2014-09.BC176–BC178]

Excerpt from ASC 606-10

• • > Example 19—Uninstalled Materials

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.

55-188 A summary of the transaction price and expected costs is as follows:

Transaction price	$5,000,000
Expected costs:	
Elevators	1,500,000
Other costs	2,500,000
Total expected costs	$4,000,000

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.

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).

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)

55-192 Consequently, at December 31, 20X2, the entity recognizes the following:

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

(a) Revenue recognized is calculated as (20% × $3,500,000) + $1,500,000. ($3,500,000 is $5,000,000 transaction price – $1,500,000 costs of elevators).
(b) Cost of goods sold is $500,000 of costs incurred + $1,500,000 costs of elevators.

Question 7.4.40
When is margin on uninstalled materials recognized?

Interpretive response: When an entity uses a cost-to-cost method and determines it needs to adjust its measure of progress for uninstalled materials, it recognizes revenue when control of the uninstalled materials is transferred to the extent of cost incurred (e.g. at zero margin). However, an entity may be entitled to a margin on the uninstalled goods that is clearly identified by the contract terms or more often forms part of the overall transaction price. Topic 606 is silent on the timing of recognition for this margin and the accounting after the materials are installed.

We believe that in general the costs should be completely excluded from the measure of progress and the margin recognized in a manner consistent with the rest of the transaction price. This is because the entity is essentially providing a simple procurement service to the customer for the materials, and including these types of costs typically would distort the entity's progress toward complete satisfaction of the performance obligation. [ASU 2014-09.BC172]

Generally, it would not be appropriate to calculate a margin specifically for the materials and apply a different margin to the materials from the rest of the performance obligation. The FASB clarified that requiring an entity to estimate a profit margin that is different from the contract-wide margin could be complex and could effectively create a performance obligation for goods that are not distinct, thereby bypassing the requirements on identifying performance obligations. [ASU 2014-09.BC171]

Example 7.4.30
Treatment of uninstalled materials

In November Year 1, Contractor enters into a lump-sum contract with Customer to refurbish a three-story building and install new elevators for total consideration of $5,000. The following facts are relevant.

- The refurbishment service, including the installation of elevators, is a single performance obligation that is satisfied over time.
- Contractor is not involved in designing or manufacturing the elevators, but is acting as the principal with respect to the project. Customer obtains control of the elevators when they are delivered to the site in December Year 1.
- The elevators are not expected to be installed until June Year 2.
- Contractor uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation.

The transaction price and expected costs are as follows.

Transaction price	$5,000
Costs	
Elevators	1,500
Other	2,500
Total expected costs	**$4,000**

Contractor concludes that including the costs of the procured elevators in the measure of progress overstates the extent of its performance. Consequently, it excludes these costs ($1,500) from the costs incurred and from the transaction price, and recognizes revenue for the transfer of the elevators at a zero margin.

The adjusted transaction price and expected costs for the measure of progress is $3,500 ($5,000 – $1,500) and $2,500 ($4,000 – $1,500), respectively.

By December 31, Year 1, other costs of $500 have been incurred (excluding the elevators) and Contractor therefore determines that its performance is 20% complete ($500 / $2,500). Consequently, it recognizes $700 of the adjusted transaction (20% × $3,500) and costs of $500. The cost of the elevators ($1,500) is added to both revenue and costs to ensure a zero profit margin.

As a result, Contractor records the following journal entries.

	Debit	*Credit*
Contract asset/receivable	700	
Revenue		700
To record transaction price for performance completed.		
Contract asset/receivable	1,500	
Revenue		1,500
To record revenue for installed elevators.		
Cost of goods sold – elevators	1,500	
Cost of goods sold – others	500	
Accounts payable/cash/inventory		500
Inventory – elevators		1,500
To record cost of goods sold.		

In Year 2, Contractor completes the installation of elevators and continues the refurbishment of the building. Contractor concludes that the cost of the elevators does not depict the progress toward completion because it distorts the progress toward complete satisfaction of the performance obligation. Contractor concludes that it should not adjust the measure of progress and record a cumulative catch up adjustment when the elevators are installed. The costs included in the measure of progress exclude the cost of the elevators before and after elevators are installed.

By December Year 2, an additional $1,500 (total of $2,000) of other costs have been incurred (excluding the elevators). Contractor determines that its performance is 80% complete ($2,000 / $2,500). As a result, it records additional revenue of $2,100 (80% × $3,500 – $700 previously recognized).

Contractor records the following journal entries.

	Debit	*Credit*
Contract asset/receivable	2,100	
Revenue		2,100
To record additional transaction price for performance completed.		

	Debit	Credit
Cost of goods sold – other	1,500	
Cash/accounts payable/inventory		1,500
To record cost of goods sold.		

7.4.40 Time-elapsed measure of progress

A time-elapsed method could be either an output or an input method. Use of a time-elapsed measure of progress generally results in a straight-line attribution of revenue over the performance period as each day passes. A time-elapsed measure of progress is generally appropriate when (not exhaustive):

- direct measurements of the value to the customer evidence that the customer obtains generally equal benefit from the service throughout the service period; or
- the entity's inputs (e.g. costs or efforts) are incurred evenly over time. This may be the case, for example, when the entity's costs to provide a service (e.g. technical support in a software licensing arrangement or access to a hosted software application or platform) are fixed and not dependent on how much the customer uses the service (e.g. how many support calls the customer makes or how much the customer makes use of the hosted software).

In contrast, an output method could be based on the consumption of time. For example, revenue for a prepaid telephone card for 60 minutes of talk time is recognized as those minutes are consumed, leading to a pattern of recognition potentially different than straight line. If so, time increments can be used as an output measure toward progress, which would be different than a time-elapsed measure of progress.

It is not acceptable to default to recognizing revenue on a time elapsed basis. Revenue is recognized under a method that faithfully depicts satisfaction of the performance obligation, which may or may not be on a time elapsed basis based on the specific facts.

Question 7.4.50

What is the appropriate measure of progress for a stand-ready performance obligation?

Interpretive response: A time-elapsed measure of progress is frequently appropriate for recognizing revenue for a stand-ready performance obligation (see section 4.2.30). For example, in a health club contract, revenue is generally recognized on a straight-line basis because the pattern of benefit to the customer as well as the entity's efforts to fulfill the contract are generally even throughout the period. However, this may not always be the case, and an entity should not simply default to a time-elapsed measure of progress.

The TRG discussed an example of an annual contract to provide snow removal services. The TRG concluded that a straight-line basis of recognition over the year is not appropriate because the pattern of benefit of these services, as well as the entity's effort to fulfill the performance obligation, generally is not even throughout the year. For example, in New York, the revenue attributable to this performance obligation would likely be recognized entirely (or almost entirely) during the November through March period of the annual contract when the service provider has equipment and crews on standby. [TRG 01-15.16]

In selecting the appropriate measure of progress, an entity considers the substance of the stand-ready obligation to ensure that the measure of progress aligns with the nature of the underlying promise. Relevant aspects of the nature of the underlying promise include the timing of transfer of goods or services and whether the entity's efforts (i.e. costs) are expended evenly throughout the period covered by the stand-ready obligation. [TRG 01-15.16]

Example 7.4.40
Stand-ready maintenance contract

ABC Corp. enters into a maintenance contract with Truck Company for one year. ABC provides maintenance services as needed or upon specified intervals for the fleet of trucks. ABC concludes that the nature of its performance obligation is to stand ready to provide the maintenance services (see Question 4.2.40) and that the performance obligation is satisfied over time because Truck Company simultaneously receives and consumes the benefits from the assurance that ABC is available when-and-if needed.

Although ABC concludes its performance obligation is to stand ready to maintain or service the engines at any point during the annual period, the maintenance services do not necessarily occur evenly throughout the year. As such, ABC selects a measure of progress that more closely aligns with its actual efforts and recognizes revenue on an input-based measure that reflects its performance – e.g. cost-to-cost or labor hours incurred.

Excerpt from ASC 606-10

• • > Example 18 — Measuring Progress When Making Goods or Services Available

55-184 An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay $100 per month.

55-185 The entity determines that its promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes. This is because the extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The entity concludes that the customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available. Consequently, the entity's performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a).

55-186 The entity also determines that the customer benefits from the entity's service of making the health clubs available evenly throughout the year. (That is, the customer benefits from having the health clubs available, regardless of whether the customer uses it or not.) Consequently, the entity concludes that the best measure of progress toward complete satisfaction of the performance obligation over time is a time-based measure, and it recognizes revenue on a straight-line basis throughout the year at $100 per month.

Question 7.4.55

When should an entity begin to recognize revenue for a stand-ready service promised to a customer's customer?

Interpretive response: When the end customer has the ability to access and begin to consume and benefit from the service.

A situation could arise where an entity sells a product through a distributor or other intermediary but also promises, explicitly or implicitly, to provide a stand-ready service to the end customer (i.e. the customer's customer). For example, a car manufacturer may sell its cars to dealers and also provide free maintenance services – e.g. oil changes and periodic required maintenance – to end customers that purchase its vehicles from a dealer. Other examples include but are not limited to software sold to retailers with online hosting or other services provided to the end customer. See section 4.2.20 on identifying promises made to a customer's customer.

Before the end customer has access to the stand-ready service, the entity has not started to fulfill the service performance obligation and control of the service has not begun to transfer to the end customer. Therefore, the entity does not begin to recognize the service revenue until the end customer can begin to consume and benefit from the service (which is typically when the end customer obtains the product).

In the car manufacturer example described above, the revenue allocated to the maintenance services should be recognized beginning when the end customer has the ability to access and begin consuming and benefiting from the maintenance services. The entity should not begin recognizing maintenance revenue when the vehicle is sold to the dealer because the car manufacturer is not yet providing any services to the end customer. See Question 7.4.50 for guidance on selecting the appropriate measure of progress for a stand-ready performance obligation.

If the entity does not have visibility into the distributor's sales to specific end customers, it may not be clear when the end customer has access to and has the ability to consume and benefit from the stand-ready service. In that case, an entity generally will need to develop processes to estimate when the products are sold through to end customers and the service period to the end customer begins. We do not believe it would be appropriate to begin to recognize service revenue when the car is transferred to the dealer on the basis that the car manufacturer cannot reliably estimate when the service period to the end customer begins; rather, we believe a reasonable estimate must be made. Oftentimes, it will be reasonable for the estimate to be based on available sell-through data for a portfolio of similar transactions.

7.4.50 'As-invoiced' practical expedient

Excerpt from ASC 606-10

• • > Output Methods

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.

For a performance obligation satisfied over time, if an entity has a right to invoice a customer at an amount that corresponds directly with the value to the customer of the entity's performance to date, the entity can elect to recognize revenue at that amount. For example, in a services contract an entity may have the right to bill a fixed amount for each unit of service provided. [606-10-55-18]

Referred to as the 'as-invoiced' practical expedient, this approach simplifies many aspects of the Topic 606 revenue model. Revenue is recognized as invoiced on the basis of the price multiplied by the measure of progress – e.g. quantities or units transferred. An entity that uses this practical expedient bypasses determining a transaction price (Step 3), allocating the transaction price to performance obligations (Step 4) and determining when to recognize revenue (Step 5). The practical expedient also brings disclosure relief (see section 15.10). [TRG 07-15.40]

The determination of whether the invoice amount represents equivalent value to the customer may be more difficult in scenarios with multiple performance obligations or when the fixed amount per unit changes over time. This might occur with contracts that have declining unit prices, rates with forward market curves, rates with contractual minimums, or volume rebates. In these cases, judgment is required to determine whether the changes in pricing are in response to a change in the underlying value to the customer. [TRG 07-15.40]

If a contract includes fixed fees in addition to per-unit invoicing (whether paid upfront or over time), substantive contractual minimums or payments to the customer such as rebates, discounts or signing bonuses, then the use of the practical expedient may be precluded because they cause the invoiced amounts not to correspond to the value that the customer receives. [TRG 07-15.40]

Question 7.4.60
For the as-invoiced practical expedient to apply, does the consideration need to be a fixed amount per unit?

Interpretive response: No. The TRG agreed that the as-invoiced practical expedient can apply when the price per unit changes during the contract. The practical expedient is appropriate when the amount invoiced for goods or services reasonably represents the value to the customer of the entity's performance completed to date. [TRG 07-15.40]

The TRG discussed the following examples.

— A contract to purchase electricity at prices that change each year based on the observable forward market price of electricity. Such a contract qualifies for the practical expedient if the rates per unit reflect the value of the provision of those units to the customer.

— An IT outsourcing arrangement with a declining unit price that reflects the decreasing level of efforts to complete the tasks. This may be the case because underlying activities performed at the outset of the contract are more complex, requiring more experienced (i.e. more costly) personnel than later activities. There may also be the effect of a 'learning curve' – i.e. in most circumstances, personnel will become more efficient at performing the same tasks over time. [TRG 07-15.40]

Additionally, the TRG agreed the following additional requirements for the as-invoiced practical expedient to apply when the price per unit changes during the contract:

— the reasons for the change in the price per unit have to be substantive – e.g. for a valid business reason, such as declining costs or changes in the relevant price index; and

— the amount of the change also has to approximate the change in value to the customer. The SEC observer at the TRG meeting stated that this conclusion has to be supported – e.g. by the change in a forward pricing curve in the case of electricity, a change in the Consumer Price Index or a change in labor data that is relevant to the entity's costs of providing the goods or services. [TRG 07-15.40]

Example 7.4.50
Changes in unit rates linked to an observable index

Law Firm enters into a contract with Customer to provide legal services related to an anti-trust lawsuit that is expected to take three years to resolve. Fees for the services are based on hourly rates: starting at $500 per hour for the first year and then adjusting each year by an amount equal to the change in the Consumer Price Index.

Even though the rate per hour will change in Years 2 and 3, Law Firm concludes that it can still apply the as-invoiced practical expedient because the change in fee results from cost of service increases commensurate with local inflation. As a result, Law Firm concludes that the fees it will receive during each period of the arrangement appropriately reflect the value to the customer of the entity's performance of providing legal services in each period of the arrangement.

Example 7.4.60

Changes in unit rates linked to greater of an observable index or fixed change

Assume the same facts as Example 7.4.50 except that Law Firm charges $500 per hour for the first year and then adjusts each subsequent year by an amount equal to the greater of the change in the Consumer Price Index (CPI) or 7%. CPI currently is expected to increase at 2% for the upcoming year and Law Firm's costs are not expected to increase more than CPI.

In this fact pattern, the price is expected to increase 7% each year which is not consistent with inflation or Law Firm's historical pricing or cost trends. As such, Law Firm concludes that it cannot use the as-invoiced practical expedient because the change is not supported by valid business reasons, such as being commensurate with the increase in costs of providing the service or changes in CPI.

Example 7.4.70

Different per-unit rates within a performance obligation

Assume the same facts as Example 7.4.50 except that Law Firm charges different rates per hour over the contract term based on the type and experience of professional providing the service.

For example, the contract provides the following rate card:

- $750 per hour for a partner;
- $500 per hour for a senior associate;
- $300 per hour for an associate;
- $100 per hour for a paralegal.

These rates reflect observable hourly rates that Law Firm charges similar customers for its professional services on a stand-alone basis. Despite the legal services being a single performance obligation, Law Firm will bill Customer a different hourly rate depending on which professional is performing the task generating the billing.

Law firm concludes that it can apply the practical expedient to recognize revenue as it has the right to bill. The practical expedient is available despite the different rates because the rate card differences reflect substantive differences between the value that each professional provides.

Question 7.4.70

Do upfront fees preclude use of the as-invoiced practical expedient?

Interpretive response: In general, the as-invoiced practical expedient is precluded when fees are paid upfront.

The practical expedient is designed to apply when the transaction price varies in direct proportion to a variable quantity of goods or services transferred to the customer – i.e. when the transaction price = a fixed per-unit price (see Question 7.4.60) × a variable quantity of units (TP = P × Q). When fees are paid upfront, the amount invoiced typically does not correspond directly with the value to the customer of *each incremental good or service* that the entity transfers to the customer. In that case, the practical expedient is precluded. In contrast, an upfront fee that reflects the value of other goods or services provided to the customer would not preclude the use of the practical expedient. [ASU 2014-09.BC167]

Notwithstanding the above, the TRG agreed that an upfront fee, not linked to units transferred, does not preclude use of the practical expedient in all circumstances. We believe the TRG discussion also suggested that an insignificant upfront fee (in relation to the expected P × Q consideration) should not preclude use of the practical expedient. This is because on a materiality basis an insignificant upfront fee would not:

— necessarily mean that the amounts later invoiced do not reflect the value to the customer of the goods or services being transferred; or

— substantively affect the overall measure of progress, based on units transferred to the customer, toward satisfaction of the performance obligation. [TRG 07-15.40]

In contrast, a more-than-insignificant upfront fee that is not linked to the transfer of goods or services to the customer does preclude use of the as-invoiced practical expedient. In that case, the upfront fee typically suggests that amounts to which the entity has a right to invoice in later periods do not reflect the value to the customer of the goods or services transferred during the applicable invoice period – i.e. the value of those goods or services includes a portion of the upfront fee.

Recognition of the upfront fee using one measure of progress (e.g. a time-based measure) and applying the as-invoiced practical expedient to variable fees would constitute using multiple measures of progress for a single performance obligation (see Question 7.4.10). This would be the case even if the measure of progress applied to the upfront fee is an output-based measure such as one based on units produced. An output-based measure selected in accordance with paragraph 606-10-55-17 is not the same measure of progress as the as-invoiced practical expedient. However, it is possible to get a similar outcome to recognizing the upfront fee on a time-elapsed measure of progress and the variable fees as billed if the performance obligation is a series and the variable amounts meet the criteria to be allocated to period in which they are earned (see section 6.7).

Judgment is necessary to determine whether an upfront fee is insignificant enough so as not to preclude use of the practical expedient.

Example 7.4.80

Upfront fees and application of the practical expedient

Outsourcer and Customer execute a two-year payroll processing arrangement in which Outsourcer processes Customer's payroll each week, which includes cutting the checks or directly depositing the payroll for Customer's employees.

The total weekly invoice is calculated based on the number of payroll employees processed each week. Customer pays $1.00 per employee per week throughout the two years, billed weekly in arrears. There are no other promised goods or services in the contract and Outsourcer concludes the variable quantities are variable consideration rather than optional purchases (see Question 5.3.10).

Based on relevant, predictive experience, Outsourcer expects total transaction-based fees from the arrangement of approximately $310,000, based on a weekly estimate of between $2,700 and $3,100.

Scenario 1: Insignificant upfront fee

In addition to the transaction-based fees, Customer pays a nonrefundable upfront fee of $7,750.

The $7,750 nonrefundable upfront fee does not relate to a promised good or service because there are no promised goods or services other than the service in the contract. However, Outsourcer concludes that it can still use the as-invoiced practical expedient because the upfront fee is insignificant to the total expected arrangement consideration (2.5% of the estimated transaction price). Therefore, recognition of the upfront fee would not significantly affect either (1) the revenue recognized each week or (2) the overall pattern of revenue recognition.

Outsourcer could recognize the upfront fee:

- on a straight-line basis, which would increase weekly revenue by $75 ($7,750 / 104 weeks); or
- on an output basis (number of transactions processed), which would increase weekly revenue by $68[1] to $78.[2]

Notes:

1. $7,750 × (2,700 / 310,000) transactions = $68.
2. $7,750 × (3,100 / 310,000) transactions = $78.

Scenario 2: Significant nonrefundable upfront fee

In addition to the transaction-based fees, Customer pays a nonrefundable upfront fee of $31,000.

In this scenario, the $31,000 upfront fee is significant to the estimated transaction price. Because the upfront fee does not reflect a payment for goods or services transferred (or partially transferred) to Customer at the time it is paid, Outsourcer concludes that the practical expedient should not be applied to this arrangement.

Even though the practical expedient does not apply, Outsourcer may be able to recognize the revenue attributable to the P × Q formula (i.e. the $310,000 in expected transaction-based fees) in a manner that is generally consistent with the recognition that would result from applying the practical expedient – i.e. recognize the transaction-based fees in the period in which the transactions are provided – as a result of the variable consideration allocation guidance that applies to series of distinct goods or services (see section 6.7).

Scenario 3: Additional fixed weekly fee

In addition to the transaction-based fees, Customer pays weekly fixed fees, in arrears, of $298 (for a total of $30,992).

The fixed fee in effect changes the transaction-based fee each period. For example:

— If Customer processes 3,500 payroll transactions in a week, the net per-transaction fee is $1.09: ((3,500 transactions × $1 = $3,500) + $298 = $3,798) / 3,500 transactions.

— If Customer processes 4,500 payroll transactions in a week, the net per-transaction fee is $1.07: ((4,500 transactions × $1 = $4,500) + $298 = $4,798) / 4,500 transactions.

However, Outsourcer applies its judgment and decides that it cannot support using the practical expedient in this scenario. The change from period to period in the net per-transaction fee reflects the changing value of the service to the customer (see Question 7.4.60), which means that use of the practical expedient is difficult to justify.

In contrast, Outsourcer might still conclude that the practical expedient can be applied if the expected per-transaction prices are within a narrow range and reasonably reflect the 'value to the customer' – e.g. if per-transaction fees within a range of $1.085 – $1.09 represent value to the customer and Outsourcer reasonably expects to be within that range each period of the contract.

Scenario 4: Significant upfront fee that is refundable

Assume the same facts as in Scenario 2 except that the upfront fee is refundable on a pro rata basis if Customer cancels the contract.

Because of the refundable nature of the fee, Outsourcer becomes entitled to $298 more of the upfront fee each week. That would make this scenario and related analysis similar to Scenario 3.

Question 7.4.80

Does a contractual minimum preclude the use of the as-invoiced practical expedient?

Interpretive response: In general, a contractual minimum amount that the entity validly expects the customer to easily surpass is not considered a substantive minimum and does not preclude the use of the as-invoiced practical expedient.

In contrast, if the contractual minimum is such that there is a reasonable possibility that the customer will not exceed that minimum, the practical expedient does not apply. Instead, the general guidance on determining the transaction price (including the constraint on variable consideration) applies (see section 5.3), and the entity needs to select an appropriate measure of progress for that performance obligation. This is because when the contractual minimum is not exceeded, the entity will need to estimate the total transactions and continuously update that amount in order to apply an output method that appropriately depicts the measure of progress instead of relying on the contract billing rates to depict that progress.

For example, assume a service arrangement with transaction-based pricing for which there is a reasonable possibility that: (1) the customer will not exceed the minimum quantity of transactions and (2) the entity cannot apply the series/variable consideration allocation guidance (see section 6.7). In this example, the service provider may conclude that a time-elapsed measure of progress applied to the sum of the minimum transaction-based fees and a constrained estimate of transaction-based fees above that minimum (if any) is appropriate.

The TRG discussed the accounting for minimum guaranteed royalties in a license of symbolic IP – i.e. a right to access license that is recognized over time (see Question 10.11.140). Under one alternative, the entity recognizes the minimum guarantee (fixed consideration) using an appropriate measure of progress and recognizes royalties above the guaranteed amount only when cumulative royalties exceed the minimum guarantee. Some have questioned whether this approach is acceptable for a service arrangement with transaction- or usage-based fees subject to a guaranteed minimum. We believe the TRG alternative applicable to licenses of symbolic IP cannot be extrapolated to service arrangements. This is because the TRG alternative is premised on application of the recognition constraint on the sales- or usage-based royalties, which only applies to licenses of IP. The general constraint on variable consideration applies to transaction-based fees in a service arrangement. Application of the general constraint results in the accounting described in the preceding paragraph. [TRG 11-16.58]

Example 7.4.90
Nonsubstantive minimum

Outsourcer and Customer execute a two-year payroll processing arrangement in which Outsourcer processes Customer's payroll each week, which includes cutting the checks or directly depositing the payroll for Customer's employees.

The total weekly invoice is calculated based on the number of payroll employees processed each week. Customer pays $1.00 per transaction per week throughout the two years, subject to an annual minimum of $50,000.

Outsourcer has a number of contracts similar to the one with Customer and relevant experience suggests that it will process more than 150,000 payroll transactions each year for Customer. Outsourcer includes an annual minimum requirement in its contracts to ensure a minimum recovery of its fixed costs if all of its customers pay only their contractual minimums annually.

Because Outsourcer expects to significantly exceed the annual minimum each year of the contract, it concludes that the annual minimum is not a substantive provision. Therefore, Outsourcer concludes that the contractual minimum does not preclude the use of the as-invoiced practical expedient.

Example 7.4.100
Substantive minimum, assume variable consideration allocation guidance does not apply

Assume the same facts as Example 7.4.90 except that the contract includes a minimum guarantee of $300,000, which is equivalent to 150,000 transactions being processed each year.

Outsourcer has a number of contracts similar to the one with Customer and relevant experience suggests that Customer will have between 145,000 and 165,000 transactions each year to be processed. Using an expected-value method to estimate variable consideration (see section 5.3), Outsourcer estimates a total transaction volume of 310,000 during the contract. Although this estimate exceeds the contract minimum, there is a risk that Customer will not meet the minimum. Therefore, using the practical expedient is not appropriate.

Outsourcer determines that its expected-value estimate of the transaction-based variable consideration does not need to be constrained because (1) its evidence is based on substantial history with similar arrangements and (2) there is little risk of any cumulative revenue reversal being significant because the performance obligation is satisfied over time (see section 7.3). In other words, Outsourcer concludes that its estimate of the transaction-based fees is unlikely to change significantly and any effect of a change in estimate (e.g. 10,000 change in estimated transaction-based fees) will apply only to the extent of progress to date in satisfying the performance obligation.

Scenario 1: Time-elapsed measure used

Outsourcer recognizes the $310,000 transaction price ratably over the two-year outsourcing period. Outsourcer concludes that a measure of progress of recognizing 1/104 of the transaction price per week is appropriate because the entity's efforts are generally equal throughout the two years.

To the extent Outsourcer's estimate of the transaction price (including consideration of the constraint) changes, Outsourcer records a cumulative-effect adjustment to adjust revenue recognized to date.

Scenario 2: Output measure used

Outsourcer determines that an output-based measure is an appropriate measure of progress to apply to the performance obligation – i.e. recognizing actual transaction-based fees earned as compared to total expected transactions that will be processed. This is because the number of transactions processed provides a direct measurement of the value Customer has obtained to date from Outsourcer's performance of providing Customer with payroll services.

In concept, to the extent Outsourcer's estimate of the transaction price (including consideration of the constraint) changes, Outsourcer records a cumulative-effect adjustment to adjust revenue recognized to date (as in Scenario 1). However, mathematically this situation wouldn't arise unless Outsourcer's estimate of total transactions that will be processed falls below the contractual minimum.

Question 7.4.90

Do contractual provisions such as tiered pricing, rebates, credits and refunds preclude the use of the as-invoiced practical expedient?

Interpretive response: It depends. Service arrangements with a P × Q pricing structure frequently include either (or both) of the following provisions.

— **A per-usage or per-transaction fee decreases based on volume *prospectively*.** For example, the customer pays $0.90 per transaction for the first 100,000 transactions processed, $0.80 for the next 200,000 transactions and $0.75 for all transactions thereafter. Tiered pricing of this nature may exist for an entire service period or it may reset multiple times (e.g. each year or each month) during the arrangement period (see Question 5.3.20).

— **The customer is entitled to a refund, rebate (of cash previously paid) or a credit that can be applied against future invoices if it passes a particular usage or transaction volume.** Often these provisions are accompanied by tiered pricing. For example, assume the same tiered pricing as above; however, when the customer passes into a lower pricing tier, it receives that pricing *retrospectively* for all prior transactions through a refund, rebate or a credit.

For a discussion of the circumstances in which a change in the unit price is permitted without precluding use of the as-invoiced practical expedient, see Question 7.4.60.

The presence of variable pricing created by expected refunds, rebates, credits or tiered pricing generally precludes use of the as-invoiced practical expedient. This is because the amount to which the customer has a right to invoice will not, at least until the customer achieves the lowest pricing tier, reflect the amount to which the entity expects to be entitled. The entity also cannot recognize the invoiced amount as revenue when there is an expectation of later price concessions. This expectation also means the invoiced amounts do not reflect the value to the customer of the services provided. [606-10-55-18]

Question 7.4.100

Does the as-invoiced practical expedient permit an entity to wait until it issues an invoice to the customer to recognize revenue?

Interpretive response: No. If an entity is using the as-invoiced practical expedient as a measure of progress it recognizes revenue in a pattern that depicts rights the entity accrues based on its performance. If contractually, it has the right to invoice but does not issue the invoice under the terms of the contract until a later date, the entity still recognizes revenue for performance on an accrual basis.

For example, an entity enters into a contract with a customer on a time and materials basis, but only bills the customer on a quarterly basis. In that scenario, when applying the as-invoiced practical expedient, the entity would recognize revenue as the time and materials are incurred rather than on a quarterly basis.

Question 7.4.110

Can the as-invoiced practical expedient be applied to performance obligations satisfied at a point in time?

Interpretive response: No. The as-invoiced practical expedient is a practical expedient for measuring progress toward complete satisfaction of a performance obligation satisfied over time. If a performance obligation is satisfied at a point in time, no measure of progress is necessary.

However, the practical expedient could potentially be applied to a combined performance obligation that includes a good or service that would normally be satisfied at a point in time if that good or service was a separate performance obligation. For example, a contract to significantly customize or modify equipment is satisfied over time when the entity charges on a time and materials basis.

7.5 Performance obligations satisfied at a point in time

Excerpt from ASC 606-10

• > Performance Obligations Satisfied at a Point in Time

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:

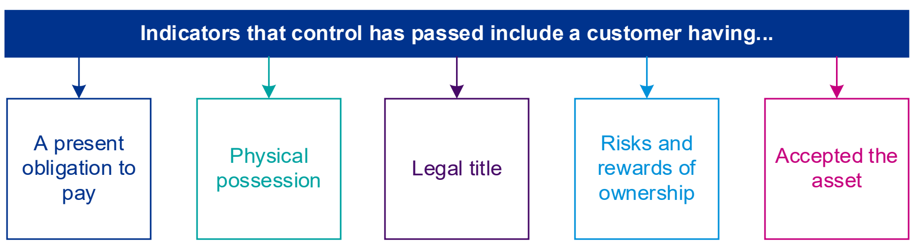
a. The entity has a present right to payment for the asset—If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.
b. The customer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

7.5.10 Overview

If a performance obligation is not satisfied over time, revenue is recognized at the point in time at which control of the good or service transfers to the customer. Topic 606 includes indicators of when the transfer of control occurs. [606-10-25-30]



The above indicators are factors that are often present if a customer has control of an asset; however, they are not necessarily individually determinative, nor are they a list of conditions that have to be met. Topic 606 does not suggest that certain indicators should be weighted more heavily than others, nor does it establish a hierarchy that applies if only some of the indicators are present. Rather the indicators are applied to an entity's specific fact pattern and in some facts and circumstances certain indicators will be more important than others. The relative weight of the indicators depends on the effect they have on a customer's ability to direct the use of and obtain substantially all the benefits of an asset. [606-10-25-30]

— **Present right to payment.** The customer's present obligation to pay for the asset can indicate that control has transferred. However, a present right to payment generally is not sufficient on its own to conclude that control has transferred. In addition, there may be cases when it does *not* indicate transfer of control. For example, the indicator is probably not relevant if the customer is required to make a nonrefundable upfront payment before the delivery of any good or service.

— **Physical possession.** The customer's physical possession of the asset can indicate that control has passed because often the customer is able to start directing the use of, and obtaining the benefits from, the asset through physical possession. However, in some instances, such as consignment arrangements or certain repurchase agreements, physical possession may not coincide with the transfer of control.

— **Legal title.** Transfer of legal title to the customer may indicate that control has transferred because legal title generally gives the ability to sell an asset, exchange it or use it to secure or settle debt. However, control may still pass to the customer when the entity retains legal title for protective reasons (see Question 7.5.10). Conversely, if title has transferred to the customer, the entity may still have the right to constrain the customer's ability to use the asset, such as when a contract contains certain repurchase agreements; in those instances, transfer of title may not coincide with the transfer of control.

— **Risks and rewards of ownership.** Transfer of the risks and rewards of ownership to the customer may indicate that control has transferred because they often indicate an entity can benefit from (the rewards) and the risk of ownership is often a consequence of control. However, when evaluating this indicator, an entity should not consider risks that give rise to separate performance obligations in the contract, such as a service-type warranty.

— **Acceptance of the asset.** Some contracts include customer acceptance clauses and the weight of such clauses can vary. If such a clause is substantive, it may indicate that control has not transferred before customer acceptance. In contrast, if customer acceptance is just a formality, it may not affect whether control has transferred. See section 7.5.40 for further discussion of customer acceptance clauses.

Question 7.5.10

Can revenue be recognized before transfer of legal title?

Interpretive response: Yes, if retaining title does not affect the customer's ability to control the good. Topic 606 requires an entity to evaluate the point in time in which the customer has obtained control of a good or service. None of the transfer-of-control indicators are determinative, and the weight of any indicator depends on how it affects the customer's ability to direct the use of and obtain substantially all of the remaining benefits from the asset. [606-10-25-30]

The transfer of legal title indicator does not preclude the customer from obtaining control when the entity retains legal title solely as protection against the customer's failure to pay. Rather, when the entity retains legal title, the weight of the legal title indicator depends on what rights are retained and whether those rights restrict the customer's ability to direct the use of and obtain substantially all of the benefits of the asset. Typically the nature of a protective right is one designed to protect the interest of the party holding that right. It does not provide that party any other power to direct the use of or obtain substantially all of the remaining benefits from the underlying asset.

To evaluate whether an entity's retention of legal title is only a protective right, we believe the entity should consider the weight of the other indicators of control in paragraph 606-10-25-30 as well as the following factors (not exhaustive).

— **The legal rights retained by the entity.** An entity's retention/possession of legal title that provides the entity with rights beyond just protection in the event of nonpayment (i.e. rights that normally are held by an owner of the goods) may indicate that the rights are not protective. The contractual provisions and the laws governing those provisions are relevant in making this assessment.

— **The ability of the entity to redirect the asset other than in the event of nonpayment.** An ability of the entity to redirect the assets to other customers may indicate that the entity's retention of legal title gives the entity substantive rights.

— **The expected length of time until title is transferred.** For example, if title never transfers or the entity holds title for a significant period of time, then the rights retained may not be protective. In contrast, if title transfers in a relatively short period of time from when the other indicators of control are met, the rights may only be protective.

— **Practical limitations on the entity's ability to exercise any rights retained.** Any practical limitations based on the nature of the asset that affect an entity's ability to redirect the underlying asset to other customers (or exercise other rights) may indicate the rights the entity has by retaining legal title are protective.

— **The customer's ability to consume, sell or direct the asset to other locations prior to title passing.** If the laws or regulations governing the contract prohibit the customer's ability to sell or consume the asset before transferring title, the rights the entity has by retaining legal title may be more than protective.

Example 7.5.10

Point-in-time revenue recognition before transfer on title

ABC Corp. enters into a contract to deliver five tons of glass sand to Customer.

— The contract includes a provision under which title does not transfer to the customer until receipt of payment.

— ABC's intent in including this provision is to allow for recovery of the goods if Customer defaults on payment.

— The transaction is subject to the Uniform Commercial Code (UCC). Under the UCC, the retention of legal title can result in the seller retaining some rights normally held by an owner of goods, such as the right to prohibit the moving, selling or use of the goods. However, ABC does not have a history of exercising these rights other than in the event of nonpayment.

— ABC ships the glass sand before receiving payment. Upon delivery to Customer's facility, ABC has a present right to payment.

— Due to the nature of the glass sand, once it has been delivered to the customer's facility, it is cost prohibitive to physically redirect it to another location. The shipment is also indistinguishable from other shipments at

Customer's location for which payments have been made and title has passed.

- Customer is not prohibited from consuming the glass sand before payment.
- ABC expects title to transfer in a relatively short period of time from delivery.

Upon delivery of the product to Customer, ABC evaluates the transfer-of-control principle and the transfer-of control indicators. It notes that some indicators are met upon delivery of the glass sand and some are met only upon receipt of payment. There is no customer acceptance provision.

Indicator	Upon delivery	Upon receipt of payment
Risks and rewards of ownership	X (rewards of ownership)	X (risk of loss)
Physical possession	X	
Legal title		X
Present right to payment	X	

ABC concludes that control transfers to Customer upon delivery of the product to Customer's facility, even though risks of loss and title have not transferred to Customer at that point. ABC's conclusion is based on the following:

- Customer can direct the use of the glass sand in the same way as any other customer from the time the product is physically delivered to Customer's location. In making this determination, ABC notes that the nature of the product mitigates its risk of loss because the product is virtually indestructible and Customer is not constrained in its ability to consume or sell the asset once it receives the asset. As such, even though the risks of ownership do not transfer upon delivery, ABC places greater emphasis on the rewards transferring because it is more relevant to Customer's ability to direct the use of and obtain benefits from the asset as well as the fact that the risk of loss is not significant.
- ABC's retention of legal title acts as a protective right in the event of nonpayment based on the weight of the other indicators in paragraph 606-10-25-30 and evaluation of the factors in Question 7.5.10. Although the UCC provides ABC with the legal rights to redirect the asset, the short period expected before title transfers, the history of exercising the rights, the practical limitations on ABC redirecting the asset and the customer's ability to consume the asset indicate ABC's rights are protective.
- Based on an analysis of all the facts and circumstances, ABC places greater weight on the other indicators – i.e. rewards of ownership, physical possession and present right to payment – that the customer obtains from the asset than on the rights it retains because those rights are protective in nature.

As a result, revenue is recognized before title transfers.

Question 7.5.20

How do shipping terms affect whether the customer has obtained control of a good?

Interpretive response: When an entity enters into a contract to deliver a product to a customer, the contract generally includes shipping terms, which may specify when legal title passes from the entity to the customer. For most US domestic shipments, if the terms are FOB (free on board) shipping point, legal title passes to the customer when the product is delivered to the carrier. If the terms are FOB destination, legal title to the product passes to the customer when the product is delivered to the customer.

The International Chamber of Commerce publishes a set of rules, referred to as Incoterms, which explains eleven of the most commonly used trade terms in contracts for the sale and purchase of goods (e.g. EXW, FCA, CIF, DAP). Incoterms are commonly used by US companies for sales outside of the United States. These rules describe the shipping obligations of the parties, who bears the shipping cost and when risk transfers. Unlike the commonly used freight terms for US domestic shipments, Incoterms do not address when legal title transfers.

Regardless of the shipping terms used, they do not dictate when control transfers. However, they may be instructive in indicating the point in time when the customer has legal title and the risk and rewards of ownership, and the seller has an unconditional right to payment – which are all indicators that control has transferred. Entities need to consider shipping terms along with other contractual provisions and indicators of control transferring, and the broader control principle to determine the point in time at which control transfers to the customer.

Question 7.5.30

Does transferring the risk of loss to a third party while goods are in transit indicate the customer has obtained control of the good at the point of shipping?

Interpretive response: Not necessarily. Often when goods are shipped FOB destination, the shipping company assumes the risk of loss while the goods are in transit. Other times, the seller may have an insurance policy that fully reimburses it if the goods are destroyed or damaged while in transit. However, these terms do not determine whether control of the goods has transferred to the customer.

An entity only recognizes revenue once it has transferred control of the good or service to the customer – i.e. the customer has obtained the ability to direct the use of, and obtain substantially all of the benefits from, the asset. The entity transferring its risk of loss to another party (i.e. the third-party carrier or insurance company) does not mean that the customer has the ability to direct the use or obtain substantially all the benefits from the good or services. In other words, revenue is not recognized solely because the entity has transferred or insured itself against some of the risks of ownership.

Question 7.5.40

Do synthetic FOB destination terms indicate control of a good has not transferred until destination?

Interpretive response: Generally, no. An entity may contract under FOB shipping point terms, which means legal title passes to the customer when the goods are shipped. However, the entity may have a business practice of providing free replacement products or waiving its invoice if the products are damaged in transit. This is commonly referred to as a 'synthetic' FOB destination arrangement.

We believe that synthetic FOB destination terms do not necessarily preclude revenue recognition. However, an entity needs to carefully evaluate the terms of each contract, and in particular how significant the risks of loss indicator is for the arrangement, to determine whether control has transferred to the customer.

One of the indicators of control is the customer having the significant risks and rewards of ownership. Synthetic FOB destination terms indicate the customer does not have all the *risks* of ownership during transit. However, the *rewards* of ownership, including the ability to benefit from the goods by selling, exchanging, pledging or consuming the asset, also need to be assessed. [606-10-25-30]

If the customer has the rewards of ownership but not the risks, not having the risks of ownership would not preclude revenue recognition depending on the relevance of the other indicators to the customer's ability to direct the use of and obtain substantially all the benefits from the asset. However, the significance of the risk of loss during transit is relevant because if there is a substantial risk of loss during transit, the customer may not be able to benefit from the good until it receives the asset. [606-10-25-30]

If the entity concludes that control transfers upon shipping under synthetic FOB destination terms, it also needs to consider whether its business practices give rise to a separate performance obligation – i.e. a stand-ready obligation to cover the risk of loss if goods are damaged in transit. If a separate performance obligation exists, then only the revenue allocated to the sale of the goods is recognized at the shipping date. However, we believe an entity can elect to account for that stand-ready obligation as a fulfillment cost under the shipping and handling accounting policy election. When elected, all the revenue and costs, including shipping costs, are recognized upon shipping when control transfers to the customer at the shipping point (see section 4.2.60).

Question 7.5.50#

Does granting price concessions to resellers / distributors affect whether control has transferred?

Interpretive response: No. Granting price concessions does not affect whether an entity transfers control of a good or service. However, a pattern of granting price concessions to resellers/distributors may affect the transaction price, which is determined in Step 3. Topic 606 treats potential price concessions as variable consideration. At contract inception, the entity estimates the variable consideration (including the constraint) and that estimate is included in the transaction price (see Question 5.3.40).

Revenue would not be deferred until the reseller/distributor sells the goods to the third party (i.e. recognized on sell-through) unless:

— control of the goods has not been transferred – e.g. inventory is consigned (see section 7.5.20); or

— the transaction price is constrained to zero (which will not usually be the case) – i.e. the entire amount of consideration is at risk of a significant revenue reversal.

The entity updates its assessment of whether the estimate of the amount is constrained at each reporting date. Even then, however, if the entity has transferred control of the goods to the distributor or reseller, it derecognizes the inventory and recognizes the related cost of goods sold when control of the goods transfers to the customer; see section 2.4 of KPMG Handbook, Inventory. This could result in the entity experiencing losses because it does not defer costs related to the unrecognized revenue when control of the goods has transferred to the customer.

Entities that sell to resellers/distributors will need to consider the guidance on consignment sales when evaluating the transfer of control (see section 7.5.20).

7.5.20 Consignment arrangements

Excerpt from ASC 606-10

• > Consignment Arrangements

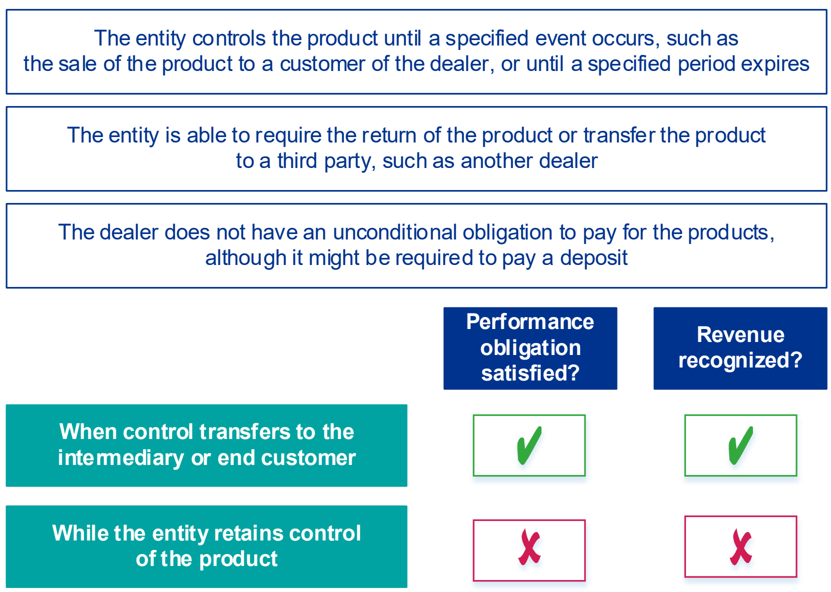
55-79 When an entity delivers a product to another party (such as a dealer or a distributor) for sale to end customers, the entity should evaluate whether that other party has obtained control of the product at that point in time. A product that has been delivered to another party may be held in a consignment arrangement if that other party has not obtained control of the product. Accordingly, an entity should not recognize revenue upon delivery of a product to another party if the delivered product is held on consignment.

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).

An entity may deliver goods to another party (e.g. a dealer or distributor for sale to an end customer) but retain control of the goods until they are resold to a third party; see section 2.3.20 of KPMG Handbook, Inventory. These types of arrangements are called consignment arrangements, and they do not allow the entity to recognize revenue on delivery of the products to the intermediary. [606-10-55-79]

Topic 606 provides indicators that an arrangement is a consignment arrangement as follows. [606-10-55-80]



Example 7.5.20
Consignment arrangement

Manufacturer enters into a 60-day contract to ship 1,000 dresses to Retailer's stores. Retailer is obligated to pay Manufacturer $20 per dress when a dress is sold to an end customer. During the 60-day period, Manufacturer has the contractual right to require Retailer to either return the dresses or transfer them to another retailer. Manufacturer is also required to accept the return of the inventory.

Manufacturer determines that control has not transferred to Retailer on delivery because:

— retailer does not have an unconditional obligation to pay for the dresses until they have been sold to an end customer;
— manufacturer can require that the dresses be transferred to another retailer at any time before Retailer sells them to an end customer; and
— manufacturer can require the return of the dresses.

Manufacturer determines that control of the dresses transfers when they are sold to an end customer – i.e. when Retailer has an unconditional obligation to pay Manufacturer and can no longer be asked to return or otherwise transfer the dresses. Manufacturer recognizes revenue as the dresses are sold to the end customer.

7.5.30 Bill-and-hold arrangements

Excerpt from ASC 606-10

• > Bill-and-Hold Arrangements

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.

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.

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.

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.

• • > Example 63—Bill-and-Hold Arrangement

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.

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.

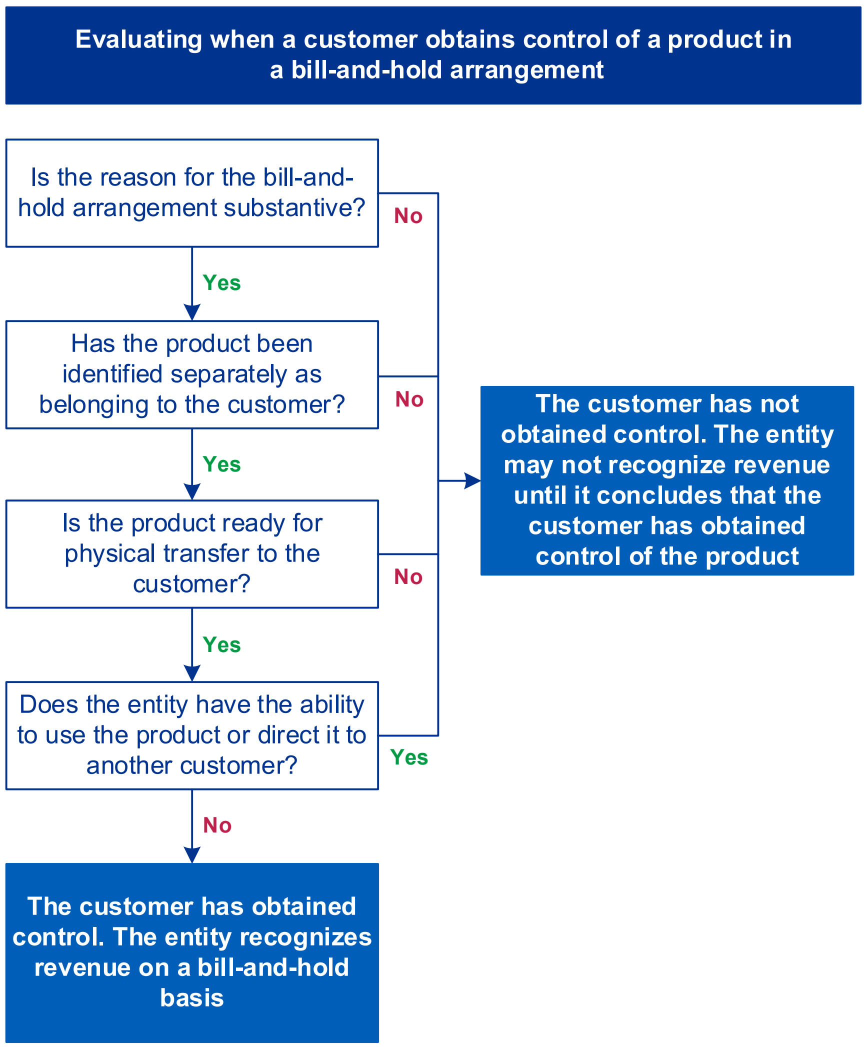
55-411 The entity identifies the promise to provide custodial services as a performance obligation because it is a service provided to the customer and it is distinct from the machine and spare parts. Consequently, the entity accounts for three performance obligations in the contract (the promises to 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.

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.

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.

Bill-and-hold arrangements occur when an entity bills a customer for a product but retains physical possession of the product until it is transferred to the customer at a future point in time; see section 2.3.30 of KPMG Handbook, Inventory. This might occur to accommodate a customer's lack of available space for the product or delays in production schedules. [606-10-55-81]

Although control often does not transfer to a customer before shipment or delivery of the goods, control can transfer when the entity still retains physical possession under a bill-and-hold arrangement if certain criteria are met.



An understanding of the substantive business reasons for the bill-and-hold arrangement is important, and in some cases this may require an explicit request from the customer as evidence to support a conclusion that it is substantive.

If a specified delivery schedule does not exist in the bill-and-hold arrangement, then it may be important that the entity receives appropriate consideration to hold the asset indefinitely to conclude the parties are committed to their obligations and a contract exists.

If an entity concludes that it is appropriate to recognize revenue for a bill-and-hold arrangement, then it is also providing a custodial service to the customer, which is a separate performance obligation unless the entity concludes that it is immaterial in the context of the contract. The entity will need a process and relevant internal controls to estimate the stand-alone selling price of the warehousing performance obligation based on its estimate of how long it will provide the warehousing service.

If an entity creates a good or service with no alternative use and has an enforceable right to payment for performance completed to date, it transfers control as it performs rather than when it delivers the product to the customer. As such, the bill-and-hold guidance may not apply if the entity transfers control as it performs.

Example 7.5.30
Bill-and-hold arrangement

ABC Corp. enters into a contract to sell equipment to Customer. Customer is awaiting completion of a manufacturing facility and requests that ABC holds the equipment until the facility is completed. No delivery date is specified.

ABC bills and collects the nonrefundable transaction price from Customer and agrees to hold the equipment until Customer requests delivery. The transaction price includes appropriate consideration for ABC to hold the equipment indefinitely. The equipment is complete and segregated from ABC's inventory and is ready for shipment. ABC cannot use the equipment or sell it to another customer.

ABC determines that Customer's request for the bill-and-hold is substantive, even though Customer has not specified a delivery date. It concludes that control of the equipment transfers to Customer at the point in time the bill-and-hold criteria are met.

The obligation to warehouse the goods on behalf of Customer represents a separate performance obligation. ABC estimates the stand-alone selling price of the warehousing performance obligation based on its estimate of how long the warehousing service will be provided. The amount of the transaction price allocated to the warehousing obligation is deferred and recognized over time as the warehousing services are provided.

Example 7.5.35**
The bill-and-hold criteria are not met

ABC Corp. enters into a contract to deliver a commodity (the Product) to Customer. ABC delivers the Product to a port and has an agreement with Third Party to manage and store the Product in tanks, as well as deliver and unload the Product to Customer. ABC pays for the storage and management services for a specified period and shares risk of loss of the Product with Third Party.

Upon delivery of the Product to the port, ABC issues an invoice to Customer, which is necessary for Customer to complete the customs process. ABC sets the price for this commodity monthly and the pricing has not historically changed significantly month over month. Once the invoice is issued, ABC notifies Third Party that a specific amount of the Product is to be held for Customer to collect once the customs process is completed.

While the Product is stored in tanks by Third Party, the tanks will contain both (1) the Product that has been sold to Customer and (2) the Product that has not been sold to Customer and is held for ABC. ABC must maintain inventory at the port at no less than the amount that is sold to Customer. However, the Product on hand at the port when the invoice is issued to Customer may not be the same Product delivered to Customer as regular deliveries of the commodity are made to port and Customer has a period of time to collect the Product at the port (i.e. the on-hand homogenous Product could be replaced before the Customer collects the Product).

ABC determines that the bill-and-hold criteria are not met because of the following:

- the Product is not identified separately as belonging to Customer because the Product is held in the same tanks as the portion of the Product held for ABC (i.e. not physically separated or segregated) and the Product is a commodity, and by definition is interchangeable and homogeneous;
- ABC has physical possession until Customer collects the Product from the port and can replace the Product held for Customer until that time;
- title to the Product has not transferred to Customer until Customer obtains physical possession; and
- ABC and Third Party have risk of loss while the Product is at port.

As such, ABC concludes that the control of the Product transfers at the time when Customer collects the Product from the port.

Question 7.5.55

Can an entity recognize revenue when it places vaccines into a vaccine stockpile program?

Interpretive response: It depends. Pharmaceutical companies may enter into contracts to supply vaccines to a governmental agency under a stockpile program. A stockpile program requires these companies to retain a certain number of vaccine doses on hand and to rotate any vaccine dose in the stockpile if its expiration date is within a certain period.

The SEC issued guidance indicating that a vaccine manufacturer should recognize revenue and provide disclosures required under Topic 606 when vaccines are placed into US Federal Governmental stockpile programs; this is because control of the vaccines will have been transferred to the customer (i.e.

the US Federal Government). The following enumerated vaccines are subject to this SEC guidance: [SEC Release 33-10403, 34-81429]

— childhood disease vaccines;
— influenza vaccines; and
— other vaccines and countermeasures sold to the US Federal Government for placement in the Strategic National Stockpile.

This interpretive guidance does not apply to transactions other than those described above with the US Federal Government. When the vaccines are placed into the US Federal Government stockpile, an entity needs to evaluate whether storage, maintenance (i.e. stock rotation), and shipping and handling of vaccine stockpiles are separate performance obligations because control of the vaccine doses transfers to the customer before the entity provides these services. [SEC Release 33-10403, 34-81429]

Entities with similar transactions with customers other than the US Federal Government should evaluate their facts and circumstances under the bill-and-hold guidance. We understand that many arrangements outside the scope of the SEC's interpretive guidance will not meet the criteria to recognize revenue under that guidance because either the product is not separately identified as belonging to a particular customer or the entity has the ability to direct the product to another customer.

7.5.40 Customer acceptance

Excerpt from ASC 606-10

• > Customer Acceptance

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.

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.

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.

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.

A customer's acceptance may indicate that the customer has obtained control of a good. [606-10-25-30(e)]

Customer acceptance clauses included in some contracts are intended to ensure the customer's satisfaction with the goods or services promised in the contract. When the clause is considered a formality, it does not affect the control determination. A clause may be considered a formality when the entity can objectively verify that goods or services comply with customer specifications. This would typically involve analyzing its experience with similar contracts. However, if an entity cannot objectively determine that the good or service meets the criteria, control does not transfer until the customer accepts the good or service. [606-10-55-86 – 55-87]

The table below illustrates how some common customer acceptance clauses may affect the transfer-of-control analysis.

If the entity …	Then …	For example …
can objectively verify that the goods or services comply with the specifications underlying acceptance	customer acceptance is a formality, and revenue could be recognized before explicit acceptance	the customer acceptance clause is based on meeting objective size and weight specifications
cannot objectively determine whether the specifications have been met	it is unlikely that the entity will be able to conclude that the customer has obtained control before formal customer acceptance	the customer acceptance clause is based on a modified product functioning in the customer's new production line
delivers products 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	the customer acceptance clause specifies that the customer may use prototype equipment for a specified period

Certain customer-specified objective criteria may give rise to a separate performance obligation under Topic 606. For further discussion of warranties, see section 4.5.

Question 7.5.58

What factors indicate that an entity has transferred control of an asset before the entity receives the customer's acceptance?

Interpretive response: The assessment of whether a customer controls an asset before the customer provides formal acceptance to an entity focuses on whether the entity is able to objectively determine whether the acceptance criteria are met and its historical experience with contracts for similar goods or services. [606-10-55-86]

Objective criteria

When an entity can measure the objective specifications, it may be able to demonstrate those criteria are met before formal customer acceptance by testing the product beforehand and considering its experience with similar goods or services.

When the specifications are not objective, generally it will be difficult for an entity to demonstrate that the criteria are met. This is because a subjective acceptance clause effectively gives the customer discretion to unilaterally reject the good or service and the acceptance provisions may be more akin to a trial or evaluation period.

Historical experience

When evaluating whether an entity has relevant history, we believe the entity should consider whether the acceptance terms are standard and the entity has the ability to test the product.

Standard acceptance terms

Standard customer acceptance clauses may enable the entity to objectively demonstrate that the criteria are met. When there are nonstandard terms, the entity may not have a history or there may be substantive risk that the provisions will not be met.

The following could be considered nonstandard terms.

- The customer specified the acceptance criteria.
- The acceptance period is longer than customary contracts.
- The entity does not have experience with the customer and the acceptance clauses are unique.

An explicit or written notification could indicate that the acceptance criteria are unique because it requires specific customer action. In contrast, a contract that has deemed acceptance after a certain period of time may indicate a more standardized term.

Ability to test the product

A history of testing and meeting the specifications before transferring similar products is an indicator that the entity can objectively demonstrate the criteria are met. However, when an entity introduces a new product, is contracting with a new customer or the contract has nonstandard terms, we believe the entity should also consider the following (not exhaustive).

— **Complexity of the product**. When the product is more complex, it may be more difficult to demonstrate that the criteria are met when there are nonstandard terms. In contrast, when the product is not complex, the entity's experience with other products of similar complexity may be relevant to demonstrate that the criteria are met.

— **Uniqueness of product**. If the good or service is a first-of-its-kind product, the entity may not have historical experience to determine that acceptance criteria are met. In other scenarios, the product may be unique but similar to other products the entity has sold and tested.

— **Uniqueness of customer environment.** If the customer has a unique environment or other equipment that could affect the ability of the product to meet its specifications, any testing done by the entity may not be sufficient to demonstrate the criteria are met.

All facts and circumstances should be considered when determining whether the entity has relevant experience. For example, an entity may conclude that the acceptance criteria are met before formal acceptance even when the product is the first of its kind, if it is not complex and the contract has standard objective acceptance criteria. In other cases, an entity may conclude that the acceptance criteria are not met when the product is not new but the contract is with a new customer, has nonstandard customer specific criteria, and requires explicit notice of acceptance.

7.5.50 Repurchase agreements

Excerpt from ASC 606-10

• > Repurchase Agreements

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.

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).

Control of an asset may not transfer to a customer upon physical delivery of the asset if the transaction is subject to a repurchase agreement. [606-10-25-30(c)]

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. The accounting for a repurchase agreement depends on its type (e.g. a forward, call option or put option) and on the repurchase price. [606-10-55-66 – 55-67]

An arrangement in which an entity subsequently decides to repurchase a good after transferring control of that good to a customer would not constitute a repurchase agreement. This is because the entity's subsequent decision to repurchase a good without reference to any pre-existing contractual right does not affect the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the good upon initial transfer. In other words, the customer is not obliged to resell that good to the entity as a result of the initial contract. [ASU 2014-09.BC423]

For example, an automotive manufacturer may initiate a repurchase of inventory sold to a dealership to move the inventory from one dealership to another. This would not constitute a repurchase agreement unless the original contract required the dealership to sell the inventory back to the manufacturer.

Guidance for certain sale and leaseback transactions

Topic 606 does not affect the guidance on the accounting for sale and leaseback transactions except when the seller-lessee holds a forward or call option to repurchase an asset for an amount that is less than its original selling price, or the buyer-lessor has a significant economic incentive to exercise a put option. In these cases, the contract is accounted for as a financing arrangement under Topic 606; therefore, no profit or loss can be recognized. See sections 7.5.60 and 7.5.70 for additional information.

Treatment of processing costs for product financing arrangements

A product financing arrangement may include processing performed by the buyer. For example, a car manufacturer may sell aluminum to a parts supplier, and in a related transaction agree to purchase component parts from the supplier containing a similar amount of aluminum. The price of the component parts includes processing, holding and financing costs.

Under Subtopic 470-40, a car manufacturer identifies the processing costs separately from the financing and holding costs and recognizes the processing costs as part of the cost of the component parts. Section 3.7.40 of KPMG Handbook, Debt and equity financing, provides additional information on product financing arrangements. [470-40-25-3]

7.5.60 Forward or call option

Excerpt from ASC 606-10

• • > A Forward or Call Option

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 842 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 and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with Subtopic 842-40.
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.

55-69 When comparing the repurchase price with the selling price, an entity should consider the time value of money.

55-70 If the repurchase agreement is a financing arrangement, the entity should continue to recognize the asset and also recognize a financial liability for any consideration received from the customer. The entity should recognize the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest and, if applicable, as processing or holding costs (for example, insurance).

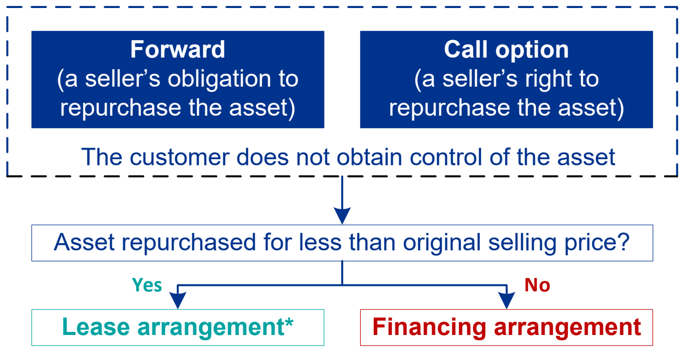
55-71 If the option lapses unexercised, an entity should derecognize the liability and recognize **revenue**.

If an entity has an obligation (a forward) or a right (a call option) to repurchase an asset, then a customer does not have control of the asset and no revenue is recognized. This is because the customer is limited in its ability to direct the use of, and obtain substantially all of the benefits from, the asset despite its physical possession. Because the customer is obliged to return or to stand ready to return the asset to the entity, the customer cannot use up or consume the entire asset. Moreover, the customer cannot sell the asset to another party – unless that sale is subject to a repurchase agreement, in which case the customer's benefit from the sale is constrained. [606-10-55-68, ASU 2014-09.BC424]

An entity does not need to consider the likelihood that a call option can be exercised because the existence of the call option effectively limits the customer's ability to control the asset. However, if the call option is nonsubstantive, it should be ignored in assessing whether and when the customer obtains control of a good or service to be consistent with the general requirement for any nonsubstantive term in a contract. [ASU 2014-09.BC427]

An entity accounts for a forward or a call option as a lease or a financing arrangement depending on the relationship between the repurchase amount and the original selling price. The FASB specified that when the forward or call option accounted for as a lease is part of a sale and leaseback transaction, the contract is accounted for as a financing transaction. Otherwise, an entity would have been required to account for the transaction as a lease and then as a leaseback, which would not have been appropriate. [606-10-55-68, ASU 2014-09.BC426]

The following chart summarizes these considerations.



* If the contract is part of a sale and leaseback transaction it is accounted for as a financing arrangement.

In a financing arrangement, the entity continues to recognize the asset and recognizes a financial liability for any consideration received. The difference between the consideration received from the customer and the amount of consideration to be paid to the customer is recognized as interest and processing or holding costs if applicable. If the option expires unexercised, then the entity derecognizes the liability and the related asset, and recognizes revenue. [606-10-55-70 – 55-71]

Example 62 Case A in Topic 606 illustrates accounting for a call option.

Excerpt from ASC 606-10

• • > Example 62 – Repurchase Agreements

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

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.

55-403 Control of the asset does not transfer to the customer on January 1, 20X7, because the entity has a right to repurchase the asset and therefore the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Consequently, in accordance with paragraph 606-10-55-68(b), the entity accounts for the transaction as a financing arrangement because the exercise price is more than the original selling price. In accordance with paragraph 606-10-55-70, the entity does not derecognize the asset and instead recognizes the cash received as a financial liability. The entity also recognizes interest expense for the difference between the exercise price ($1.1 million) and the cash received ($1 million), which increases the liability.

55-404 On January 1, 20X7, the option lapses unexercised; therefore, the entity derecognizes the liability and recognizes revenue of $1.1 million.

Question 7.5.60

Does the forward or call option guidance apply to conditional rights?

Interpretive response: It depends. The guidance on forward or call options does not distinguish between conditional and unconditional rights.

In some cases, a forward contract or a call option may be conditioned on a future event (other than the passage of time). Although all of the facts and circumstances need to be evaluated, treating certain conditional forwards or call options as rights of return (see section 5.4) rather than as a lease or financing arrangement may be more consistent with the economics of an arrangement. In making this determination, the entity needs to evaluate whether the conditional right restricts its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

The condition is entirely controlled by the customer

If the customer controls the condition that makes the right exercisable, we believe that generally the entity should consider whether the customer has an economic incentive to trigger the entity's right to repurchase the asset. This is similar to the analysis used for evaluating customer put options (see section 7.5.70). An example of when the customer controls the condition that triggers the repurchase right is an anti-speculation clause in which the entity has the right to repurchase a real estate asset only if the customer fails to comply with certain provisions of the sales contract. [606-10-55-72 – 55-76]

If the customer has a significant economic incentive to trigger the entity's right to repurchase the asset, or it is more than remote that the customer would trigger the entity's repurchase right for other reasons, the contract is accounted for as a lease or a financing arrangement because this would be economically similar to an unconditional right.

If the customer does not have a significant economic incentive to trigger the entity's right to repurchase the asset, and it is remote that the customer would trigger the entity's repurchase right for other reasons, the entity follows the sales return guidance (see section 5.4).

The condition is entirely controlled by the entity

If the entity controls the event that makes the right exercisable, we believe that generally the contingency should be ignored and the entity should account for the contract as a lease or financing arrangement because that right is no different than an unconditional right. However, if the option is not substantive, the entity should ignore the provision. [ASU 2014-09.BC427]

The condition is not entirely controlled by either party

If the condition that makes the right exercisable is outside the control of both the entity and customer, the entity considers the effect of the condition on a customer's ability to control the asset.

— **Contingency is considered to be remote.** Remote contingencies outside the control of the entity and customer, such as a natural disaster, generally do not preclude the entity from transferring control. The right does not constrain the customer's ability to use up or consume the remaining asset, and the entity follows the sales return guidance (see section 5.4).

— **Contingency is considered to be more than remote.** An entity should consider whether the conditional right restricts the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset for substantially all of its estimated useful life.

  We believe that when the customer is obligated to stand ready to return the asset for a period of time and cannot use up or consume the entire asset until after the right lapses, the contract should be accounted for as a lease or a financing. This would also be the case if the right restricted the customer's ability to benefit from reselling the asset because they could only sell the asset subject to the repurchase right. If the right expires, the entity would derecognize any liability and recognize revenue. [ASU 2014-09.BC424]

  In contrast, if the condition is more than remote but the right does not restrict the customer's ability to direct the use or obtain substantially all the benefits of the asset, the conditional right may more appropriately be accounted for as a right of return.

  See Example 7.5.40.

Example 7.5.40
Conditional forward or call option

Scenario 1: Control does not transfer

Manufacturer sells a product with a useful life of five years to Customer for $100. If the fair value of the asset is greater than $50 after three years, Manufacturer has the option to repurchase the asset for $50. The likelihood of the fair value being greater than $50 is more than remote.

If Customer sells the asset to a third party before the end of three years, Manufacturer retains its right to repurchase the asset at the end of three years from the new owner. The contract also restricts Customer's ability to dispose of the asset, which it is required to keep in good working condition.

In this scenario, the repurchase right restricts Customer's ability to consume or use up the remaining asset and to benefit from it. Therefore, control does not transfer.

As a result, Manufacturer accounts for the transaction as a lease because the asset would be repurchased for less than the original selling price.

Scenario 2: Right of return

Manufacturer sells perishable goods to Customer. Manufacturer has the right to remove and replace out-of-date products to ensure that end consumers receive the product quality and freshness that they expect. Manufacturer does not have the unconditional right to repurchase the products at any time because the products must be past their sell-by dates for Manufacturer to apply this right. The likelihood of the food expiring is more than remote.

In this scenario, the existence of a conditional call option does not restrict Customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the products. This is because Customer controls the products for the entirety of the time that they have economic value.

Manufacturer has no right to repurchase the product if the sell-by date has not passed. When its right is triggered, Manufacturer cannot repurchase anything of value, but rather is compensating Customer for removing expired products.

Therefore, Manufacturer accounts for the arrangement as a sale with a right of return. Manufacturer's call option in this scenario is a protective right to recall the goods upon expiration and does not prevent Customer from controlling the asset (i.e. selling it) before the products' sell-by date (i.e. useful life).

As a result, Manufacturer accounts for the provision as a right of return (see section 5.4).

Scenario 3: Non-substantive call option

Specialized equipment Manufacturer enters into a contract with Retailer that includes a conditional call option. Manufacturer can require Retailer to return all of Manufacturer's inventory that is in Retailer's possession at the time of contract termination.

The contract requires that Manufacturer provide Retailer with a written request and a minimum notice of 120 days to terminate the contract. Retailer is not restricted from selling the inventory during the notice period and Manufacturer does not have a history of repossessing inventory once a contract is terminated.

Retailer does not generally maintain inventory in excess of 120 days given its limited space and the short lead time necessary to access inventory from Manufacturer. Retailer also collateralizes its debt with Manufacturer's inventory in its possession.

In this scenario, Manufacturer concludes that the call option that can only be exercised after a 120-day notice period is *not* substantive and therefore control has transferred to Retailer. Retailer can still direct the use of and obtain substantially all the benefits from the inventory in its possession.

As a result, Manufacturer ignores the non-substantive 120-day call option in assessing whether and when Retailer obtains control of the inventory.

Question 7.5.70

Is a right of first refusal (or a right of first offer) considered a repurchase agreement under Topic 606?

Background: A right of first refusal provides the entity with a right to purchase an asset before the owner (in this case the customer) can sell it to a third-party buyer.

Interpretive response: We do not believe a right of first refusal based on a bona fide offer by a third party constitutes an obligation or right to repurchase the asset subject to the guidance on repurchase agreements. Even if the right of first refusal on the resale of the asset is a condition of the initial sale, that right alone does not constrain the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. When determining if control transfers upon initial sale, an entity would evaluate all of the facts in the arrangement including whether:

— the customer unilaterally controls the decision about whether and when to sell the asset; and

— if the customer does decide to sell the asset, it will realize the asset's remaining benefits even if the original seller exercises its right because the original seller must match the amount offered by a third party (i.e. the fair value or amount the customer would otherwise be willing to accept).

Further, the entity is not required or economically compelled to exercise its right. We believe a similar conclusion applies to a right of first offer that allows the entity to make an offer to the customer before the customer solicits or receives offers from third parties. However, the customer needs to be able to act in its best interest and cannot be economically or contractually compelled to accept the offer, nor can the entity be economically compelled to make an offer.

7.5.70 Put option

Excerpt from ASC 606-10

• • > A Put Option

55-72 If an entity has an obligation to repurchase the asset at the **customer's** request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 842 on leases unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with Subtopic 842-40.

55-73 To determine whether a customer has a significant economic incentive to exercise its right, an entity should consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of the repurchase and the amount of time until the right expires. For example, if the repurchase price is expected to significantly exceed the market value of the asset, this may indicate that the customer has a significant economic incentive to exercise the put option.

55-74 If the customer does not have a significant economic incentive to exercise its right at a price that is lower than the original selling price of the asset, 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.

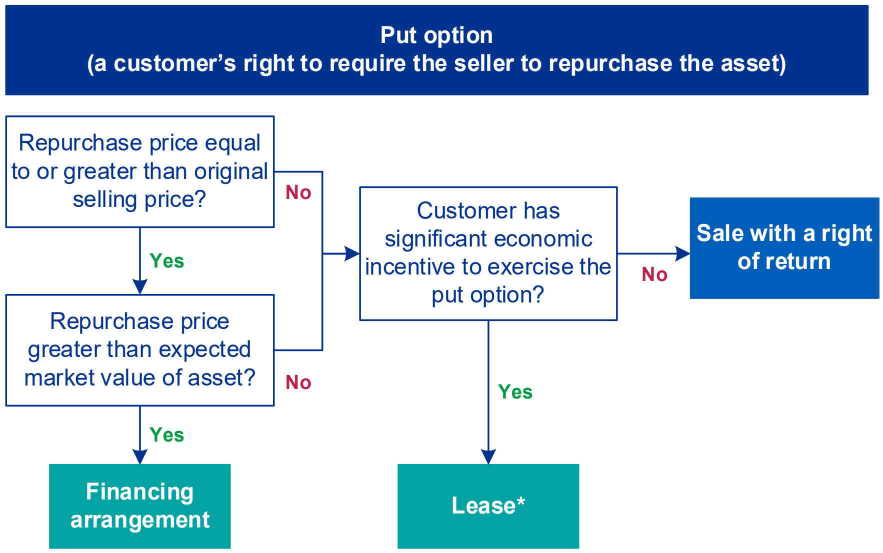
55-75 If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is in effect a financing arrangement and, therefore, should be accounted for as described in paragraph 606-10-55-70.

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.

55-77 When comparing the repurchase price with the selling price, an entity should consider the time value of money.

55-78 If the option lapses unexercised, an entity should derecognize the liability and recognize **revenue**.

If a customer has a right to require an entity to repurchase the asset (put option), an entity accounts for that transaction as either a financing arrangement, a lease or a sale with a right of return depending on the facts and circumstances. The following chart summarizes these considerations.
[606-10-55-72 – 55-76]



* If the contract is part of a sale-leaseback transaction it is accounted for as a financing arrangement.

Financing

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, then the customer does not control the asset and the contract is accounted for as a financing arrangement. In this case, if the option expires unexercised, the entity derecognizes the liability and the related asset and recognizes revenue at the date on which the option expires. [606-10-55-75]

Lease

If a customer has a right to require an entity to repurchase the asset (put option) at a price that is lower than the original sales price and the customer has a significant economic incentive to exercise that right, the entity accounts for the agreement as a lease. Although the customer is not obliged to exercise its put option, the fact that it has a significant economic incentive to exercise that right means that it probably would incur a loss if it did not do so. [606-10-55-72]

The following factors are relevant to determining whether a customer has a significant economic incentive to exercise a put option: [606-10-55-73]

- relationship of the repurchase price to the expected market value of the asset at the date of repurchase; and
- amount of time until the right expires.

Judgment is necessary in making this determination. This determination is made at contract inception and is not updated for subsequent changes in asset prices. Historical customer behavior in similar arrangements may be relevant to this analysis.

Right of return

An entity accounts for a put option as a right of return (see section 5.4) if it does not have an economic incentive to exercise the put and either: [606-10-55-74]

— the repurchase price of the asset is equal to or greater than the original selling price but is less than or equal to the expected market value of the asset; or
— the repurchase price is lower than the original selling price of the asset.

Example 62 Case B in Topic 606 illustrates how to account for a put option.

Excerpt from ASC 606-10

• • > Example 62 – Repurchase Agreements

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

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.

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.

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 842 on leases.

Question 7.5.80

Are sales in which the entity guarantees a minimum resale value subject to the repurchase agreement guidance?

Interpretive response: No. The FASB observed that although the cash flows of an agreement with a guaranteed minimum resale value (or a residual value guarantee) may be similar to those of an agreement with a put option, the customer's ability to control the asset is different, and therefore the recognition of revenue may differ. This is because if a customer has a significant economic incentive to exercise a put option, then it is restricted in its ability to consume, modify or sell the asset. However, when the entity guarantees that the customer will receive a minimum amount of sales proceeds, the customer is not constrained in its ability to direct the use of and obtain substantially all of the benefits from the asset. This could result in different accounting for arrangements with similar expected cash flows. [ASU 2014-09.BC431]

Because of the similarities between some put options and minimum resale guarantees, care is necessary to determine whether a feature like a guaranteed minimum resale provision contains a put option. If the customer has the right to require the entity to repurchase the asset, the feature is considered a put option that the entity needs to evaluate under the repurchase agreement guidance.

In contrast, if a contractual provision only requires the entity to pay the customer whole upon sale to a third party, the entity accounts for the guarantee under Topic 460 (guarantees). The implementation guidance on leases states that "a sales incentive program in which an entity (for example, a manufacturer) contractually guarantees that it will pay a purchaser for the deficiency, if any, between the sales proceeds received and the guaranteed minimum resale value should be accounted for in accordance with Topic 460 on guarantees and Topic 606 on revenue from contracts with customers". In that case, the entity would account for the guarantee separately from the sale of the asset. [842-30-55-4]

Question 7.5.90

Are trade-in rights subject to the repurchase agreement guidance in Topic 606?

Interpretive response: It depends. Entities may enter into contracts where they sell a product and grant a right to trade in that product for a fixed price in the future. An entity needs to determine if the trade-in right is in the scope of other guidance such as Topic 460 on guarantees.

Specifically, entities need to evaluate the following scope exception to the guarantee guidance.

Excerpt from ASC 460-10

15-7K A sales incentive program in which a manufacturer contractually guarantees to reacquire the equipment at a guaranteed price or guaranteed prices at a specified time, or at specified time periods (for example, the entity is obligated to reacquire the equipment or the entity is obligated to at the **customer's** request to reacquire the equipment). That program shall be evaluated in accordance with Topic 606 on **revenue** from **contracts** with customers, specifically the implementation guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78.

Generally, we believe that a customer trade-in right is excluded from the scope of Topic 460 and is considered a put option in the scope of the revenue standard. In that case, and depending on the facts and circumstances, the entity will account for the contract as a lease, financing or a sale with a right of return in accordance with the repurchase agreement guidance in Topic 606. [606-10-55-72 – 55-76]

However, if the trade-in right requires the customer to enter into a subsequent contract for goods or services with the entity, we believe it is acceptable to account for the trade-in right as a guarantee in the scope of Topic 460. In this case, an entity allocates the transaction price between the elements in scope of Topic 460 and Topic 606.

When a contract with a customer contains elements addressed by different Codification topics, if the other topics specify how to separate or measure one or more parts of the contract, an entity first applies those separation or measurement requirements. Therefore, the separation and fair value measurement guidance in Topic 460 applies to guarantees within its scope. [606-10-15-4]

As a result, an entity that has determined that a trade-in right requires the customer to enter into a subsequent contract may account for that right as a Topic 460 guarantee by recording a guarantee liability at fair value. The transaction price less the fair value of the guarantee is then allocated to the performance obligations in the scope of Topic 606. [AICPA AAG-REV 13.2.33]

Question 7.5.95

Does a trade-in right offered after contract inception constitute a repurchase agreement?

Background: Sometimes an entity may not provide a trade-in right at contract inception; instead, a trade-in offer is made after contract inception. For example, telecom entities may make offers after contract inception that provide customers with an option to trade in their handsets. Often, these offers are widely provided, made for a limited time and can be retracted at any time.

Interpretive response: Generally, no. An arrangement in which an entity subsequently decides to provide a trade-in offer to repurchase a good after transferring control of that good to a customer, generally would not constitute a repurchase agreement. However, if trade-in offers are frequently provided after contract inception, they may constitute customary business practices and therefore represent an implied promise at contract inception. In those cases, an entity needs to evaluate the specific implied offer to determine if the guidance on repurchase agreements or variable consideration applies.

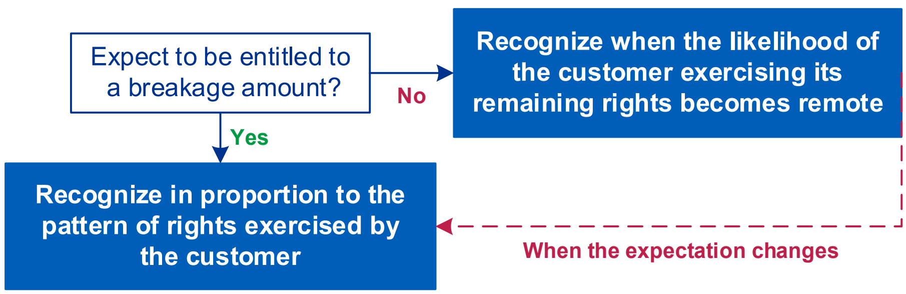
If the subsequent trade-in offer does not constitute an entity's customary business practice, it may be viewed as a marketing offer. In this case, the customer controls the asset and if they decide to accept the marketing offer, the trade-in of the asset represents noncash consideration and is included in the transaction price when the offer is accepted. For further discussion on noncash consideration, see section 5.6.

7.6 Customers' unexercised rights (breakage)

7.6.10 Overview

An unexercised right (or breakage) occurs when a customer makes a prepayment in return for the right to obtain goods or services in the future but fails to exercise that right (e.g. gift cards). Because an entity may not be required to completely satisfy its performance obligations, Topic 606 provides guidance on how to recognize revenue related to customer rights that are not exercised.

The following decision tree summarizes how an entity receiving the prepayment and incurring the obligation to provide future goods or services to the customer accounts for prepayment amounts that represent estimated breakage.



7.6.20 Accounting for breakage

Excerpt from ASC 606-10

• > Customers' Unexercised Rights

55-46 In accordance with paragraph 606-10-45-2, upon receipt of a prepayment from a customer, an entity should recognize a contract liability in the amount of the prepayment for its performance obligation to transfer, or to stand ready to transfer, goods or services in the future. An entity should derecognize that contract liability (and recognize revenue) when it transfers those goods or services and, therefore, satisfies its performance obligation.

55-47 A customer's nonrefundable prepayment to an entity gives the customer a right to receive a good or service in the future (and obliges the entity to stand ready to transfer a good or service). However, customers may not exercise all of their contractual rights. Those unexercised rights are often referred to as breakage.

55-48 If an entity expects to be entitled to a breakage amount in a contract liability, the entity should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, the entity should recognize the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote. To determine whether an entity expects to be entitled to a breakage amount, the entity should consider the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

55-49 An entity should recognize a liability (and not revenue) for any consideration received that is attributable to a customer's unexercised rights for which the entity is required to remit to another party, for example, a government entity in accordance with applicable unclaimed property laws.

An entity recognizes a contract liability when it receives a nonrefundable prepayment from a customer that gives the customer the right to receive goods or services in the future. Common examples include gift cards, vouchers and nonrefundable tickets. The entity recognizes the prepayment as revenue (i.e. the contract liability is reduced) when the customer exercises its right to receive goods or services and those goods or services are transferred to the customer. [606-10-55-46]

However, a portion of the contract liability recognized as revenue may relate to contractual rights that the entity does not expect to be exercised – i.e. a breakage amount. For example, if an entity expects a customer will redeem only 90% of the value of a gift card, then 10% of the amount paid for the gift card is breakage. In this instance, the customer is expected to let its right to obtain goods or services for 10% of its prepayment expire unexercised. [606-10-55-47]

Revenue is eventually recognized because the customer will either exercise its right to obtain goods or services or let its right to do so expire. However, an entity does not simply recognize revenue when the customer either exercises its right to obtain goods or services or when the right expires unexercised. The amount of revenue recognized is based on breakage to which an entity *expects* to be entitled.

— **Measuring a breakage amount.** To determine the amount of breakage to which it expects to be entitled (i.e. to estimate the breakage amount), an entity considers the principles in paragraphs 606-10-32-11 – 32-13 that are also used to measure variable consideration under the variable consideration constraint (see section 5.3.40). Under these principles, an entity assesses whether it is probable that recognizing revenue on a proportionate basis for the unexercised rights (the recognition model required if a breakage estimate can be made) will not result in a significant revenue reversal in the future. If an entity does not have a basis for estimating breakage, it will likely conclude that any estimate is fully constrained because it is unable to conclude that breakage is expected. In that case, the entity does not recognize breakage until the likelihood of customer redemption is remote. [606-10-55-48]

  Although an entity considers the variable consideration guidance to determine the amount of breakage, breakage itself is not a form of variable consideration because it does not affect the transaction price. It is a recognition, rather than a measurement, concept in Topic 606. For example, the transaction price for a sale of a $50 gift card is fixed at $50; the possibility of breakage does not make the transaction price variable.

However, the expected breakage affects the timing and pattern in which that $50 revenue is recognized.

— **Recognizing revenue from a breakage amount.** When an entity determines that it expects to be entitled to breakage, the estimated breakage is recognized as revenue in proportion to the pattern of rights exercised by the customer (proportional method). Otherwise, the entity recognizes breakage when the likelihood of the customer exercising its remaining rights becomes remote (remote method). [606-10-55-48, ASU 2014-09.BC398–BC399]

— **Changing the measurement of a breakage amount.** An entity updates its analysis on estimated breakage each period. If changes in the estimate are required, the entity adjusts the contract liability to reflect the remaining pattern of redemption expected. If the breakage estimate is related to an option that gives rise to a material right and is therefore factored into the stand-alone selling price of the option, the entity does not adjust the original allocation of the stand-alone selling price to the material right (see Question 8.5.20). For a discussion of the accounting for take-or-pay arrangements, see Question 7.6.60. [606-10-32-31, 32-43]

— **Paying a breakage amount to a government or other entity.** If an entity is required to remit to a government entity the amount that is attributable to customers' unexercised rights – e.g. under applicable unclaimed property or escheatment laws – then it recognizes a financial liability for the breakage amount. The financial liability is derecognized when the rights are extinguished in accordance with Subtopic 405-20. [606-10-55-49]

Example 7.6.10

Sale of a gift card – entity expects to be entitled to breakage

Retailer sells a nonrefundable gift card to Customer for $100. On the basis of historical experience with similar gift cards, Retailer estimates that 10% of the gift card balance will remain unredeemed and that the unredeemed amount will not be subject to escheatment (i.e. unclaimed property laws). Because Retailer can reasonably estimate the amount of breakage expected, and it is probable a significant revenue reversal will not occur if it recognizes breakage on a proportional basis, Retailer recognizes the breakage revenue of $10 in proportion to the pattern of exercise of the customer's rights.

Specifically, when it sells the gift card, Retailer recognizes a contract liability of $100 because Customer prepaid for a nonrefundable card. No breakage revenue is recognized at this time.

If Customer redeems $45 of the gift card amount in 30 days, then half of the expected redemption has occurred ($45 / ($100 – $10) = 50%). Therefore, half of the breakage – i.e. $5 ($10 × 50%) – is also recognized.

Accordingly, on this initial gift card redemption, Retailer recognizes revenue of $50: $45 from transferring goods or services, plus breakage of $5.

Example 7.6.20
Sale of a gift card – entity does not expect to be entitled to breakage

Retailer implements a new gift card program in a new market. Retailer sells Customer a nonrefundable gift card for $50. Retailer does not have an obligation to remit the value of unredeemed cards to any government authority or other entity. The gift card expires two years from the date of issue.

Because this is a new program, Retailer has very little historical information about customer redemption patterns and breakage. Specifically, Retailer does not have sufficient entity-specific information, nor does it have knowledge of the experience of other retailers in the market to estimate breakage. Therefore, Retailer concludes that it does not have a basis to conclude that it is expected to be entitled to breakage in an amount that if recognized would be probable of not resulting in a significant revenue reversal.

Retailer therefore recognizes the breakage when the likelihood of Customer exercising its remaining rights becomes remote. This may occur on expiration of the gift card, or earlier if there is evidence to indicate that the probability has become remote that Customer will redeem any remaining amount on the gift card.

However, Retailer will continue to evaluate its information about breakage prior to the Customer's exercise becoming remote. If it subsequently obtains sufficient evidence to support an estimate of breakage, it will begin recognizing breakage on a proportional basis. Retailer will also make a cumulative catch-up adjustment to revenue in the period that it concludes it has sufficient information about breakage.

Example 7.6.30
Loyalty program – entity expects to be entitled to breakage

Airline maintains a customer loyalty program that awards its customers five points for every $100 spent on flights. Upon redemption, customers can use 20 points to obtain a $1 discount on future flights.

During Year 1, Airline sold $100 million of flights and awarded five million loyalty points to its customers. Airline estimates that its customers will not exercise their rights to one million of the five million loyalty points awarded during Year 1. During Year 1, customers redeemed two million of the four million points expected to be redeemed (or 50%).

Airline estimates the stand-alone selling price of each awarded loyalty point to be $0.80 or a total of $4 million. The stand-alone selling price of $0.80 incorporates assumptions about the redemption rates of loyalty points (see section 6.3). Airline concludes that the loyalty points provide material rights to customers (see section 8.6), which are separate performance obligations to which revenue should be allocated.

Therefore, the $100 million in flights purchased by customers in Year 1 is allocated between the flights and the loyalty points as follows.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation
Flights	$100,000,000	96.15%	$96,153,846[1]
Loyalty points	4,000,000	3.85%	3,846,154[2]
Total	**$104,000,000**	**100%**	**$100,000,000**

Notes:
1. $100,000,000 × ($100,000,000 / $104,000,000).
2. $100,000,000 × ($4,000,000 / $104,000,000).

Based on these facts, Airline records revenue for the loyalty points redeemed in Year 1 based on the transaction price allocated to the loyalty points using the ratio of loyalty points redeemed to loyalty points expected to be redeemed. The ratio is 50% (2,000,000 points redeemed / 4,000,000 points expected to be redeemed).

Airline recognizes revenue as follows.

Year 1	Price allocation	Ratio redeemed	Revenue recognized
Loyalty points	$3,846,154	50%	$1,923,077

Adjusting for changes in expected loyalty points to be redeemed

In Year 2, Airline estimates that customers will redeem four and half million of the loyalty points awarded in Year 1. As of December 31, Year 2, customers have redeemed one and half million more loyalty points (for a total of three and half million).

Airline recognizes revenue as follows.

Year 2	Price allocation	Ratio redeemed	Cumulative revenue	Revenue recognized in Year 2
Loyalty points	$3,846,154	77.7%[1]	$2,991,453[2]	$1,068,376[3]

Notes:
1. Calculated as 3,500,000 loyalty points redeemed / 4,500,000 loyalty points now expected to be redeemed.
2. Calculated as 77.7% × $3,846,154 (total amount allocated to the loyalty points).
3. Calculated as $2,991,453 – $1,923,077 (total amount of revenue recognized in Year 1).

As of December 31, Year 2, Airline has a remaining contract liability related to the loyalty points of $854,701 ($3,846,154 – $2,991,453).

See section 8.6 for further discussion of loyalty points programs and the determination of whether they give rise to material rights.

Question 7.6.10

Are prepaid stored-value cards in the scope of Topic 606's guidance on unexercised rights?

Interpretive response: It depends. A prepaid stored-value product (e.g. a gift card) that is issued by an entity and gives the customer rights to goods and services provided by that entity is in the scope of Topic 606. However, a prepaid product that is redeemable for goods or services at a third party or redeemable for cash (e.g. a prepaid bank card) results in the recognition of a financial liability for the card issuer. The guidance under Topic 606 on the recognition of breakage excludes prepaid stored-value products that meet the definition of financial liabilities. [606-10-15-2]

Although these types of prepaid stored-value cards are not in the scope of Topic 606, the liability derecognition guidance in Subtopic 405-20 requires recognition of breakage based on the guidance in Topic 606 on prepaid stored-value products that give rise to financial liabilities for the issuer. This results in the same pattern of recognition as gift cards that are in the scope of Topic 606. The Subtopic 450-20 guidance does not apply to products that can be redeemed by the holder for cash only (e.g. nonrecourse debt, bearer bonds or trade payables) or card products that are attached to a segregated bank account (e.g. a customer depository account). [405-20-15-2, ASU 2016-04.BC9]

Question 7.6.15**

Can an entity have a policy to recognize breakage only at the point of redemption or expiration or when redemption becomes remote?

Interpretive response: No. The guidance requires an entity to estimate the amount of breakage to which it expects to be entitled. If an entity does not have a basis for estimating breakage, it will likely conclude that any estimate is fully constrained because it is unable to conclude that breakage is expected. In that case, the entity does not recognize breakage until the likelihood of customer redemption is remote. However, we expect it to be rare for an entity to recognize breakage only at the point it becomes remote. See Question 7.6.50. See also Question 7.6.30 related to binary options, which are not subject to the breakage guidance. [606-10-55-48]

Question 7.6.20

Can an entity use a portfolio of data in estimating breakage?

Interpretive response: Yes. An entity can and typically would use a portfolio of similar transactions as a source of data to estimate expected breakage for an individual contract if the entity has a sufficiently large number of similar transactions or other history. Doing so is not using the portfolio approach to account for contracts under Topic 606, but rather it is using a portfolio of data to estimate breakage for an individual contract (see Question 5.3.130).

Question 7.6.30

Can an entity recognize revenue from a customer option before it expires if that option conveys a material right and the exercise of that option is binary?

Interpretive response: No. The guidance on recognition of breakage does not apply to options that provide the customer with a material right that are binary (i.e. will either be exercised in full or expire unexercised). Revenue for an individual customer option to acquire additional goods or services that gives rise to a material right is recognized when the future goods or services are transferred to the customer or when the option expires.

The basis for the accounting for both options and customers' unexercised rights is that revenue is recognized as the entity performs under the contract. In the case of a binary option (unlike gift cards or loyalty points), the entity does not perform unless the single option is exercised. However, breakage related to binary options is factored into the determination of the stand-alone selling price of the option but revenue is not recorded in advance of the option exercise or expiration. [606-10-55-42, ASU 2014-09.BC398]

See section 8.2 for a discussion of the accounting for options.

Example 7.6.40

Customer option that is binary

Retailer sells Customer a TV for $500. Because Customer purchased the TV, it receives a coupon for 20% off the price of a DVR player. The coupon expires in 60 days and is not provided to customers who do not purchase a TV.

Retailer concludes that the coupon conveys a material right to Customer. The stand-alone selling price of the DVR player is $200 and Retailer determines there is a 40% likelihood that Customer will purchase the DVR player. Retailer therefore determines the stand-alone selling price of the option to be $16 ($200 sales price × 20% discount × 40% likelihood of redemption).

The option in this example is binary – Customer either exercises the option or it expires unexercised. Retailer recognizes the $16 as revenue when Customer subsequently purchases the DVR player or the coupon expires. The accounting for breakage does not apply.

Question 7.6.40

Is an entity ever able to recognize revenue from a customer option that conveys a material right if that option is never exercised and does not expire?

Interpretive response: Yes. Technically, the guidance in paragraphs 606-10-55-46 – 55-49 on recognition of breakage does not apply to a binary option that conveys a material right to a customer. However, when an option does not expire, we believe it is reasonable for an entity to apply the remote method under the recognition of breakage guidance and recognize revenue when the likelihood of the customer exercising its remaining rights becomes remote. [606-10-55-48]

Assume the same facts as Example 7.6.40 except that the coupon does not have an expiration date. If Retailer applies the guidance in that example, it might never record revenue if the coupon is never redeemed. In these cases, we believe it is appropriate for Retailer to recognize the $16 as revenue when the likelihood of the customer exercising its remaining rights becomes remote.

Question 7.6.50

Can an entity change its recognition of unexercised rights from the remote to the proportional method?

Interpretive response: Yes. An entity reassesses its determination of whether it expects to be entitled to breakage on an ongoing basis.

— If the entity initially determines that it is not expected to be entitled to breakage, it uses the remote model for recognizing breakage for the unexercised rights.

— If the entity later determines that it does expect to be entitled to breakage, then it would apply a proportional model going forward by recognizing a cumulative catch-up adjustment to revenue in the period it concludes it is expected to be entitled to breakage. [250-10-45-17]

Because the estimated breakage when the proportional method is applied only needs to be 'not probable' of reversal, we expect it to be rare for an entity to recognize breakage only at the point it becomes remote. This is because the point at which an entity determines that it is entitled to breakage (i.e. reversal of breakage revenue not likely to occur) may occur before the reporting period in which reversal becomes remote (i.e. slight chance of occurring). However, unexercised binary options would only be recognized when the option expires (see Question 7.6.30).

Question 7.6.60

How should an entity account for breakage in a take-or-pay arrangement?

Background: ABC Corp. enters into a contract with Customer to provide natural gas. The contract specifies that ABC will provide a minimum of 1,500 units a year at a price per unit of $1 (which is the stand-alone selling price) for two years on a take-or-pay basis (total of 3,000 units). If Customer does not take all the units in each year, it must pay the difference between $1,500 and amounts previously paid at the end of the contract year. Customer does not have rights to the units forfeited at the end of the contract year. Each unit is a separate performance obligation satisfied at a point in time.

ABC initially estimated that there would be no breakage (i.e. Customer would take at least 1,500 units per year). However, after delivering the first 500 units in Year 1, its estimate changed from 3,000 total units to 2,000 total units (1,250 in Year 1 and 750 in Year 2).

Interpretive response: It depends. Entities often enter into take-or-pay arrangements with customers. These arrangements require the customer to pay for the minimum specified goods or services even if the customer ultimately does not obtain control of the goods or services – i.e. once the take-or-pay period expires the customer forfeits their right to the goods or services.

The specified minimum may be for the entirety of the contract term or for distinct periods within the contract term (e.g. annually or quarterly). A take-or-pay arrangement may require the customer to make a nonrefundable upfront payment or payment at the end of the take-or-pay term.

Because the scope of the breakage guidance appears to apply to contracts that result in a contract liability, we believe entities can account for the changes in the minimum under a breakage model or as a contract modification.

Take-or-pay arrangements are distinguished from contracts where the number of distinct goods or services does not change – e.g. when the entity is providing a stand-ready service over distinct time periods or an IP licensing arrangement with usage-based fees. In these arrangements, the number of performance obligations does not change – i.e. the scope of the contract does not change, and the customer's right to obtain the stand-ready service or IP does not expire unexercised; therefore, a modification or breakage approach would not apply.

We believe it would not be appropriate to analogize to these approaches or to allocate fixed minimums of a usage-based fee using this guidance when the number of distinct goods or services does not change.

Approach 1: Breakage

Under a breakage approach, an entity could view a customer's subsequent decision to take less than the minimum quantity as breakage and account for that breakage under either the proportional method or, on rare occasions, the remote method (see Question 7.6.50). When applying the proportional method, an entity recognizes its estimate of breakage on a take-or-pay arrangement as revenue in proportion to the pattern of rights exercised by the customer – i.e. in proportion to revenue recognized for the related good or service. [606-10-55-48]

Generally, changes in the estimate of breakage should be accounted for as an adjustment to cumulative revenue under the contract. In the background example, the average price per unit is $1.50 ($3,000 total consideration / 2,000 expected units) after the change in estimate. At that time, ABC would have recognized $500 at a price per unit of $1.00 and therefore the change in estimate requires a cumulative-catch adjustment of $250: 500 units × ($1.50 - $1.00). ABC would then recognize $1.50 as it transfers control of each remaining unit.

In some cases, the estimated breakage (and related changes in these estimates) may be attributed to the respective period's revenue and not the entire contract term. This may occur when:

- each distinct period has its own contractual minimum independent of other periods in the contract – i.e. the customer cannot make up the shortfall from one period in another period; and
- the allocated price is consistent with the allocation objective.

Approach 2: Contract modification

Under a contract modification approach, an entity could view a customer's subsequent decision to take less than the minimum quantity as a contract modification that reduces the scope of the contract – i.e. reducing the quantity the entity is obligated to provide and effectively increasing the price per unit. This approach results in accounting similar to a partial termination of a contract (see Question 11.3.60).

In a common take-or-pay arrangement, the remaining goods or services are typically distinct from the units previously transferred – e.g. units that transfer at a point in time or goods or services that form part of a series. Therefore, the modification is typically accounted for prospectively instead of on a cumulative catch-up basis. However, entities should evaluate the change under the modification guidance (see section 11.3).

In the background example, ABC would account for the modification only when the rights and obligations change, which is when the customer's right to the goods expires at the end of Year 1 (i.e. ABC no longer has the obligation to deliver the units and Customer no longer has the right to obtain the units). At that time, ABC would account for the modification prospectively, and the remaining consideration of $1,750 ($250 remaining from Year 1) would be recognized over the units delivered in Year 2.

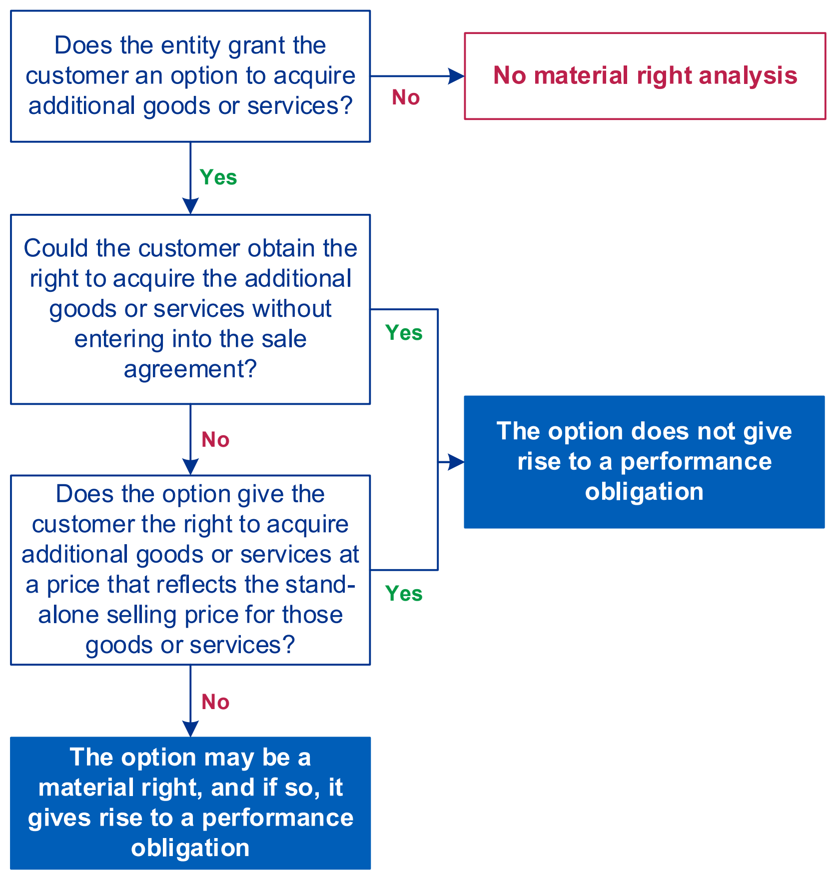
8. Customer options for additional goods or services

Detailed contents

New item added to this chapter: **
Item has been moved in this edition: ●

8.1 How the standard works

An option in a contract that allows the customer to purchase additional goods and services is a performance obligation in the contract if it conveys a material right to the customer. The following decision tree shows the steps an entity takes to determine if an option gives rise to a performance obligation.



8.2 Customer options

Excerpt from ASC 606-10

• > Customer Options for Additional Goods or Services

55-41 Customer options to acquire additional goods or services for free or at a discount come in many forms, including sales incentives, customer award credits (or points), contract renewal options, or other discounts on future goods or services.

55-42 If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

55-43 If a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those cases, the entity has made a marketing offer that it should account for in accordance with the guidance in this Topic only when the customer exercises the option to purchase the additional goods or services.

8.2.10 Overview

Customer options to acquire additional goods or services can come in many forms, but common examples include customer loyalty points, sales incentives and renewal options. Identifying customer options is important because if determined to be a material right, that right is a performance obligation in the contract with the customer. [606-10-55-41, 55-42]

However, not all customer options are material rights. Instead, some options are simply marketing or promotional offers, which are accounted for separately from the contract with the customer. A right is material if the customer is essentially paying for the right and it would not otherwise receive the right without entering into the current contract. [606-10-55-42, 55-43]

An example of a material right is an option that provides a discount that is incremental to a discount the customer otherwise could have obtained for the same future purchases. A material right could also arise when a customer pays a nonrefundable upfront fee. That is because that arrangement may provide the customer with the right to discounted goods or services in future periods by not having to pay a similar fee upon renewal (see section 5.8).

A material right is a performance obligation in the contract because the entity has paid for the option to acquire additional goods or services. As a consequence, an entity allocates part of the contract's transaction price to the material right.

Question 8.2.10

Can an entity account for the additional goods or services underlying a customer option as a separate performance obligation?

Interpretive response: No. An entity only accounts for a customer option when it conveys a material right to the customer. The material right is the performance obligation, not the goods or services that the customer can purchase by exercising the option.

The TRG agreed that an entity would not account for the goods or services underlying a customer option as a performance obligation because the entity does not have any enforceable rights regarding those goods or services. This would be the case even if the customer is *economically* compelled to exercise its option, or the entity is virtually assured that the customer will exercise its option. Examples of a customer being economically compelled are when the entity is the sole provider of the goods or services, or the contract includes an exclusivity clause that requires the customer to purchase goods or services only from that entity. [TRG 11-15.48]

In some cases, the entity may sell a good or service upfront at a significant discount or loss with the expectation or hope that the customer will purchase additional goods or services (loss leader). If a loss leader contract contains a customer option to purchase additional goods, the entity accounts for the option only if it represents a material right.

Regardless of whether the option represents a material right, the entity does not include the future purchase(s) in the current contract – even if it means the entity recognizes a loss under the current contract. The entity may recoup that loss in the subsequent optional transaction(s) but those transactions cannot be accounted for until the customer has exercised the option and the entity has transferred control of those goods and services. This accounting is illustrated in Example 8.2.10.

Example 8.2.10

Customer options in 'loss leader' contracts

Manufacturer sells equipment and related consumable parts, both of which are distinct goods that are satisfied at a point in time. The equipment does not function without the consumable part, but Customer could resell the equipment for an amount more than scrap value.

The stand-alone selling price of the equipment is $20,000 and the stand-alone selling price of each consumable part is $200. The costs of the equipment and each part are $16,000 and $120, respectively.

Manufacturer sells the equipment for $12,000 (40% discount from its stand-alone selling price) with a contractual option to purchase each consumable part for $200. There are no contractual minimums for part purchases; however, Manufacturer estimates that Customer will purchase 200 parts over the next two years. Manufacturer and Customer have an exclusive contract whereby Customer cannot purchase the goods from other vendors during the contract term.

The options do not convey a material right to Customer because the consumables are priced at their stand-alone selling price. It is irrelevant that Customer is compelled to exercise its option for the consumables for the equipment to function or that there is an exclusivity clause. Accordingly, the transaction price is $12,000, which is attributed entirely to the equipment. This results in a loss to Manufacturer of $4,000 when it transfers control of the equipment to Customer. [TRG 11-15.48]

Question 8.2.20

Is a renewal option subject to the guidance on material rights?

Interpretive response: Yes. An option to renew the current contract is considered an option for additional goods or services. Therefore, an entity considers whether the option conveys a material right to the customer (and therefore is a performance obligation). [ASU 2014-09.BC391]

Question 8.2.30

Is a customer option to terminate a contract subject to the guidance on material rights?

Interpretive response: Yes. A customer cancellation right is economically similar to a renewal right. For example, a three-year contract that allows the customer to cancel at the end of each year is no different from a one-year contract with two one-year renewal options – as long as there is not a substantive termination penalty the customer must pay if it elects to cancel. [ASU 2014-09.BC391]

If there is a substantive penalty for exercising the right to terminate a contract, the contract duration is the shorter of the stated period or the period during which the contract can be terminated without paying a penalty. As a consequence, the presence of a substantive termination penalty makes the option nonsubstantive from an accounting perspective, and therefore it is not accounted for as a customer option. For further discussion of the effects of a customer termination clause on contract term, see Questions 3.8.10 and 3.8.20.

Question 8.2.40

Is a retroactive discount earned once a customer has completed a specified volume of optional purchases subject to the guidance on material rights?

Interpretive response: No. Volume discounts (or rebates) that are retroactive are accounted for as variable consideration because the final transaction price is unknown until the customer completes (or fails to complete) the specified volume of purchase. See section 5.3 and Questions 5.3.10, 5.3.20 and 5.3.30 for guidance on distinguishing between contracts with variable consideration and optional purchases.

Question 8.2.50

Is a prospective discount earned once a customer has completed a specified volume of optional purchases subject to the guidance on material rights?

Interpretive response: Yes. A prospective volume discount (or rebate) earned once a customer has completed a specified volume of optional purchases is not variable consideration. Therefore, the potential discount or rebate on the optional goods or services needs to be evaluated for the presence of a material right. Such discounts are not variable consideration because they do not change the consideration for the goods or services transferred under the current contract. See Question 5.3.10 on distinguishing between contracts with variable consideration and optional purchases.

For example, an entity might offer to sell goods at $10 in the first year of an agreement; then if the entity purchases at least 1,000 units, the price in the second year decreases to $8. The purchases in the first year accumulate to give the entity a right to make discounted purchases in the second year.

For guidance on identifying when volume discounts or rebates are variable consideration or material rights, see Question 5.3.30. For guidance on how to evaluate whether such an option represents a material right, see section 8.3.

Question 8.2.60

Does the practical expedient for immaterial promises apply to customer options?

Interpretive response: No. Topic 606 allows an entity to forgo assessing whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer. See section 4.2.50.

However, this exception does not apply to the evaluation of customer options. Therefore, even if a customer option is immaterial in the context of the contract, an entity evaluates whether it conveys a material right. This is because customer options may accumulate over time across many contracts and that accumulation feature may cause an option that is immaterial in the context of one contract to be material to the customer (see Question 8.3.50). [606-10-25-16B]

8.3 Determining whether a customer option is a material right

8.3.10 Overview

A customer option conveys a material right if the customer obtains a right that it would not have received without entering into the contract. For example, an option conveys a material right if it provides a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market. In contrast, if the option simply provides the customer with an option to purchase additional goods or services at their stand-alone selling prices, then the option is not a material right. [606-10-55-42, 55-43]

Determining whether the customer would have received the incremental discount without entering into the contract is not always straightforward. In many cases, the entity will simply be able to compare the option price to the stand-alone selling price of the good or service. However, in some cases entities will make marketing offers to customers at or below stand-alone selling price and an entity will need to evaluate if that discount is incremental to discounts offered to other customers.

The TRG agreed that the objective of this analysis is to evaluate whether a customer option would exist independently of the current contract. When an option is independent, it is a marketing offer and not a material right. The TRG clarified the following.

- A customer option to acquire additional goods or services gives rise to a performance obligation only if that option provides a material right to the customer that it would not receive without entering into the contract. In that situation the customer pays in advance for the future goods or services – i.e. the option is dependent on the current contract.
- A customer option to purchase additional goods or services at stand-alone selling prices is not a performance obligation because the customer could execute a separate contract to obtain goods or services at the same price – i.e. the option is independent of current contract. [TRG 04-16.54]

Topic 606 provides the following examples on evaluating customer options.

Excerpt from ASC 606-10

• • > Example 49 – Option that Provides the Customer with a Material Right (Discount Voucher)

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.

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.

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**	

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.

• • > Example 50 – Option that Does Not Provide the Customer with a Material Right (Additional Goods or Services)

55-340 An entity in the telecommunications industry enters into a contract with a customer to provide a handset and monthly network service for two years. The network service includes up to 1,000 call minutes and 1,500 text messages each month for a fixed monthly fee. The contract specifies the price for any additional call minutes or texts that the customer may choose to purchase in any month. The prices for those services are equal to their standalone selling prices.

55-341 The entity determines that the promises to provide the handset and network service are each separate performance obligations. This is because the customer can benefit from the handset and network service either on their own or together with other resources that are readily available to the customer in accordance with the criterion in paragraph 606-10-25-19(a). In addition, the handset and network service are separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b) (on the basis of the factors in paragraph 606-10-25-21).

55-342 The entity determines that the option to purchase the additional call minutes and texts does not provide a material right that the customer would not receive without entering into the contract (see paragraph 606-10-55-43). This is because the prices of the additional call minutes and texts reflect the standalone selling prices for those services. Because the option for additional call minutes and texts does not grant the customer a material right, the entity concludes it is not a performance obligation in the contract. Consequently, the entity does not allocate any of the transaction price to the option for additional call minutes or texts. The entity will recognize revenue for the additional call minutes or texts if and when the entity provides those services.

Question 8.3.10

Does a discount need to be significant in addition to being incremental to the range of discounts typically offered to similar customers for it to represent a material right?

Interpretive response: Yes. In promulgating Topic 606, the FASB noted that the concept of a significant and incremental discount forms the basis for the principle of a material right. It is this concept that differentiates an option from a mere marketing or promotional offer. [ASU 2014-09.BC387]

Therefore, we believe a material right is one that is both:

— significant to the customer; and
— incremental to the range of discounts typically given for those goods or services to that class of customer in the applicable geographical area or market.

To be a material right, the discount offered does not need to be incremental to the discount given for other goods or services in the contract. Entities will need to exercise judgment to determine when a discount is significant. [ASU 2014-09.BC387]

Question 8.3.20

How does an entity determine if a discount is incremental to discounts offered to a similar class of customers?

Interpretive response: The TRG generally agreed with a framework for how an entity evaluates whether a discount on a customer option is incremental to discounts given for goods or services to that class of customer.

The TRG agreed that the objective of the analysis is to determine whether the pricing offered in the customer option would exist independently from the current purchase. If the pricing is independent, it represents a marketing offer and no material right exists. This analysis entails comparing the discount in the current transaction to discounts provided to similar customers in transactions that were not dependent on prior purchases – i.e. discounts not offered through options embedded in similar contracts with other customers. The fact that discounts given to similar customers in stand-alone transactions are similar to the discount offered in the current contract indicates the customer could obtain the discount without entering into the current contract.

In contrast, the TRG generally agreed it would not be appropriate to compare discounts offered through options embedded in similar contracts with other customers. This comparison would not be relevant because it would not be possible to discern whether the discount provided to the other customer was independent of the current purchase. [TRG 04-16.54]

Example 8.3.10
Discount is incremental to discounts provided to similar customers

Retailer has a current promotion whereby it offers customers that purchase either a television or washing machine a 50% discount on a future purchase of a computer. The coupon for the computer is redeemable within one year of the purchase of the television or washing machine.

Customer A purchases a television from Retailer and receives the coupon to purchase a computer at a 50% discount. To evaluate whether the voucher provides Customer A with a material right, Retailer considers the discount provided for a computer to Customers B and C, who are similar customers.

- Customer B purchased a new television from Retailer two months ago. When Customer B purchased a computer, it paid full price because no discount was available.
- Customer C purchased a washing machine and received a similar coupon to purchase a computer.

Retailer concludes it would be inappropriate to compare the discount provided to Customer C because the discount was provided together with the purchase of another product.

Retailer then compares the discount offered to Customer A on the computer with the price Customer B paid to purchase a computer. Because Customer A is provided with a 50% discount while Customer B received no discount, Retailer concludes that the option provides Customer A with a material right.

Example 8.3.20

Discount is not incremental to discounts provided to similar customers

Retailer hands out coupons for 5% off purchases of a computer to all customers who walk through the door. The coupons can be used for one year.

Customer A purchases a television from Retailer and receives the coupon to purchase a computer. To evaluate whether the coupon provides Customer A with a material right, Retailer compares the discounts provided for a computer to Customers B and C, who are similar customers.

— Customer B received the coupon while window shopping. Customer B then used the coupon to purchase a computer at a 5% discount.
— Customer C purchased a washing machine and received a similar coupon to purchase a computer.

Retailer concludes that the coupon is not a material right because it is not incremental to discounts offered to similar customers. In reaching this conclusion, Retailer compared the discount offered to Customer A to the discount offered to Customer B, and noted that Customer B received the discount without a prior purchase.

Retailer concludes it would be inappropriate to compare the discount provided to Customer C because the discount was provided together with the purchase of another product.

As such, the discount provided to Customer A does not provide a material right because it is independent of the purchase of the television – i.e. Customer A could have received the discount without purchasing the television.

Question 8.3.30

Should an entity look to the low, mid or high end of the range of discounts offered to similar customers when assessing whether a discount is incremental?

Interpretive response: To evaluate whether a customer option conveys a material right, an entity assesses whether the discount is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market. Whether the discount provided to a customer is incremental depends on how it relates to discounts typically offered to that class of customer.

Topic 606 does not specify what point in the range an entity should use when determining whether a discount is incremental. As a consequence, we believe an entity should apply a reasonable approach, which should be applied consistently.

Question 8.3.40

Is the evaluation of whether a customer option is a material right only quantitative in nature?

Interpretive response: No. The TRG generally agreed that the assessment of whether an option is a material right is both quantitative and qualitative in nature. TRG members that supported this view believe that considering qualitative factors is consistent with the notion that the existence of implied performance obligations depends on whether a transaction creates reasonable expectations of the customer. Therefore, a material right may exist even if it is not quantitatively material. [TRG 10-14.6]

Qualitative factors are particularly important when evaluating the expectations of the customer. Examples of qualitative factors include, but are not limited to:

- availability and pricing of service alternatives;
- average customer life;
- whether a fee incents a customer to remain after the stated contract term ends; and
- whether the right accumulates.

Example 8.3.30

Quantitative and qualitative analysis of a material right

Retailer provides its customers who purchase goods on a specific date with a voucher for 40% off their next purchase of any amount. The voucher can be used for any product in the store and expires 60 days after issue. Based on its historical experience, Retailer determines that the typical customer uses the voucher to make an additional purchase that is more expensive than the customer's original purchase. No other discounts are offered to customers during the year.

On the date Retailer offers the voucher, Customer A purchases a product for $500 and Customer B purchases a product for $25.

Retailer concludes that the voucher provides both Customer A and Customer B with a material right. In reaching this conclusion, Retailer considers the quantitative nature of any rights received by each customer, such as evaluating the stand-alone selling price of the voucher in relation to the transaction price with the customer. In the context of the current transaction only, Customer A received a quantitatively material right because the voucher is quantitatively worth a lot more than Customer B's voucher. Just looking at each customer's current purchase, the voucher would be worth $200 ($500 × 40%) for Customer A and only $10 for Customer B ($25 × 40%).

However, Retailer also considers that the voucher has given both Customer A and Customer B the opportunity to receive a 40% discount on a future purchase, including purchases for products that may have observable stand-alone selling prices that are significantly higher than the selling prices of the products purchased by Customer A and Customer B in the current transactions.

As such, on a qualitative basis the voucher provides both Customer A and B with a material right.

Question 8.3.50

Are past and future transactions relevant when evaluating whether an option that provides accumulating rights represents a material right?

Interpretive response: Yes. In many cases, the rights that an entity grants to a customer accumulate as the customer makes additional purchases. For example, in a customer loyalty program, the points granted in an initial transaction are typically used in conjunction with points granted in subsequent transactions when the customer redeems the points. Further, the value of the points granted in a single transaction may be low, but the combined value of points granted over an accumulation of transactions may be much higher. In such cases, the accumulating nature of the right is an essential part of the arrangement.

The TRG agreed that entities should consider the cumulative value of the rights received in the transaction, the rights that have accumulated from past transactions, and additional rights expected from future transactions. We believe the existence of an accumulation feature tends to be a strong indicator of a material right. [TRG 10-14.6]

For a discussion of customer loyalty programs, see section 8.6.

Example 8.3.40

Buy four, get one free program

Retailer offers a program in which customers who have purchased four ice cream cones over a given period may receive a fifth cone free. Based on its historical data, Retailer determines that it is likely that many of its customers will receive a free product.

Customer purchases his first ice cream cone for $5. The first purchase provides Customer with the right to purchase three more cones and receive the fifth for free.

Retailer concludes that the option in the current transaction represents a material right. In making this determination, Retailer considered both current and future transactions. Retailer concludes that Customer has in substance paid for one-fourth of a free product (a 20% discount on five purchases) in the current transaction. In other words, Customer has paid for the right to receive one free product if he purchases three additional products. Retailer's conclusion is also based on its historical experience with similar programs, which suggests that it is likely Customer will purchase three additional products that will entitle him to a free product.

Question 8.3.60

How does an entity determine whether a prospective discount based on a customer completing a specified volume of optional purchases is a material right?

Interpretive response: Prospective volume discounts (or rebates) that are earned once a customer has completed a specified volume of optional purchases are evaluated for the presence of a material right and do not give rise to variable consideration. For example, an entity might provide a customer with the option to purchase goods at $10 in the first year of an agreement; but if the entity purchases at least 1,000 units, the price in the second year decreases to $8. The purchases in the first year accumulate to give the entity a right to make discounted purchases in the second year.

These prospective volume discounts (or rebates) provide the customer an option to purchase additional goods at a discount. To evaluate if an option represents a material right, the TRG agreed that an entity evaluates whether a similar class of customer could receive the discount independent of a contract with the entity (see Question 8.3.20). [TRG 04-16.54]

To make that assessment, the entity looks at the range of prices in contracts with customers that purchase similar volumes without a volume-based discount provision and compares those prices against the discounts offered in the current contract. The entity does not compare discounts given to other customers under a similar volume-based discount provision.

However, if there is an accumulating feature, it is a strong indicator of a material right (see Question 8.3.50, and Examples 8.3.50 and 8.3.60). [TRG 10-14.6]

Significant judgment will be required to determine whether discounts provided to customers convey a material right. There are many variations of contracts and variations in facts and circumstances that can affect the conclusion in each fact pattern. Entities should thoroughly evaluate their specific facts and circumstances. Examples 8.3.50 and 8.3.60 are meant to show how slightly different fact patterns can lead to the different accounting conclusions.

Example 8.3.50

Volume discounts do not provide a material right

Manufacturer enters into a two-year master services agreement (MSA) with Customer, a new customer, to supply widgets for $2 per widget. Each widget is a distinct good that is transferred at a point in time.

The following additional facts are relevant:

— Customer committed to a minimum quantity of 500 widgets per year with an option to purchase additional widgets for $2 per widget (up to 1,000 widgets).

— If Customer purchases 1,000 widgets in Year 1:
  – the pricing for the remainder of Year 1 is reduced to $1.50; however, there is no rebate or credit on previous purchases; and
  – the pricing in Year 2 is also reduced to $1.50.

Manufacturer consistently prices its products with customers based on an expectation of annual sales volumes. This expectation is based on experience with the customer, size of customer and/or commitments by the customer for volumes during the year.

Manufacturer's internal pricing tiers and stand-alone selling price for the classes of customer are as follows.

Tier	Volumes	Price
1	0-499	$2.50
2	500 – 1,000	$2.00
3	> 1,000	$1.50

When Manufacturer has experience with customers that expect to purchase more than 1,000 units (a Tier 3 customer) those customers typically receive pricing of $1.50 for all purchases. Similarly, when a Customer is in Tier 2 it receives pricing of $2.00 for all purchases. That is, the pricing does not decrease as those customers purchase additional volumes.

Manufacturer provides some volume incentives to customers but typically will provide the prices to customers without such a requirement.

Manufacturer evaluates whether the potential discount on purchases above 1,000 units and pricing in Year 2 provides Customer with a material right. To make this determination, Manufacturer evaluates whether a customer that purchases similar volumes would be given the same pricing absent previous purchases. Manufacturer compares the price after Customer exceeds 1,000 units to the price that other customers would receive without a similar volume incentive.

While an accumulation feature is a strong indicator that a material right is present, Manufacturer concludes that the pricing on future purchases is independent from the previous purchases and does not provide a material right. That is because Manufacturer typically prices widgets at $1.50 for a class of customer without a similar volume purchase program. In other words, customers that purchase a similar volume could get that discount without a similar volume incentive program.

Example 8.3.60
Volume discounts provide a material right

Manufacturer enters into a two-year MSA with a new customer to supply widgets under a tiered-pricing arrangement. Customer does not commit to a specified quantity and each purchase is considered a separate contract. In each year, the pricing is as follows.

Volumes	Price
0-499	$2.50
500-1,000	$2.00
>1,000	$1.50

There is no rebate or credit on previous purchases – the first 499 widgets are at $2.50 and even if Customer purchases 1,000 widgets, the price paid for the first 499 stays at $2.50. Manufacturer typically provides similar tiered pricing to customers that are similar to Customer.

Manufacturer evaluates whether the future discounts provide the customer with a material right. Manufacturer concludes that the pricing on future purchases within each year is dependent on previous purchases and therefore the future discount conveys Customer with a material right during each year.

— While Manufacturer typically uses similar pricing structures with similar customers, in each case the customer receives the future discount only as a result of prior purchases. As a consequence, it is not appropriate to compare the pricing provided to other customers.

— The right accumulates and qualitatively it incentivizes Customer to make future purchases. This accumulation factor is a strong indicator that the entity in effect paid for the option in its previous purchases.

Question 8.3.70

Do coupons issued at the point of sale convey material rights?

Interpretive response: It depends. Retail stores often print coupons at the register after a purchase is completed – sometimes referred to as 'Catalina coupons' or 'bounce-back coupons' – that can be redeemed for a short period. The coupons are handed to the customers at the point of sale, or packaged with the good that the customers purchased.

Customers can often access similar discounts without making a purchase – e.g. if coupons are printed in a newspaper or freely available in-store or online. This type of general marketing offer would indicate that the coupon does not provide a material right because the discount is available to the customer independent of a prior purchase.

If there is no general marketing offer, then the entity assesses whether the coupon conveys a material right. This assessment includes consideration of the likelihood of redemption. A low redemption rate, which is typical for point-of-sale coupons, is a factor that suggests the coupon does not convey a material right or the stand-alone selling price of the right is immaterial. When the coupons are not deemed to convey a material right to the customer, the coupons are recognized as a reduction in revenue on redemption.

However, when there is no general marketing offer and the value of the coupon and likelihood of exercise is more significant, a material right could be conveyed. The fact that the discount is offered at a point of sale, though, is not determinative.

Question 8.3.80

How should an entity evaluate if a customer option conveys a material right when the stand-alone selling price of the goods or services subject to the option is highly variable or uncertain?

Interpretive response: Determining if a material right exists for options to purchase goods or services for which the stand-alone selling price is highly variable or uncertain may require significant judgment. This is because a comparison of the option price to a stand-alone selling price (or even a relatively narrow range of stand-alone selling prices) is not possible.

An entity considers all relevant and available evidence in determining whether the purchase option is a material right. We believe that there may be a few acceptable approaches to this evaluation that are consistent with the principle of identifying whether the pricing exists independently of the current purchase. Here we outline two approaches.

— **Approach 1:** Analyze the option price against a range of stand-alone selling prices for that good or service established in previous contracts. This approach can be used even if those stand-alone selling prices were established using a residual approach – including where a performance obligation was part of a 'residual bundle' of goods or services.

— **Approach 2:** Evaluate whether the option provides a discount to the customer that is incremental to the range of discounts reflected in the pricing of the other promised goods and services in the contract.

We believe that Approach 2 is appropriate only when the stand-alone selling price of the good or service that is the subject of the option is highly variable or uncertain. However, we do not believe that it should be used more generally because Topic 606 does not contain the notion that a 'discount' must be "incremental to the range of discounts reflected in the pricing of the other elements of the arrangement." When the stand-alone selling price is highly variable or uncertain, a comparison to the stand-alone selling price of the good or service would be meaningless. In this limited circumstance, we believe consideration of the pricing of the promised goods and services in the contract is a reasonable approach.

In any approach that uses the entity's established list prices as a data point (including the above approaches), we would expect the entity's established list prices to be substantive. This means that changes to the price list should be subject to the entity's effective internal controls (including who can authorize price list updates), and there should be a systematic process to identify any triggers resulting in adjustments to the price list.

We expect whichever approach an entity uses to be applied consistently in similar circumstances.

Question 8.3.90

Does an option to purchase goods or services for less than stand-alone selling price without any other purchases represent a material right?

Interpretive response: An entity may enter into an agreement that does not obligate the customer to make any purchases but provides it with the right to purchase the goods or services at a discounted price when it submits a purchase order or statement of work. However, discounted prices on their own does not necessarily mean that there is a material right. Similar to any other customer option, entities need to determine if the discount is independent from other purchases. If the discount in a future purchase order is independent from a current contract then a material right likely does not exist.

The TRG agreed with an example where the entity entered into a new agreement with a customer at significantly discounted prices. In that example, the customer did not pay for the option as it received the discounted prices without making a purchase and each subsequent purchase did not affect the pricing in future contracts. As a result, the TRG concluded that there was no material right. See Example 8.3.70. [TRG 04-16.54]

In contrast, there may be a material right if the right to the discount accumulates based on additional purchases. See Question 8.3.50.

Example 8.3.70

Discounted pricing not a material right

In an attempt to become the supplier to Customer, Bottle Maker offered to supply bottles at a rate of $0.05 per bottle for two years, which is below its stand-alone selling price of $0.08 per bottle.

As a result of this offer, Customer and Bottle Maker enter into an MSA. The MSA does not specify a set quantity of bottles to be purchased, but does set the price per bottle. As such, each time Customer and Bottle Maker enter into a specific purchase order (contract), it is priced using the price set out in the MSA.

Although Bottle Maker agrees to charge Customer a rate that is less than what it would typically charge a similar customer, this arrangement does not include a material right. This is because the rate per bottle that Bottle Maker offers in each purchase order exists independently – the rate Bottle Maker would charge for the second purchase order would be the same regardless of whether the first purchase order was placed.

The objective of the analysis is to determine whether the customer option would exist independently of current purchases. In this example, the pricing set in the MSA is independent of any past purchases – e.g. the terms were negotiated separately. Moreover, the pricing provided to similar customers would not be relevant because the discount already exists outside of an existing contract – i.e. the subsequent purchase orders.

Similarly, when Customer submitted its first purchase order, no material right was present in that contract. That is because Customer already had the right to the future discounts so those rights existed independently from that purchase order. This is different from discounts earned after the customer completes a certain number of purchases because in those scenarios the discount would not be available until the customer completes the other purchases. [TRG 04-16.54]

8.4 Accounting for the exercise of a material right

8.4.10 Overview

When a customer exercises an option that is a marketing offer and not a material right that option is accounted for separately from the current contract. However, Topic 606 is silent on how to account for the exercise of a material right. The TRG discussed this issue, which is described in Question 8.4.10.

Question 8.4.10

How does an entity account for the exercise of a material right?

Interpretive response: The TRG agreed that when a customer exercises a material right, an entity may account for it using either of the following approaches. [TRG 03-15.32]

— **Continuation of the original contract.** Under this approach, an entity treats the consideration allocated to the material right as an addition to the consideration for the goods or services under the contract option – i.e. as a change in the transaction price.

— **Contract modification.** Under this approach, an entity applies the contract modification guidance to evaluate whether the remaining goods or services to be transferred after exercise of the option are distinct from the other goods or services in the contract. The outcome of this evaluation will determine whether the modification is accounted for prospectively (remaining goods are distinct) or with a cumulative catch-up adjustment (not distinct). [TRG 03-15.32]

While the additional goods or services underlying a material right are typically distinct, there could be some situations where the option exercised by the customer results in changes to the scope of the work that is not distinct. For example, a customer could have a contractual option to change or upgrade certain aspects of an asset under construction that is not distinct from the asset.

Example 8.4.10**

Continuation of the original contract approach – software license and mandatory PCS

ABC Corp. enters into a contract with Customer to provide a perpetual license for Product H and also to provide both technical support services and any updates, upgrades and enhancements developed (collectively, PCS) for one year. If Customer does not renew PCS each year it loses the right to use the software – i.e. there is a mandatory PCS provision in the contract.

ABC has determined that:

— it can account for its PCS as a single performance obligation (see Question 10.5.20); and
— the PCS, even though mandatory, is distinct from the Product H license.

In addition, the following facts are relevant:

— the stand-alone selling price for a perpetual license to Product H is $2,000,000;

— the stand-alone selling price for one year of ABC's PCS on a perpetual license at contract inception is $400,000;

— the stand-alone selling price for a one-year license to Product H and co-terminus PCS on a one-year license (which are never sold separately from each other) is $600,000; and

— the economic life of Product H is eight years.

Customer pays an upfront fee of $2,400,000 for the license and the first year of the mandatory PCS. The contract states that Customer must pay a fee of $400,000 each year to renew the mandatory PCS. After five years, Customer may choose not to renew the PCS, but retains its right to use Product H.

Analysis

Determine performance obligations

ABC concludes that the mandatory PCS provision means that the enforceable rights and obligations of the parties under the contract are for only a one-year term license to Product H and one year of PCS. Absent Customer deciding to renew PCS, Customer only has a right to a one-year license and to one year of PCS.

However, the upfront fee ($2.4 million) is substantially larger than the fee Customer would pay during the potential renewal periods ($400,000 per year in Years 2-5). Therefore, ABC concludes that the initial contract for Year 1 includes a material right with respect to renewing the one-year license and related PCS for Years 2-4. In addition, ABC concludes that Customer is obtaining a material right to a perpetual license (bundled with one year of PCS) that it will control upon renewing PCS for Year 5. That is, upon accepting the option to renew PCS for Year 5 at the beginning of Year 5 (which includes accepting its obligation to pay the Year 5 PCS fee), Customer now controls a *perpetual* right to use Product H.

Consequently, at contract inception there are the following performance obligations in the contract:

- a one-year license to Product H;
- one year of PCS related to Product H;
- material rights to obtain further one-year licenses to Product H and related PCS in each of Years 2-4; and
- a material right to obtain a perpetual license to Product H and one year of related PCS at the beginning of Year 5.

Estimate stand-alone selling price of option

The perpetual license to Product H that Customer may acquire at the beginning of Year 5 is not similar to the one-year term licenses Customer obtains initially and has the right to obtain in Years 2-4. Therefore, ABC cannot apply the alternative approach in paragraph 606-10-55-45 (see section 8.5.10); ABC must estimate the stand-alone selling price of the option to obtain a perpetual license to Product H. Various facts and circumstances, including the estimated stand-alone selling price of a perpetual license to Product H (which may be highly variable or uncertain) and consideration of breakage (i.e. the likelihood that Customer will forgo its material right by choosing not to renew PCS for Years 2-5), will affect the estimated stand-alone selling price of the perpetual license option.

Perform stand-alone selling price allocation

Assume the following stand-alone selling prices are estimated for the material rights in the contract.

Option	Discount	Probability of exercise	Stand-alone selling price
Year 2 one-year license/PCS option	$ 200,000	98%	$ 196,000
Year 3 one-year license/PCS option	200,000	95%	190,000
Year 4 one-year license/PCS option	200,000	91%	182,000
Year 5 perpetual license/one-year of PCS option	$2,000,000	90%	$1,800,000

Consequently, the contract inception relative stand-alone selling price allocation is as follows (rounded to nearest dollar and tenth of a percent):

Performance obligation	Stand-alone selling price	Relative allocation %	Allocated amount
Year 1 license/PCS	$ 600,000	20.2%	$ 485,175
Year 2 option	196,000	6.6%	158,490
Year 3 option	190,000	6.4%	153,639
Year 4 option	182,000	6.1%	147,170
Year 5 option	1,800,000	60.7%	1,455,526
Total	**$2,968,000**	**100.0%**	**$2,400,000**

The $485,175 allocated to Year 1 is then allocated between the license and the PCS based on the relative stand-alone selling price of each. ABC will recognize the portion allocated to the license at the beginning of Year 1 and recognize the portion allocated to the PCS over the one-year PCS period.

The amounts allocated to the options will remain deferred (i.e. as contract liabilities) until the respective option is exercised. When the option is exercised, the consideration for the additional license and PCS (e.g. the $400,000 fee applicable to Year 2) is added to the amount allocated to the Year 2 option for a total amount of consideration of $558,490. Consistent with the accounting for the license and PCS in Year 1, ABC will allocate the $558,490 between the license and PCS on a relative stand-alone selling price basis. ABC will recognize the portion allocated to the license at the beginning of Year 2 and recognize the portion allocated to the PCS over the one-year PCS period.

The accounting for Years 3-5 will generally be consistent with that for Year 2 other than with respect to the amounts recognized (due to the differing amounts allocated to the options).

8.5 Allocating the transaction price to a material right

Excerpt from ASC 606-10

• > Customer Options for Additional Goods or Services

55-44 Paragraph 606-10-32-29 requires an entity to allocate the transaction price to performance obligations on a relative standalone selling price basis. If the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity should estimate it. That estimate should reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

a. Any discount that the customer could receive without exercising the option
b. The likelihood that the option will be exercised.

55-45 If a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, then an entity may, as a practical alternative to estimating the standalone selling price of the option, allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration. Typically, those types of options are for contract renewals.

8.5.10 Overview

Estimating the stand-alone selling price of an option

If a customer option to acquire additional goods or services represents a material right, an entity estimates the option's stand-alone selling price and allocates the transaction price to that performance obligation on a relative stand-alone selling price basis. The stand-alone selling price of an option could be a directly observable price, if available. However, if the stand-alone selling price is not directly observable, an entity estimates the stand-alone selling price. Entities should have internal processes and controls for establishing such stand-alone selling prices. [606-10-55-44]

A common way to estimate the value of an option is to use an option pricing model. Option pricing models generally take into account the intrinsic value and time value of the option. However, under Topic 606, an entity estimates only the intrinsic value of an option because the benefits of including the time value component would not justify the costs of making the estimate. [ASU 2014-09.BC390]

An entity estimates stand-alone selling price of a material right by obtaining the discount the customer would receive when exercising the option and adjusts for:

— any discount that the customer would receive without exercising the option; and
— the likelihood that the option will be exercised. [606-10-55-44]

The stand-alone selling price of the material right includes only the incremental discount provided through the current purchase. For example, if an option provides a 50% discount on future purchases when customers within the same class can receive a 10% discount on the same products, the estimate of the stand-alone selling price considers only the 40% discount that is incremental to what the customer could otherwise receive. [606-10-55-336 – 55-338]

The stand-alone selling price is adjusted for the likelihood that the option will be exercised. In effect, the stand-alone selling price of a material right includes estimated breakage. For example, if as part of a current purchase an entity provides the customer with an option to purchase an item that is normally sold for $100 for $50 (a 50% discount) the entity would start with the $50 discount and adjust for the probability of redemption. If the entity concluded that customers exercise the option only 80% of the time, the stand-alone selling price of the option would be $40 ($50 discount × 80% probability of exercise).

Alternative approach

Topic 606 provides an alternative approach to estimating the stand-alone selling price of a customer option when certain criteria are met. This alternative typically applies when a renewal option is considered to be a material right. Under this alternative, the entity allocates the transaction price to the optional goods or services it expects to provide and the corresponding consideration it expects to receive. Essentially, this alternative treats a contract with renewal options as a hypothetical contract for its expected term, thereby eliminating the need to estimate the stand-alone selling prices for each renewal. If an entity does not elect this alternative, it has to separately calculate the stand-alone selling price for each good or service, which entails estimating the likelihood that the customers will renew in each subsequent period. [ASU 2014-09.BC393]

This alternative can be applied when: [606-10-55-45]

— the material right relates to goods or services that are similar to the original goods or services in the contract; and
— those goods or services are provided in accordance with the terms of the original contract.

The first criterion specifies that the additional goods or services provided under the option are similar to those provided under the initial contract – i.e. the entity is continuing to provide what it was already providing. As a result, the alternative would typically apply to renewals of services provided in the original contract. [ASU 2014-09.BC394]

The second criterion specifies that the additional goods or services provided under the option are provided in accordance with the terms of the original contract. In other words, the option price and goods or services that the customer can acquire when exercising the option are established in the original contract. This criterion functionally prohibits the alternative from applying to any type of options – such as loyalty points or certain discount vouchers – in which the entity can charge a price for the additional goods or services that differs from the pricing in the original contract. [ASU 2014-09.BC395]

Excerpt from ASC 606-10

• • > Example 51 – Option that Provides the Customer with a Material Right (Renewal Option)

55-343 An entity enters into 100 separate contracts with customers to provide 1 year of maintenance services for $1,000 per contract. The terms of the contracts specify that at the end of the year, each customer has the option to renew the maintenance contract for a second year by paying an additional $1,000. Customers who renew for a second year also are granted the option to renew for a third year for $1,000. The entity charges significantly higher prices for maintenance services to customers that do not sign up for the maintenance services initially (that is, when the products are new). That is, the entity charges $3,000 in Year 2 and $5,000 in Year 3 for annual maintenance services if a customer does not initially purchase the service or allows the service to lapse.

55-344 The entity concludes that the renewal option provides a material right to the customer that it would not receive without entering into the contract because the price for maintenance services are significantly higher if the customer elects to purchase the services only in Year 2 or 3. Part of each customer's payment of $1,000 in the first year is, in effect, a nonrefundable prepayment of the services to be provided in a subsequent year. Consequently, the entity concludes that the promise to provide the option is a performance obligation.

55-345 The renewal option is for a continuation of maintenance services, and those services are provided in accordance with the terms of the existing contract. Instead of determining the standalone selling prices for the renewal options directly, the entity allocates the transaction price by determining the consideration that it expects to receive in exchange for all the services that it expects to provide in accordance with paragraph 606-10-55-45.

55-346 The entity expects 90 customers to renew at the end of Year 1 (90 percent of contracts sold) and 81 customers to renew at the end of Year 2 (90 percent of the 90 customers that renewed at the end of Year 1 will also renew at the end of Year 2, that is 81 percent of contracts sold).

55-347 At contract inception, the entity determines the expected consideration for each contract is $2,710 [$1,000 + (90 percent × $1,000) + (81 percent × $1,000)]. The entity also determines that recognizing revenue on the basis of costs incurred relative to the total expected costs depicts the transfer of services to the customer. Estimated costs for a three-year contract are as follows:

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

55-348 Accordingly, the pattern of revenue recognition expected at contract inception for each contract is as follows:

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

55-349 Consequently, at contract inception, the entity allocates to the option to renew at the end of Year 1 $22,000 of the consideration received to date [cash of $100,000 – revenue to be recognized in Year 1 of $78,000 ($780 × 100)].

55-350 Assuming there is no change in the entity's expectations and the 90 customers renew as expected, at the end of the first year, the entity has collected cash of $190,000 [(100 × $1,000) + (90 × $1,000)], has recognized revenue of $78,000 ($780 × 100), and has recognized a contract liability of $112,000.

55-351 Consequently, upon renewal at the end of the first year, the entity allocates $24,300 to the option to renew at the end of Year 2 [cumulative cash of $190,000 – cumulative revenue recognized in Year 1 and to be recognized in Year 2 of $165,700 ($78,000 + $877 × 100)].

55-352 If the actual number of contract renewals was different than what the entity expected, the entity would update the transaction price and the revenue recognized accordingly.

Question 8.5.10

Can the sales price of separately sold gift cards or coupons be used for the stand-alone selling price of gift cards or coupons that convey a material right to the customer?

Interpretive response: Generally, no. In some cases, an entity may sell gift cards or coupons in stand-alone transactions with customers. In addition, the entity may grant similar gift cards or coupons in transactions in which customers purchase other goods and services. In the latter case, the gift cards or coupons may be identified as conveying a material right to the customer – e.g. an entity offers a free gift card or coupon with a value of $15 with every $100 of goods purchased.

If a directly observable price of an option is available, entities would use that to determine the stand-alone selling price; however, an entity may conclude that there is no directly observable stand-alone selling price of a free gift card or coupon provided to a customer in connection with the purchase of another good or service. This is because customers who receive the gift card or coupon as a material right may be significantly less likely to redeem them than customers who purchase a gift card or coupon in a separate transaction. As a result, the stand-alone selling price of the material right may differ from the price of a separately sold gift card or coupon.

In this case, the entity estimates the stand-alone selling price, which requires an estimate of the likelihood that the gift card or coupon will be used. As a result, the price when the gift card or coupon is sold separately will be adjusted for breakage to determine the stand-alone selling price of the material right.
[606-10-55-44]

Question 8.5.20

Does an entity revise the stand-alone selling price of a material right if its estimate of the likelihood of exercise changes?

Interpretive response: No, unless the alternative approach is used. The stand-alone selling price of performance obligations in a contract are not adjusted after contract inception even if the assumptions change. This is also true for the stand-alone selling price of material rights. To determine the stand-alone selling price of a material right, an entity estimates the likelihood that the customer will exercise the option at contract inception and that initial estimate is not revised. However, the estimates of the stand-alone selling price of a similar option in subsequent contracts may be affected by those changes in estimates.
[606-10-32-43]

As a consequence, a customer's decision to exercise an option or allow the option to expire affects the timing of recognition for the material right, but it does not result in reallocation of the transaction price.

The exception is when an entity applies the alternative approach to estimating stand-alone selling price of an option. When an entity applies the alternative approach, any changes in the number of options exercised result in an adjustment to the transaction price and revenue recognized in accordance with Example 51 in Topic 606. [606-10-55-352]

We believe it is acceptable to adjust the number of expected goods or services on either a cumulative catch-up or prospective basis. However, an entity should have a policy for the approach it uses and apply it consistently. See Example 8.5.20.

Question 8.5.30

Is the alternative approach limited to renewals of services?

Interpretive response: No. The FASB discussed the concept of the practical alternative only in terms of service renewals. However, we believe this alternative can be applied to a material right for the purchase of additional goods – assuming the material right relates to goods that are similar to the original goods in the contract and are provided in accordance with the terms of the original contract. [606-10-55-45]

See Example 8.5.10 for an application of this concept.

Question 8.5.40

To apply the alternative approach, does the outcome have to be the same as estimating the stand-alone selling price for each option?

Interpretive response: No. The alternative approach may result in a different accounting outcome. Depending on the individual facts and circumstances the difference could result in more or less of the transaction price being deferred and recognized as the options are exercised.

Regardless of the approach an entity selects, it should apply that approach consistently to similar circumstances.

Question 8.5.50

How is the amount of goods or services expected to be provided determined under the alternative approach?

Interpretive response: The alternative approach allows an entity to allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration. However, Topic 606 does not provide detailed guidance on how to determine the amount of expected goods or services. We believe an entity can determine the amount of expected goods or services on either a portfolio of data or contract-by-contract basis. [606-10-55-45]

Portfolio of data basis

Example 51 in Topic 606 (reproduced above) illustrates the application of the alternative approach to a service arrangement, whereby the entity estimates the number of contracts expected to be renewed for a portfolio of contracts. In that example, the entity enters into 100 similar annual contracts with two renewal periods around the same time. The entity estimates the number of expected renewals for the portfolio to estimate the transaction price and to allocate consideration to the initial and renewal contracts. The example states that if the actual number of contract renewals is different from what the entity expected, the entity would update the transaction price and revenue recognized accordingly. We believe it is acceptable to adjust the number of expected goods or services during the period(s) for which a material right exists, on either a cumulative catch-up or prospective basis as long as the entity has a policy for the approach it uses and applies it consistently. [606-10-55-343 – 55-352]

Based on Example 51 in Topic 606, a similar approach would be acceptable whereby the entity estimates the number of goods or services expected to be provided based on historical data for a portfolio of similar transactions.

Contract-by-contract basis

When an entity estimates the expected goods or services on a contract-by-contract basis, it could consider each option that provides the customer with a material right to be a 'good or service that is expected to be provided' unless it expects the customer's right to expire unexercised – e.g. it would be likely that the right will expire unexercised. To determine whether it is likely the customer's right will expire unexercised (i.e. breakage), the entity should consider the guidance on unexercised rights (see section 7.6).

The approach outlined in the preceding paragraph ensures that the entity's obligation to provide future goods or services is not understated by allocating an appropriate amount of consideration to the material right. We believe the analogy to breakage is appropriate because the alternative approach factors in breakage based on the number of goods or services included in the contract instead of requiring an entity to estimate the stand-alone selling price of an option based on the likelihood of exercise. For a discussion of breakage, see section 7.6.

Further, we believe that under this alternative, the estimate of the expected consideration would not need to be further adjusted for the likelihood of exercise. This is because breakage is already considered in determining the expected goods or services to be provided, and breakage (by analogy as noted above) is not a form of variable consideration that affects the transaction price. However, to determine the expected goods or services to be provided, the entity considers the principles used in the guidance on constraining estimates of variable consideration (see section 5.3.40). [606-10-55-48]

See Approach 2 in Example 8.5.10 for an illustration of how to determine and subsequently allocate the expected consideration to the goods or services expected to be provided when applying this alternative.

If the *actual* number of contract renewals is different from what the entity expected, the entity updates the transaction price and revenue recognized accordingly. We believe it is acceptable to adjust the number of expected goods or services during the period(s) for which a material right exists, on either a cumulative catch-up or prospective basis as long as the entity has a policy for the approach it uses and applies it consistently. If a renewal option is not exercised, any remaining revenue is recognized when the material right expires unexercised.

Under a contract-by-contract basis, we believe it is also acceptable to include all of the options that represent a material right in the expected consideration and then estimate the expected consideration based on the likelihood of exercise similar to Example 51 in Topic 606. For example, if an entity includes a renewal option with a contract price of $100 that has a 60% probability of being exercised, it could include $60 in the expected consideration.

Example 8.5.10
Allocation of a material right using both approaches

ABC Corp. enters into a contract with Customer to transfer two units of Product P for $2,000 ($1,000 per unit, which is the stand-alone selling price) with an option to purchase up to two more units of Product P at $500 per unit (i.e. 50% discount). ABC concludes that each unit of Product P is distinct and satisfied at a point in time.

ABC concludes that the option for up to two additional units of Product P is a material right because the discount is incremental to discounts provided to other customers in this class of customers, and does not exist independently from the current contract. ABC also concludes that the stand-alone selling price for the two additional units of Product P is $1,000.

The following illustrates ABC's accounting for the material rights using approaches discussed in this section.

Approach 1: Estimate the stand-alone selling price of the option

ABC estimates the stand-alone selling price of the customer options by calculating the discount adjusted for the likelihood of exercise related to each option. ABC estimated the likelihood of exercise for option 1 and option 2 to be 90% and 80%, respectively. As such, the stand-alone selling price for option 1 is $450[1] and option 2 is $400.[2] ABC allocates the transaction price as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Original purchase	$2,000	70%	$1,400
Option 1	450	16%	320
Option 2	400	14%	280
Total	**$2,850**	**100%**	**$2,000**

ABC recognizes revenue as follows.

- When it transfers control of the first two units, it recognizes $700 per unit: $1,400 / 2 units.
- After Customer exercises Option 1, when ABC transfers control of that unit it recognizes $820: $500 price + $320 allocated to the option.
- After Customer exercises Option 2, when ABC transfers control of the last unit, it recognizes $780: $500 price + $280 allocated to the option.
- If Customer does not exercise the options, the $320 and $280 will be recognized as revenue when the respective options expire.

Notes:

1. $1,000 stand-alone selling price × 50% discount × 90% chance of exercise = $450.
2. $1,000 stand-alone selling price × 50% discount × 80% chance of exercise = $400.

Approach 2: Apply the alternative approach

ABC could also use the alternative approach to allocate the transaction price to the options. This is because the options allow Customer to acquire additional units of Product P, which are the same goods purchased in the original contract, and the purchases would be made in accordance with the original terms of the contract – i.e. the price is determined in the original contract.

ABC uses the contract-by-contract basis to estimate the number of goods it expects to provide and related consideration. ABC expects there is a high likelihood of the customer exercising each option because of the significant discount provided. Therefore, ABC determines by including both renewal options in the expectation of goods to be providedit is probable that there will not be a significant revenue reversal when the contingency is resolved (i.e. options are exercised or not). As such, ABC does not expect breakage and includes all of the options in the expected number of goods it expects to provide (as discussed in Question 8.5.50). Therefore, ABC allocates the expected consideration to the units expected to be provided.

Expected consideration	$3,000	$2,000 (price of original 2 units purchased) + $500 (price of third unit) + $500 (price of fourth unit)
Number of units expected to be provided	4	2 original units purchased + option for 1 unit + option for 1 unit
Price allocated to each unit	$750	$3,000 / 4 units

Therefore, in effect $1,500 of the total consideration in the original contract of $2,000 is allocated to the purchase of the original two units and the remaining $500 is allocated to the two options.

If Customer exercises its option for the third unit, ABC recognizes $750 in revenue when it transfers control of that unit. Similarly, if Customer exercises its option for the fourth unit and control transfers to Customer, ABC recognizes $750 in revenue. If Customer decides not to exercise the options, ABC recognizes the revenue allocated to the options when the respective options expire.

For remaining performance obligation disclosure considerations for Approach 2 see Example 15.7.17.

Question 8.5.60

Is the alternative approach available only when a renewal option applies to all of the goods or services in the initial contract?

Interpretive response: No. We believe the practical alternative is available even though a renewal option does not apply to all of the goods or service in the original contract. However, the renewal option must be for a good or service similar to a good or service in the original contract.

For example, an entity may provide a customer with an equipment and maintenance contract for a year with the option to renew the maintenance in subsequent years. If the renewal options are material rights, the entity could apply the alternative approach even though the renewals do not apply to both the equipment and maintenance as long as the renewals are provided in accordance with the terms of the original contract – i.e. the renewal price is established in the contract.

In contrast, if an entity provides a customer with a credit or voucher to purchase goods or services (including but not limited to the types of goods or services in the original contract), the practical alternative is not available. This is because the terms of the contract do not state the price of all of the underlying goods or services that the customer is able to purchase with the credit or voucher.

Example 8.5.20

Allocating the transaction price to a material right – comprehensive example

ABC Corp. enters into 100 contracts to provide equipment for $10,000 and one year of maintenance for $2,000 – both prices are equal to their stand-alone selling price. Each contract provides Customer the option to renew the maintenance for $1,000 for two additional years (i.e. a 50%discount from stand-alone selling price that Customer can only receive from entering into the contract).

ABC concludes that:

— the equipment and maintenance are separate performance obligations.

— each renewal option provides a material right to Customer that Customer would not receive without entering into the contract because the discount is significant to what ABC charges other similar customers.

This example illustrates both approaches for allocating the transaction price to renewal options.

Approach 1: Estimate the stand-alone selling price of each option

To estimate the stand-alone selling price of each material right, ABC calculates the discount Customer would receive from exercising the option adjusted for the probability of renewal.

ABC expects 90 customers to renew at the end of Year 1 (90% of contracts sold) and 81 customers to renew at the end of Year 2 (90% of the 90 customers that renewed at the end of Year 1).

It estimates the stand-alone selling price for each material right as follows.

Option	Discount	Probability of renewal	Stand-alone selling price
Renewal option 1	$1,000	90%	$900
Renewal option 2	$1,000	81%	$810

ABC then allocates the transaction price on a relative stand-alone selling price basis as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Equipment	$10,000	73.0%	$ 8,760
Maintenance Year 1	2,000	14.5%	1,740
Material right – renewal option 1	900	6.5%	780
Material right – renewal option 2	810	6.0%	720
Total	**$13,710**	**100.0%**	**$12,000**

ABC records the following journal entries, assuming that Customer exercises the renewal options.

	Debit	*Credit*
Cash/trade receivables	12,000	
Revenue		8,760
Contract liability		3,240
To recognize revenue on transfer of control of equipment.		
Contract liability	1,740	
Revenue		1,740
To recognize revenue ratably as maintenance performance obligation satisfied over the year.		
Cash/trade receivables	1,000	
Contract liability	780	
Revenue		1,780
To recognize revenue when renewal option 1 exercised.		
Cash/trade receivables	1,000	
Contract liability	720	
Revenue		1,720
To recognize revenue when renewal option 2 exercised.		

If Customer does not exercise its option, ABC recognizes as revenue the amounts allocated to all remaining options.

Approach 2: Apply the alternative approach

ABC allocates the transaction price by reference to the goods or services expected to be provided and corresponding expected consideration. To apply the alternative approach, it could estimate the transaction price either on a portfolio or on a contract-by-contract basis.

Portfolio of data basis

ABC estimates the total number of expected goods or services it expects to provide and corresponding consideration it expects to receive for the 100 contracts based on expectations for similar customers. It estimates the number of renewals and corresponding expected transaction price. It also concludes that the stand-alone selling price for each maintenance period is the same.

Based on its expectations, it allocates the expected consideration to each performance obligation per contract as follows.

Performance obligation	Contract price	Expected renewals	Expected consider-ation	Stand-alone selling price	Selling price ratio	Price allocation
Equipment	$10,000	n/a	$10,000	$10,000	65.0%	$ 8,911
Maintenance Year 1	2,000	n/a	2,000	2,000	13.0%	1,782
Renewal option 1	1,000	90%	900	1,800	11.5%	1,577
Renewal option 2	1,000	81%	810	1,620	10.5%	1,440
Total	**$14,000**		**$13,710**	**$15,420**	**100.0%**	**$13,710**

ABC records the following journal entries for the portfolio of contracts in Year 1.

	Debit	*Credit*
Cash/trade receivables	1,200,000	
Revenue		891,100
Contract liability		308,900
To recognize revenue on transfer of control of equipment.		
Contract liability	178,200	
Revenue		178,200
To recognize revenue ratably over the year as maintenance performance obligations are satisfied.		

At the end of Year 1, the balance of the contract liability is $130,700, which relates to renewal options 1 and 2.

If the actual number of renewals is different from what was expected, ABC's policy is to update the transaction price and recognize revenue with a cumulative catch-up adjustment. For example, if 95 customers exercise the first renewal option, ABC updates the transaction price and reallocates the consideration to each performance obligation per contract as follows.

Performance obligation	Contract price	Expected renewals	Expected consider-ation	Stand-alone selling price	Selling price ratio	Price allocation
Equipment	$10,000	n/a	$10,000	$10,000	64.0%	$ 8,835
Maintenance Year 1	2,000	n/a	2,000	2,000	12.8%	1,767
Renewal option 1	1,000	95.0%	950	1,900	12.2%	1,685
Renewal option 2	1,000	85.5%	855	1,710	11.0%	1,518
Total	**$14,000**		**$13,805**	**$15,610**	**100.0%**	**$13,805**

ABC records the following journal entries for the portfolio of contracts in Year 2.

	Debit	*Credit*
Revenue	9,100[1]	
Contract liability		9,100
To reverse revenue at start of Year 2, based on adjustment to allocation of consideration.		
Cash/trade receivables	95,000	
Contract liability	73,500	
Revenue		168,500[2]
To recognize revenue ratably over the year as performance obligations related to renewal option 1 are satisfied.		

Notes:

1. Calculated as (($8,835 + $1,767) – ($8,911 + $1,782)) × 100 contracts.
2. Calculated as $1,685 × 100 contracts.

At the end of Year 2, the balance of the contract liability is $66,300, which relates to renewal option 2.

In Year 3, assuming no change in expected renewals, ABC recognizes the following journal entry for the portfolio of contracts.

	Debit	*Credit*
Cash/trade receivables	85,500	
Contract liability	66,300	
Revenue		151,800[1]
To recognize revenue ratably over the year as performance obligations related to renewal option 2 are satisfied.		

Note:
1. Calculated as $1,518 × 100 contracts.

Contract-by-contract basis

If ABC applies the alternative approach on a contract-by-contract basis, it estimates the goods or services it expects to provide and the corresponding consideration it expects to receive. Customer has a material right for both renewal options 1 and 2 and ABC does not expect the rights to go unexercised. ABC considers the constraint on variable consideration factors (see section 5.3) when determining whether either of the rights will go unexercised and notes that:

— the exercise is out of its control;

— the uncertainty will not be resolved until the end of Year 1; and

— although it has experience with similar customers and has data that suggests there will be some breakage, historical evidence suggests that on a customer-by-customer basis neither of the options will expire unexercised.

Therefore, based on the factors above, ABC determines it is probable that by including both renewal options in the expectation of goods or services to be provided there will not be a significant revenue reversal when the contingency is resolved (i.e. option is exercised or not).

Based on its expectations, it allocates the expected consideration to each performance obligation in the contract as follows.

Performance obligation	Contract price	Expected consider-ation	Stand-alone selling price	Selling price ratio	Price allocation
Equipment	$10,000	$10,000	$10,000	62.5%	$ 8,750
Maintenance Year 1	2,000	2,000	2,000	12.5%	1,750
Renewal option 1	1,000	1,000	2,000	12.5%	1,750
Renewal option 2	1,000	1,000	2,000	12.5%	1,750
Total	**$14,000**	**$14,000**	**$16,000**	**100.0%**	**$14,000**

In Year 1, ABC recognizes $8,750 when it transfers control of the equipment to Customer, and $1,750 as it satisfies the related maintenance performance obligation. The difference between the amount recognized as revenue in Year 1 and consideration received of $1,500 ($12,000 – $8,750 – $1,750) is recognized as a contract liability. The amounts allocated to the renewal options will be recognized as the performance obligations are satisfied.

If Customer does not exercise its options, ABC recognizes as revenue the amounts allocated to all remaining options.

8.6 Customer loyalty programs

8.6.10 Overview

Loyalty programs can vary widely, but common examples are airline programs that offer 'free' air miles, hotel programs that offer 'free' hotel points and retail store programs that offer future discounts after a specific number of purchases have been made. A customer loyalty program that provides a customer with a material right is accounted for as a separate performance obligation.

Excerpt from ASC 606-10

• • > Example 52—Customer Loyalty Program

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 (totaling $9,500) on the basis of the likelihood of redemption in accordance with paragraph 606-10-55-44.

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)]

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.

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).

Question 8.6.01●

How are customer loyalty programs that provide a customer with a material right accounted for under Topic 606?

Interpretive response: Revenue is deferred if the customer loyalty program provides a customer with a material right. See Question 8.3.50 for how accumulating rights can represent a material right. A portion of the consideration in the contract is allocated to that material right, which results in an initial revenue deferral until the customer exercises the right by redeeming points. As indicated in Example 52 of Topic 606 (reproduced above), the amount of revenue recognized when points are redeemed incorporates an estimate of breakage (i.e. points expected to expire). [606-10-55-353 – 55-356]

Question 8.6.10

Do customer loyalty programs that can be cancelled by the entity convey a material right?

Interpretive response: Generally, yes. Many customer loyalty programs can be cancelled or changed by the entity at any time. However, unlike in Step 1 promises do not require legal enforceability to be a performance obligation. If the entity has a past practice that creates a reasonable expectation by its customers that it will fulfill its promises under the loyalty program, it treats the program as conveying a material right. The entity has made an implicit promise to continue to operate the customer loyalty program, which is accounted for as a performance obligation under the contract. [606-10-55-42, ASU 2014-09.BC87]

Example 8.6.10

Customer loyalty points program

Retailer offers a customer loyalty program at its store. Under the program, customers are awarded one point for every $10 they spend on goods. Each point is redeemable for a cash discount of $1 on future purchases.

Retailer expects 97% of customers' points to be redeemed. This estimate is based on Retailer's historical experience, which Retailer determines is predictive of the amount of consideration to which it will be entitled.

During Year 1, customers purchase products for $100,000 and earn 10,000 points. The stand-alone selling price of the products to customers without points is $100,000. Retailer determines the stand-alone selling price of the material right based on the likelihood of the loyalty point being redeemed.

Retailer allocates the transaction price between the products and the material right on a relative selling price basis as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation	Calculation
Products	$100,000[1]	91%	$ 91,000	$100,000 × 91%
Material right (points)	9,700[2]	9%	9,000	$100,000 × 9%
Total	**$109,700**	**100%**	**$100,000**	

Notes:
1. Stand-alone selling price for the products.
2. Stand-alone selling price for the points: 10,000 × $1 × 97%.

Retailer recognizes a contract liability of $9,000 for the amount allocated to the material right (points).

The following occurs in Years 2 and 3.

— During Year 2, 4,500 points are redeemed, and Retailer continues to expect that 9,700 points will be redeemed in total.

— During Year 3, a further 4,000 points are redeemed. Retailer updates its estimate because it now expects 9,900 rather than 9,700 points to be redeemed in total.

In Years 2 and 3, Retailer determines the revenue to be recognized as follows.

Calculation of cumulative revenue (Redeemed points / Total expected to be redeemed) × Allocation of revenue	Cumulative revenue	Revenue already recognized	Revenue to recognize this year
Year 2: (4,500 / 9,700) × $9,000	$4,175	-	$4,175
Year 3: (8,500 / 9,900) × $9,000	$7,727	$4,175	$3,552

Retailer records the following journal entries.

	Debit	*Credit*
Cash/trade receivables	100,000	
Revenue		91,000
Contract liability		9,000
To recognize sale of products in Year 1.		
Contract liability	4,175	
Revenue		4,175
To recognize redemption of points in Year 2.		
Contract liability	3,552	
Revenue		3,552
To recognize redemption of points in Year 3.		

At the end of Year 3, Retailer has a contract liability of $1,273 for the remaining 1,400 points expected to be redeemed.

Question 8.6.20
Do customer loyalty programs typically include a significant financing component?

Interpretive response: No. Customer loyalty programs generally do not include a significant financing component even though the period between when the customer pays for the points and redeems the points may be greater than one year. This is because the transfer of the related goods or services to the customer – i.e. use of the loyalty points – occurs at the discretion of the customer, which indicates that a significant financing component does not exist. [606-10-32-17(a)]

Question 8.6.30
Does the accounting for loyalty points differ based on how the loyalty points can be redeemed?

Interpretive response: Yes. Loyalty points can be redeemed to acquire goods and services in a variety of ways. The following are examples.

— **For goods and services from the issuing entity.** For example, an airline issuing loyalty points that are redeemed to purchase flights on that airline.

— **For goods or services from other parties (but not the issuing entity).** For example, a retailer awarding points in a third party's loyalty program for each dollar a customer spends at its store when those points are administered by and can only be redeemed at the third party, such as a hotel. Typically, the entity issuing the points to the customer (the retailer in this scenario) will pay the entity that redeems the points (the hotel) an agreed monetary amount.

— **For goods and services from the issuing entity or other parties.** For example, a hotel chain issuing loyalty points that can be redeemed for its hotel rooms or other travel services, such as flights or car rentals.

To evaluate the accounting for these transactions, the entity first evaluates if it is the principal or agent in the arrangement.

— If the entity is the principal, it allocates consideration to the points as they are issued to the customer. The principal recognizes revenue for those points once it satisfies its performance obligation by providing the goods or services purchased by the customer using points.

— If the entity is an agent, then it allocates consideration to the points but recognizes only the net revenue retained in the exchange (i.e. its agent's commission) once it satisfies its performance obligation as the agent (see chapter 9).

When the customer can redeem the points only from another party or has the choice to redeem the points from either the entity or another party the accounting can be more complex. In either case, the entity evaluates whether it is a principal or agent in the transaction.

Points redeemed for goods and services only from the issuing entity

When the points can be redeemed only from the issuing entity, the entity is typically the principal in the transaction.

Points redeemed for goods or services only through a third party's loyalty program

If the points can only be redeemed through another party's loyalty program, the entity issuing the points to an end customer may be the principal for the points if it controls the points before they are transferred to the customer (see section 9.3). If the entity does not control the points prior to awarding them to an end customer, the entity is the agent of the party that redeems the points.

When the entity is the agent, it recognizes revenue when it satisfies its obligation as an agent in the transaction. An entity could satisfy its promise when it provides the customers with loyalty points if:

- The entity's promise is to provide loyalty points to customers when the customer purchases the 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 (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. [ASU 2014-09.BC383]

If the entity satisfies its promise to customers when it transfers the points, it does the following upon issuance of the points:

- recognizes revenue; and
- reduces revenue and records a liability for the amount it owes to the party that is the principal in the transaction.

Points redeemed for goods or services from either the issuing party or other parties

When the customer has the choice to acquire goods or services from the issuing entity or other parties, the analysis of whether the entity is a principal or an agent typically takes place once the customer redeems the points.

Until the points are redeemed, the entity stands ready to provide the goods or services, and therefore defers the consideration allocated to the points. As a result, the entity does not recognize revenue when issuing the points. When the points are redeemed, the entity determines if it is the principal or the agent for the underlying goods or services.

If, at the time of redemption, the entity determines it is the principal, it then recognizes revenue for the gross amount deferred as it transfers the underlying goods or services to the customer that redeemed the points. Alternatively, if the entity determines it is an agent, it then recognizes revenue for its net commission when it satisfies its obligation as an agent. When it is an agent, the entity relieves the contract liability in an amount commensurate with the points redeemed. The offsetting entry in this instance is to record revenue for the commission and a liability for payment to the principal in the transaction.

Example 8.6.20

Loyalty points used to purchase goods or services only from another party

Retailer participates in a customer loyalty program in partnership with Car Rental that awards one car point for each dollar that a customer spends on goods purchased from Retailer. Participants in the program can redeem the points only with Car Rental, and Car Rental administers the program.

At the end of every quarter, Retailer pays Car Rental $0.018 for each point that Retailer's customers earn. Car Rental then deposits all of the points paid for by Retailer into the customers' award accounts. Car Rental has discretion to establish prices for the rental cars and how many points it takes to rent a car in a particular market.

Retailer evaluates the principal-agent guidance (see chapter 9). Retailer's promise is to provide its customers with Car Rental's loyalty points when the customer purchases goods or services from Retailer. The points entitle the customer to future discounted purchases with Car Rental (not Retailer). Assume Retailer determines that it is an agent because its only promise is to arrange for the customers to be provided with the points, and Retailer does not control those points before they are transferred to the customer. As such, Retailer is the principal for the goods and agent for the points.

Retailer sells goods for $10 million during the quarter, which results in Retailer's customers earning 10 million points. Retailer uses Method A discussed in Question 9.4.10 to allocate the transaction price between the points and goods because its contract with Car Rental does not objectively depict the commission earned for the agency services.

Retailer estimates that the stand-alone selling price of the commission for each point is $0.01 – i.e. the estimate of the stand-alone selling price of the point is $0.028 less the $0.018 remitted to Car Rental. Therefore, the stand-alone selling price of the commission in the quarter is estimated to be $100,000 (10,000,000 points × $0.01). The amount that must be remitted to Car Rental ($180,000 = $0.018 × 10 million points) is excluded from the transaction price. Therefore, Retailer allocates the remaining transaction price of $9,820,000 as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Goods	$10,000,000	99%	$9,721,800
Commission on points	100,000	1%	98,200
Total	**$10,100,000**	**100%**	**$9,820,000**

The commission is recognized when Retailer issues the points to customers because at that time Retailer has satisfied its promise to provide the customer with points (see Question 8.6.30). Therefore, Retailer records the following journal entry.

	Debit	Credit
Cash	10,000,000	
Revenue (goods)		9,721,800
Revenue (points)		98,200
Liability (to Car Rental)		180,000
To recognize revenue from goods sold and commission earned on points when issued.		

Example 8.6.30

Loyalty points used to purchase goods or services from the issuing entity or another party

Hotel administers a loyalty program and issues one point based on each dollar spent at Hotel's properties. Participants in the program can redeem points for discounts on future purchases with Hotel, or they can redeem their points through Hotel for free or discounted services at Car Rental. Hotel pays Car Rental upon each redemption for Car Rentals services.

Hotel's customers spend $10 million and it grants 10 million points during the quarter. Hotel considers the likelihood of exercise and potential to be redeemed for stays at Hotel or for services at Car Rental to determine the stand-alone selling price of the points, which is $205,000. Hotel allocates $200,882 ($10,000,000 × $205,000/($10,000,000+$205,000)) of the transaction price to the material right and $9,799,118 to hotel stays. Because the customer may elect to redeem the points either with Hotel or with Car Rental, Hotel has concluded that it has not yet satisfied its performance obligation; it needs to stand ready to transfer goods if customer redeems the points with Hotel.

In this example, Hotel recognizes a contract liability of $200,882 for the amount allocated to the points when they are issued because it has not satisfied its performance obligation. This contract liability exists regardless of whether Hotel is a principal or agent in the ultimate use of the points because Hotel does not know the ultimate disposition of the points until redemption.

Hotel does not release the contract liability (and recognize revenue) until:

1. it transfers control of the goods or services for which it is the principal, in which case it recognizes gross revenue of $200,882;
2. the customer redeems points for a good or service for which Hotel is the agent; or
3. the points expire unexercised, in which case it recognizes $200,882 of revenue.

In (2), when the customer redeems points for goods or services with Car Rental, Hotel has satisfied its performance obligation as an agent by remitting the agreed amount to Car Rental. In this case, it recognizes the net amount as revenue – i.e. the difference between the $200,882 contract liability and the amount remitted to Car Rental.

In (3), Hotel considers the likelihood of redemption and recognizes the amount allocated to points in proportion to the points expected to be redeemed. See Example 8.6.10 and section 7.6.20.

Question 8.6.40

Is tier status within an entity's customer loyalty program a material right?

Interpretive response: It depends. An entity may offer tier status to its customers based on their previous purchases from the entity. A common example of a tier status program is an airline program that offers its customers certain levels of status based on how much they have flown during the previous year. Those programs provide benefits such as free upgrades to the next class of service, early boarding, free lounge membership and free bag checking.

The contract to purchase a good or service (such as an airline ticket) could contain a material right if the purchase provides the customer with benefits on future purchases (the right to free or discounted services in the future) through a tier status program. When evaluating whether purchases that contribute to earning tier status include a material right, the entity evaluates whether the benefits exist independently of the existing contract (see Question 8.3.20).

If the tier status benefits offered to the customer are comparable to benefits that would be provided to similar customers that did not have to make prior purchases with the entity, then the benefits of status do not represent a material right. If the benefits are offered only as a result of purchases already made, the customer in effect paid for the benefits as part of its historical purchases and the future benefits would represent a material right. [TRG 04-16.54]

For example, consider an airline that has a tiered status program based on travel volume. The airline should consider all available factors to determine if the benefits exist independently from customer purchases. These factors include, but not limited to, the following.

— **Whether and how frequently the entity matches the status that a customer receives from another airline, and the time limit for how long the entity is willing to match that benefit.** For example, providing a customer that has earned status on another airline with the same benefits for a similar period without purchasing the entity's flights might indicate that those benefits are available to a class of similar customers and exist independently of the historical purchases. However, if the status match period is for a significantly shorter period of time than status is available to customers earning status for travel on the entity's airline or the benefits matched are less than those offered to customers earning status on the entity's airline, this might indicate that the benefit is not independent of the historical purchases and is a material right.

— **Whether a customer could earn status through purchases or promotions with another entity.** This frequently occurs in the airline industry when airlines include 'airline partners' (which are unrelated) in their frequent flyer programs. The customers of one airline are provided the same status that they receive on the other airline partner, and the customer may also use points on both of the airlines. This is done to attract and retain a certain class of customer. Additionally, some airlines enter into arrangements with an unrelated financial institution for co-branded credit cards wherein the customer can earn status on the airline based on its use of the credit card. If customers can earn status on the airline without making purchases for travel on the specific airline where status is given, this might indicate that the benefit is independent of historical purchases and therefore not a material right.

- **Whether the airline would continue to offer the status to customers even if they fail to travel enough in the current year to maintain their status.** For example, the more that an airline provides status without the customer earning it through prior purchases, the stronger the indication that benefits exist independently of the historical purchases.
- **Whether and how frequently an entity offers similar status benefits to customers who demonstrate that they are frequent travelers through other means.** For example, granting a new executive of a company who will travel frequently with similar benefits prior to making a purchase might indicate that the benefits exist independently of historical purchases.

Significant judgment is required to evaluate whether the status benefits provide the customer with rights that exist independently of historical purchases. If the entity concludes that the rights are not independent, it then determines whether the rights are material by evaluating the significance of the rights considering both quantitative and qualitative factors. See Question 8.3.40.

9. Principal vs. agent

Detailed contents

New item added to this chapter: **

9.6 Timing of agency revenue

Questions

Examples

9.1 How the standard works

A critical part of identifying performance obligations in Step 2 is determining whether the nature of the entity's promise is to provide the specified good or service itself (in which case the entity is a principal) or to arrange for it to be provided to the customer by another party(ies) (in which case the entity is an agent). [606-10-55-36]

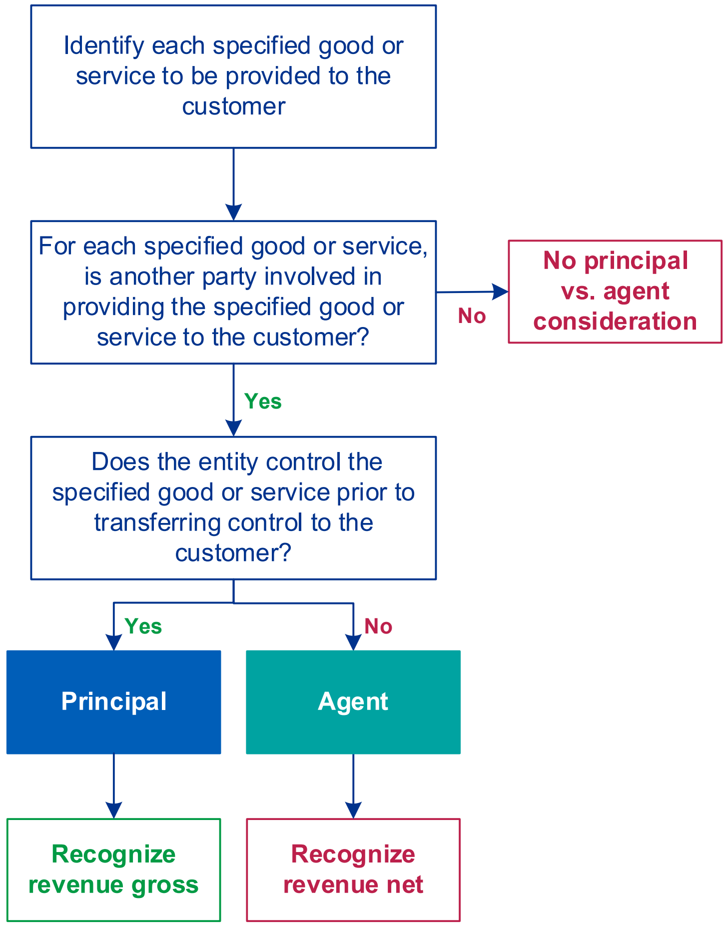
— If the entity is a principal, the performance obligation is transferring the specified good or service and revenue is recognized on a gross basis – corresponding to the consideration to which the entity expects to be entitled.

— If the entity is an agent, the performance obligation is arranging for the other party to provide the specified good or service and revenue is recognized on a net basis – corresponding to any fee or commission to which the entity expects to be entitled. An entity's fee or commission might be the net amount of consideration that the entity retains after paying other parties.

When an entity is a principal, the party it is providing the specified good or service to is the entity's customer. When the entity is acting as an agent, its customer could be viewed as either the third-party principal, the end customer or in some cases both parties. For example, an entity that provides an online marketplace that matches buyers and sellers may view both the buyer (end customer) and seller (third-party principal) as its customers.

An entity is a principal if it controls the goods or services before they are transferred to the customer. The first step in this analysis is identifying each specified good or service in the contract, which is the unit of account for the principal-agent analysis. The second step is to assess whether the entity controls each specified good or service before that good or service is transferred to the customer. If there are multiple specified goods or services in the contract, the entity may be a principal for some and an agent for others. [606-10-55-36A]

See section 5.2.20 for guidance on the accounting for payments from a customer that are collected on behalf of third parties – e.g. sales taxes collected by the entity. [606-10-32-2A]



9.2 Unit of account: specified goods or services

Excerpt from ASC 606-10

• > Principal versus Agent Considerations

55-36 When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by the other party (that is, the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 606-10-25-19 through 25-22). If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

55-36A To determine the nature of its promise (as described in paragraph 606-10-55-36), the entity should:

a. Identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party [see paragraph 606-10-25-18])
b. Assess whether it controls (as described in paragraph 606-10-25-25) each specified good or service before that good or service is transferred to the customer.

9.2.10 Overview

The unit of account for the principal-agent analysis is each specified good or service. A 'specified good or service' is a distinct good or service (or a distinct bundle of goods or services) in the contract with the customer. If individual goods and services are not distinct from one another, the entity assesses whether it is a principal or an agent for the combined promise to which the individual goods or services are inputs. An entity determines the distinct goods or services in the same manner as it identifies performance obligations in Step 2 of revenue model (see section 4.3). [606-10-55-36]

The FASB decided to refer to the unit of account for the principal-agent analysis as a specified good or service rather than the performance obligation. This is because use of the term 'performance obligation' would have been confusing if the entity is an agent. An agent's performance obligation is to arrange for the other party to provide its goods or services to the customer; it does not promise to provide the goods or services to the end customer. Accordingly, the specified good or service to be provided to the end customer is the performance obligation of the principal, not the performance obligation of the agent. [ASU 2016-08.BC10]

Once an entity identifies each specified good or service in the contract, it evaluates whether it obtains control of each specified good or service from the third-party provider before the good or service is transferred to the customer.

Because an entity evaluates whether it is a principal or an agent for each specified good or service, it is possible for the entity to be a principal for one or more specified goods or services in a contract and an agent for others (see section 9.4). [606-10-55-36, 55-36A]

9.3 Assessing control of the specified good or service

Excerpt from ASC 606-10

• > Principal versus Agent Considerations

55-37 An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

55-39 Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal [see paragraph 606-10-55-37]) include, but are not limited to, the following:

a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.
b. The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.
c. The entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

55-39A The indicators in paragraph 606-10-55-39 may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

55-40 If another entity assumes the entity's performance obligations and contractual rights in the contract so that the entity is no longer obliged to satisfy the performance obligation to transfer the specified good or service to the customer (that is, the entity is no longer acting as the principal), the entity should not recognize revenue for that performance obligation. Instead, the entity should evaluate whether to recognize revenue for satisfying a performance obligation to obtain a contract for the other party (that is, whether the entity is acting as an agent).

9.3.10 Overview

An entity is the principal for the transfer of a specified good or service if it controls that specified good or service *before* the good or service is transferred to the customer. If an entity does not obtain control of the specified good or service before it is transferred to the customer, it is an agent for the provision of that good or service. That is because an entity cannot provide a specified good or service that it does not control to a customer. Obtaining title only momentarily to a good does not necessarily mean the entity controls the good before it is transferred to the customer. [606-10-55-37, ASU 2016-08.BC12]

The assessment of whether the entity obtains control of the specified good or service is based on the control principle outlined in paragraph 606-10-25-25 (reproduced below). That principle is also used to determine whether a customer obtains control of a good or service for purposes of recognizing revenue – i.e. Step 5 of the revenue model. [606-10-55-36A, ASU 2016-08.BC27 – BC28]

Excerpt from ASC 606-10

> Satisfaction of Performance Obligations

25-25 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

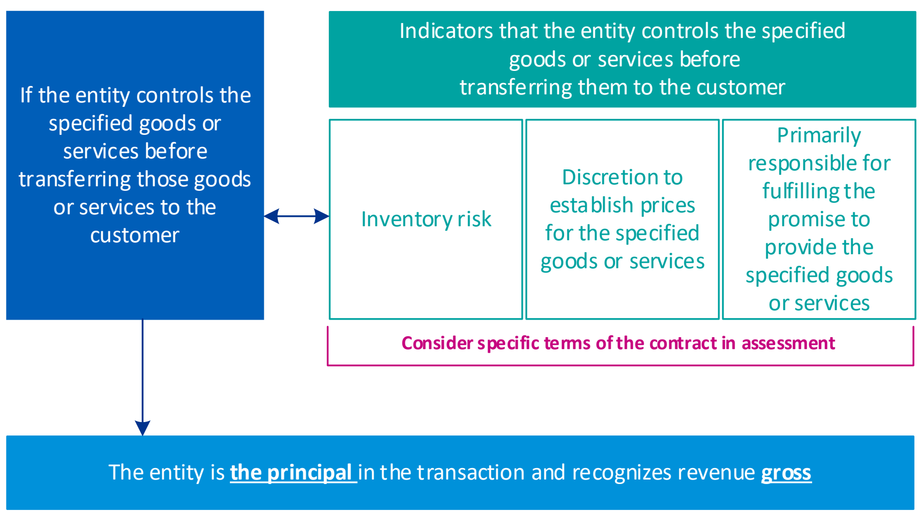
a. Using the asset to produce goods or provide services (including public services)
b. Using the asset to enhance the value of other assets
c. Using the asset to settle liabilities or reduce expenses
d. Selling or exchanging the asset
e. Pledging the asset to secure a loan
f. Holding the asset.

The FASB concluded that if a good or service is part of a combined performance obligation to the customer for which the entity provides the significant service of integrating individual goods or services into a combined output (i.e. the specified good or service), it is the principal for the specified good or service. It therefore controls all of the inputs (including any provided by third parties) that go into the specified good or service, directing their use to create the combined item. This conclusion is determinative; no further analysis of the principal-agent guidance is undertaken. [606-10-55-37A(c), ASU 2016-08.BC30]

When the specified good or service is not a combined item for which the entity is providing a significant integration service, the entity considers whether it controls the specified good or service before the good or service is transferred to the customer. It does this by evaluating the control principle (see excerpt above) – control is the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. [606-10-25-25]

In addition, the FASB developed the indicators in paragraph 606-10-55-39 to assist entities in evaluating whether they control a specified good or service before it is transferred to a customer. An entity may be considered to control a specified good or service if the other party involved in transferring that good or service to the customer is acting on the entity's behalf. [606-10-55-36A(b), 55-37, 55-39]

The following diagram illustrates the interaction of those indicators with the control principle. [606-10-55-39]



The indicators are not evaluated in isolation as either a separate or an additional assessment from that of the control principle. Rather, the indicators should be considered in the context of the control principle they serve, with more weight given to those indicators that provide more relevant evidence about whether the entity has the ability to direct the use of, and obtain substantially all the remaining benefits from, the specified good or service before it is transferred to the customer. Therefore, the presence of one or more of the indicators cannot override a conclusion reached based on other evidence more relevant to an evaluation of the control principle. [ASU 2016-08.BC16]

The indicators may not all provide relevant evidence for a given transaction. Meeting or not meeting an indicator may say little or nothing about whether the entity has the ability to direct the use of, and obtain substantially all the remaining benefits from, the specified good or service. In other circumstances, one or more of the indicators may provide substantial relevant evidence in that regard. For example, the inventory risk indicator may provide relatively determinative evidence in evaluating certain scenarios, but negligible evidence in others; see the applicable discussion about control of services in Question 9.3.60. [606-10-55-39A]

Because the relevancy of each indicator depends on an entity's facts and circumstances, the FASB did not create a specified hierarchy for the indicators – i.e. no specified 'strong' or 'weak' indicators. Different indicators may provide more relevant evidence for different facts and circumstances, and it may be that none of the indicators provide evidence that is relevant or persuasive to the assessment of control. In some cases, it may be clear that the entity does or does not control the specified good or service solely from assessment of the governing control principle and therefore no assessment of the indicators is needed. Evidence provided by the indicators does not override a clear conclusion that the entity is a principal or an agent reached on the basis of the control principle. [ASU 2016-08.BC16]

Assessing the relevance of the indicators may be particularly challenging when there are shared responsibilities between the entity and another party. This might be the case when one entity delivers the specified good or performs the specified service and the other entity sets the price and assumes responsibility for the customer's satisfaction with that specified good or service. In that case, the entity assesses all of the facts and circumstances to determine which of the different roles the two entities play that confer rights to direct the use of the specified good or service and obtain substantially all of its remaining benefits. The objective of this assessment is to determine if the entity is directing the third party *on its behalf* or arranging for the third party to provide the specified good or service to the end customer.

Question 9.3.10

Does an entity assess the control principle differently for the principal-agent analysis than for other areas of Topic 606?

Interpretive response: No. An entity is a principal for a specified good or service if the entity controls *that good* or *service* before it is transferred to the customer. Therefore, control of the economics of the transaction or ownership (i.e. control) of the overall 'customer relationship', without control of the specified good or service, will still result in the conclusion that the entity is an agent for the specified good or service. [606-10-25-25, 55-36A]

Control in the context of the principal-agent evaluation uses the same control principle that is used throughout Topic 606, most notably in Step 5 to determine when a good or service is transferred to a customer. However, rather than evaluating whether the customer controls the good or service, it evaluates whether it controls the specified good or service before it is transferred to the customer. Therefore, an entity controls a specified good or service when it has the ability to direct the use of, and obtain substantially all the remaining benefits from, the good or service before it is transferred to the customer. [606-10-25-25, 55-36A]

Because the control principle is the same as when an entity evaluates when a good or service is transferred to a customer, a contractual provision that prevents a customer from obtaining control of a good or service from a seller also generally prevents an entity from obtaining control of a specified good or service before transferring it to the customer. For example:

— If a supplier has the contractual right to repurchase a good (i.e. a call option) from the entity until it is transferred to an end customer, the entity does not control the good before it is transferred to the customer. This is consistent with the guidance on call options that states a customer does not obtain control of a good from a seller if the seller has a right to repurchase it. However, in some situations a repurchase feature may not preclude the customer (or the entity in a principal-agent evaluation) from obtaining control of a good if the repurchase right is conditional upon an event such as the good expiring or perishing before the entity can sell it (see Question 7.5.60 on conditional repurchase features) or the right is not substantive (see ASU 2014-09.BC427). See section 7.5.50 for a discussion of repurchase features.

— If a supplier sells a good to an entity and the guidance on consignment sales indicates that the entity does not obtain control of the good until the customer purchases and obtains control of the item, the entity does not obtain control of the good before it is transferred to the customer. See section 7.5.20 for a discussion of consignment arrangements. [606-10-25-25]

Question 9.3.20

Are any of the principal-agent indicators determinative to the principal-agent evaluation?

Interpretive response: No. The assessment of whether the entity controls the specified good or service before it is transferred to the customer does not depend on whether one or more of the indicators are met or on a majority evaluation of the indicators. For instance, meeting two of the three indicators, or not meeting two of the three indicators, is not alone persuasive to the control evaluation. [606-10-55-39, ASU 2016-08.BC16]

The indicators are intended to *inform* the control evaluation and, depending on the facts and circumstances, provide more or less relevant (i.e. persuasive) evidence to that evaluation. Therefore, meeting one (or more) of the indicators cannot override other, more relevant/persuasive, evidence – whether provided by meeting or not meeting one or more of the other indicators or another source of evidence – as to whether the entity controls the specified good or service before it is transferred to the customer in accordance with the control principle in paragraph 606-10-25-25. [ASU 2016-08.BC16]

9.3.20 Evaluating control of a good or an asset from another party

Excerpt from ASC 606-10

• > Principal versus Agent Considerations

55-37 An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

55-37A When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

a. A good or another asset from the other party that it then transfers to the customer.
b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.
c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 606-10-25-21(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

When an arrangement to provide a good involves another party, an entity is the principal if it obtains control of that asset from the other party that it then transfers to the customer. Judgment is necessary when: [606-10-55-37 – 55-37A]

— the third party delivers the goods to the customer without the entity's involvement – e.g. the third party ships, itself or through a shipping company that is not the entity, the product directly to the customer; or

— when the entity only momentarily obtains legal title before the good is transferred to the end customer – commonly referred to as obtaining 'flash title' (see Question 9.3.40).

Example 45 in Topic 606 (reproduced below) illustrates a scenario in which an entity arranges for customers to purchase goods from different suppliers through its website. Those suppliers then deliver the goods directly to the customer. In that example, the conclusion is that the entity is the agent to those sales because it does not control the goods before they are transferred to the customer. The evidence supporting this conclusion is that the entity does not at any time have the ability to direct the use of the goods that are transferred to the customers – e.g. it cannot direct the goods to parties other than the customer or prevent the supplier from transferring those goods to the customer (or other customers or parties).

Excerpt from ASC 606-10

• • > Example 45—Arranging for the Provision of Goods or Services (Entity Is an Agent)

55-317 An entity operates a website that enables customers to purchase goods from a range of suppliers who deliver the goods directly to the customers. Under the terms of the entity's contracts with suppliers, when a good is purchased via the website, the entity is entitled to a commission that is equal to 10 percent of the sales price. The entity's website facilitates payment between the supplier and the customer at prices that are set by the supplier. The entity requires payment from customers before orders are processed, and all orders are nonrefundable. The entity has no further obligations to the customer after arranging for the products to be provided to the customer.

55-318 To determine whether the entity's performance obligation is to provide the specified goods itself (that is, the entity is a principal) or to arrange for those goods to be provided by the supplier (that is, the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

55-318A The website operated by the entity is a marketplace in which suppliers offer their goods and customers purchase the goods that are offered by the suppliers. Accordingly, the entity observes that the specified goods to be provided to customers that use the website are the goods provided by the suppliers, and no other goods or services are promised to customers by the entity.

55-318B The entity concludes that it does not control the specified goods before they are transferred to customers that order goods using the website. The entity does not at any time have the ability to direct the use of the goods transferred to customers. For example, it cannot direct the goods to parties other than the customer or prevent the supplier from transferring those goods to the customer. The entity does not control the suppliers' inventory of goods used to fulfill the orders placed by customers using the website.

55-318C As part of reaching that conclusion, the entity considers the following indicators in paragraph 606-10-55-39. The entity concludes that these indicators provide further evidence that it does not control the specified goods before they are transferred to the customers.

a. The supplier is primarily responsible for fulfilling the promise to provide the goods to the customer. The entity is neither obliged to provide the goods if the supplier fails to transfer the goods to the customer nor responsible for the acceptability of the goods.

b. The entity does not take inventory risk at any time before or after the goods are transferred to the customer. The entity does not commit to obtain the goods from the supplier before the goods are purchased by the customer and does not accept responsibility for any damaged or returned goods.

c. The entity does not have discretion in establishing prices for the supplier's goods. The sales price is set by the supplier.

55-319 Consequently, the entity concludes that it is an agent and its performance obligation is to arrange for the provision of goods by the supplier. When the entity satisfies its promise to arrange for the goods to be provided by the supplier to the customer (which, in this example, is when goods are purchased by the customer), the entity recognizes revenue in the amount of the commission to which it is entitled.

Question 9.3.30

Are the indicators of transferring control at a point in time relevant to identifying if an entity obtains control of a good before it is transferred to a customer?

Interpretive response: It depends. There is no restriction on what evidence an entity may consider when undertaking the control assessment. Therefore, to the extent the point-in-time transfer of control indicators in paragraph 606-10-25-30 (see section 7.5) provide relevant evidence to the control assessment, an entity can (and likely should) consider such evidence. These indicators may frequently provide relevant evidence to the control assessment because they were developed together with the control principle, and with the intent to provide evidence about when a customer obtains control of a good in accordance with that principle. [ASU 2016-08.BC17]

For example, *if* an entity had title to, physical possession of and a present obligation to pay the supplier for a good before it sold that good to one of its customers, that would generally be relevant evidence in determining whether the entity controlled the good, in accordance with the control principle, before it transferred it to the customer. [606-10-25-30]

However, just as the relevance of the principal indicators in paragraph 606-10-55-39 will vary depending on the facts and circumstances of the contract, so too will the relevance of the point-in-time indicators. And just like with the principal indicators, it may be that the control assessment is clear without any need to evaluate the point-in-time indicators.

Question 9.3.35**

Can an entity be the principal in a transaction when it only retains a fixed percentage commission for reselling a supplier's good?

Interpretive response: Yes. While a fixed-percentage commission indicates that the supplier maintains pricing discretion, no one indicator of control is determinative. The indicators are not evaluated in isolation as either a separate or an additional assessment from that of the control principle. Rather, the indicators should be considered in the context of the control principle they serve, with more weight given to those indicators that provide more relevant evidence about whether the entity has the ability to direct the use of, and obtain substantially all the remaining benefits from, the specified good or service before it is transferred to the customer. The entity must weigh all of the indicators to support its determination of whether it controls the specified good prior to transfer to a customer, including but not limited to, whether it is primarily responsible for fulfilling the promise to provide the specified good to the customer and whether it has inventory risk. [606-10-55-37, 606-10-55-39, 606-10-55-39A]

Jillian Pearce, Professional Accounting Fellow, Office of Chief Accountant, discussed this topic in a speech given during the 2020 AICPA National Conference on Current SEC and PCAOB Developments.

> "I would like to share observations on a fact pattern involving a registrant that produces and sells a commodity to its customers. In this fact pattern, the registrant had the contractual right to market and sell 100 percent of the commodity produced by a related party.
>
> The registrant determined how to source the commodity to fulfill its contracts with customers – either from its own production, from production from the related party facility, or from a third party. This raises the issue of whether the registrant was acting as a principal or an agent in selling the commodity produced by the related party. If the registrant sourced the product from the related party facility, the registrant took possession and legal title of the product and transported it to the customer. The registrant had the right to redirect the product to different customers during transportation, subject to certain geographic restrictions, but the registrant believed inventory risk was mitigated by an insurance policy that covered risk of damage or loss. The selling price of the commodity was generally determined based on the market price of the product at the time of delivery. For product sourced from the related party facility, the registrant received payment from the end customer and remitted payment to the producer, less a fixed percentage commission that the registrant retained.
>
> The registrant proposed to account for the commodity sales from this producer on a net basis, as it determined it was acting as an agent in the sale of the commodity from the producer and did not believe it controlled the product. The registrant evaluated the indicators of control outlined within the revenue standard. While it did not believe any of the indicators were determinative, the registrant ultimately concluded it was an agent in the transaction as it did not receive substantially all of the benefits from the sale of the commodity as a result of its fixed percentage commission.

OCA staff objected to the registrant's conclusion that it did not have the right to direct the use of and obtain substantially all of the remaining benefits of the product from the producer, and therefore concluded the registrant was the principal in the transaction based on the total mix of information presented." [2020 AICPA Conf]

Question 9.3.40

Can an entity be the principal in a transaction when it only obtains flash title before transferring a good to the customer?

Interpretive response: It depends. A flash title scenario is common in the retail and commodity industries in which a retailer or a commodity dealer does not take title to the goods or services until the point of sale to a customer, and the end customer immediately takes control after that.

Although taking title may indicate that an entity can direct the use of and obtain substantially all of the remaining benefits of a good, it is not determinative that control has transferred. For example, taking title to a good only momentarily does not in and of itself mean an entity controls the specified good or service before it is transferred to the customer. In contrast, an entity could control a good before obtaining title. [606-10-55-37]

Further, the SEC has recognized, in an SEC staff speech, that determining whether an entity controls a specified good or service immediately prior to the good or service being transferred to the customer may be especially challenging in transactions that take place in an instant. The SEC speaker emphasized that the indicators of control in Topic 606 are not a checklist. The indicators may be more or less relevant to the assessment of control depending on the nature of the specified good or service and terms and conditions of the contract. Determining the relevance of an indicator to the assessment of control will require reasonable judgment. [2017 AICPA Conf]

When an entity obtains only flash title to the specified good, we believe the principal-agent evaluation will focus on whether it obtains control of the specified good or service before obtaining flash title and a consideration of the entity and supplier's rights prior to the transfer of the good to the end customer. All facts and circumstances will need to be considered when evaluating the control principle and we believe the following are likely to be the key factors to consider in many circumstances.

— Whether the entity has physical possession of the goods (one of the point-in-time indicators providing relevant evidence) and could direct the use of the products in the same way it could direct the use of products for which it had title before a customer purchases the product at the register. For example, the entity could decide in which store or which part of its store the products are placed and what price is charged or it could control access to the products through its operation of the store.

— Whether the entity has the ability to obtain substantially all the benefits from the product in the form of the cash flows from the sale with the customer.

— Whether the supplier can constrain the entity's ability to direct the use of and obtain substantially all of the remaining benefits from the products.

Question 9.3.45

Can a distributor in a consignment arrangement be the principal in a transaction?

Interpretive response: Generally, no. A consignment arrangement is one in which an entity delivers a product to another party (e.g. a dealer or a distributor for sale to an end customer) but retains control of the goods. In most consignment arrangements, the entity retains control of the goods until they are resold to the end customer. To be the principal in a transaction, the distributor must obtain control of the goods before transferring them to the end customer. [606-10-55-37, 55-79]

Consignment arrangements could have several indicators that the distributor controls the good before it is transferred to the end customer. For example, the distributor may:

— be responsible for fulfilling the end customer's order;
— have sole discretion in setting the price and marketing the good;
— have risk of loss if the consigned item is damaged or lost while in its possession; and/or
— obtain flash title before transferring the good to the end customer.

However, in many consignment arrangements the entity is able to require the return of the good on consignment at any time before sale to an end customer. The definition of control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. An entity that can require the return of a good can prevent the distributor from obtaining the benefits from a consigned good. In these cases, notwithstanding the other indicators of control, the distributor does not control the good as long as the entity can require the return of the good. [606-10-25-25]

Consistent with the analysis in Question 9.3.40, the principal-agent evaluation when flash title is obtained focuses on whether the distributor obtains control of the good before obtaining flash title. As a result, obtaining flash title would not be sufficient to conclude that the distributor is the principal in the transaction with the end customer when the entity and not the distributor controls the good before transfer to the end customer.

A distributor may be the principal in an arrangement when an entity's restrictions on sale or its requirement to return goods to the entity are removed before the distributor transfers control to the end customer. All relevant facts and circumstances, including the indicators of a consignment arrangement, would need to be evaluated to determine whether the distributor obtained control of the good before transfer to the end customer. [606-10-55-80]

Question 9.3.50

Can an entity be the principal when the specified good or service is a tangible asset if it does not take physical possession of the good?

Interpretive response: It depends. Although physical possession is an indicator that the entity has the ability to direct the use of and can obtain substantially all of the remaining benefits of an asset, it is not determinative. See Question 9.3.30 for further discussion of the point-in-time transfer of control indicators.

If an entity does not take physical possession of the asset, such as in drop shipment arrangements (see Question 9.3.55), we believe an entity might still control the specified good or service when it:

- has the ability to direct or redirect the asset for other uses (for its own use or to other customers); or otherwise
- can restrict the ability of the customer or supplier to direct the use of the asset.

For example, this may be the case in some contract manufacturing scenarios in which a supplier produces parts solely for the entity. In those cases, the entity may have the sole right to direct the use of those parts – e.g. for its own use or resale or to selected distributors or customers. Example 9.3.10 illustrates such a scenario.

Example 9.3.10

Entity is a principal even though it does not take physical possession of goods

Auto Manufacturer contracts with Supplier to manufacture the bumper for its vehicle model. Auto Manufacturer owns the IP rights for that bumper technology, which is specifically designed to fit its vehicles. Further, Auto Manufacturer owns the machinery, equipment and molds used by Supplier to produce the bumpers at Supplier's facilities. Supplier may not use that machinery, equipment or molds to produce bumpers for any other entities besides Auto Manufacturer. Supplier only produces bumpers based on Auto Manufacturer's orders. Auto Manufacturer uses the same bumpers from Supplier in its own production facilities and for aftermarket sales.

Body Shop orders a new bumper directly from Auto Manufacturer for an existing vehicle (e.g. for a repair). Auto Manufacturer then submits a purchase order to Supplier and instructs Supplier to ship the new bumper directly to Body Shop. Supplier makes the bumper and ships it to Body Shop and then invoices Auto Manufacturer.

In evaluating whether it is the principal for the sale of the bumper to Body Shop, Auto Manufacturer evaluates whether it controls the bumper before it is transferred to Body Shop. Even though the bumper is shipped directly to Body Shop from Supplier, Auto Manufacturer concludes that it controls the bumper before it is transferred to Body Shop and therefore that it is the principal.

Auto Manufacturer's conclusion that it controls the bumper is based on the following factors.

— **Auto Manufacturer has the ability to direct the use of the bumper.** Auto Manufacturer owns and controls the use of the IP and the equipment used to manufacture the bumper; *no* bumpers are produced other than from Auto Manufacturer's orders. Auto Manufacturer decides whether to direct a particular unit to its own facilities (e.g. to install in a new vehicle) or to another customer (e.g. a different repair shop or auto parts retailer). Supplier cannot sell the bumper to a customer not permitted by Auto Manufacturer or use at its discretion (because Supplier does not manufacture cars); it can only direct the bumper as instructed by Auto Manufacturer.

— **Auto Manufacturer has the ability to obtain substantially all the remaining benefits from the bumper.** Auto Manufacturer is entitled to all of the proceeds (which it determines as to amount) from the sale of the bumper to Body Shop or it could use the bumper to produce a new vehicle. As a result Auto Manufacturer is able to obtain substantially all the remaining benefits from each bumper.

Auto Manufacturer does not need to consider the principal indicators in paragraph 606-10-55-39 because it is apparent that Auto Manufacturer controls the bumper before it is transferred to Body Shop and therefore is the principal in providing the bumper to Body Shop.

Question 9.3.55

When is an entity the principal in a drop shipment arrangement?

Interpretive response: It depends. In a typical drop shipment arrangement, an entity contracts with a customer to sell the customer a good, and then a third party vendor (e.g. a manufacturer or distributor) ships the good to the customer directly from its facility.

The entity does not take physical possession of the specified good before control of that good is transferred to the customer. Despite that fact, the issue in this arrangement is whether:

— the entity controls the specified good before it is transferred to the customer, and therefore is the principal in the arrangement with the third party vendor acting on the entity's behalf; or

— the third party vendor controls the specified good until it is transferred to the customer, and therefore the entity is an agent in the sale of the good.

The entity's lack of physical possession makes the principal-agent analysis more challenging in drop shipment arrangements. However, 'control' refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, a good or service (including the ability to prevent others from doing so). Therefore, physical possession is not always required to have control of a good before it is transferred to a customer.

Similarly, momentary physical possession does not necessarily convey control. Obtaining title for a short period of time (e.g. during transit) or obtaining 'flash title' – or where title is 'limited' in terms of not conveying the right to redirect or resell the good to another customer – does not on its own convey control. See Question 9.3.40 on flash title arrangements. Further, obtaining title only *after* a customer returns the good does not on its own mean the entity controls the specified good *before* it is transferred to the customer. [606-10-55-36(b), 55-37]

Front-end inventory risk

Topic 606 states that when the principal indicators in paragraph 606-10-55-39 provide relevant evidence about whether an entity controls a specified good or service before it is transferred to a customer, one of those indicators will frequently provide more relevant evidence than the others. Control of a tangible good frequently goes hand-in-hand with having front-end inventory risk with respect to the good. [606-10-55-39, 55-39A, ASU 2016-08.BC16, BC18(e)]

Front-end inventory risk arises when, for example, the entity:

- maintains an inventory of the good that is being drop shipped in fulfillment of the contract;
- has the right to sell (or use, lease, etc.) and an obligation to formally purchase (or make payment for, etc.) the good before the customer places its order with the entity; or
- has an enforceable purchase commitment for the good with the supplier before the customer's order.

Many entities in drop shipment arrangements will not have front-end inventory risk.

Control in the absence of front-end inventory risk

Despite the absence of front-end inventory risk, the entity may still control – i.e. have the ability to direct the use of, and obtain substantially all the remaining benefits from – the specified good before it is transferred to the customer. For example, this may occur when either:

- the entity has a substantive right to redirect the specified good to another customer (or for another use) before the customer obtains control of it. This might occur in some scenarios when the delivery agent (e.g. the common carrier) is engaged by the entity, rather than the third party vendor (manufacturer or distributor), and the entity has the right and practical ability to change the delivery agent's instructions – e.g. instruct the delivery agent to deliver the specified good to a different customer; or
- the entity can require the vendor to 'reserve' (or 'hold') some of its inventory for the entity that the third party vendor cannot sell to another customer or use for another purpose because of the hold, even if the entity is not obligated to purchase that inventory as a result. This may also indicate that the entity is directing the third party vendor to act on its behalf (see below).

Acting on the entity's behalf

When evaluating drop shipment arrangements, it may be important to consider that Topic 606 suggests that an entity may be a principal – i.e. deemed to control a specified good or service – if the other party involved in transferring the good to the customer (e.g. a third-party vendor) is effectively acting on behalf of the entity. For example, this may be the case when an entity obtains a contract with a customer and then engages a subcontractor to fulfill its performance obligation. [606-10-55-37]

In the context of a drop shipment arrangement, the following are indicators that may, depending on the facts and circumstances, suggest that the third-party vendor is effectively acting on behalf of the entity. These factors are not exhaustive, and no one factor will necessarily be determinative; therefore, the totality of the evidence surrounding the arrangement needs to be considered.

— The third-party vendor is 'invisible' to the customer – i.e. the customer is unaware of who the supplier of the specified good is before it obtains control of the good.

— The vendor packages the specified good as coming from the entity – e.g. in the entity's packaging.

— The vendor is obligated to maintain ('hold') an inventory of the specified good that it is not permitted to sell, use or otherwise direct for a purpose other than shipment to the entity's customers (when ordered) – i.e. in this case, the vendor may essentially be holding inventory for the entity.

— The entity has the right and ability to source the specified good from more than one supplier after the customer places its order with the entity – e.g. to decide whether to purchase from the original equipment manufacturer (OEM) or one of multiple distributors.

The entity should also consider the indicators in paragraph 606-10-55-39 when assessing whether the vendor in a drop shipment arrangement is effectively acting on the entity's behalf. They may provide relevant evidence in this regard.

— **Primary responsibility for fulfillment.** Is the entity or the third-party vendor primarily responsible for fulfilling the customer order? What is the entity's responsibility for fulfillment and product acceptability compared to the vendor's?

— **Inventory risk.** Does the entity have front-end inventory risk with respect to the third-party goods? Does the entity bear the risk of loss or damage and/or return risk? If so, how significant is that 'back-end' inventory risk – e.g. how much of that risk, if any, is mitigated by the ability to return items to the vendor and/or return terms with customers that permit the entity to refuse returns that will not in turn be accepted by the vendor?

— **Pricing discretion.** What is the degree of the entity's discretion in establishing the price to the customer?

Example 9.3.15
Entity is an agent in a drop shipment arrangement – reseller of hardware

ABC Corp. markets itself as a leading provider of end-to-end IT security solutions. ABC aims to operate as a specialist extension of its customers by having its experts match customers' needs to available solutions.

ABC helps a customer evaluate available technologies and determine which combination of technology solutions will best meet its specific needs. This assistance generally leads to the purchase of an enterprise-wide solution by the customer. The products typically consist of hardware and software licenses and related support, maintenance and training.

ABC does not modify or customize the hardware or licensed software in any way, nor does ABC, individually or with the customer, develop modified or customized specifications for the hardware or software. As such, ABC concludes that it is not providing a single, integrated service or fulfilling a single, integrated performance obligation of the nature described in section 9.3.30. Therefore, each hardware product and each software license is typically a specified good.

Drop shipped hardware

ABC does not maintain an inventory of hardware; all hardware purchased by ABC's customers is drop shipped by one of ABC's vendor partners to ABC's customer.

ABC's terms with its vendor partners typically mirror its terms with its customers. For example, title typically transfers to ABC at the same time it transfers to the customer (typically, at the vendor partner's location), and return rights from the customer to ABC are typically mirrored by the return terms from ABC to its vendor partner.

In addition, ABC considers the following facts when determining whether it is a principal or agent in the drop shipment arrangement.

- ABC sets the price of the hardware to the customer, but its discretion to set that price is effectively constrained by market pressures – i.e. it cannot price goods too expensively because ABC's customers generally have alternative supply options.
- Any vendor warranties and end-user agreements or documentation are between the third-party vendor and the customer – ABC is not a party thereto. Therefore, the third-party vendors are clearly not invisible to the customer.
- ABC frequently serves as a contact point for its customers, but does not maintain a call center or helpdesk. When customers reach out, ABC generally just facilitates the customer's contact with the appropriate personnel from the third-party vendor.
- ABC generally does not accept returns from customers that will not be accepted by the third-party vendor.

ABC concludes that it is an agent for sales of drop shipped hardware. Important to ABC's conclusion is that at no point before control is transferred to the customer can ABC direct a specified unit of hardware to anyone or prevent the third-party vendor from directing (e.g. selling, giving or leasing) it to any other customer the vendor chooses. ABC has no rights to hardware units before a customer places an order with ABC and ABC, in turn, places an order with the third-party vendor. In addition, ABC does not maintain hardware inventory of its own, has no pre-customer order purchase commitments with the third-party vendors, and does not have any arrangements with its vendor partners for them to hold units for ABC.

Moreover, ABC concludes that its vendor partners do not perform on ABC's behalf in these drop shipment arrangements. Although ABC establishes the price of the hardware with its customers, the weight of relevant evidence supports that the third-party vendors are not acting on ABC's behalf. ABC notes the following.

- The third-party vendors have primary responsibility for fulfillment. They pick and are responsible for shipping the requested hardware.
- The warranties and end-user agreements generally ensure that the third-party vendors are known to the customer and establish their responsibility for the acceptability of the hardware.
- ABC has no return or other back-end inventory risk. Even though ABC's customers will frequently initiate and send returns to ABC, substantially all of ABC's return terms with its customers are mirrored in the contracts between ABC and its vendor partners.

Third-party software licenses

See section 9.3.40 and Examples 9.3.60 and 9.3.70 related to the evaluation of control of a right to a service (e.g. software license) performed by another party.

Example 9.3.16
Entity is the principal in a drop shipment arrangement

Scenario 1: Appliance retailer

DEF Corp. markets itself as a leading retailer of home appliances – refrigerators, washers, dryers, ovens, etc. DEF has floor models of all appliances it sells; however, the floor models are not for sale.

Customers visit DEF's store in person and shop for the various models and manufacturers. Customers contract with DEF and negotiate a sales price for each appliance.

Once a customer contracts with DEF for the appliance, DEF contacts the manufacturer to obtain the appliance in accordance with previously agreed terms. Further, DEF contracts with one of its third-party delivery agents to collect the appliance from the manufacturer and deliver it to the customer's location. DEF's delivery agents, acting on DEF's behalf, are responsible for picking up, transporting, delivering and frequently installing the appliance.

Installation is often essential to the customer's ability to make use of the appliance (e.g. a stove or a gas dryer).

The following facts are also relevant to DEF's principal-agent analysis.

1. **Front-end inventory risk.** DEF has no front-end inventory risk because it does not own, or commit to own on a non-cancellable basis, any appliances before obtaining a non-cancellable customer order. If a customer cancels its order before the appliance is delivered, DEF has full recourse to the manufacturer.

   Therefore, DEF has no rights to any manufacturer appliances before placing an order. In general, the manufacturer can sell any of its appliances to another customer or use the appliances in any manner it chooses.

2. **Supplier discretion.** DEF has supplier discretion in procuring the appliance for its customer. DEF has supplier agreements with the manufacturers of the appliances with specified low prices. However, if a third-party distributor is selling the same appliance at a price lower than DEF's contracted price with the manufacturer, DEF has the right and ability to procure the appliance from the other party. The appliance supplier is frequently invisible in that respect to the customer; the customer only knows that it is contracting with DEF.

3. **Control during shipment.** During shipment, DEF has control of the appliance through its selected delivery agent – i.e. DEF has the ability to direct the use of the appliance and obtain substantially all of its remaining benefits.

   For example, if a large customer contacts DEF with an issue with one of its appliances, DEF can contact its delivery agents and redirect an appliance that is in transit to that customer; DEF has a demonstrated history of doing this. In doing so, DEF is entitled to the consideration the other customer (to whom the appliance is being redirected) has agreed to pay for the appliance.

   Therefore, while the delivery agent physically possesses the appliance, during this period DEF has the substantive right and ability to redirect the appliance to another use (e.g. to fulfill an order from another customer) and obtain the benefits (i.e. cash flows) from that sale. Neither the manufacturer/third-party distributor, nor the customer, has that ability during this period.

4. **Pricing.** Although manufacturers have limits on the prices that DEF may publicly advertise their appliances, those limits do not restrict DEF's discretion to ultimately sell the appliances to its customers at prices of its choosing.

5. **Back-end inventory risk.** DEF's agreements with manufacturers allow for a two-day window where an appliance may be returned without an additional charge. However, after the two-day window there is a 40–60% restocking and repackaging fee for the appliances. Because DEF will accept customer returns for approximately 30 days and the manufacturers enforce a significant penalty for returns after the two-day window, these fees give DEF substantive back-end inventory risk.

6. **Customer service line.** After delivery, DEF maintains a DEF-branded customer service line for its appliance customers for questions and issues.

7. **Flash title.** DEF momentarily has title of the appliance before transfer to the customer. The manufacturer retains title and risk of loss until the customer signs off on the delivery and installation bill of lading. Upon signing the bill of lading, flash title is passed from the manufacturer to DEF and then to the customer.

8. **Customer warranty.** The customer's warranty on the appliance is with the manufacturer, not DEF. It is the manufacturer that will fulfill that warranty – even though the customer may use DEF's customer service line to reach the manufacturer.

DEF considers all of the above factors and concludes that it is the principal in its appliance sales contracts. In reaching this conclusion, DEF places most emphasis on factors (2) and (3): DEF obtains control of (i.e. the ability to redirect the use of, and obtain substantially all the remaining benefit from) the specified appliance before it is transferred to the customer. Further, DEF's supplier discretion indicates the manufacturers (or distributors) are, in effect, fulfilling an inventory function for DEF (i.e. permitting DEF not to maintain an appliance inventory of its own), and *acting on DEF's behalf* (at its selection) in delivering the appliance to DEF's chosen delivery agent. Factors (4) through (6) also support DEF being a principal, but are less relevant to DEF's analysis.

Factor (1) is a strong indicator of agency, while factors (7) and (8) also provide evidence that DEF may be an agent in the appliance sales. However, even when taken together, the evidence provided by those factors does not outweigh the evidence supporting that DEF obtains control of the appliance before control transfers to the customer.

The specific facts and circumstances of DEF's appliance sale arrangements, along with the totality of the evidence about DEF's appliance sales, influenced the conclusion that DEF reaches. Changes to those facts and circumstances could change the conclusion reached.

Scenario 2: Website sales

GHI Corp. operates a website on which it advertises and showcases for sale a wide variety of consumer products. For a significant portion of its sales, customers' orders placed with GHI are drop shipped to the customer. GHI does not take title to or possess any inventory of those consumer products at any point.

When a customer places an order, GHI notifies the vendor and provides it with the appropriate customer shipping information – i.e. where to drop ship the product. GHI charges the customer the advertised price of the product (which GHI established), and then pays the vendor the specified unit price under the Vendor Partner Agreement.

At least a few days prior to products being offered for sale on GHI's website, GHI issues a purchase order to the vendor that 'reserves' a specified number of units, at a fixed price, that reflects its estimate of the number of units it expects to sell to customers. The purchase orders are cancellable, meaning that GHI does not have inventory risk – i.e. if it cannot sell the goods to its customers, GHI can cancel the purchase order without recourse or penalty.

Despite the purchase orders being cancellable by GHI, GHI concludes that those purchase orders convey control over the specified products in these drop shipment arrangements before the products are transferred to customers. Therefore, GHI is acting as principal.

GHI's conclusion is based on the following regarding the purchase orders.

— Before GHI customers purchase one of the specified products, the vendor cannot direct the use of the reserved units subject to the purchase order to another customer (or for its own use) and cannot obtain substantially all of its remaining benefits. Specifically, the vendor cannot obtain the remaining benefits in terms of cash flows from sale because the vendor cannot sell the product to another party while it is being held for GHI. Also, the vendor cannot realize any beneficial change in value during the hold period because the price to GHI for the products is defined in the purchase order.

— From the time GHI issues the purchase order until it either sells the product to one of its customers or cancels the purchase order (i.e. releasing the hold), GHI has the sole ability to direct the product to one of its customers and obtain substantially all of its remaining benefits, including by adjusting the price it charges for the product on the website.

The control evaluation is further supported by the fact that GHI's reserved unit count 'depletes' as it completes sales to customers. Each unit sold and shipped to a GHI customer is a unit that GHI (1) controlled before it was transferred to the customer and (2) directed the vendor to pick and ship at GHI's direction.

Based on its evaluation, GHI concludes that it has the ability to direct the use of and obtain substantially all the remaining benefits from the products (and can prevent others from doing so), consistent with the control principle in paragraph 606-10-25-25. Therefore, GHI concludes it is the principal in its drop shipment arrangements with the vendor.

GHI notes that the indicators in paragraph 606-10-55-39 do not provide any disconfirming evidence to this conclusion because these indicators are mixed. Specifically, GHI controls the price to the customer, but it does not have inventory risk with respect to the products and it shares responsibility with the vendor for fulfillment to the customer.

9.3.30 Evaluating control of a combined good or service

Excerpt from ASC 606-10

• > Principal versus Agent Considerations

55-37 An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

55-37A When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

a. A good or another asset from the other party that it then transfers to the customer.
b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.
c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 606-10-25-21(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

If a good or service is part of a combined performance obligation to the customer for which the entity provides the significant service of integrating the individual goods or services into the combined output (i.e. the specified good or service) to the customer, the entity is the principal for the specified good or service. Therefore, it controls all of the inputs (including any provided by third parties) that go into the specified good or service, directing their use to create the combined item. This conclusion is determinative; no further analysis of the principal-agent guidance is undertaken. [606-10-55-37A(c), ASU 2016-08.BC30]

Example 46 in Topic 606 (reproduced below) illustrates that providing a significant integration service is determinative in the principal-agent analysis for a specified good or service that is a combined item (i.e. comprising multiple goods or services). In that example, the entity contracts to provide specialized equipment and uses a subcontractor to manufacture the equipment. However, the entity concludes that the design and manufacturing of the equipment are not distinct because they are both inputs to the specialized equipment (a combined output) and the entity is providing a significant service of integrating the items into the specialized equipment. Because the entity is the integrator for the specified equipment that is a combined output from multiple inputs, the entity is the principal for that specified good and no further analysis is necessary.

Excerpt from ASC 606-10

• • > Example 46—Promise to Provide Goods or Services (Entity Is a Principal)

55-320 An entity enters into a contract with a customer for equipment with unique specifications. The entity and the customer develop the specifications for the equipment, which the entity communicates to a supplier that the entity contracts with to manufacture the equipment. The entity also arranges to have the supplier deliver the equipment directly to the customer. Upon delivery of the equipment to the customer, the terms of the contract require the entity to pay the supplier the price agreed to by the entity and the supplier for manufacturing the equipment.

55-321 The entity and the customer negotiate the selling price, and the entity invoices the customer for the agreed-upon price with 30-day payment terms. The entity's profit is based on the difference between the sales price negotiated with the customer and the price charged by the supplier.

55-322 The contract between the entity and the customer requires the customer to seek remedies for defects in the equipment from the supplier under the supplier's warranty. However, the entity is responsible for any corrections to the equipment required resulting from errors in specifications.

55-323 To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by another party (that is, the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

55-323A The entity concludes that it has promised to provide the customer with specialized equipment designed by the entity. Although the entity has subcontracted the manufacturing of the equipment to the supplier, the entity concludes that the design and manufacturing of the equipment are not distinct because they are not separately identifiable (that is, there is a single performance obligation). The entity is responsible for the overall management of the contract (for example, by ensuring that the manufacturing service conforms to the specifications) and thus provides a significant service of integrating those items into the combined output—the specialized equipment—for which the customer has contracted. In addition, those activities are highly interrelated. If necessary modifications to the specifications are identified as the equipment is manufactured, the entity is responsible for developing and communicating revisions to the supplier and for ensuring that any associated rework required conforms with the revised specifications. Accordingly, the entity identifies the specified good to be provided to the customer as the specialized equipment.

55-323B The entity concludes that it controls the specialized equipment before that equipment is transferred to the customer (see paragraph 606-10-55-37A(c)). The entity provides the significant integration service necessary to produce the specialized equipment and, therefore, controls the specialized equipment before it is transferred to the customer. The entity directs the use of the supplier's manufacturing service as an input in creating the combined output that is the specialized equipment. In reaching the conclusion that it controls the specialized equipment before that equipment is transferred to the customer, the entity also observes that even though the supplier delivers the specialized equipment to the customer, the supplier has no ability to direct its use (that is, the terms of the contract between the entity and the supplier preclude the supplier from using the specialized equipment for another purpose or directing that equipment to another customer). The entity also obtains the remaining benefits from the specialized equipment by being entitled to the consideration in the contract from the customer.

55-324 Thus, the entity concludes that it is a principal in the transaction. The entity does not consider the indicators in paragraph 606-10-55-39 because the evaluation above is conclusive without consideration of the indicators. The entity recognizes revenue in the gross amount of consideration to which it is entitled from the customer in exchange for the specialized equipment.

9.3.40 Evaluating control of a right to a service performed by another party

Excerpt from ASC 606-10

• > Principal versus Agent Considerations

55-37 An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

55-37A When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

a. A good or another asset from the other party that it then transfers to the customer.
b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.
c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 606-10-25-21(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

An entity controls a service provided by another party when it controls a right to the specified services that will be provided to the customer. The entity then either transfers the right to the customer or uses that right to direct the other party to provide the specified services that will be provided to the customer on its behalf. Therefore, it is important to identify whether the specified service is a: [606-10-55-37(b), ASU 2016-08.BC25, BC33, BC34]

- right to a service – e.g. a right to a flight service (an airline ticket); or
- the underlying service itself.

When the nature of the promise is to provide a right to a service to be performed by a third party (e.g. a ticket to a flight or meal voucher) the analysis is based on whether the entity controls *the right* to the service before it is transferred. An entity may be a principal even if another party controls and transfers the underlying service (e.g. the flight or the meal) to the end customer. The fact that the entity will not provide the service itself is not determinative. [ASU 2016-08.BC25]

In contrast, when the specified service is the underlying service (and not the right to that service), the entity evaluates whether it controls the service provided by the third party, directing the third party to perform its service in satisfaction of the entity's performance obligation to the end customer (i.e. on the entity's behalf). This scenario is fundamentally no different from an entity using its own resources to fulfill the service obligation. [ASU 2016-08.BC33 – BC34]

In some cases it will be challenging to determine if the specified service is the right to the service or the underlying service itself. Example 46A and Example 47 in Topic 606 (reproduced below) illustrate scenarios in which the right is the specified service and when the underlying service itself is the specified service.

- In Example 46A, the specified service is the provision of maintenance services and the entity is a principal because it is directing the third party to satisfy the performance obligation on its behalf.
- In Example 47, the specified service is a right to the right to a flight and the entity is principal because it obtains control of that right before it is transferred to the customer.

The basis for conclusions to ASU 2016-08 explain how that determination was reached for those two examples. [ASU 2016-08.BC27 – BC28]

Excerpt from ASU 2016-08

BC27. In Example 47, the entity itself does not transport the customers and it cannot change or modify the service (that is, change the flight time or destination). The entity does not obtain a customer and then obtain a flight service provider to fulfill its performance obligation to the customer to transport the customer from Point A to Point B. Rather, the entity obtains tickets before a customer is identified for each of those tickets. The tickets represent specified rights to fly on specific flights. The entity, therefore, controls a right to fly, which is an asset because:

a. The entity can direct the use of the ticket—the entity can use the ticket itself, sell the ticket to any customer it wishes, or let the ticket to expire unused.

b. The entity can obtain substantially all the remaining benefits of the ticket—the entity can either consume the right or obtain all of the cash flows from sale of that right.

The entity then transfers that specific right to the customer. Hence, the customer obtains from the entity a specified asset (the ticket representing the right to fly on a specified flight) that the entity controlled.

BC28. In contrast, Example 46A concludes that the specified good or service is the underlying office maintenance services rather than a right to those services. In that Example, the entity obtains the contract with the customer to provide the office maintenance services before it engages a subcontractor (the third-party maintenance services provider) to perform those services. While the entity enters into a contract to obtain office maintenance services from the subcontractor after entering into the contract with the customer (but before the office maintenance services are provided to the customer), the right to the subcontractor's services is not transferred to the customer. The entity retains control over that right (that is, the entity retains the right to utilize the services from the subcontractor as it sees fit—it can utilize its right to office maintenance services to fulfill the customer contract or another customer contract or to service its own facilities). The customer does not obtain control of the entity's right to direct the subcontractor. The customer has contracted with the entity for office maintenance services and the customer is indifferent as to whether the subcontractor, the entity, or any other subcontractor carries out the maintenance services as long as those services are in accordance with the contractual terms. In contrast, in Example 47, the customer is not indifferent as to which ticket the ticket broker transfers to it. The customer wants the ticket broker to transfer a specific right that the customer will then control (that is, a ticket for a specific flight).

Excerpt from ASC 606-10

• • > Example 46A—Promise to Provide Goods or Services (Entity is a Principal)

55-324A An entity enters into a contract with a customer to provide office maintenance services. The entity and the customer define and agree on the scope of the services and negotiate the price. The entity is responsible for ensuring that the services are performed in accordance with the terms and conditions in the contract. The entity invoices the customer for the agreed-upon price on a monthly basis with 10-day payment terms.

55-324B The entity regularly engages third-party service providers to provide office maintenance services to its customers. When the entity obtains a contract from a customer, the entity enters into a contract with one of those service providers, directing the service provider to perform office maintenance services for the customer. The payment terms in the contracts with the service providers generally are aligned with the payment terms in the entity's contracts with customers. However, the entity is obliged to pay the service provider even if the customer fails to pay.

55-324C To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

55-324D The entity observes that the specified services to be provided to the customer are the office maintenance services for which the customer contracted and that no other goods or services are promised to the customer. While the entity obtains a right to office maintenance services from the service provider after entering into the contract with the customer, that right is not transferred to the customer. That is, the entity retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right. For example, the entity can decide whether to direct the service provider to provide the office maintenance services for that customer, or for another customer, or at its own facilities. The customer does not have a right to direct the service provider to perform services that the entity has not agreed to provide. Therefore, the right to office maintenance services obtained by the entity from the service provider is not the specified good or service in its contract with the customer.

55-324E The entity concludes that it controls the specified services before they are provided to the customer. The entity obtains control of a right to office maintenance services after entering into the contract with the customer but before those services are provided to the customer. The terms of the entity's contract with the service provider give the entity the ability to direct the service provider to provide the specified services on the entity's behalf (see paragraph 606-10-55-37A(b)). In addition, the entity concludes that the following indicators in paragraph 606-10-55-39 provide further evidence that the entity controls the office maintenance services before they are provided to the customer:

a. The entity is primarily responsible for fulfilling the promise to provide office maintenance services. Although the entity has hired a service provider to perform the services promised to the customer, it is the entity itself that is responsible for ensuring that the services are performed and are acceptable to the customer (that is, the entity is responsible for fulfilment of the promise in the contract, regardless of whether the entity performs the services itself or engages a third-party service provider to perform the services).
b. The entity has discretion in setting the price for the services to the customer.

55-324F The entity observes that it does not commit itself to obtain the services from the service provider before obtaining the contract with the customer. Thus, the entity has mitigated its inventory risk with respect to the office maintenance services. Nonetheless, the entity concludes that it controls the office maintenance services before they are provided to the customer on the basis of the evidence in paragraph 606-10-55-324E.

55-324G Thus, the entity is a principal in the transaction and recognizes revenue in the amount of consideration to which it is entitled from the customer in exchange for the office maintenance services.

• • > Example 47—Promise to Provide Goods or Services (Entity Is a Principal)

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.

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.

55-327 The entity also assists the customers in resolving complaints with the service provided by the airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

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 those goods or services to be provided by another party (that is, the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

55-328A The entity concludes that with each ticket that it commits itself to purchase from the airline, it obtains control of a right to fly on a specified flight (in the form of a ticket) that the entity then transfers to one of its customers (see paragraph 606-10-55-37A(a)). Consequently, the entity determines that the specified good or service to be provided to its customer is that right (to a seat on a specific flight) that the entity controls. The entity observes that no other goods or services are promised to the customer.

55-328B The entity controls the right to each flight before it transfers that specified right to one of its customers because the entity has the ability to direct the use of that right by deciding whether to use the ticket to fulfill a contract with a customer and, if so, which contract it will fulfill. The entity also has the ability to obtain the remaining benefits from that right by either reselling the ticket and obtaining all of the proceeds from the sale or, alternatively, using the ticket itself.

55-328C The indicators in paragraph 606-10-55-39(b) through (c) also provide relevant evidence that the entity controls each specified right (ticket) before it is transferred to the customer. The entity has inventory risk with respect to the ticket because the entity committed itself to obtain the ticket from the airline before obtaining a contract with a customer to purchase the ticket. This is because the entity is obliged to pay the airline for that right regardless of whether it is able to obtain a customer to resell the ticket to or whether it can obtain a favorable price for the ticket. The entity also establishes the price that the customer will pay for the specified ticket.

55-329 Thus, the entity concludes that it is a principal in the transactions with customers. The entity recognizes revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred to the customers.

Example 48 in Topic 606 (reproduced below) further illustrates application of the principal-agent guidance when the specified service is a right to a service provided by a third party. In that example, the entity sells meal vouchers through its website that customers can use at specified restaurants; the vouchers represent rights to obtain specified meals. In contrast to Example 47 in Topic 606 (airline tickets), the entity does not control the vouchers before they are created contemporaneously with the customer's purchase of (and obtaining) the voucher.

The entity does not control the voucher before it is transferred to the customer because it does not exist until it is purchased by the customer. The entity does not prepay or firmly commit to purchase vouchers before obtaining customers for those vouchers (in contrast to the facts in Example 47 in Topic 606). Further, the entity does not contract with the customer for a meal and then obtain a voucher from a restaurant to fulfill its meal obligation to the customer.

Excerpt from ASC 606-10

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

55-330 An entity sells vouchers that entitle customers to future meals at specified restaurants, and the sales price of the voucher provides the customer with a significant discount when compared with the normal selling prices of the meals (for example, a customer pays $100 for a voucher that entitles the customer to a meal at a restaurant that would otherwise cost $200). The entity does not purchase or commit itself to purchase vouchers in advance of the sale of a voucher to a customer; instead, it purchases vouchers only as they are requested by the customers. The entity sells the vouchers through its website, and the vouchers are nonrefundable.

55-331 The entity and the restaurants jointly determine the prices at which the vouchers will be sold to customers. Under the terms of its contracts with the restaurants, the entity is entitled to 30 percent of the voucher price when it sells the voucher.

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.

55-333 To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls the specified good or service before that good or service is transferred to the customer.

55-333A A customer obtains a voucher for the restaurant that it selects. The entity does not engage the restaurants to provide meals to customers on the entity's behalf as described in the indicator in paragraph 606-10-55-39(a). Therefore, the entity observes that the specified good or service to be provided to the customer is the right to a meal (in the form of a voucher) at a specified restaurant or restaurants, which the customer purchases and then can use itself or transfer to another person. The entity also observes that no other goods or services (other than the vouchers) are promised to the customers.

55-333B The entity concludes that it does not control the voucher (right to a meal) at any time. In reaching this conclusion, the entity principally considers the following:

a. The vouchers are created only at the time that they are transferred to the customers and, thus, do not exist before that transfer. Therefore, the entity does not at any time have the ability to direct the use of the vouchers or obtain substantially all of the remaining benefits from the vouchers before they are transferred to customers.
b. The entity neither purchases nor commits itself to purchase vouchers before they are sold to customers. The entity also has no responsibility to accept any returned vouchers. Therefore, the entity does not have inventory risk with respect to the vouchers as described in the indicator in paragraph 606-10-55-39(b).

55-334 Thus, the entity concludes that it is an agent in the arrangement with respect to the vouchers. The entity recognizes revenue in the net amount of consideration to which the entity will be entitled in exchange for arranging for the restaurants to provide vouchers to customers for the restaurants' meals, which is the 30 percent commission it is entitled to upon the sale of each voucher.

Question 9.3.60

What are the key considerations for determining when an entity is a principal when a third party is involved in providing services?

Interpretive response: The FASB observed that service arrangements involving third parties *in which the entity is a principal* can broadly be grouped into the following categories. [ASU 2016-08.BC34]

1. Contracts in which the service provided by a third party is used to create a combined item that is not distinct from other goods or services promised to the customer (illustrated in Example 46 in Topic 606 reproduced in section 9.3.30).

2. Contracts in which an entity directs another party to provide services on its behalf (illustrated in Example 46A in Topic 606 reproduced above).

3. Contracts in which a customer transfers a right to a future service provided by another party (illustrated in Example 47 in Topic 606 reproduced above).

Based on Examples 46 and 46A and other examples in Topic 606, we believe the following illustrates some of the key considerations in reaching each of the above conclusions.

1. The service is an input to a combined output that is the specified good or service and for which the entity is the integrator for that combined output

When a service performed by a third party is an input to a combined performance obligation (comprising multiple inputs) for which the entity is providing the significant service of integrating those multiple inputs into the combined output that is the specified good or service, the entity controls the third-party service before the combined output is transferred to the customer. This is because the entity directs the use of all the inputs (including those provided by third parties) in creating the combined specified good or service.

Whenever an entity is transferring a single, integrated performance obligation for which it is providing the significant integration service, it is the principal for that specified good or service and controls all of the inputs (goods and services) that contribute to the combined output. No further evaluation occurs because this is determinative to the principal-agent evaluation. [606-10-55-37A(c), 55-323B – 55-324, ASU 2016-08.BC30, BC34(b)]

2. The entity directs another party to provide services on its behalf

The ability to direct the third party to provide services on its behalf indicates the entity is the principal. When the entity directs another party to provide services on its behalf, the entity may simply be using the other entity (e.g. a subcontractor) to provide the specified service in lieu of either using or hiring its own employees, and directing the subcontractor's resources in the same way it would its own resources. The following are indicators that an entity controls the services in this manner. [ASU 2016-08.BC35]

Entity enters into the contract before engaging the third party

Entering into a contract that commits to the entity to provide a customer with a service before a third party agrees to be involved in fulfilling the service is evidence that an entity may be using the third party as a 'subcontractor' to fulfill its performance obligation to provide the specified service. The fact that the entity enters into the contract with the customer before the third party becomes involved in the contract is not determinative on its own that the entity is the principal. The entity still needs to control the services provided by that third party. [ASU 2016-08.BC35 – BC36]

Directing the third party to perform the services provided by the third party

A strong indicator that the entity directs the third-party services is that the entity, rather than the customer, is the counterparty to the contract with the third party. Typically, in that case, the entity is then directing the third party to perform services *on its behalf* in the same manner any subcontractor performs on behalf of the prime contractor. In contrast, if the customer is the counterparty to the contract with the third party, the entity will generally have no control over those services before or as they are provided. [ASU 2016-08.BC35]

When the entity controls the services provided by the third party, the substance of the arrangement is that it is using the third party's services just as it would services performed by its own employees to fulfill its performance obligation to the customer (entered into before retaining the third party's services). Further, when the entity controls the contractual relationship with the third party, consistent in principle with what is outlined in Example 46A in Topic 606 (reproduced above) and the basis for conclusions to ASU 2016-08, it will generally be the case that the entity: [606-10-55-324D, ASU 2016-08.BC28, BC35]

— defines the services to be performed by the third party and has the right to direct that party as it sees fit within the constraints of its contract with the third party. The right to direct the third party could include using the third party's services to fulfill the current contract with the customer (or suspending such services if, for example, the customer does not pay the entity timely), for its own purposes or to fulfill other contracts; and

— does not transfer the right to the third-party services to the customer, and therefore the customer cannot direct the third party.

In addition, the indicators of control in paragraph 606-10-55-39 may provide relevant evidence about whether the third party is fundamentally performing services on the entity's behalf and under its direction. Consider the following:

— **Primary responsibility for fulfillment/acceptability of fulfillment.** The entity with primary responsibility for fulfillment and primary responsibility for the acceptability of that fulfillment will often accompany a conclusion that the third party is performing services on the entity's behalf and under its direction. For example, an entity is more likely to accept responsibility for the acceptability of services it can direct. In contrast, the third party with responsibility for both fulfillment and the acceptability of that fulfillment would typically suggest the third party is fulfilling its own performance obligation rather than acting on behalf of the entity to fulfill the entity's performance obligation.

— **Inventory risk.** An entity does not have direct inventory risk if it does not commit to a quantity of services before having contracts with customers. However, consistent with the notion in the preceding bullet, if the entity is primarily responsible to the customer for the acceptability of fulfillment, such that it is required to pay the subcontractor regardless of whether the customer accepts the specified service, that may be considered a form of 'back-end' inventory risk. This back-end inventory risk, together with primary responsibility for the acceptability of fulfillment, may indicate that the third party's services are a resource of the entity that it directs to provide the specified service to the customer.

— **Price discretion.** Having or not having pricing discretion will typically not be determinative. However, one would typically expect an entity to have pricing discretion when it concludes the third party is fulfilling the entity's performance obligation to provide the specified service on its behalf. In contrast, it would be less likely that the third party is acting on its behalf if the third party is in control of the price the customer is paying for the specified service. [606-10-55-39]

3. The entity controls a right to the specified service before it is provided to the customer

An entity controls a specified service before it is provided to a customer if it has an enforceable right to the service that it transfers to the customer. For example, in Example 47 in Topic 606 (reproduced above), an airline will provide a flight service to a passenger. The entity has a right to such service, that it controls, in the form of a ticket that when tendered to the airline will permit flying from Point A to Point B on a specified date. The customer then contracts with the entity to obtain the entity's right to the flight service indicated. Because the entity is transferring to the customer the ticket it controls (i.e. its asset), the entity is directing the airline to provide the flight service (to which the entity is entitled) to the customer. [606-10-55-37(b)]

In scenarios that are potentially of this nature, the inventory risk indicator in paragraph 606-10-55-39(b) will generally provide important, relevant evidence.

This is because, if the entity controls a right to a service, it will have inventory risk in the form of that right for which it has already paid (or committed to pay) on a nonrecourse basis. In contrast, an entity that does not have inventory risk does not control a right for which it has already paid (or committed to pay). [606-10-55-39(b)]

Example 48 in Topic 606 (reproduced above) illustrates a scenario where the specified good or service is a right to a food service (i.e. a meal voucher), but the entity does not control that right to the food service before it is transferred to the customer; the entity does not have any inventory risk in the form of prepaid vouchers.

The other two indicators in paragraph 606-10-55-39 (i.e. primarily responsible and discretion in establishing price) do not provide evidence that is as relevant as that provided by the inventory risk indicator when evaluating whether an entity controls a right to a specified service before it is provided to the customer. That is, those indicators will not be determinative to this question, while inventory risk generally will provide determinative evidence.

Example 9.3.20
Entity is agent for product placement services

ABC Corp. contracts with consumer products companies and content developers to create video content (published on the internet) that promotes products sold by the consumer products companies.

ABC enters into a contract with Customer (a consumer products company) to provide the services of Provider (a content developer) to create videos that promote the use of Customer's products. The contract with Customer specifies that ABC is entering into the agreement on behalf of Provider (identified in the contract).

ABC is not involved in developing the specifications for what the content developer will produce. ABC is not responsible if Customer is unsatisfied with Provider's end product. If a Provider does not fulfill its responsibilities under the contract or takes action that causes harm, Customer has protective rights that allow it to take injunctive action or obtain other equitable relief against Provider. Customer has no recourse against ABC, unless ABC has not satisfied its obligations in the contract – generally limited to the responsibility for coordination between the content developer and the consumer products company.

ABC has contracts with multiple content developers, including Provider, to create video content. ABC separately negotiates a fee with each content developer for creating the content. ABC and Customer set the price for the content development and Provider does not have visibility into that price. However, Customer must pay Provider for costs incurred plus a reasonable margin if it terminates the contract for reasons other than Provider's failure to perform.

ABC concludes there is only a single specified service in this contract, which is the service to produce the video content that promotes Customer's consumer products. ABC considers the following in evaluating whether it controls the specified service using the framework in Question 9.3.60.

1. Is the service combined with other goods or services into a combined output that is the specified good or service?

No. There are no other promised goods or services in the contract.

2. Does ABC direct Provider to provide services on its behalf?

No. ABC did not first enter into a contract with Customer and then engage Provider. Customer and ABC entered into a contract that specified Provider's involvement, so Provider was engaged concurrently with ABC and Customer concluding their contract. Further, ABC does not control the services because it does not define the services to be performed by Provider and is not involved with the fulfillment of the product.

3. Does ABC control a right to the specified service before it is provided to Customer?

No. ABC did not obtain the rights to the content, the content itself or commit to purchase the finished content before entering into the contract with Customer. Therefore, ABC cannot direct the use of or benefit from Provider's finished content because it cannot use, resell or consume the content on its own. Further, ABC cannot benefit from the service in the contract for its own purposes.

ABC observes that its agent conclusion is further supported by the control indicators.

- **Primary responsibility for fulfillment.** Provider is primarily responsible for providing the content to Customer. Although ABC entered into the contract with Customer, ABC is not responsible for providing the specified service. This supports that ABC is not directing Provider's service. While ABC is responsible for coordinating between Provider and Customer, that further supports the nature of the promise is to arrange for the specified service to be provided by Provider.
- **Price discretion.** ABC sets the price in contract with Customer. However, this does not change the conclusion based on the other evidence provided.
- **Inventory risk.** ABC does not have inventory risk, which supports that it does not obtain control of the content prior to it being transferred to Customer.

Conclusion

Based on the above, ABC concludes that it is the agent for the specified service and recognizes revenue on a net basis, which reflects its commission for acting as an agent in the transaction.

Example 9.3.30
Cloud service reseller – entity is a principal

ABC Corp. partners with third parties who own and operate web-based platforms. ABC creates IT environments for its customers on these platforms, secures the platform processing capacity for its customers and provides software to monitor and manage the cloud consumption on the platforms. ABC is an authorized reseller of three different cloud platforms and provides customer support on each cloud platform to ensure customer applications have maximum up-time (i.e. are always available on the cloud).

ABC enters into a contract with Customer to provide professional services required to implement a cloud-based solution and provide cloud capacity management. These services include identification and procurement of cloud computing capacity, a software interface (the ABC Software) to help customers monitor their cloud computing usage, as well as customer support and maintenance. Customer selects Platform Provider's product to be used in the services. However, Customer and Platform Provider do not enter into a contractual relationship and ABC accepts responsibility for the cloud platform.

ABC sets the price charged to Customer for the services, and Platform Provider is not involved in the negotiations and does not have visibility into the contract. However, given market competition for the cloud platform and rates at which Platform Provider sells separately, ABC is practically limited in the amount it can charge Customer for the platform.

ABC's separate contract with Platform Provider requires it to pay Platform Provider even if Customer does not pay ABC for the services. ABC also pre-pays for reserved instances on the various provider platforms that it will resell to its customers. ABC does this to ensure services are able to be provided uninterrupted.

ABC concludes it is providing a single specified service to Customer because it is performing a significant service of integrating the platform, software, support and maintenance into a single performance obligation. ABC evaluates whether it is the principal for the cloud platform provided by Platform Provider using the framework in Question 9.3.60.

Is the service combined with other goods or services into a combined output that is the specified good or service (1. In Question 9.3.60)?

The specified cloud services are a single, integrated offering and ABC provides the significant service to Customer of integrating all the items, including the third-party cloud platform, into the combined output (i.e. the integrated cloud services) for which Customer contracted. The third-party web platform is merely one input to ABC's integrated cloud offering, which ABC controls and makes use of in fulfilling the specified service. That the third-party cloud platform is an input to a single, integrated offering provided by ABC is determinative. ABC controls that cloud platform service along with all of the other inputs to the specified service (i.e. the single, integrated cloud offering). No further analysis is performed.

Example 9.3.40
Shipping vessel pooling arrangement

Companies A, B, C and D are unrelated entities that separately own and operate seaborne shipping vessels. The companies mutually agree to establish a commercial arrangement for common marketing and commercial operation of certain vessels. Under this arrangement, each company commits one or more of its vessels to the arrangement and the companies share proportionately in net voyage revenues of all vessels in the arrangement (the revenue-sharing arrangement' or 'pool'). The arrangement is not a joint venture because no separate legal entity is used to operate the pool.

Shipping vessels in the revenue-sharing arrangement are operated as a single fleet by a manager. The pool provides the participating companies the opportunity to maximize profit by improving scheduling, diversifying geographically and mitigating the risk of unused shipping capacity. All participating companies are permitted to withdraw their committed vessels by providing 90 days' notice.

Company A is appointed to manage the operation of the pool. As the manager, Company A is responsible for the following for all vessels in the pool:

— identify customers and negotiate the terms and pricing of each customer contract – e.g. to ship specified product for Customer Z from Sydney to Los Angeles;
— chart the voyage and make arrangements with port authorities, coordinate tug boats and obtain freight insurance; and
— provide the charter instructions to the shipping vessel crew and instruct the crew on any changes to the charter throughout the voyage.

Company A is entitled to a fixed daily amount for each shipping vessel committed to the pool and 1% of the contract price for each customer contract entered into for vessels in the pool. The shipping vessel owner, the pool manager (Company A) and the customer are signatories to each customer contract.

The non-manager participants (Companies B, C and D) have the following obligations:

— to accept the terms and conditions of any charter arranged by the manager, meaning they cannot decline a voyage, except for protective reasons – e.g. ship damage that requires the vessel to remain in port for repairs;
— to not accept voyages for vessels committed to the pool that are not arranged by the pool manager (Company A);
— to operate and provide crews for their vessels, as well as maintain ongoing insurance for those vessels; and
— to resolve disputes with customers and assume liability related to any claims or legal actions resulting from operating its vessels.

Identifying the principal to the arrangement with the pool customer

A contract is entered into with Company A as the manager, Company B as the shipping vessel owner, and Customer Z to have Company B's ship transport a specified product from Sydney to Los Angeles. The companies determine that the owner of the vessel assigned to fulfill the customer contract (Company B) is the contract's principal rather than the manager (Company A).

This conclusion is based on the following analysis.

- Company A does not lease the pool vessels owned by Companies B, C or D. Even though each ship is an identified asset under Topic 842, consistent with Question 3.3.70 in KPMG Handbook, Leases, no lease exists because Company A does not have the right to obtain substantially all of the economic benefits from use of the asset.
- A direct evaluation of the control principle in paragraph 606-10-25-25 is inconclusive to the principal versus agent analysis. Although Company A does not control the 'means' of providing the service (i.e. it does not own or lease those vessels), it does control aspects of the service – i.e. the identification of the customer, the specifications of the service to be provided and the price for the service. In contrast, the vessel owner (Company B) controls the means of providing the service, but does not control those significant aspects of the service controlled by Company A.
- Because the companies' evaluation of the control principle is inconclusive, they rely on the following relevant evidence provided by the control indicators in paragraph 606-10-55-39. The companies conclude that the weight of evidence supports that the owner of the vessel assigned to fulfill the customer contract (Company B in this example), rather than the pool manager (Company A), is the principal in the Customer Z contract.
  - **Primary responsibility for fulfillment.** Company B has primary responsibility for fulfilling the contract by (1) providing the vessel and crew and (2) assuming responsibility for resolving any disputes that arise with the customer and accepting liability for any claims that result.
  - **Inventory risk.** Company B as the vessel owner has the equivalent of inventory risk because it is providing the ship and incurring the crew and carrying costs of the vessel without recovery if the vessel remains idle; in contrast, the pool manager (Company A) has no such inventory risk related to the vessels in the pool that it does not own.
  - **Price discretion.** Company A establishes the price for the shipping service in the Customer Z contract. While the evidence provided by this indicator is supportive of Company A being the principal in the Customer Z contract, it is not persuasive when considered together with the other relevant evidence.

Because the vessel owner (Company B) is determined to be the principal to the contract with Customer Z, the pool manager (Company A) is therefore an agent to that contract – i.e. arranging for the vessel owner to provide a shipping service to the customer. Note that the pool manager in this example (Company A) *will* be principal for those contracts it fulfills with its own vessels that it has committed to the pool.

Facts and circumstances were important to the conclusions reached in this example; different facts and circumstances could result in different principal-agent (and potentially, lease) conclusions.

Example 9.3.50
Distribution services – entity is a principal

Bank has a contract with Mutual Fund to distribute shares in the fund to investors. Bank has determined that Mutual Fund is the customer in the arrangement.

After entering into the arrangement, Bank delegates its distribution activities to third-party broker-dealers under separately executed distribution agreements. Under these distribution agreements, the third-party broker-dealers agree to sell mutual fund shares on behalf of Bank to investors for a variable commission-based fee.

The entity directs another party to provide services on its behalf

Bank controls the right to services performed by third-party broker-dealers because it has the ability to direct those parties to provide services to Mutual Fund (the customer) on its behalf. Bank combines the services performed by the third-party broker-dealers together with services it performs in providing the combined selling and distribution services to Mutual Fund.

While focused on whether it obtains control of the distribution services before they are transferred to Mutual Fund, Bank also considers the following control indicators.

— **Primary responsibility for fulfillment.** Although Bank subcontracts distribution services to third-party broker-dealers, it remains responsible for the acceptability of those services. Bank continuously and actively monitors outsourced services, regularly communicates with third-party broker-dealers, and is responsible for identifying performance issues and related corrective actions. Bank performs upfront and ongoing due diligence and has the right to terminate the agreement with third-party broker-dealers.

— **Inventory risk.** Bank does not have direct inventory risk because it does not commit to buy a quantity of services from the third-party broker dealers before it obtains the contract with the customer.

— **Price discretion.** Bank has discretion in setting the price for distribution services under the agreements with third-party broker-dealers.

Bank evaluates all of the facts of the arrangements, considering the control principle (whether it controls the distribution services before they are transferred to Mutual Fund) and what the control indicators relay about whether the control principle is met, and concludes it is the principal in providing distribution services to its customer (Mutual Fund).

As a result, Bank recognizes distribution revenue on a gross basis, and third-party distribution fees and commissions are presented as expenses.

Example 9.3.60
Reseller of third-party software licenses – entity is an agent

Same facts as Example 9.3.15

ABC is a reseller of third-party software and concludes that each software license is typically a specified good or right to a service. ABC evaluated whether it was directing the third-party software vendor to perform and whether it had a right to the software before it was provided to the customer.

In this evaluation, ABC noted the following.

— **Primary responsibility for fulfillment.** ABC frequently serves as a contact point for customers, but does not maintain a call center or helpdesk. ABC generally only facilitates the customer's contact with the appropriate personnel from the third-party vendor when customers contact ABC.

— **Inventory risk.** ABC does not have a pre-purchased pool of licenses that it can resell and does not have minimum purchase commitments. ABC has customer return terms that mirror the terms of the vendor and generally does not accept returns from customers that will not be accepted by the third-party vendor. Therefore, ABC does not have front-end or back-end inventory risk.

— **Price discretion.** ABC sets the price of the software to the customer, but its discretion to set that price is effectively constrained by market pressures – i.e. it cannot price goods too expensively because ABC's customers generally have alternative supply options.

— **Right to the specified service before provided to customers.** As noted, ABC does not pre-purchase a pool of licenses. The software requires configuration and/or modification by the vendor before it provides the software license to the customer. As a result, ABC does not obtain a master copy of the licensed software and cannot generate or grant licenses or keys for a customer independently of the third-party software vendor. It is the third-party software vendor that transfers a copy of the software to the customer, provides the key necessary to register the license directly to the customer, and enters into an end-user license agreement with the customer that grants the license to the customer.

ABC concludes that the customer directs the third-party software vendor, rather than ABC, to perform. Further, ABC concludes the software licenses in its contracts, similar to the meal voucher in Example 48 in Topic 606, do not exist until customers issue a purchase order and execute the applicable end-user license agreement with the third-party software vendor. Therefore, ABC concludes that it does not control the software licenses before they are transferred to its customers and is an agent for those specified licenses.

Example 9.3.70

Reseller of third-party software licenses – entity is a principal

DEF is a reseller of third-party software and concludes that each software license is typically a specified good or right to a service. DEF evaluated whether it was directing the third-party software vendor to perform and whether it had a right to the software before it was provided to the customer.

In this evaluation, DEF noted the following.

— **Primary responsibility for fulfillment.** DEF frequently serves as a contact point for its customers and maintains a call center and helpdesk. DEF retains responsibility to resolve customer matters and accepts the financial risk to make the customer whole if the vendor is unable to fulfill the software license.

— **Inventory risk.** DEF does not have a pre-purchased pool of licenses that it can resell and does not have minimum purchase commitments. However, DEF has back-end inventory risk because it generally provides customer refunds when the return is not accepted by the vendor.

— **Price discretion.** DEF sets the price of the software to the customer, but its discretion to set that price is effectively constrained by market pressures – i.e. it cannot price goods too expensively because DEF's customers generally have alternative supply options.

— **Right to the specified service before provided to customers.** As noted, DEF does not pre-purchase a pool of licenses. However, DEF's master distribution arrangement with the third-party software vendor transfers an enforceable right to DEF to grant software licenses to its customers. The software vendor has transferred a right to DEF to use its IP (i.e. to sell licenses to its IP) that is separate from the underlying software licenses themselves. Further, the software does not require configuration and/or modification by the software vendor prior to DEF providing the software license.

DEF concludes that it has an enforceable right to grant licenses before those licenses are transferred to the customer. It is DEF's enforceable rights with the software vendor that give it the right to direct the vendor to issue the software licenses. These rights exist before the customer places a purchase order. Therefore, DEF concludes that it controls the software licenses before they are transferred to its customers and is a principal for those specified licenses.

Question 9.3.70

How does the principal in the transfer of a good to a customer present shipping and handling costs that are accounted for as fulfillment costs?

Interpretive response: Gross. Revenue and related shipping and handling costs are reported gross when an entity elects to account for shipping and handling that occurs after it transfers control of the good (acting as the principal for the good) as a fulfillment activity rather than a performance obligation.

As discussed in section 4.2.60, when shipping and handling activities are performed *after* the customer obtains control of the goods, an entity may elect to account for the related shipping and handling costs (including the cost of insurance) as fulfillment costs. [606-10-25-18B]

As discussed in Question 4.2.150, an entity can apply the shipping and handling accounting policy election when it either ships the goods itself or arranges for a third-party shipper.

When shipping and handling is accounted for as a fulfillment activity, there is only one promised good or service that requires a principal versus agent analysis – the good being transferred. Therefore, when the entity is the principal for the good and the related shipping and handling is accounted for as a fulfillment cost, the entity presents the shipping and handling costs gross in the income statement. This is true regardless of whether the entity or a third party provides the shipping.

Question 4.2.160 discusses the appropriate income statement classification for shipping and handling costs.

9.4 Principal for part of a contract and agent for another part

Each distinct good or service (or distinct bundle of goods or services) in a contract is a specified good or service. Because an entity evaluates whether it is a principal or an agent for each specified good or service, it is possible for the entity to be a principal for one or more goods or services and an agent for others in the same contract. However, Topic 606 does not provide guidance on how to allocate the transaction price to each of those goods or services once that determination is made (see Question 9.4.10). [606-10-55-36 – 55-39]

Example 48A in Topic 606 (reproduced below) illustrates a scenario in which the contract has two specified services: (1) recruitment services and (2) access to a database that is provided by a third party. In that example, the entity concludes it is the agent for the database access and principal for the recruitment services.

The entity concludes it is the agent for the database access because it does not control the specified service at any time. This example highlights some key considerations when evaluating the control principle, including:

— the entity does not have the ability to direct the use of the license – e.g. sell to another party, use or consume – because the customer contracts directly with the third party; and

— it does not obtain access to the database – e.g. it cannot grant access to a third party or prevent the third party from providing access to another customer. [606-10-55-334D]

This example also illustrates that because the entity performs the recruitment services itself, it is the principal and does not need to evaluate the principal-agent guidance for that specified service. [ASU 2016-08.BC13]

Excerpt from ASC 606-10

• • > Example 48A—Entity Is a Principal and an Agent in the Same Contract

55-334A An entity sells services to assist its customers in more effectively targeting potential recruits for open job positions. The entity performs several services itself, such as interviewing candidates and performing background checks. As part of the contract with a customer, the customer agrees to obtain a license to access a third party's database of information on potential recruits. The entity arranges for this license with the third party, but the customer contracts directly with the database provider for the license. The entity collects payment on behalf of the third-party database provider as part of its overall invoicing to the customer. The database provider sets the price charged to the customer for the license and is responsible for providing technical support and credits to which the customer may be entitled for service down-time or other technical issues.

55-334B To determine whether the entity is a principal or an agent, the entity identifies the specified goods or services to be provided to the customer and assesses whether it controls those goods or services before they are transferred to the customer.

55-334C For the purpose of this Example, it is assumed that the entity concludes that its recruitment services and the database access license are each distinct on the basis of its assessment of the guidance in paragraphs 606-10-25-19 through 25-22. Accordingly, there are two specified goods or services to be provided to the customer—access to the third-party's database and recruitment services.

55-334D The entity concludes that it does not control the access to the database before it is provided to the customer. The entity does not at any time have the ability to direct the use of the license because the customer contracts for the license directly with the database provider. The entity does not control access to the provider's database—it cannot, for example, grant access to the database to a party other than the customer or prevent the database provider from providing access to the customer.

55-334E As part of reaching that conclusion, the entity also considers the indicators in paragraph 606-10-55-39. The entity concludes that these indicators provide further evidence that it does not control access to the database before that access is provided to the customer.

a. The entity is not responsible for fulfilling the promise to provide the database access service. The customer contracts for the license directly with the third-party database provider, and the database provider is responsible for the acceptability of the database access (for example, by providing technical support or service credits).
b. The entity does not have inventory risk because it does not purchase or

commit to purchase the database access before the customer contracts for database access directly with the database provider.

c. The entity does not have discretion in setting the price for the database access with the customer because the database provider sets that price.

55-334F Thus, the entity concludes that it is an agent in relation to the third-party's database service. In contrast, the entity concludes that it is the principal in relation to the recruitment services because the entity performs those services itself and no other party is involved in providing those services to the customer.

Question 9.4.10

How should an entity allocate the transaction price when it is the principal for part of the contract and an agent for another part?

Interpretive response: Topic 606 does not include guidance on how to allocate the transaction price in an arrangement in which the entity is a principal for some of the specified goods or services that will be provided to an end customer and an agent for others.

The transaction price includes only the amount to which the entity expects to be entitled for transferring promised goods or services to the customer, and therefore excludes amounts that it will remit to another party for which it is acting as an agent. The amount to which the entity expects to be entitled in the arrangement is then allocated to the performance obligations. Depending on the facts and circumstances, we believe the following allocation methods could be appropriate. [606-10-32-2, 32-28]

Method A: Treat the agency service as part of the contract with the customer

Under this method, the entity views its performance obligations to transfer the specified goods or services for which it is the principal and to provide the agency service(s) as part of a single contract with the end customer. The entity therefore determines and then allocates the transaction price to all of the performance obligations (including the agency services) in accordance with the allocation guidance (see chapter 6), which may result in the entity recognizing agency revenue that is different from the stated commission for that service. In this situation, all of the entity's performance obligations could equally share in any discounts given to the end customer.

Method B: Treat the agency service as if it were a separate contract between the entity and the principal

Under this method, the entity views the transaction as if there are two customer contracts to account for:

— the contract to provide the specified goods or services for which it is the principal to the end customer; and
— the contract to provide agency services to the supplier of the specified goods or services (i.e. the principal).

Because the two contracts are separate from each other, they each have their own transaction price. Therefore, the transaction price for the agency service(s) is the commission to which the entity expects to be entitled in exchange for providing the agency service(s). Correspondingly, the remaining transaction price is allocated to the specified goods or services for which the entity is the principal.

Method A vs. Method B

Although either method may be acceptable in certain facts and circumstances, generally the facts and circumstances will dictate which method is appropriate for a given arrangement. For example:

— Method A will generally be more appropriate when the entity considers itself to be acting on behalf of the end customer for the agency service or when the price is negotiated with the customer as a bundle. The entity may be acting on behalf of the end customer when the contract provides for the entity to procure the third party's contract on behalf of the end customer. Similarly, when the entity negotiates the price of the contract with the end customer as a bundle, each performance obligation may be fundamentally a part of the single arrangement for which any discount should be allocated to each performance obligation in accordance with the general allocation model (see section 6.4.10). For example, if the fee the entity will receive for providing the agency service (i.e. a contractual commission from the third party) is not stated in a separate contract with the third party, then any discount should be allocated using the general allocation model.

— Method B will generally be appropriate when the entity considers itself to be acting on behalf of the third party for the agency service and it has a separate contractual relationship with the third party that objectively depicts the amount of the commission the entity earns for providing the agency services.

The results of applying the two approaches may be the same if, when applying Method A, the entity has observable evidence that the discount relates entirely to the bundle of performance obligations for which it is the principal in accordance with the discount allocation exception (see section 6.5).

Either method may be acceptable when the entity is not clearly acting on behalf of only one party as long as the allocation depicts the amount the entity expects to be entitled to for providing those services. For example, this might be the case when the entity has an existing agency relationship with the principal, but its contract with the customer requests the entity to procure the specified good or service for the customer. In that case, entities should apply the chosen policy consistently to similar contracts.

When selecting a policy for a class of contracts, the entity might consider whether its existing agency relationship with the principal drives selection of the supplier or whether it considered other suppliers with its primary aim to obtain the best alternative for the customer. If the former, that may indicate it was primarily performing its agency service on behalf of the principal; if the latter, that may indicate it was primarily acting as an agent for the customer. The entity could then select its policy on that basis.

Example 9.4.10

Allocating revenue when an entity is a principal and agent (Method A)

Dealership enters into a contract to sell a used vehicle and a separately priced five-year extended warranty to Customer for $18,000. Dealership identifies the car and the extended warranty (a service-type warranty – see section 4.5.20) as the specified goods and services in the contract with Customer. The extended warranty is fulfilled by Auto Warranty and Dealership is not responsible for providing any of those services.

Dealership has agreements with Auto Warranty and two of its competitors under which it remits a contractually stipulated price for each extended warranty that it sells to customers, which in this case is $3,000. However, Dealership has pricing discretion and often bundles the extended warranty with the sale of a vehicle for various prices as part of the overall negotiation with a customer. Further, there is no contractually specified commission percentage or stated dollar amount in its contract with Auto Warranty that it retains from the sale. Dealership's commission is the difference between what it receives from Customer and what it remits to Auto Warranty (i.e. Auto Warranty does not know how much Dealership charges Customer for the warranty).

Dealership currently owns the vehicle and will provide the vehicle to Customer itself and therefore is the principal for the vehicle. Dealership evaluates whether it is the principal for the warranty using the framework in Question 9.3.60.

1. Is the service combined with other goods or services into a combined output that is the specified good or service?

No. The warranty is distinct from the vehicle.

2. Did Dealership direct Auto Warranty to provide warranty service on its behalf?

No. Auto Warranty and Customer have a separate contract. Dealership does not before or during the service period have the ability or right to direct Auto Warranty in its fulfillment of the extended warranty. Dealership is not responsible for fulfilling the warranty and does not have any responsibility for the acceptability of that fulfillment. Further, Auto Warranty is named in the Customer contract as the entity providing the extended warranty so Dealership did not commit to providing the warranty service to Customer and then retain another party to fulfill the warranty on its behalf.

3. Did Dealership commit to purchase or obtain rights to the services prior to those items being transferred to Customer?

No. Dealership did not commit to or obtain rights to the extended warranty that it controlled before entering into the customer contract that it then transferred to Customer.

Conclusion

Dealership concludes that it is the principal for the vehicle and an agent for the extended warranty.

Allocation of consideration

The consideration paid by the end customer for the bundle is $18,000. However, the $3,000 that will be remitted to Auto Warranty is excluded from the transaction price.

Dealership concludes that while it has a contractual relationship with both Auto Warranty and Customer, Dealership is more directly providing an agency service to Customer by advising Customer on the most appropriate warranty to obtain. The bundled nature of the pricing indicates that the agency service is fundamentally part of the overall negotiation and arrangement with Customer. Further, there is no objective amount of the commission in Dealership's contract with Auto Warranty. Therefore, Dealership decides to apply Method A (see Question 9.4.10) and allocates the transaction price as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Vehicle	$15,000	93.75%	$14,063
Extended warranty commission	1,000	6.25%	937
Total	**$16,000**	**100.00%**	**$15,000**

Dealership records the following cumulative journal entry when it satisfies its performance obligations to transfer the vehicle and completes its agency services. While in this example, Dealership recognizes revenue for both items at a point in time, the allocation may be important if Dealership is required to present or disclose the revenue amounts separately.

	Debit	*Credit*
Cash/Accounts receivable	18,000	
Payable – Auto Warranty		3,000
Revenue – vehicle		14,063
Revenue – extended warranty agency service		937
To recognize revenue associated with each performance obligation.		

Example 9.4.20

Allocating revenue when an entity is a principal and agent (Method B)

ABC Corp. enters into a contract with Customer to provide IT outsourcing and certain implementation services. The IT outsourcing and the implementation services are distinct from each other (see section 4.3.20) and both are performance obligations satisfied over time (see section 7.3). ABC also arranges for Partner to provide data conversion and migration services to Customer that ABC does not provide to any of its customers.

The arrangement includes three contracts:

- a contract between ABC and Customer for IT outsourcing and implementation services;
- a contract between Customer and Partner for data conversion and migration services (collectively, Partner services), which designates ABC as an authorized agent of the third-party vendor; and
- a partnership agreement between ABC and Partner, which stipulates that ABC will receive 5% of the consideration in the contract between Customer and Partner.

The contracts together stipulate that Customer will remit payment for both the ABC-provided IT outsourcing and implementation services and Partner-provided services to ABC, and ABC will then remit the agreed payment to Partner net of the commission to which it is entitled under its partnership agreement.

The contract price for the IT outsourcing and the implementation services is $100,000; the contract price for Partner's services is $10,000 (5% of which is $500). The stand-alone selling prices for the IT outsourcing and the implementation services are $85,000 and $25,000, respectively.

ABC identifies the specified goods and services in the contract as IT outsourcing, implementation and Partner services.

- IT outsourcing and implementation are performed entirely by ABC so it is the principal for those specified services.
- ABC evaluates whether it is the principal for Partner's services using the framework in Question 9.3.60.

1. Is the Partner-provided service combined with other goods or services into a combined output that is the specified good or service?

No. The service is distinct.

2. Does ABC direct Partner to provide services on its behalf?

No. Partner directly entered into a contract with Customer. ABC did not first enter into a contract with Customer and then engage Partner. Further, ABC does not have the ability to direct the services provided by Partner. Customer has a contract directly with Partner and therefore ABC never controls the services provided by Partner.

3. Does ABC control a right to the specified service before it is provided to Customer?

No. ABC does not obtain or commit to purchasing the specified service before it is provided to the customer and is not transferring a right that it previously obtained and controls.

Conclusion

ABC concludes that it is the principal for the IT outsourcing and implementation services and an agent for the data conversion and migration services.

Allocation of consideration

The payment made to ABC for Partner services is not part of the transaction price of the contract between ABC and Customer because that amount is collected on behalf of Partner for the services Partner provides to Customer. ABC further concludes that the $500 it retains from the Partner payment as an agency fee is also not part of the transaction price of its contract with Customer.

ABC concludes that it should apply Method B for allocation purposes because ABC has a partnership agreement with Partner such that ABC is providing the agency service to Partner that objectively depicts the commission ABC earns for its agency services. Consequently, ABC accounts for the $500 agency fee as a separate contract with Partner that is unrelated to Customer.

ABC's transaction price allocation for the contract with Customer is as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
IT outsourcing	$ 85,000	77.27%	$ 77,270
Implementation	25,000	22.73%	22,730
Total	**$110,000**	**100.00%**	**$100,000**

9.5 Estimating transaction price as the principal

Excerpt from ASC 606-10

• > Principal versus Agent Considerations

55-37B When (or as) an entity that is a principal satisfies a performance obligation, the entity recognizes revenue in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred.

55-38 An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might 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.

9.5.10 Overview

When an entity is the principal for a specified good or service, it includes the gross amount of consideration to which it expects to be entitled for that specified good or service in the transaction price. In contrast, when the entity is an agent for a specified good or service, the fee or commission to which it expects to be entitled for the agency service is included in the transaction price – the fee or commission might be the net amount retained after paying the supplier. [606-10-55-37B - 55-38]

Question 9.5.10

Is an entity that is a principal in a transaction required to estimate the total consideration paid by the end customer when the amount is not known to the principal?

Interpretive response: No. In some arrangements, the entity may be the principal even though it does not know the price paid by the end customer to the intermediary. In these cases, the entity typically receives a fixed amount per unit from the intermediary regardless of the price paid by the end customer. Topic 606 does not explicitly address how to account for this situation, but the FASB provided views in the basis for conclusions to ASU 2016-08. [ASU 2016-08.BC38]

The FASB indicated that if the price charged to the end customer is not expected to be known to the principal, then the net amount received from the intermediary is the transaction price. The FASB further indicated that the guidance on variable consideration is instructive in making this determination. A key tenet of variable consideration is that at some point the uncertainty in the transaction price will be resolved. As a result, when the uncertainty is not expected to ultimately be resolved, the difference between the amount to which the entity is entitled from the intermediary and the amount charged by the intermediary to the end customer is not variable consideration and therefore is not part of the transaction price. [ASU 2016-08.BC38]

While this accounting yields a practical outcome in many circumstances, the financial statements will not reflect the relationship between the customer and principal in the transaction.

Example 9.5.10

Revenue is net amount received (1)

ABC Corp. is a principal to end customers that purchase its goods from Intermediary. ABC is entitled to receive $3 from Intermediary for each good sold to end customers. Intermediary may sell the good to the end customer for a range of prices from $2 to $5, but the amount remitted by Intermediary to ABC will be $3 for each good sold to end customers on ABC's behalf.

ABC does not know and will not know the specific price charged by Intermediary to the end customer based on the contract terms. As such, ABC records revenue of $3 when it transfers control of the good to the end customer.

Example 9.5.20
Revenue is net amount received (2)

Car Manufacturer is a principal to end customers that purchase separately priced extended warranties from Dealership. Car Manufacturer is entitled to receive $1,500 from Dealership for each separately priced extended warranty that Dealership sells to customers. The suggested retail price for the separately priced extended warranty is $2,000; however, Dealership may sell the extended warranty to the end customer for more if it can. Regardless of what the customer pays, Dealership will pay Car Manufacturer $1,500 for each separately priced extended warranty it sells to end customers.

Car Manufacturer does not know and will not know the specific price charged by Dealership to the end customer. As such, the Car Manufacturer records revenue of $1,500 as it satisfies its performance obligation.

Example 9.5.30
Revenue is net amount received (3)

Retailer is a principal to end customers that purchase its gift cards from Drugstore. Retailer is entitled to receive $45 from Drugstore for each $50 gift card that Drugstore sells to its customers. The suggested retail price for the gift card is $50, but Drugstore can decide to sell the card to the end customer for more or less if it wants. Regardless of what the customer pays, Drugstore will pay Retailer $45 for each gift card sold and Retailer will honor the $50 gift card when customers make purchases at Retailer.

Retailer does not know and will not know the specific price charged by Drugstore to the end customer. As such, Retailer records revenue of $45 as it satisfies its performance obligation (i.e. when the gift cards are redeemed).

Example 9.5.35
Revenue is gross transaction price (1)

Retailer is a principal to end customers that purchase its gift cards from Drugstore. Retailer is entitled to receive $45 from Drugstore for each $50 gift card that Drugstore sells to its customers. The suggested retail price for the gift card is $50, but Drugstore can sell the card to the end customer for more or less if it wants. Regardless of what the customer pays, Drugstore will pay Retailer $45 for each gift card sold and Retailer will honor the $50 gift card when customers make purchases at Retailer.

However, unlike the facts in Example 9.5.30, Drugstore must report to Retailer any discounts it provides to end customers for the $50 gift card. Also, Drugstore has no history of selling the gift cards for more than $50, recognizing that customers won't pay more than $50 because other merchants sell the gift cards at face value.

There is no substantive uncertainty that the transaction price would be higher than $50; and when the transaction price is lower than $50, Drugstore reports it to Retailer. Therefore, Retailer records revenue of $50 as it satisfies its performance obligation – i.e. when the gift cards are redeemed. Retailer also records $5 of commission expense for the difference between the revenue recorded and amount received from Drugstore, which is evaluated for capitalization as a cost to obtain a contract (see section 12.3).

If Drugstore provided a $2 discount to the end customer, Retailer would still receive cash of $45 from Drugstore, but would instead record revenue of $48 and a $3 commission expense.

Example 9.5.40
Revenue is gross transaction price (2)

ABC Corp. is a principal to end customers that purchase its goods from Intermediary. ABC is entitled to receive 80% of the price for each good sold by Intermediary to end customers. Regardless of whether Intermediary sells the good for $7, $10 or another amount, the amount remitted by Intermediary will be 80% of the price paid by the end customer.

ABC knows the gross price paid by the end customer because the contractual provisions allow it to calculate the amount charged to the customer – i.e. it receives 80% of the fee charged to the end customer. It records the gross amount paid by the end customer as revenue when it transfers control of the good to the end customer and records the 20% fee retained by Intermediary as an expense.

9.6 Timing of agency revenue

Excerpt from ASC 606-10

• > Principal versus Agent Considerations

55-36A To determine the nature of its promise (as described in paragraph 606-10-55-36), the entity should:

a. Identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party [see paragraph 606-10-25-18])
b. Assess whether it controls (as described in paragraph 606-10-25-25) each specified good or service before that good or service is transferred to the customer.

55-38 An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might 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.

An agent arranges for the provision of a good or service by another party, and recognizes revenue when (or as) it satisfies its performance obligation to its customer. Satisfaction of the performance obligation may require the agent to simply obtain a purchase or sale commitment from an end customer or vendor partner, or it may require the agent to provide additional services or meet certain conditions. For considerations on when a service (e.g. an agency service) meets the criteria to be satisfied over time or is satisfied at a point in time, see Question 7.3.20. [606-10-55-38]

When an agent satisfies its point-in-time agency performance obligation can vary based on the facts and circumstances. For example, an agent may satisfy its performance obligation when the principal and the end customer have each committed to the contract, when the specified good is shipped, or when the specified good is delivered or specified service provided. In an agency relationship, the timing of when the principal transfers control of the specified good or service to the end customer may differ from the timing of when the agent satisfies its performance obligation.

Question 9.6.10

What factors influence when a point-in-time agency performance obligation is satisfied?

Interpretive response: There are multiple factors that can affect the point in time that an agent's performance obligation to arrange for the provision of a specified good or service is satisfied. The following are important factors that we believe influence this determination.

— **Who is the agent's customer?** Agency relationships typically involve the agent entering into contractual agreements with different counterparties; Example 9.6.20 provides one example involving an agent that contracts with an end customer that wants to purchase goods and the agent separately contracts with a third-party vendor to supply those goods.

  An agent's customer for its agency service may be the principal in the contract, the customer purchasing the specified good or service, or both. Question 2.2.30 describes situations in which there may be multiple counterparties that meet the definition of a customer.

  Determining its customer(s) is key to the agent establishing the nature of its agency service – i.e. the nature of its promise to that (those) customer(s). For example, the nature of an agent's promise may be different to an end customer that is looking to the agent to procure a specified good or service on its behalf than to a supplier for which the agent is one of many sales channels it uses to sell its goods or services.

— **What is the nature of the agent's promise to its customer(s)?** Topic 606 establishes that an agent 'arranges for provision of the specified good or service' by the principal. However, it does not provide further guidance about what that promise entails. The agent's promise to its customer may involve more than 'connecting' the two parties. For example, the agent may:

  - be responsible for the delivery of a specified good to the end customer because it, rather than the principal, contracts with the delivery agent (see Question 9.6.20);
  - provide a value-add service, such as consulting or training services, after the specified good is delivered or specified service is provided; and/or
  - continue to perform a customer service function after the parties have entered into their contract(s) – e.g. interfacing with the end customer about timing of shipping or delivery or, in the case of a service, coordinating timing between the end customer and the principal.

  The first two examples likely represent performance obligations (for which the entity is a principal) separate from the agency service, and therefore would not affect the timing of satisfaction of the agency service. However, judgment may be involved in deciding whether a customer service function is a separate performance obligation – i.e. separate from the agency service – or an integral *part of* the agent's promise to provide the agency service.

  If the entity is an agent for a specified good or service and also a principal for another performance obligation in the contract (e.g. shipping or a value-add service), the entity will need to consider the guidance in section 9.4.

  Determining the nature of the entity's promise to provide the agency service is critical to determining when that performance obligation is satisfied. How this affects the timing of agency revenue recognition is illustrated in Examples 9.6.10 and 9.6.20.

— **When does control of the specified goods or service transfer to the end customer?** When control of the specified good or service transfers (or begins to transfer) to the end customer may provide an indication of when the agent's performance obligation has been satisfied in some circumstances.

  For example, an agent may continue to perform an important customer service function, interfacing with the principal on the end customer's behalf about matters such as timing of shipment or service provider arrival, before control of the specified good or service transfers to the end customer. However, after control transfers (or begins to transfer in the case of a specified service satisfied over time), that availability may no longer be an integral part of its promise to arrange for the provision of the specified good or service – even if the agent remains available to the end customer as a matter of customer relationship – because the end customer may have access to information or to the service provider that it did not have previously. For example, the customer may be provided shipment tracking information it can obtain online, independent of the agent, or may now have direct access to the service provider.

Example 9.6.10

Timing of agency revenue recognition – price comparison website

Price Comparison Site provides a service to various travel companies (e.g. airlines, hotels, car rental companies) by presenting site users with comparative prices for travel services meeting specified search criteria and arranging for the site users' bookings with the travel companies.

Price Comparison Site has agency contracts with the travel companies to provide them with bookings and does not enter into contracts with the end consumers. It receives a completion-based referral fee from the travel companies when an end consumer ultimately uses the travel service and does not receive a payment if the end consumer subsequently cancels the reservation after booking.

Scenario 1: Nature of the promise is to deliver a booking to Hotel A

Price Comparison Site has a contractual relationship with Hotel A under which it advertises Hotel A's pricing and availability on its website. Hotel A enters into this arrangement because it knows Price Comparison Site attracts a large number of visitors looking to obtain hotel reservations, and therefore Price Comparison Site will help Hotel A obtain a higher level of occupancy.

Because Price Comparison Site has a contractual arrangement with Hotel A, and does not enter into similar arrangements with end consumers, Price Comparison Site generally views Hotel A as its customer (i.e. rather than the end consumer). In evaluating the nature of the promise in its contract with Hotel A, Price Comparison Site determines its promise is to deliver a booking to Hotel A for the following reasons.

— When a site user wishes to make a reservation at Hotel A, Price Comparison Site directs the site user to Hotel A's website to finalize the booking.

— Any subsequent changes to a booking (e.g. cancellations, changes in dates, upgrades) are handled by Hotel A directly.

— Hotel A takes on responsibility for all subsequent interactions with the end consumer after booking.

— Despite the nature of the fee arrangement, Price Comparison Site has no further obligations to Hotel A or the end consumer after booking.

Based on the nature of its promise in the contract with Hotel A, Price Comparison Site determines that its performance obligation is complete upon booking and records revenue at that time. The potential for cancellations results in the fee being variable, so the revenue is estimated using the guidance on variable consideration, including the constraint (see section 5.3.40).

Scenario 2: Nature of the promise is to deliver a paying customer

Consistent with Scenario 1, Price Comparison Site has a contractual relationship with Hotel B under which it advertises Hotel B's pricing and availability on its website. However, the following factors differ from Scenario 1.

- When an end consumer wishes to make a reservation at Hotel B, the end consumer can secure the booking on Price Comparison Site's website (rather than being automatically directed to Hotel B's website).
- Price Comparison Site collects and processes payment information from the end consumer and subsequently remits payment to Hotel B.
- Price Comparison Site often handles subsequent changes to a booking (e.g. cancellations, changes in dates, upgrades) on behalf of Hotel B.
- Price Comparison Site provides customer service (e.g. provides a booking confirmation, answers end consumer phone calls) through the date of the stay.

In evaluating the nature of the promise in its contract with Hotel B, Price Comparison Site determines the nature of its promise is to deliver a paying customer to Hotel B, rather than merely providing a booking (as in Scenario 1). Price Comparison Site retains a substantive obligation to provide customer service to prospective Hotel B customers until the date of their stay at Hotel B to help ensure Hotel B obtains a customer who ultimately pays for a hotel stay.

Based on the nature of its promise in the contract with Hotel B, Price Comparison Site determines that its performance obligation (which includes activities performed on behalf of Hotel B through the date of stay) is not complete until the end consumer ultimately stays at the hotel. Therefore, it records revenue when the end consumer stays at the hotel rather than on the booking date.

Question 9.6.20

Can an entity apply the shipping and handling practical expedient when it is the agent for a specified good but is the principal for shipping the specified good?

Interpretive response: Yes. When an entity is the agent for a specified good, but principal for shipping and handling of that good *after* the end customer obtains control of the goods, we believe an agent may elect the practical expedient to account for shipping and handling as fulfillment activities, rather than as an additional performance obligation. Conversely, that entity may elect to treat shipping and handling as a separate performance obligation– i.e. separate from the agency service. An entity's election of the practical expedient is an accounting policy election that requires consistent application and disclosure. [606-10-25-18B]

Consistent with the response to Question 4.2.150, we believe the shipping and handling expedient may be elected by an entity regardless of whether it or a third party performs the shipping and handling services.

See section 4.2.60 for additional discussion of the shipping and handling practical expedient.

Example 9.6.20
Timing of agency revenue recognition – hardware and software reseller

Scenario 1: Same facts as Example 9.3.15

Assume the same facts as Example 9.3.15, where ABC Corp. is a leading provider of end-to-end IT security solutions and aims to operate as a specialist extension of its customers by having its experts match the customer's needs to available solutions.

In Example 9.3.15, ABC concluded that it was an agent for sales of drop shipped hardware and third-party software licenses. In this example, ABC now considers *when* it satisfies its agency performance obligation.

The following facts are relevant.

- ABC helps companies evaluate available technologies and determine which combination of technology solutions will best meet the company's specific needs. The company can approve or reject ABC's advice. If the company agrees with ABC's recommendations, it places a binding, non-cancellable purchase order with ABC for the recommended hardware and software. ABC then places a binding, non-cancellable sales order with the applicable third-party vendor(s).
- ABC provides substantive customer service to the purchasing companies after the purchase order (between ABC and the company) and the sales order (between ABC and the vendor) are confirmed. ABC monitors and communicates shipping status, ensures shipments are made timely and continues to serve as the focal point for questions from the companies through delivery.
- ABC typically provides shipping information (e.g. tracking numbers) to the purchasing companies once the goods have shipped from the vendor's location.
- Control of the hardware transfers to the purchaser at the vendor's location when it ships.
- Control of the software licenses transfers to the purchasing company when the copy of the licensed software and the access key are delivered electronically to the customer (provided the software license term commences concurrently).

In general, ABC identifies the purchasing company as the customer in its agency arrangements. Although ABC has contractual relationships with the third-party vendor partners that supply the hardware and the software licenses, in general, ABC believes the nature of its promise to customers is, in effect, acting as a specialist extension of the *purchasing company's* IT department, helping the purchasing company meet its IT needs in a cost-effective manner.

This is based on the fact that ABC continues to assist its customers even after binding purchase and sales orders are processed (and its customers would generally expect that). ABC monitors and communicates shipping status, ensuring shipments are made timely, and continues to serve as the focal point for questions from the companies up through delivery.

Based on the nature of its promise to its customers, ABC concludes that its performance obligation to arrange for the provision of a specified piece of hardware or a specified software license is satisfied at the point in time control of the specified drop shipped hardware or software license is transferred to the customer. Up until that point in time, ABC continues to perform substantive activities that are an integral part of its agency service. After the goods are shipped from the vendor's location or the copy of the software and license key are provided to the customer, at which point control of the specified good transfers to the customer, the customer has independent access to delivery information during the relatively short shipping period. And once delivered, the warranties on the hardware and the software exist between the customer and the vendor.

Note: If ABC has multiple agency performance obligations to the same customer (e.g. to obtain multiple pieces of hardware and multiple software licenses) that are not satisfied at the same point in time, it allocates the agency fee among these performance obligations using the guidance in section 9.4.

Scenario 2: Entity selects the delivery agent

Assume the same facts as in Scenario 1, except that, in addition, ABC selects and contracts with the delivery agent that will deliver the hardware to the purchasing company, and incurs the shipping cost (for which it receives reimbursement from the purchasing company).

This additional fact does not change the conclusion reached in Scenario 1 about when ABC's agency performance obligation is satisfied or the basis for that conclusion.

However, ABC concludes that its provision (as principal) of the shipping services for the drop shipped hardware – i.e. its contracting with the delivery agent and incurring the cost of the delivery – is an additional performance obligation because these shipping services occur after transfer of control of the specified hardware to the customer. Consistent with Question 9.6.20, ABC has elected the practical expedient to not separately account for the shipping services. Consequently, ABC accrues the cost to ship the hardware at the point in time it recognizes its related agency fee.

10. Licensing of intellectual property

Detailed contents

Item has been moved in this edition: ●

Questions

10.11.05	Can the royalty exception apply to a portion of a royalty?
10.11.10	Does the royalty exception apply if no single license is predominant?
10.11.20	Can the royalty exception apply when a license is not distinct from other goods or services?
10.11.25	Does the royalty exception apply for an agent if revenue is based on royalties from the customer's license of IP?
10.11.30	Is a promise to provide future updates, upgrades and enhancements a license of IP for purposes of the royalty exception?
10.11.40	How does an entity distinguish between an option to acquire an additional license and a usage-based royalty?
10.11.45	How does an entity account for additional fees identified through an audit of customer usage?
10.11.50	Is a milestone payment subject to the royalty exception?
10.11.55	Is a milestone payment for the license of IP that is based solely on the first commercial sale subject to the royalty exception?
10.11.60	Is a minimum guaranteed royalty subject to the royalty exception?
10.11.65	Can an entity apply the royalty exception when the royalty is calculated on a financial metric other than sales?
10.11.68	Does the royalty exception apply in a license and supply agreement when the fees are based on the cost of the products transferred plus a sales-based royalty?
10.11.70	Is it acceptable to recognize revenue from sales- or usage-based royalties on a lag basis?
10.11.80	In a right-to-use license, does a declining royalty rate that applies retrospectively preclude the recognition of royalties as the customer's sales or usage occurs?
10.11.90	In a right-to-use license, does a royalty rate that declines on a prospective basis affect how the royalty is recognized?
10.11.100	In an increasing royalty rate scenario for a right-to-use license, should the entity recognize revenue at the expected 'blended' rate?
10.11.110	When is a guaranteed minimum royalty promised in exchange for a license to functional IP recognized?
10.11.120	Under the royalty exception, how does an entity allocate and recognize revenue from a sales- or usage-based royalty between a right-to-use license and a performance obligation satisfied over time?

Examples

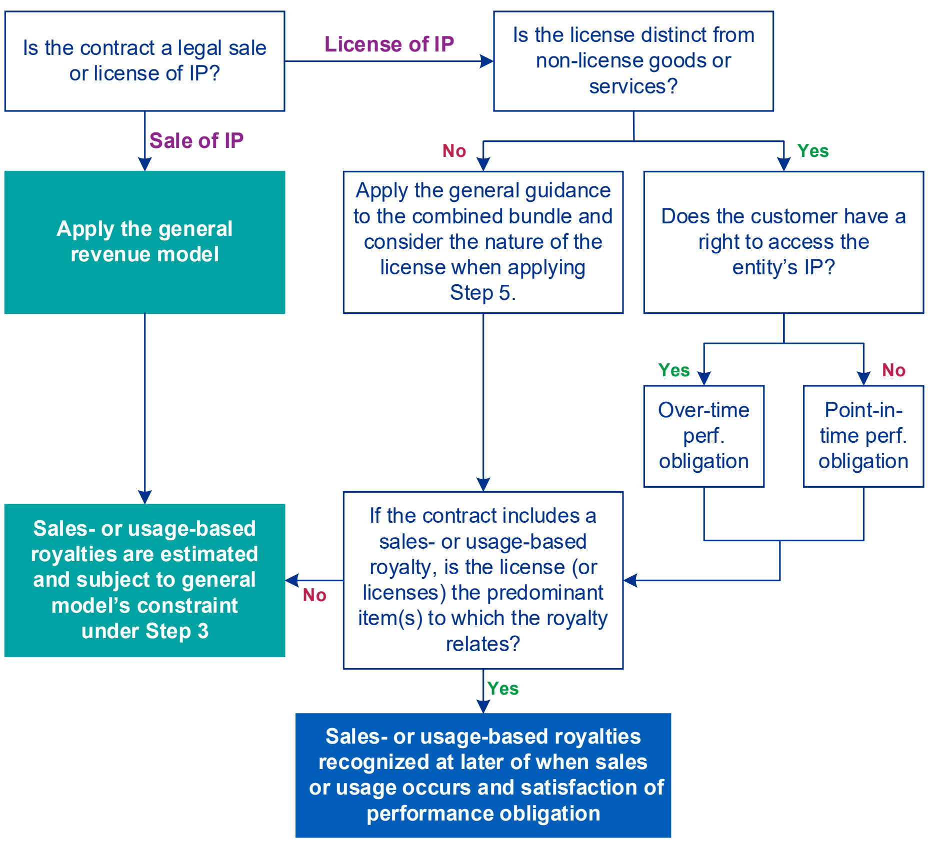
10.1 How the standard works

A license of IP establishes a customer's rights to that IP and the licensor's obligations to provide those rights. Licenses of IP can vary significantly and include a wide array of features and economic characteristics.

How a licensor recognizes revenue from a licensing transaction depends on the nature of the license. Some licenses provide the customer the ability to control the IP at a point in time (right-to-use licenses), and some licenses provide access to the IP over the term of the license (right-to-access licenses). It would be difficult to assess the nature of the different types of licenses under the general revenue model. Therefore, Topic 606 provides implementation guidance specific to the recognition of revenue attributable to a distinct license of IP.

Before assessing the nature of a license, an entity determines whether a transaction actually contains a license and whether it is distinct from the other goods or services promised in the contract. Then it assesses the nature of a distinct license to determine whether to recognize revenue allocated to the license at a point in time or over time. The licensing guidance also contains an exception to the general revenue model for sales- or usage-based royalties on a license of IP when the license is the sole or predominant item to which the royalty relates.

The following decision tree summarizes how Topic 606 applies to licenses of IP.



See KPMG Handbook, Revenue for software and SaaS, for more detailed discussion and analysis of software licensing arrangements.

10.2 Scope of licensing guidance

Excerpt from ASC 606-10

• > Licensing

55-54 A license establishes a customer's rights to the intellectual property of an entity. Licenses of intellectual property may include, but are not limited to, licenses of any of the following:

a. Software (other than software subject to a hosting arrangement that does not meet the criteria in paragraph 985-20-15-5) and technology
b. Motion pictures, music, and other forms of media and entertainment
c. Franchises
d. Patents, trademarks, and copyrights.

10.2.10 Overview

The licensing guidance discussed in this chapter applies only to a license of IP. Examples of IP include: [606-10-55-54]

— software and technology;
— franchises;
— patents, trademarks and copyrights;
— movies, music and video games; and
— scientific compounds.

The term 'intellectual property' is not defined in Topic 606, or elsewhere in US GAAP. In some cases, it will be clear that an arrangement includes a license of IP – e.g. a trademark. In other cases, such as when content is being made available to a customer over the internet, it may be less clear and the accounting may be different depending on that determination. Therefore, an entity needs to apply judgment to determine whether the guidance on licenses applies to an arrangement.

Even if a contract states that a license is part of the arrangement, the nature of the promise to the customer may be that of providing a service. The licensing guidance requires entities to apply specific criteria to distinguish when a contract includes a software license or the entity is providing software-as-a-service (SaaS). If the criteria are not met, a software license does not exist for accounting purposes and the licensing guidance does *not* apply. Although the guidance on distinguishing between a software license and SaaS is directly related to licenses of software, other entities may find this guidance useful in determining whether an arrangement contains a license of IP for accounting purposes (see Question 10.2.30). [606-10-55-54, 985-20-15-5]

The licensing guidance does not apply to the sale of IP. Therefore, the scope also depends on the legal distinction of a sale or a license of IP. If a transaction is a legal sale of IP, then it is subject to Topic 606's general model in the same way as the sale of any good or other nonfinancial asset. If the transaction is legally a license of IP (and not a service), then the licensing guidance is applicable. The licensing guidance applies even if the license could be seen as an in-substance sale of IP – e.g. a license that transfers control to all of the worldwide rights on an exclusive basis in perpetuity for all possible IP applications. The form of the arrangement dictates whether the licensing guidance in Topic 606 is applicable. [ASU 2016-10.BC78(b)]

Question 10.2.10

Does the licensing guidance apply to IP embedded in a tangible product subject to the first-sale doctrine?

Interpretive response: Generally, no. IP may be included in tangible products such as DVDs, hard-copy books or CDs. The first-sale doctrine, which exists in US copyright law, provides that an individual who purchases a copyrighted work from the copyright holder is the owner of that individual copy and receives the right to sell or lease that particular copy.

Generally, when IP is embedded in the tangible product, the licensing guidance does not apply to the sale of goods subject to the first-sale doctrine. Instead, an entity applies the general guidance in Topic 606 to determine the transaction price and when control of the goods transfers to the customer. For transactions in jurisdictions other than the United States, entities should consider whether laws and concepts similar to the first-sale doctrine apply.

Question 10.2.20

Does the licensing guidance apply to a license of IP that is not an output of the entity's ordinary activities?

Interpretive response: No, however, we believe it should be applied by analogy. Topic 606 applies only to contracts with customers for goods or services that are an output of the entity's ordinary activities. When an entity's ordinary activities do not involve licensing IP, the contract is not in the scope of Topic 606. For example, a pharmaceutical company, whose ordinary activities are the sale of commercialized drugs, may license rights to a drug compound that it decides not to develop. This arrangement may not be an output of the entity's ordinary activities. Those transactions are typically recorded as other income or loss rather than revenue from customers. [606-10-15-3, 610-20-05-1]

Subtopic 610-20 requires entities to apply revenue recognition principles to certain non-revenue transactions. However, that guidance applies only to gains and losses on the derecognition of nonfinancial assets. As a result, an IP licensing transaction with a noncustomer is not directly in the scope of Subtopic 610-20 because the entity is not derecognizing the IP – i.e. the entity is licensing rights to the IP rather than transferring the asset itself. As a result, there is no clear guidance on how to account for licenses of IP that are not a part of the entity's ordinary activities. [610-20-15-2]

We believe that in the absence of other guidance, an entity should apply the licensing guidance in Topic 606 by analogy to determine the recognition and measurement of consideration in the transactions that are not an output of the entity's ordinary activities. That is because there is no economic difference between licensing transactions that are a part of the entity's ordinary activities and those that are not. This is consistent with the FASB's views when creating Subtopic 610-20 to require that the recognition and measurement guidance in Topic 606 apply to transfers of nonfinancial assets in nonrevenue transactions. For example, the FASB noted that there is little economic difference between sales of real estate that are an output of an entity's ordinary activities and sales of real estate that are not. However, when the real estate is not an output of an entity's ordinary activities, it is presented as a gain or other revenue rather than revenue from customers. [ASU 2014-09.BC497 – BC498]

Question 10.2.30

How does an entity distinguish between a license and service?

Interpretive response: Even if a contract states that a license is part of the arrangement, the nature of the promise to the customer may be that of providing a service. Topic 606 requires entities to apply specific criteria in Subtopic 985-20 to distinguish when a contract includes a software license or the entity is providing software-as-a-service (SaaS). If the criteria are met, a license exists for accounting purposes and the licensing guidance applies. However, if the criteria are not met an entity cannot apply the licensing guidance. [606-10-55-54)]

While this guidance is directly related to licenses of software, we believe the criteria could also be helpful in evaluating whether an entity is transferring other types of licenses (e.g. media content) to a customer.

The criteria are: [985-20-15-5]

a. the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty; and

b. it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the entity to host the software.

With respect to criterion (a), the notion of 'without significant penalty' includes two concepts: [985-20-15-6]

— the ability of the customer to take delivery of the software without incurring significant costs; and

— the ability of the customer to use the software separately – i.e. on the customer's own hardware or that of a third party – without a significant diminution in utility or value of the software.

Criterion (b) is met if either: [985-20-15-5]

— the customer has the IT infrastructure to host the software or is readily able to obtain such IT infrastructure – e.g. the customer can obtain the necessary hardware, and potentially services, from a third party; or

— there are unrelated, third-party hosting services readily available to the customer.

See chapter A of KPMG Handbook, Revenue for software and SaaS, for more detailed discussion and analysis of when hosting arrangements grant a software license.

Example 10.2.10
Music subscription service

Streaming Service provides a streaming music service to consumers. Streaming Service enters into a one-year contract that grants Customer a license to access the music content via the internet on Customer's personal devices. However, Customer does not have the ability to take delivery of the music content during the contract term and it can only listen to the music through the internet.

Streaming Service evaluates whether it is providing Customer with a service or a license to its content and considers the criteria in Subtopic 985-20 (Question 10.2.30) by analogy. Streaming Service concludes that the contract does not include a license because Customer does not have the ability to take delivery of the music during the contract term and use it without accessing Streaming Service's site. As a result, the licensing guidance does not apply. [985-20-15-5]

Example 10.2.20
License to music library

Production Company produces music content. Production Company enters into a three-year license agreement to provide an initial music library and rights to future content to Customer (which provides a streaming music service to end consumers). The terms of the license allow Customer to play, stream and broadcast the content to other parties.

Production Company evaluates whether it is providing Customer with a service or a license to its content, and considers the criteria in Subtopic 985-20 (Question 10.2.30) by analogy. Production Company concludes that the contract includes a license of IP because Customer takes delivery of the music library that it can use without further services from Production Company. [985-20-15-5]

As a result, the licensing guidance applies and Production Company needs to evaluate whether the license is distinct from the rights to future content.

10.3 Identify distinct licenses

10.3.10 Overview

Just like promises for other goods or services, a license is a performance obligation in a contract if it is distinct. In order to identify the performance obligations, at contract inception an entity needs to determine:

- the number of licenses in the contract; and
- whether each license in the contract is distinct from the other goods or services.

10.4 Identify the number of licenses

Excerpt from ASC 606-10

• • > Other Licensing Considerations

55-64 Contractual provisions that explicitly or implicitly require an entity to transfer control of additional goods or services to a customer (for example, by requiring the entity to transfer control of additional rights to use or rights to access intellectual property that the customer does not already control) should be distinguished from contractual provisions that explicitly or implicitly define the attributes of a single promised license (for example, restrictions of time, geographical region, or use). Attributes of a promised license define the scope of a customer's right to use or right to access the entity's intellectual property and, therefore, do not define whether the entity satisfies its performance obligation at a point in time or over time and do not create an obligation for the entity to transfer any additional rights to use or access its intellectual property.

55-64A Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorized use do not affect whether a license provides a right to access the entity's intellectual property or a right to use the entity's intellectual property. Similarly, a promise to defend a patent right is not a promised good or service because it provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract.

• • > Example 61A—Right to Use Intellectual Property

55-399A An entity, a television production company, licenses all of the existing episodes of a television show (which consists of the first four seasons) to a customer. The show is presently in its fifth season, and the television production company is producing episodes for that fifth season at the time the contract is entered into, as well as promoting the show to attract further viewership. The Season 5 episodes in production are still subject to change before airing.

• • • > Case A—License Is the Only Promise in the Contract

55-399B The customer obtains the right to broadcast the existing episodes, in sequential order, for a period of two years. The show has been successful through the first four seasons, and the customer is both aware that Season 5 already is in production and aware of the entity's continued promotion of the show. The customer will make fixed monthly payments of an equal amount throughout the two-year license period.

55-399C The entity assesses the goods and services promised to the customer. The entity's activities to produce Season 5 and its continued promotion of the show do not transfer a promised good or service to the customer. Therefore, the entity concludes that there are no other promised goods or services in the contract other than the license to broadcast the existing episodes in the television series. The contractual requirement to broadcast the episodes in sequential order is an attribute of the license (that is, a restriction on how the customer may use the license); therefore, the only performance obligation in this contract is the single license to the completed Seasons 1–4.

55-399D To determine whether the promised license provides the customer with a right to use its intellectual property or a right to access its intellectual property, the entity evaluates the intellectual property that is the subject of the license. The existing episodes have substantial standalone functionality at the point in time they are transferred to the customer because the episodes can be aired, in the form transferred, without any further participation by the entity. Therefore, the customer can derive substantial benefit from the completed episodes, which have significant utility to the customer without any further activities of the entity. The entity further observes that the existing episodes are complete and not subject to change. Thus, there is no expectation that the functionality of the intellectual property to which the customer has rights will change (that is, the criteria in paragraph 606-10-55-62 are not met). Therefore, the entity concludes that the license provides the customer with a right to use its functional intellectual property.

55-399E Consequently, in accordance with paragraph 606-10-55-58B, the license is a performance obligation satisfied at a point in time. In accordance with paragraphs 606-10-55-58B through 55-58C, the entity recognizes revenue for the license on the date that the customer is first permitted to air the licensed content, assuming the content is made available to the customer on or before that date. The date the customer is first permitted to air the licensed content is the beginning of the period during which the customer is able to use and benefit from its right to use the intellectual property. Because of the length of time between the entity's performance (at the beginning of the period) and the customer's annual payments over two years (which are noncancellable), the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

• • • > Case B—Contract Includes Two Promises

55-399F Consistent with Case A, the contract provides the customer with the right to broadcast the existing episodes, in sequential order, over a period of two years. The contract also grants the customer the right to broadcast the episodes being produced for Season 5 once all of those episodes are completed.

55-399G The entity assesses the goods and services promised to the customer. The entity concludes that there are two promised goods or services in the contract:

a. The license to the existing episodes (see paragraph 606-10-55-399C)
b. The license to the episodes comprising Season 5, when all of those episodes are completed.

55-399H The entity then evaluates whether the license to the existing content is distinct from the license to the Season 5 episodes when they are completed. The entity concludes that the two licenses are distinct from each other and, therefore, separate performance obligations. This conclusion is based on the following analysis:

a. Each license is capable of being distinct because the customer can benefit from its right to air the existing completed episodes on their own and can benefit from the right to air the episodes comprising Season 5, when they are all completed, on their own and together with the right to air the existing completed content.
b. Each of the two promises to transfer a license in the contract also is separately identifiable; they do not, together, constitute a single overall promise to the customer. The existing episodes do not modify or customize the Season 5 episodes in production, and the existing episodes do not, together with the pending Season 5 episodes, result in a combined functionality or changed content. The right to air the existing content and the right to air the Season 5 content, when available, are not highly interdependent or highly interrelated because the entity's ability to fulfill its promise to transfer either license is unaffected by its promise to transfer the other. In addition, whether the customer or another licensee had rights to air the future episodes would not be expected to significantly affect the customer's license to air the existing, completed episodes (for example, viewers' desire to watch existing episodes from Seasons 1–4 on the customer's network generally would not be significantly affected by whether the customer, or another network, had the right to broadcast the episodes that will comprise Season 5).

55-399I The entity assesses the nature of the two separate performance obligations (that is, the license to the existing, completed episodes of the series and the license to episodes that will comprise Season 5 when completed). To determine whether the licenses provide the customer with rights to use the entity's intellectual property or rights to access the entity's intellectual property, the entity considers the following:

a. The licensed intellectual property (that is, the completed episodes in Seasons 1–4 and the episodes in Season 5, when completed) has significant standalone functionality separate from the entity's ongoing business activities, such as in producing additional intellectual property (for example, future seasons) or in promoting the show, and completed episodes can be aired without the entity's further involvement.
b. There is no expectation that the entity will substantively change any of the content once it is made available to the customer for broadcast (that is, the criteria in paragraph 606-10-55-62 are not met).
c. The activities expected to be undertaken by the entity to produce Season 5 and transfer the right to air those episodes constitute an additional promised good (license) in the contract and, therefore, do not affect the nature of the entity's promise in granting the license to Seasons 1–4.

55-399J Therefore, the entity concludes that both the license to the existing episodes in the series and the license to the episodes that will comprise Season 5 provide the customer with the right to use its functional intellectual property as it exists at the point in time the license is granted. As a result, the entity recognizes the portion of the transaction price allocated to each license at a point in time in accordance with paragraphs 606-10-55-58B through 55-58C. That is, the entity recognizes the revenue attributable to each license on the date that the customer is first permitted to first air the content included in each performance obligation. That date is the beginning of the period during which the customer is able to use and benefit from its right to use the licensed intellectual property.

• • > Example 61B—Distinguishing Multiple Licenses from Attributes of a Single License

55-399K On December 15, 20X0, an entity enters into a contract with a customer that permits the customer to embed the entity's functional intellectual property in two classes of the customer's consumer products (Class 1 and Class 2) for five years beginning on January 1, 20X1. During the first year of the license period, the customer is permitted to embed the entity's intellectual property only in Class 1. Beginning in Year 2 (that is, beginning on January 1, 20X2), the customer is permitted to embed the entity's intellectual property in Class 2. There is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period. There are no other promised goods or services in the contract. The entity provides (or otherwise makes available—for example, makes available for download) a copy of the intellectual property to the customer on December 20, 20X0.

55-399L In identifying the goods and services promised to the customer in the contract (in accordance with guidance in paragraphs 606-10-25-14 through 25-18), the entity considers whether the contract grants the customer a single promise, for which an attribute of the promised license is that during Year 1 of the contract the customer is restricted from embedding the intellectual property in the Class 2 consumer products), or two promises (that is, a license for a right to embed the entity's intellectual property in Class 1 for a five-year period beginning on January 1, 20X1, and a right to embed the entity's intellectual property in Class 2 for a four-year period beginning on January 1, 20X2).

55-399M In making this assessment, the entity determines that the provision in the contract stipulating that the right for the customer to embed the entity's intellectual property in Class 2 only commences one year after the right for the customer to embed the entity's intellectual property in Class 1 means that after the customer can begin to use and benefit from its right to embed the entity's intellectual property in Class 1 on January 1, 20X1, the entity must still fulfill a second promise to transfer an additional right to use the licensed intellectual property (that is, the entity must still fulfill its promise to grant the customer the right to embed the entity's intellectual property in Class 2). The entity does not transfer control of the right to embed the entity's intellectual property in Class 2 before the customer can begin to use and benefit from that right on January 1, 20X2.

55-399N The entity then concludes that the first promise (the right to embed the entity's intellectual property in Class 1) and the second promise (the right to embed the entity's intellectual property in Class 2) are distinct from each other. The customer can benefit from each right on its own and independently of the other. Therefore, each right is capable of being distinct in accordance with paragraph 606-10-25-19(a)). In addition, the entity concludes that the promise to transfer each license is separately identifiable (that is, each right meets the criterion in paragraph 606-10-25-19(b)) on the basis of an evaluation of the principle and the factors in paragraph 606-10-25-21. The entity concludes that it is not providing any integration service with respect to the two rights (that is, the two rights are not inputs to a combined output with functionality that is different from the functionality provided by the licenses independently), neither right significantly modifies or customizes the other, and the entity can fulfill its promise to transfer each right to the customer independently of the other (that is, the entity could transfer either right to the customer without transferring the other). In addition, neither the Class 1 license nor the Class 2 license is integral to the customer's ability to use or benefit from the other.

55-399O Because each right is distinct, they constitute separate performance obligations. On the basis of the nature of the licensed intellectual property and the fact that there is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period, each promise to transfer one of the two licenses in this contract provides the customer with a right to use the entity's intellectual property and the entity's promise to transfer each license is, therefore, satisfied at a point in time. The entity determines at what point in time to recognize the revenue allocable to each performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Because a customer does not control a license until it can begin to use and benefit from the rights conveyed, the entity recognizes revenue allocated to the Class 1 license no earlier than January 1, 20X1, and the revenue on the Class 2 license no earlier than January 1, 20X2.

10.4.10 Overview

A license is, by its nature, a bundle of rights conveyed to a customer. Some contractual provisions define the attributes of a license (e.g. restrictions on time, geography or use) that outline the customer's right to use or right to access the entity's IP. However, other contractual provisions require an entity to transfer control of additional goods or services. An entity needs to distinguish between contractual provisions that are attributes of a license and those that require it to transfer control of additional licenses. [606-10-55-64]

A contractual provision that requires the entity to transfer additional rights to use or access IP that the customer does not already control generally describes an additional promise for the entity to fulfill. However, when the entity does not have any additional promises to fulfill, the contractual provisions are generally attributes of a license. [606-10-55-64]

However, an entity does not need to identify the number of licenses it transferred to a customer if the distinct set of rights in a license are coterminous and transfer at the same point in time or over the same period of time. For example, if the customer in Example 61B in Topic 606 (reproduced above) was able to use and benefit from the two sets of distinct rights on January 1, 20X1, the licensor would not be precluded from accounting for the two sets of rights as a single performance obligation. [ASU 2016-10.BC47]

Question 10.4.10

Do restrictions on the time, geography or use affect the number of licenses provided?

Interpretive response: It depends. A restriction on time, geography or use generally is an attribute of a license. For example, a license may be perpetual, for a stated period less than the economic life of the IP, for use only within a specified geography and/or only permit specified uses.

However, in some cases the restriction is substantively a promise to transfer additional rights at a later point in time. This might be the case when a contract conveys initials rights (i.e. an initial license) to a customer with a restriction that results in additional rights being conveyed at a future date. That is because:

- a license is the contractual right to use or access IP and not the IP itself; and
- the FASB decided that a customer obtains control of a license only when it can use and benefit from the license, which occurs no earlier than the beginning of the time period it can use those rights.

As a consequence, a customer does not control a right when a restriction prevents the customer from being able to use and benefit from that right until a future point in time. This is the case even if the entity has transferred a copy of the IP. Therefore, for accounting purposes that type of restriction indicates the entity still has an obligation to transfer control of those rights to the customer in the future.

For example, in Example 61B in Topic 606 (reproduced above), the contractual restriction on embedding the licensed IP in the Class 2 products until January 1, 20X2 means that the customer does not control the rights to use the license in Class 2 products until it can begin to use and benefit from the rights conveyed. As a result, the entity must still fulfill a second promise (e.g. transfer control of the additional right) to embed the licensed IP in Class 2.

In some cases, a substantial break in time between periods that a customer is able to use (or access) IP suggests that those two separate periods represent separate licenses, even if the rights conveyed during each period are the same. This scenario arises principally in the media industry and is often referred to as a 'broken windows' scenario. The facts and circumstances need to be considered when deciding whether broken windows should be accounted for as a single license or multiple licenses. [ASU 2016-10.BC45]

Example 10.4.10
Subsequently accruing rights to IP

On January 1, Year 1, Film Studio enters into a three-year contract with Broadcaster granting Broadcaster the exclusive right to air Movie in the United States and Canada during the term of the contract.

However, because of an overlapping contract with a Canadian competitor, the rights to air Movie in Canada do not begin until July 1, Year 1 – i.e. there is a six-month hold-back period for the Canadian rights. Film Studio provides a copy of Movie to Broadcaster immediately, and Broadcaster has the right to air Movie in the United States immediately.

Film Studio considers whether the contract grants Broadcaster a single license, subject to a use restriction, or two licenses. It concludes that the provision in the contract preventing Broadcaster from airing Movie in Canada for the first six months of the contract term requires Film Studio to transfer additional rights on July 1, Year 1 that Broadcaster does not control; this is because it cannot use and benefit from those rights in Canada before that date.

Therefore, Film Studio concludes that the contract includes two promised licenses.

Example 10.4.20
Attributes of a promised license

Assume the same facts as Example 10.4.10, except that the rights to air Movie in the United States and Canada both commence on January 1, Year 1. However, the terms of Broadcaster's rights to air Movie extend only to eight broadcasts of Movie in each territory during the three years and, as part of the contract, Broadcaster agrees not to air certain types of advertisements during the movie.

The term of the license (three years), the geographical scope of the license (Broadcaster's US and Canadian networks only) and the usage limitations (limited to eight showings per territory and restrictions on advertisements during airings) define the scope of Broadcaster's rights. None of these provisions requires Film Studio to transfer additional rights to use or access IP after January 1, Year 1, which is when Broadcaster can begin to use and benefit from the rights conveyed by the contract. Therefore, Film Studio concludes that the contract is for a single license.

Question 10.4.20
When does a promise to transfer multiple copies of licensed IP constitute a promise to transfer multiple licenses?

Interpretive response: In general, we believe that a promise to transfer multiple copies (whether characterized as users, seats or similar) of IP constitutes a promise to transfer multiple licenses if the customer's ability to make use of (or derive benefit from) the licensed IP varies in proportion to the number of copies transferred.

The guidance in Topic 606 on what constitutes a promise does not mention payment provisions in the contract. Nevertheless, a further strong indicator of a multiple license arrangement is when the consideration in the contract is proportional to the number of copies transferred, and is due and payable when the additional copies are transferred to the customer.

In other cases, a promise to transfer multiple copies may not be a promise to transfer multiple licenses – e.g. if the customer's ability to make use of (or derive benefit from) the IP does not vary in proportion to the number of copies transferred.

Question 10.4.30

How does an entity account for a promise to transfer additional copies of licensed IP if they are not considered multiple licenses?

Interpretive response: If a promise by the entity to transfer multiple copies of the licensed IP is *not* a promise to transfer multiple licenses, the entity then considers whether that promise to provide copies of the licensed IP either:

1. represents the service of producing and delivering additional copies of the licensed IP; or
2. is solely a fulfillment activity that does not transfer any additional good or service to the customer – i.e. the activity does not provide any substantive incremental benefit to the customer.

We believe that a promise to provide additional copies of licensed IP falls into category (2) only if both:

- the customer could make the additional copies without the entity's participation – i.e. suggesting that the production and delivery of additional copies is effectively a convenience to the customer; and
- the costs to produce and deliver the additional copies is largely nominal. A greater cost would suggest that the entity's promise to transfer the additional copies provides a service to the customer.

If either of these criteria is not met, we believe that the promise to provide additional copies of the licensed IP is providing a service to the customer – i.e. it falls into category (1).

There may be circumstances in which the entity concludes that a promised service of producing and delivering additional copies is immaterial in the context of the contract. This determination involves consideration of both quantitative and qualitative factors. Consequently, a promised service of providing additional copies may not be immaterial in the context of the contract, even if the cost of producing the additional copies is nominal. This will depend on the importance to the customer of those additional copies and the customer's ability to produce the copies itself. The customer's need for those copies to make effective use of the IP and the customer's inability to produce those copies itself may suggest that the entity's promised service to provide those copies is not qualitatively immaterial in the context of the contract. [606-10-25-16A]

10.5 Determine whether a license is distinct

Excerpt from ASC 606-10

• > Licensing

55-55 In addition to a promise to grant a license (or licenses) to a customer, an entity may also promise to transfer other goods or services to the customer. Those promises may be explicitly stated in the contract or implied by an entity's customary business practices, published policies, or specific statements (see paragraph 606-10-25-16). As with other types of contracts, when a contract with a customer includes a promise to grant a license (or licenses) in addition to other promised goods or services, an entity applies paragraphs 606-10-25-14 through 25-22 to identify each of the performance obligations in the contract.

55-56 If the promise to grant a license is not distinct from other promised goods or services in the contract in accordance with paragraphs 606-10-25-18 through 25-22, an entity should account for the promise to grant a license and those other promised goods or services together as a single performance obligation. Examples of licenses that are not distinct from other goods or services promised in the contract include the following:

a. A license that forms a component of a tangible good and that is integral to the functionality of the good
b. A license that the customer can benefit from only in conjunction with a related service (such as an online service provided by the entity that enables, by granting a license, the customer to access content).

10.5.10 Overview

After an entity identifies the IP licenses in a contract, it determines whether each license is distinct from other goods and services in the contract and therefore is a separate performance obligation. Consistent with other contracts, an entity applies Step 2 of the revenue model (see section 4.3) to make this determination. Specifically, it uses the 'distinct' criteria in Step 2 to identify each of the performance obligations in a contract that includes a promise to grant a license in addition to other promised goods or services. [606-10-55-55]

When applying the 'distinct' criteria, an entity assesses whether the: [606-10-25-19]

— customer can benefit from the license on its own or together with other resources that are readily available – i.e. whether the license is capable of being distinct; and

— license is separately identifiable from other goods or services in the context of the contract – i.e. whether the license is distinct within the context of the contract.

Topic 606 provides two examples of licenses that are typically not distinct. [606-10-55-56]

Type of license	Example
1. License that forms a component of a tangible good and is integral to the functionality of the good	– Software embedded in the operating system of a car
2. License from which the customer can benefit only in conjunction with a related service	– Drug compound that requires proprietary R&D services from the entity

The first example refers to a situation in which license and hardware components are inputs to a combined output (i.e. are not distinct in the context of the contract). An entity needs to evaluate the facts and circumstances of each contract to determine if a license is integral to the functionality of the good; see Question 10.5.10 for further considerations. [ASU 2014-09.BC406(a)]

The second example refers to a situation in which the customer does not take control of the license and therefore cannot benefit from (or use) the license on its own without the service. However, an entity needs to apply the Step 2 model to each contract to determine if the license is distinct from a related service. [ASU 2014-09.BC406(b)]

Question 10.5.10

How does an entity evaluate whether a license is distinct from a tangible good?

Interpretive response: An entity applies the guidance in Step 2 of the model to evaluate whether the license and tangible good should each be a separate performance obligation. Under this guidance, when a license is integral to the functionality of a tangible good, the license is not distinct from the tangible good. [606-10-55-56(a)]

Topic 606 is anchored to the notion that what the entity should be evaluating is whether the software and the hardware elements of the tangible good are each inputs to a combined good. Therefore, we believe the key question in determining whether a license of IP is a component of a tangible good that is integral to the functionality of the good is whether the IP and the hardware components only *together* produce the essential functionality of the tangible good. Each element (IP and hardware) contributes substantively to the essential functionality of the tangible good.

If the license and tangible good together produce the essential functionality, the hardware element(s) cannot simply be a delivery mechanism for the IP. For example, a smartphone's operating system software and its hardware components work together to produce the smartphone's essential functionality. A customer would not purchase an operating system software license without a device for the software to operate, and would not purchase a smartphone without operating system software to perform the key functions that a smartphone is expected to perform.

In contrast, if the IP or the hardware provides or contributes to *additive* functionality rather than *essential* functionality, the license is not an integral component of the tangible good. Continuing the smartphone example, many smartphone software applications do not contribute to the smartphone's essential, combined functionality, even if the applications come installed on the smartphone at the time of customer purchase. They merely provide *added* functionality. In that case, the application is not an input to the smartphone – it is an additive feature.

In many situations, it may require significant judgment to determine what is essential versus additive functionality. In making this determination, it may be relevant to consider whether the tangible good is ever sold without the functionality and whether the functionality is optional to the customer. This might include not only the option to include that functionality in the tangible good but also the ability to remove that functionality – e.g. uninstall the related software.

The fact that IP included in the tangible good is also sold separately from the tangible good does not affect the assessment of whether the IP and hardware elements function together to deliver that tangible good's essential functionality. Nor does the fact that the hardware elements are sold as a tangible good either without the software element or with a different software element affect this determination – e.g. a different model of the tangible good may have different essential functionality.

If the software license is transferred to the customer at the same time as the tangible good as a whole, the question of whether the software license is distinct from the tangible good may not matter because both items are transferred concurrently and the same guidance applies. For the same reason, any question as to whether services in the contract are software-related may not matter.

Question 10.5.20

Are a license to software and post-contract customer support (PCS) separate performance obligations?

Interpretive response: It depends. Software licensing arrangements often include PCS, which includes the right to receive technical support services and/or unspecified upgrades and enhancements.

The software license and the PCS typically are both capable of being distinct. This is because the customer can benefit from the license on its own or with separately sold PCS (e.g. PCS provided on renewal) and can benefit from PCS together with the license transferred before the support services or upgrades/enhancements are provided.

The promises are also more commonly separately identifiable (i.e. distinct in the context of the contract), and therefore the software license and PCS are separate performance obligations, because:

— neither the license nor the support services significantly customize or modify the other – e.g. technical support services do not change or enhance the functionality of the software and upgrades generally do not significantly modify the software; and

— the entity is able to transfer the license and provide the support services and upgrades/enhancements independently of each other. For example, the entity is able to transfer the software license without ever providing support services or upgrades to the customer, and is also able to provide support services or upgrades to a customer that acquired its license to the software product from a third party, such as a reseller.

In these cases, it is generally clear that there is neither a significant integration service being performed by the software entity to create a combined item comprising the licensed software and the support services, nor any significant level of interrelationship or interdependence between the license and the support services. That the entity is only *later* (i.e. after license grant) transferring any updates, upgrades or enhancements produced provides further evidence that the entity is not providing a significant integration service.

In more limited fact patterns, a software license may not be distinct from a right to unspecified updates or upgrades/enhancements (or unspecified additional software products), when those updates are critical to the customer's ability to derive benefit and value from the license – e.g. in an anti-virus software scenario where subsequent updates and upgrades are critical to the promise to provide ongoing protection from existing and emerging threats. In those cases, the software license and the right to the unspecified items would be a single performance obligation.

The components of PCS – e.g. technical support and rights to unspecified updates or upgrades/enhancements – will also typically be distinct from each other, and therefore separate performance obligations. However, if they are provided over the same period and have the same pattern of transfer to the customer – e.g. if they are both stand-ready obligations satisfied ratably over the PCS period – an entity could account for both elements as if they were a single performance obligation.

For more detailed discussion and analysis , see Questions C150, C160 and C170 in KPMG Handbook, Revenue for software and SaaS.

Question 10.5.30

Does a license to a drug compound and research and development services constitute separate performance obligations?

Interpretive response: It depends. In arrangements to transfer a license to a drug compound and provide R&D services, both the license and R&D services are evaluated to determine whether they are distinct. To this end, an entity evaluates whether the license and services are:

- capable of being distinct; and
- distinct in the context of the contract – i.e. separately identifiable. [606-10-25-19]

Capable of being distinct

A license is generally capable of being distinct if: [606-10-25-19(a)]

- the customer can use, consume or sublicense the rights on their own; or
- the R&D services are a readily available resource that is sold separately by the entity or others.

In contrast, if the R&D services are proprietary and not considered a readily available resource, the license is only distinct if the customer can benefit from the license without the services. This is consistent with Example 56 Case A in Topic 606 (see the excerpt in section 10.6), in which a license to a drug compound was not distinct because the customer could not benefit from the license without the proprietary manufacturing services that only the entity can provide.

R&D services are generally capable of being distinct if: [606-10-25-19(a)]

- The entity sells the services on their own – i.e. without a related license. This indicates that customers can benefit from the services on their own and they are therefore capable of being distinct; or

- The customer can benefit from the services together with the license that has already been transferred to the customer. Readily available resources include goods or services that have already been transferred. If the license is transferred at the beginning of the contract, the services will typically be capable of being distinct.

As discussed in section 4.3.30, contractual restrictions do not affect the analysis.

Distinct in the context of the contract

In making this assessment, an entity applies judgment to specific facts to determine whether a license and services are separately identifiable. This evaluation includes a consideration of whether the IP and services have a transformative effect on each other such that they are inputs into a combined output (see section 4.3.40).

In making this determination, the key analysis is whether the R&D services significantly modify or customize the drug compound so that the IP is significantly different at the end of the arrangement as a result of the services. This may be more frequent in early stages of development when the formula is being developed or when the services are developing an existing technology for a significantly different use.

In some cases an entity may provide a significant integration service if the services integrate the licensed IP with the customer's IP to create a new combined functionality that neither the drug compound nor the customer's IP could provide on its own (i.e. create a combined output). However, this would not be the case when the two items are only additive such that each item provides the same functionality as they would on their own.

Finally, there may be circumstances in which R&D services are so integral to the customer's ability to derive benefit from the license that the license and services are effectively inputs to a single promise to the customer. This may be the case when the service relies on the proprietary knowledge of the entity in order for the customer to obtain the specified functionality from that license (e.g. an early stage compound or deriving new uses for the IP). However, we believe that when other parties (including the customer) are capable of performing the services it would be inappropriate to conclude that the promises are not separately identifiable because the services are so integral to the customer's ability to derive benefit from the license. As described in section 4.3.40, contractual restrictions do not affect the analysis.

Example 10.5.10
License to drug compound and related services – separate performance obligations

Biotech owns the IP to Drug Compound, which is currently in clinical trials. Biotech enters into an agreement with Customer whereby Biotech grants to Customer a license to Drug Compound. Biotech also agrees to continue performing R&D services with a goal of obtaining FDA approval for Drug Compound needed to be able to bring the drug to market. The R&D services are designed around testing and validating the efficacy of the related compound and do not change the nature of the compound.

The license provides Customer with a right to use Biotech's IP and the performance of R&D services, which are the outputs of Biotech's ordinary activities. Although contractually the R&D services will be performed by Biotech, these services could be performed by Customer or any other third party qualified to continue these efforts. These services are sold separately by other vendors.

Biotech determines that the license as transferred and services are capable of being distinct because Customer can benefit from the license either alone or together with the services, which are a readily available resource because they are sold separately by other vendors. The services are capable of being distinct because the entity can benefit from the services together with the license that is transferred at the beginning of the contract.

Biotech next determines that the license and services are distinct in the context of the contract because the services do not change the underlying IP such that the license and services have a transformative effect on each other. That is, the services do not significantly modify or customize the IP. Further, Biotech does not provide a significant service of integrating both the services and license into a combined output, and it could fulfill each promise independently. For example, Biotech could transfer the license and then transfer the services, which is further supported by other vendors providing the services on a stand-alone basis.

Example 10.5.20

License to drug compound and related services – combined performance obligation

Assume the same facts as Example 10.5.10, except that Biotech is licensing rights to Drug Compound for three years to Customer and enters into an agreement to provide R&D services with the goal of significantly modifying the biological compound so that Customer can use the compound with its new technology that treats a different illness. However, without those services Drug Compound could not be used by Customer for its intended use and other entities (including Customer) do not have the proprietary knowledge to perform the services. Biotech has licensed Drug Compound to other entities for different uses.

Biotech concludes that the license and services are not distinct based on the following.

- The license and service are capable of being distinct because the IP has been licensed separately to other parties and Customer could benefit from the services together with the license.
- However, the nature of the promise is to provide Customer with a significantly different compound with different functionality and therefore is not distinct within the context of the contract. The service is significantly modifying Drug Compound such that it has a transformative effect on the IP, and therefore the license and services are inputs into that combined output.

As a result, the license and services are combined into a single performance obligation.

Question 10.5.40

Does a license and manufacturing of a drug compound constitute separate performance obligations?

Interpretive response: It depends. In arrangements to transfer a license to a drug compound and manufacture some or all of the related product, both the license and manufacturing are evaluated to determine whether they are distinct. To this end, an entity evaluates whether the license and manufacturing are: [606-10-25-19]

- capable of being distinct; and
- distinct in the context of the contract – i.e. separately identifiable.

In some cases, the contract will not contain a minimum volume of the product to be manufactured and delivered – i.e. the contract contains optional purchases. In these cases, this question and analysis is still relevant because it may affect the accounting for any upfront consideration and whether the optional purchases are a material right. An entity needs to determine whether any upfront consideration relates to a distinct license that is transferred before the optional purchases. If the license is not distinct from the manufacturing and there is an upfront payment, the entity needs to determine whether that upfront fee gives rise to a material right; see section 5.8 on nonrefundable upfront fees.

Capable of being distinct

A license is generally capable of being distinct if: [606-10-25-19(a)]

- the customer can use, consume or sublicense the rights on their own; or
- the manufacturing is a readily available service from the entity or others.

A license is capable of being distinct if the customer can benefit from it on its own or together with readily available resources. To make this determination an entity needs to evaluate the inherent characteristics of the license and ignore contractual restrictions. A customer may be able to benefit from a license on its own if:

- the entity has previously licensed similar rights on a stand-alone basis;
- the customer can sublicense the rights for 'more than scrap' value; or
- the customer can use the license to obtain rights to a commercialized product that it owns.

A license is also capable of being distinct if the customer can benefit from the license together with readily available resources. The manufacturing may be considered a readily available resource if:

- the entity separately sells the manufactured product or other goods or services that the customer could use to benefit from the license;
- the customer can obtain the manufacturing from other sources; or
- the customer or other parties are capable of manufacturing the product within a reasonable time because the process is not unique or specialized.

An entity needs to consider the nature and substance of the rights conveyed by the license to evaluate whether a customer could benefit from it on its own or together with readily available resources. For example, a license that only conveys the rights to sell or distribute a commercialized product in a territory may be more akin to an exclusivity provision rather than a right to use or access the underlying IP. In that scenario, the provision may be an attribute of a promised good or service rather than a separate promise to license IP and therefore not capable of being distinct (see Question 4.2.100). In contrast, a license granted to a customer that includes the rights to develop and commercialize the product provides the rights to the underlying IP in addition to the right to sell or distribute in a territory. Therefore, rights that convey additional IP should be distinguished from contractual restrictions that are an attribute of a license.

Manufacturing is generally capable of being distinct if either of the following conditions exists. [606-10-25-19(a)]

- The entity sells the goods on their own – i.e. without a related license. This indicates that customers can benefit from the goods on their own; or

- The customer can benefit from the goods together with the license that has already been transferred to the customer. Readily available resources include goods or services that have already been transferred. If the license is transferred at the beginning of the contract, the manufacturing will typically be capable of being distinct.

Topic 606's Example 56 Cases A and B illustrate different scenarios of a contract to license and manufacture a mature drug rather than one that is in development.

- In Case A, the license is not capable of being distinct because no other entity can manufacture the drug because the manufacturing process is unique or specialized.
- In Case B, the license is capable of being distinct because the process is not unique or specialized and other entities can manufacture the drug.

However, in both cases the example is silent about the customer's ability to benefit from the license on its own without the manufacturing and whether the entity separately sells the products without the license.

We believe Example 56 assumes that the rights conveyed were so limited that the customer had no ability to benefit from the license on its own and that the products are not sold separately. Therefore, the example focuses on whether manufacturing is a readily available resource, in which case the unique nature and specialization of the manufacturing is the key consideration. However, we believe an entity still should consider the nature and substance of the rights conveyed and the customer's ability to benefit from the license on its own under the general capable of being distinct guidance.

Distinct in the context of the contract

In making this assessment, an entity applies judgment to specific facts to determine whether a license and manufacturing are separately identifiable. This evaluation includes considering whether the IP and manufacturing have a transformative effect on each other that makes them inputs into a combined output (see section 4.3.40).

Generally, manufacturing does not modify or customize the drug compound and there is no significant integration service. Similarly, a license to a mature drug and manufacturing will typically not be highly interrelated or interdependent such that the license and manufacturing significantly affect each other. However, for compounds in development, there may be scenarios where the license and manufacturing are not separately identifiable.

When an entity is involved in the development process, the manufacturing process may be highly interrelated and interdependent with the development service because manufacturing is an input required to fulfill the development service – e.g. the entity must manufacture the active pharmaceutical ingredient to use in development. See Question 10.5.30 to determine if research and development (including research and development combined with manufacturing) is distinct from a license.

In some situations, performing and/or developing the manufacturing process during development may be so integral to the customer's ability to derive benefit from the license that the license and manufacturing are effectively inputs to a single promise to the customer. This may be the case when manufacturing relies on proprietary knowledge of the entity in order for the customer to obtain the specified functionality from that license – e.g. a patented process or formula not available to others. However, when other parties (including the customer) are capable of performing the manufacturing, we believe it would be inappropriate to conclude that the services are so integral to the customer's ability to derive benefit from the license that the promises are not separately identifiable.

Question 10.5.50

Are a franchise license and pre-opening activities separate performance obligations?

Interpretive response: It depends. Franchisors often perform pre-opening activities related to a new franchise location and may charge an upfront or separate fee. However, the fact that a franchisor charges a fee does not on its own mean that the franchisor is transferring a distinct good or service to the franchisee.

Franchisors first evaluate whether the pre-opening activities are an administrative activity or a promised good or service that transfers to the franchisee. We believe this evaluation focuses on whether the activities provide incremental benefit beyond providing or facilitating access to the franchise license. See Question 4.2.70 for further discussion about distinguishing between an administrative/set-up activity and a promised good or service. [606-10-25-17]

Goods or services transferred to the franchisee that provide some measure of benefit beyond solely being able to use the franchise license are promised goods or services that are evaluated to determine if they are distinct from the franchise license. Both the franchise license and the pre-opening activities are evaluated to determine whether they are: [606-10-25-19]

- capable of being distinct; and
- distinct in the context of the contract – i.e. separately identifiable.

Capable of being distinct

A franchise license is capable of being distinct if: [606-10-25-19(a)]

- the franchisee can use, consume or sublicense the rights on their own; or
- the pre-opening activities are resources that the franchisee has already obtained or are readily available services from the franchisor or others.

Franchise licenses are typically capable of being distinct because the franchisee has the right to sell or sub-license its rights or otherwise benefit from the license.

Pre-opening activities are capable of being distinct if either of the following conditions exist:

- the franchisor or another entity sells the pre-opening activities on their own; or
- the franchisor renews its licenses to franchisees (i.e. the license is a readily available resource) without the need for pre-opening activities.

Stand-alone sales of pre-opening services may vary, but franchise licenses are typically renewable, and therefore the pre-opening activities would be capable of being distinct. See Question 4.3.30 for discussion of how renewals are considered a readily available resource. However, those activities still need to be distinct in the context of the contract to be accounted for as a separate performance obligation.

Distinct in the context of the contract

A franchisor applies judgment to the specific facts and circumstances to determine whether its promise to provide a license and pre-opening activities, within the context of the contract, is to transfer each of those goods or services individually, or instead, to transfer a combined item or items to which the promised goods or services are inputs. [606-10-25-21]

This evaluation considers whether the pre-opening services and franchise license:

— have a transformative effect on each other that makes them inputs into a combined output; or

— are highly interrelated to a degree that the franchisor would not be able to fulfill its promise by transferring each of the goods or services independently.

Franchisors typically provide a variety of goods or services at the outset of a franchise arrangement. Goods such as equipment to be used in a franchise operation generally would not have a transformative effect on the license or be highly interrelated, and therefore would be distinct in the context of the contract. However, services that provide operational or pre-opening assistance (e.g. operating manuals, copies of approved architectural plans) are often unique to the license or the franchisor's business model and standards. Therefore, many of these services will be highly interrelated with the specific franchise license or combined with the franchise license to provide the franchisee with the overall ability to operate its franchise.

Question 10.5.55

Can nonpublic company franchisors account for certain pre-opening activities as distinct from the franchise license?

Interpretive response: Yes. Nonpublic company franchisors may apply a practical expedient that permits certain pre-opening activities to be accounted for as distinct from the franchise license, if the pre-opening activities are consistent with those included in a predefined list in the guidance. The practical expedient applies only to identifying performance obligations. [952-606-25-2]

The nonpublic company guidance also includes an accounting policy election for franchisors (1) to account for multiple pre-opening activities (that are eligible for the practical expedient) as a single bundled performance obligation or (2) to perform an analysis of whether the pre-opening services are distinct from one another by applying the guidance in Step 2 of the revenue model. [952-606-25-3]

The following pre-opening activities are eligible for the practical expedient: [952-606-25-2]

— assistance in the selection of a site;
— assistance in obtaining facilities and preparing the facilities for their intended use (including related financing, architectural, and engineering services) and lease negotiation;
— training of the franchisee's personnel or the franchisee;
— preparation and distribution of manuals and similar material concerning operations, administration and record keeping;
— bookkeeping, information technology and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate and other taxes or about regulations affecting the franchisee's business; and
— inspection, testing and other quality control programs.

Example 10.5.30
Franchise and pre-opening activities – single performance obligation

Franchisor enters into a 20-year franchise agreement with Franchisee, its customer. Franchisor charges Franchisee a nonrefundable upfront fee of $20,000. Pre-opening activities by Franchisor include providing Franchisee with copies of standard architectural plans and access to the operating manual, and on-site pre-opening assistance from Franchisor's personnel.

Copies of the architectural plans and operating manual are part of Franchisor's IP, and cannot legally or practically be used without access to the trade name and logo contained in the franchise license. Operational assistance is unique to Franchisor's business model and standards.

Franchisee has contracted with Franchisor to obtain the ability to operate one of its franchise locations. These pre-opening activities do not provide Franchisee with incremental benefit beyond the right to operate the franchise; they are inputs necessary to provide the right to operate its franchise and are highly interrelated with the franchise brand. Therefore, Franchisor determines that the pre-opening activities do not represent distinct goods or services transferred to Franchisee.

Consequently, Franchisor includes the $20,000 upfront fee in the transaction price and recognizes the fee in revenue over the term of the franchise license based on an appropriate measure of progress (e.g. straight-line over 20 years).

Example 10.5.40

Franchise and pre-opening activities – multiple performance obligations

A theme park operator (Franchisor) licenses its brand to a third party (Franchisee). Under the agreement, Franchisee is responsible for the design, construction and operation of the theme park, and Franchisor assists with the upfront design and development of the theme park. Franchisor regularly provides design services to third-party theme park operators that are not its franchisees.

The design and development services are not brand specific because there is no standard design to Franchisor's parks, and there are no brand-specific themed rides. The design services could be performed by a third party and are regularly provided by Franchisor to non-franchisees. Additionally, if Franchisee terminated the license agreement, it would be able to rebrand the theme park and continue to operate it as designed.

Therefore, Franchisor determines that the design and development services are distinct for the following reasons:

- they do not represent administrative services because they provide incremental benefit beyond the license; and
- they are not highly interrelated with the brand license because Franchisor can provide the design services and the license independently.

Franchisor recognizes the transaction price allocated to the design and development services when (or as) the service is performed, which may be before the theme park opens or the franchise relationship begins.

Example 10.5.45

Franchise and pre-opening activities – nonpublic company franchisor applying practical expedient

Franchisor enters into a 20-year franchise agreement with Franchisee, its customer. Franchisor charges Franchisee a nonrefundable upfront fee of $20,000, and a sales-based royalty of 10% of Franchisee's sales for the term of the franchise agreement. Pre-opening activities provided to Franchisee by Franchisor relate to the opening of the franchise location and include site selection, training services, and preparation of operating manuals.

Franchisor determines that it can apply the practical expedient for identifying performance obligations related to pre-opening services because:

- it is not a public business entity;
- it is a franchisor in the scope of Topic 952; and
- the pre-opening activities (site selection, training services and preparation of operating manuals) are consistent with those eligible services listed in the guidance.

Franchisor elects to apply the practical expedient to the pre-opening services and accounts for them as distinct from the franchise license. Franchisor also makes an accounting policy election to account for the pre-opening activities as a single bundled performance obligation instead of performing an analysis of whether the pre-opening services are distinct from one another. As a result, Franchisor has two performance obligations – a franchise license and pre-opening services.

Franchisor applies the remaining guidance in Topic 606 to allocate the transaction price and recognize revenue related to the franchise license and pre-opening services. [952-606-55-1 – 55-4]

Question 10.5.60

Are a franchise license and advertising services separate performance obligations?

Background: Franchisors typically control brand marketing and advertising for all locations (company-owned and franchise), with the franchisor holding final decision-making authority on the timing and nature of spending. Often a separate legal entity or fund is established (advertising fund) to manage contributions and advertising spending. Franchise agreements typically require franchisees to contribute a percentage of their sales to the advertising fund and require the franchisor to spend all amounts collected for the specified purpose (i.e. advertising).

Interpretive response: Generally, no. Advertising services that promote the brand (rather than an individual location), such as national advertising campaigns, are not separable between different franchise agreements or franchisees, and not distinct because the services and franchise right are highly dependent and interrelated with each other.

However, advertising services may be separable and distinct from the franchise license if the advertising provides a distinct benefit to an individual franchisee and the advertising is determined to not be highly interdependent on or interrelated with the franchise license. For example, location or regional advertising that is exclusive to one franchisee under an area development agreement may be distinct from the franchise license.

When the advertising services are not distinct from the franchise license, sales-based advertising fees represent sales-based royalties related to the license of intellectual property (i.e. the franchise right) and therefore the sales-based royalty exception guidance applies. Section 10.11.50 discusses application of the royalty exception to a right-to-access license (e.g. a franchise license).

Example 10.5.50

Franchisor advertising fund

Franchisor enters into a franchise agreement with Franchisee to operate a location for 20 years. The franchise agreement includes the following terms related to sales-based royalties and advertising.

- Royalty of 5% of gross monthly sales for access to franchise rights.
- Advertising contribution of 2% of gross monthly sales.
- Franchisor must use the advertising contribution for market research, developing advertising and sales promotions, public relations or the delivery of advertising or promotional messages.

Franchisor has a separate advertising fund – which is controlled by Franchisor and consolidated in its financial statements – to manage receipts of the advertising contribution and the advertising spending. Franchisor performs marketing and advertising activities for the benefit of all franchisees and is not performing a service for an individual franchisee in the context of an individual franchise agreement.

Franchisor determines that the marketing and advertising activities do not represent a performance obligation that is distinct from the franchise license. Instead, they are part of the overall obligation to undertake activities to enhance the franchise brand.

Franchisor identifies no other distinct performance obligations in the arrangement and allocates the entire 7% sales-based royalty to the license of the franchise right. Franchisor records revenue based on the entire 7% sales-based royalty in accordance with the royalty exception (when the underlying franchisee sales occur), regardless of the stated purpose or contractual use of those amounts. Section 10.11 discusses the sales-or usage-based royalty exception, and Question 15.4.60 addresses when it may be appropriate to disaggregate revenue from a single performance obligation into multiple categories.

Franchisor recognizes marketing and advertising expenses in accordance with Subtopic 720-35.

10.6 Examples – assessing whether a license is distinct

10.6.10 Overview

The evaluation of whether a license is distinct is often complex and requires assessment of the specific facts and circumstances of the contract. Topic 606 provides several examples that may be helpful in evaluating different fact patterns. These examples highlight the potential difficulty of determining whether services and IP are in effect inputs into a combined item and therefore not separately identifiable from each other.

Type of contract	Description	Observations
Example 10 (Case C) – Technology		
Contract to transfer a three-year license for antivirus software and	The example illustrates the identification of a combined performance obligation when the	Determining the degree to which updates are critical to the utility of a software license may require

Type of contract	Description	Observations
critical unspecified updates	promise to provide updates is an input to a combined item. It is an input because the software license would be of little value without the updates, and the updates significantly modify the functionality of the initial software. The example concludes that the license and the updates are not distinct and should be accounted for as a single performance obligation.	significant judgment for arrangements other than antivirus software arrangements. Some considerations may include: — the value that the customer would ascribe to the upfront deliverable versus the upgrades; — whether customers choose to delay or never install upgrades; and — the nature of the promise (e.g. a digital protection service versus a business application).
Example 11 (Case A and Case B) – Technology		
Contract to transfer a software license, installation services, unspecified software updates and technical support	Two cases are provided to illustrate differences in identifying performance obligations depending on whether the software will be significantly customized or modified as part of professional services also promised to the customer in the contract.	Installation services involving the customization or modification of a software license may result in a conclusion that the license is not distinct from the services. Determining whether professional services involve significant customization or modification of the software may require significant judgment. Some entities may conclude that services and software should be combined under Topic 606, even though the services may not be essential to the software's functionality.
Example 55 – Technology		
Contract to license IP related to the design and production processes for a good, including updates to that IP	The customer is entitled to all updates for new designs or production processes.	There may be diversity in views about the kinds of technology to which the fact pattern, analysis and

Type of contract	Description	Observations
	The updates are essential to the customer's ability to derive benefit from the license. The example concludes that the license and the updates are inputs into a combined item for which the customer contracted and that the promises to grant the license and the updates are not distinct. The entity's overall promise to the customer is to provide ongoing access to the entity's IP.	outcome may apply in practice. Similar to the discussion of Example 10 (Case C) in Topic 606 related to the antivirus software, an entity considers the nature of the promise in these fact patterns. For example, this promise is a service rather than a license of IP with upgrades.
Example 56 (Case A and Case B) – Life sciences		
Contract to license patent rights to an approved drug, which is a mature product, and to manufacture the drug for the customer	Two cases are provided to illustrate differences in identifying performance obligations depending on whether the manufacturing process is unique or specialized; whether the license can be purchased separately; or whether other entities can also manufacture the drug.	Manufacturing services that can be provided by another entity are an indication that the customer can benefit from a license on its own.

Excerpt from ASC 606-10

• • > Example 10—Goods and Services Are Not Distinct

• • • > Case C—Combined Item

55-140D An entity grants a customer a three-year term license to anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The entity frequently provides updates that are critical to the continued utility of the software. Without the updates, the customer's ability to benefit from the software would decline significantly during the three-year arrangement.

55-140E The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer), while the customer can benefit from the updates together with the software license transferred at the outset of the contract.

55-140F The entity concludes that its promises to transfer the software license and to provide the updates, when-and-if available, are not separately identifiable (in accordance with paragraph 606-10-25-19(b)) because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The updates significantly modify the functionality of the software (that is, they permit the software to protect the customer from a significant number of additional viruses that the software did not protect against previously) and are integral to maintaining the utility of the software license to the customer. Consequently, the license and updates fulfill a single promise to the customer in the contract (a promise to provide protection from computer viruses for three years). Therefore, in this Example, the entity accounts for the software license and the when-and-if available updates as a single performance obligation. In accordance with paragraph 606-10-25-33, the entity concludes that the nature of the combined good or service it promised to transfer to the customer in this Example is computer virus protection for three years. The entity considers the nature of the combined good or service (that is, to provide anti-virus protection for three years) in determining whether the performance obligation is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and in determining the appropriate method for measuring progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37.

• • > Example 11—Determining Whether Goods or Services Are Distinct

• • • > Case A—Distinct Goods or Services

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, 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.

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. The customer can benefit from the updates together with the software license transferred at the outset of the contract. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 606-10-25-19(a) is met.

55-143 The entity also considers the principle and the factors in paragraph 606-10-25-21 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus, the criterion in paragraph 606-10-25-19(b) is met). In reaching this determination the entity considers that although it integrates the software into the customer's system, the installation services do not significantly affect the customer's ability to use and benefit from the software license because the installation services are routine and can be obtained from alternate providers. The software updates do not significantly affect the customer's ability to use and benefit from the software license because, in contrast with Example 10 (Case C), the software updates in this contract are not necessary to ensure that the software maintains a high level of utility to the customer during the license period. The entity further observes that none of the promised goods or services significantly modify or customize one another and the entity is not providing a significant service of integrating the software and the services into a combined output. Lastly, the entity concludes that the software and the services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the initial software license independent from its promise to subsequently provide the installation service, software updates, or technical support.

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.

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 paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A (see Example 54 in paragraphs 606-10-55-362 through 55-363B).

• • • > Case B—Significant Customization

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.

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 first assesses whether the criterion in paragraph 606-10-25-19(a) has been met. For the same reasons as in Case A, the entity determines that the software license, installation, software updates, and technical support each meet that criterion. The entity next assesses whether the criterion in paragraph 606-10-25-19(b) has been met by evaluating the principle and the factors in paragraph 606-10-25-21.The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) specified in the contract (see paragraph 606-10-25-21(a)). The software is significantly modified and customized by the service (see paragraph 606-10-25-21(b)). Consequently, the entity determines that the promise to transfer the license is not separately identifiable from the customized installation service and, therefore, the criterion in paragraph 606-10-25-19(b) is not met. Thus, the software license and the customized installation service are not distinct.

55-148 On the basis of the same analysis as in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

55-149 On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a. Software customization which is comprised of the license to the software and the customized installation service
b. Software updates
c. Technical support.

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 and paragraphs 606-10-25-31 through 25-37 to measure progress toward complete satisfaction of those performance obligations determined to be satisfied over time. In applying those paragraphs to the software customization, the entity considers that the customized software to which the customer will have rights is functional intellectual property and that the functionality of that software will not change during the license period as a result of activities that do not transfer a good or service to the customer. Therefore, the entity is providing a right to use the customized software. Consequently, the software customization performance obligation is completely satisfied upon completion of the customized installation service. The entity considers the other specific facts and circumstances of the contract in the context of the guidance in paragraphs 606-10-25-23 through 25-30 in determining whether it should recognize revenue related to the single software customization performance obligation as it performs the customized installation service or at the point in time the customized software is transferred to the customer.

• • > Example 55—License of Intellectual Property

55-364 An entity enters into a contract with a customer to license (for a period of three years) intellectual property related to the design and production processes for a good. The contract also specifies that the customer will obtain any updates to that intellectual property for new designs or production processes that may be developed by the entity. The updates are integral to the customer's ability to derive benefit from the license during the license period because the intellectual property is used in an industry in which technologies change rapidly.

55-365 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer can benefit from (a) the license on its own without the updates and (b) the updates together with the initial license. Although the benefit the customer can derive from the license on its own (that is, without the updates) is limited because the updates are integral to the customer's ability to continue to use the intellectual property in an industry in which technologies change rapidly, the license can be used in a way that generates some economic benefits. Therefore, the criterion in paragraph 606-10-25-19(a) is met for the license and the updates.

55-365A The fact that the benefit the customer can derive from the license on its own (that is, without the updates) is limited (because the updates are integral to the customer's ability to continue to use the license in the rapidly changing technological environment) also is considered in assessing whether the criterion in paragraph 606-10-25-19(b) is met. Because the benefit that the customer could obtain from the license over the three-year term without the updates would be significantly limited, the entity's promises to grant the license and to provide the expected updates are, in effect, inputs that, together fulfill a single promise to deliver a combined item to the customer. That is, the nature of the entity's promise in the contract is to provide ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. The promises within that combined item (that is, to grant the license and to provide when-and-if available updates) are therefore not separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b).

55-366 The nature of the combined good or service that the entity promised to transfer to the customer is ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. Based on this conclusion, the entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to determine the appropriate method for measuring progress toward complete satisfaction of the performance obligation. The entity concludes that because the customer simultaneously receives and consumes the benefits of the entity's performance as it occurs, the performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) and that a time-based input measure of progress is appropriate because the entity expects, on the basis of its relevant history with similar contracts, to expend efforts to develop and transfer updates to the customer on a generally even basis throughout the three-year term.

• • > Example 56—Identifying a Distinct License

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 for 5 years, while the customer develops its own manufacturing capability. The drug is a mature product; therefore, there is no expectation that the entity will undertake activities to change the drug (for example, to alter its chemical composition). There are no other promised goods or services in the contract.

• • • > Case A—License Is Not Distinct

55-368 In this case, no other entity can manufacture this drug while the customer learns the manufacturing process and builds its own manufacturing capability because of the highly specialized nature of the manufacturing process. As a result, the license cannot be purchased separately from the manufacturing service.

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.

55-370 The nature of the combined good or service for which the customer contracted is a sole sourced supply of the drug for the first five years; the customer benefits from the license only as a result of having access to a supply of the drug. After the first five years, the customer retains solely the right to use the entity's functional intellectual property (see Case B, paragraph 606-10-55-373), and no further performance is required of the entity during Years 6–10. The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation (that is, the bundle of the license and the manufacturing service) is a performance obligation satisfied at a point in time or over time. Regardless of the determination reached in accordance with paragraphs 606-10-25-23 through 25-30, the entity's performance under the contract will be complete at the end of Year 5.

• • • > Case B—License Is Distinct

55-371 In this case, the manufacturing process used to produce the drug is not unique or specialized, and several other entities also can manufacture the drug for the customer.

55-372 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct, and it concludes that the criteria in paragraph 606-10-25-19 are met for each of the license and the manufacturing service. The entity concludes that the criterion in paragraph 606-10-25-19(a) is met because the customer can benefit from the license together with readily available resources other than the entity's manufacturing service (that is, because there are other entities that can provide the manufacturing service) and can benefit from the manufacturing service together with the license transferred to the customer at the start of the contract.

55-372A The entity also concludes that its promises to grant the license and to provide the manufacturing service are separately identifiable (that is, the criterion in paragraph 606-10-25-19(b) is met). The entity concludes that the license and the manufacturing service are not inputs to a combined item in this contract on the basis of the principle and the factors in paragraph 606-10-25-21. In reaching this conclusion, the entity considers that the customer could separately purchase the license without significantly affecting its ability to benefit from the license. Neither the license nor the manufacturing service is significantly modified or customized by the other, and the entity is not providing a significant service of integrating those items into a combined output. The entity further considers that the license and the manufacturing service are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the license independent of fulfilling its promise to subsequently manufacture the drug for the customer. Similarly, the entity would be able to manufacture the drug for the customer even if the customer had previously obtained the license and initially utilized a different manufacturer. Thus, although the manufacturing service necessarily depends on the license in this contract (that is, the entity would not contract for the manufacturing service without the customer having obtained the license), the license and the manufacturing service do not significantly affect each other. Consequently, the entity concludes that its promises to grant the license and to provide the manufacturing service are distinct and that there are two performance obligations:

a. License of patent rights
b. Manufacturing service.

55-373 The entity assesses the nature of its promise to grant the license. The entity concludes that the patented drug formula is functional intellectual property (that is, it has significant standalone functionality in the form of its ability to treat a disease or condition). There is no expectation that the entity will undertake activities to change the functionality of the drug formula during the license period. Because the intellectual property has significant standalone functionality, any other activities the entity might undertake (for example, promotional activities like advertising or activities to develop other drug products) would not significantly affect the utility of the licensed intellectual property. Consequently, the nature of the entity's promise in transferring the license is to provide a right to use the entity's functional intellectual property, and it accounts for the license as a performance obligation satisfied at a point in time. The entity recognizes revenue for the license performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C.

55-374 In its assessment of the nature of the license, the entity does not consider the manufacturing service because it is an additional promised service in the contract. The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the manufacturing service is a performance obligation satisfied at a point in time or over time.

10.7 Determining the nature of a distinct license

Excerpt from ASC 606-10

• • > Determining the Nature of the Entity's Promise

55-59 To determine whether the entity's promise to provide a right to access its intellectual property or a right to use its intellectual property, the entity should consider the nature of the intellectual property to which the customer will have rights. Intellectual property is either:

a. Functional intellectual property. Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality.
b. Symbolic intellectual property. Intellectual property that is not functional

intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities.

55-60 A customer's ability to derive benefit from a license to symbolic intellectual property depends on the entity continuing to support or maintain the intellectual property. Therefore, a license to symbolic intellectual property grants the customer a right to access the entity's intellectual property, which is satisfied over time (see paragraphs 606-10-55-58A and 606-10-55-58C) as the entity fulfills its promise to both:

a. Grant the customer rights to use and benefit from the entity's intellectual property
b. Support or maintain the intellectual property. An entity generally supports or maintains symbolic intellectual property by continuing to undertake those activities from which the utility of the intellectual property is derived and/or refraining from activities or other actions that would significantly degrade the utility of the intellectual property.

55-62 A license to functional intellectual property grants a right to use the entity's intellectual property as it exists at the point in time at which the license is granted unless both of the following criteria are met:

a. The functionality of the intellectual property to which the customer has rights is expected to substantively change during the license period as a result of activities of the entity that do not transfer a promised good or service to the customer (see paragraphs 606-10-25-16 through 25-18). Additional promised goods or services (for example, intellectual property upgrade rights or rights to use or access additional intellectual property) are not considered in assessing this criterion.
b. The customer is contractually or practically required to use the updated intellectual property resulting from the activities in criterion (a).

If both of those criteria are met, then the license grants a right to access the entity's intellectual property.

55-63 Because functional intellectual property has significant standalone functionality, an entity's activities that do not substantively change that functionality do not significantly affect the utility of the intellectual property to which the customer has rights. Therefore, the entity's promise to the customer in granting a license to functional intellectual property does not include supporting or maintaining the intellectual property. Consequently, if a license to functional intellectual property is a separate performance obligation (see paragraph 606-10-55-55) and does not meet the criteria in paragraph 606-10-55-62, it is satisfied at a point in time (see paragraphs 606-10-55-58B through 55-58C).

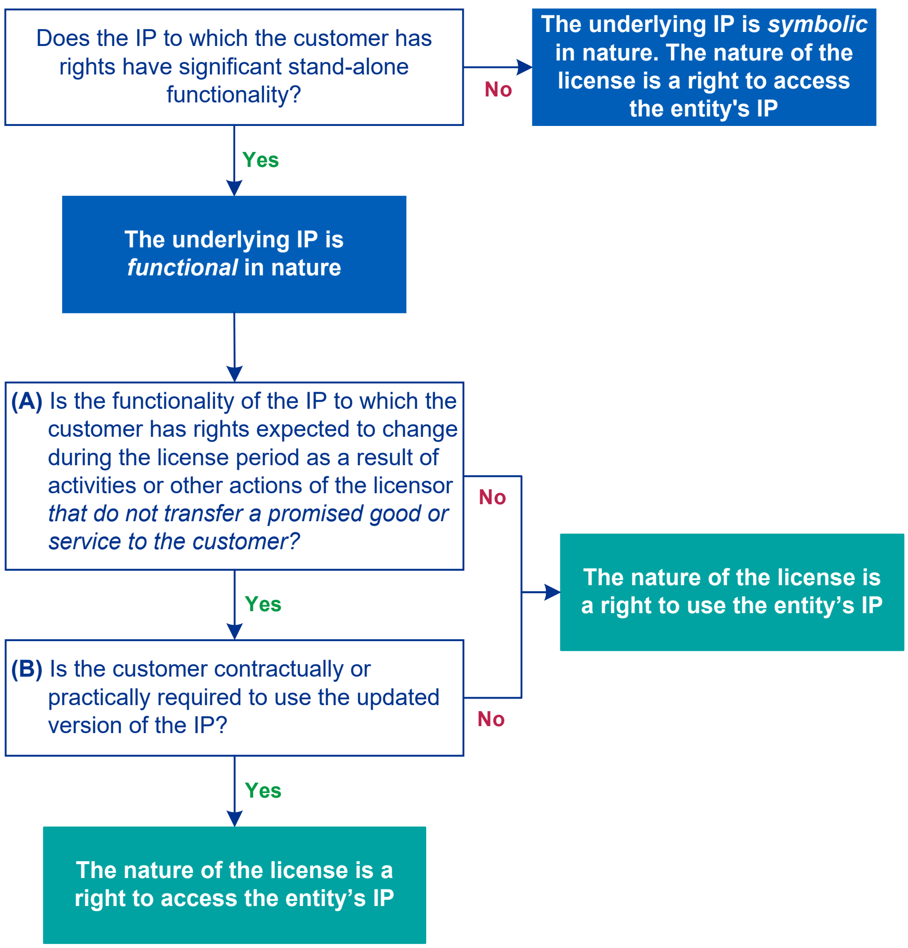
10.7.10 Overview

A license of IP that is distinct from other goods or services in the contract is a separate performance obligation. To determine when an entity recognizes revenue for the license, it needs to determine if it is a performance obligation satisfied at a point in time or over time (see section 10.9).

To determine whether the performance obligation is satisfied at a point in time or over time, the entity considers whether the nature of its promise is to provide the customer with a right to: [606-10-55-59]

— access the entity's IP throughout the license period (i.e. a right-to-access license); or
— use the entity's IP as it exists at the point in time at which the license is granted (i.e. a right-to-use license).

The following decision tree summarizes how to evaluate whether a license provides a right to access or a right to use the entity's IP.



The licensed IP is first classified into one of two categories: functional or symbolic. The category generally determines whether the entity's promise is to provide a right to use or right to access the IP. [606-10-55-59]

10.7.20 Functional IP

Functional IP such as software, biological compounds, drug formulas or media content have significant stand-alone functionality – e.g. the ability to process a transaction, perform a function or task, or be played or aired. In those licenses, a customer typically derives a substantial portion of the overall benefit of the license from the IP's stand-alone functionality. Continuing to support or maintain the IP is not considered part of the promise to the customer in providing a license of functional IP because the activities to support or maintain the IP do not substantively change that functionality and would not significantly affect its utility. As a result, a license to functional IP typically grants the customer a right to use the IP and is satisfied at a point in time. [606-10-55-59(a), ASU 2016-10.BC56]

However, the FASB provided criteria that if met would result in a conclusion that the license to functional IP provides a right to access IP and is satisfied over time. These criteria, *both* of which must be met for the license to functional IP to be satisfied over time, are as follows: [606-10-55-62]

1. functionality of the IP to which the customer has rights is expected to change substantively during the license period as a result of activities of the entity that do not transfer a good or service to the customer; and
2. the customer is contractually or practically required to use the updated IP.

When evaluating the first criterion, additional goods or services (e.g. upgrade rights or rights to use or access additional IP) are not considered. The FASB indicated that it expects these criteria will be met rarely, if at all. This is because when an entity provides updates to functional IP, the provision of those updates is typically a promised service to the customer, and therefore the entity's activities involved in providing those updates do not meet the first criterion. For example, an entity's activities to develop and provide software updates or provide software customization services do not meet the first criterion because the updates and the customization services are additional promised services to the customer. Therefore, distinct licenses to functional IP almost always provide the customer with a right to use the entity's IP. [ASU 2016-10.BC58]

10.7.30 Symbolic IP

Symbolic IP is anything other than functional IP. Symbolic IP includes items such as a brand, team or trade names, logos, and franchise rights. The utility of symbolic IP to a customer largely depends on the entity continuing to support or maintain that IP – e.g. a license to a sports team's name and logo will typically have limited ongoing value if the team stops playing games. Therefore, a license to symbolic IP grants the customer a right to access the entity's IP, which is satisfied over time as the entity fulfills its promise to both: [606-10-55-59(b), 55-60]

— grant the customer rights to use and benefit from the entity's IP; and

— support or maintain the IP. An entity generally supports or maintains symbolic IP by continuing to undertake those activities from which the utility of the IP is derived and/or refraining from activities or other actions that would significantly degrade its utility.

Example 10.7.10
Assessing the nature of a drug compound license

Biotech licenses rights to a drug compound that is currently in clinical trials to Customer. Biotech also agrees to continue to perform R&D services to test and validate the efficacy of the compound to obtain FDA approval. The R&D services do not change the nature or application of the compound. Biotech concludes that the license of the compound is distinct from the R&D services (See Example 10.5.10).

The drug compound has significant stand-alone functionality and therefore is functional IP. There is no expectation that Biotech will undertake activities that will change the functionality of the drug compound and therefore the license provides a right to use IP and is satisfied at a point in time. [606-10-55-62]

Example 10.7.20
Assessing the nature of a film license and the effect of marketing activities

Film Studio grants a license to Customer to show a completed film. Film Studio plans to undertake significant marketing activities that it expects will affect box-office receipts for the film. The marketing activities will not change the functionality of the film, but they could affect its value.

The licensed film is functional IP because it has substantial stand-alone functionality – i.e. the ability to be aired in its current, completed form. There is no expectation that Film Studio will undertake activities to change the film. Therefore, the license provides a right to use the film and is satisfied at a point in time. [606-10-55-62]

Example 10.7.30
Assessing the nature of a team name and logo license – active sports team

Sports Team enters into a three-year agreement to license its team name and logo to Apparel Maker. The license permits Apparel Maker to use the team name and logo on its products, including display products, and in its advertising or marketing materials.

The team name and the logo do not have significant stand-alone functionality and therefore are symbolic IP. Because the license conveys rights to symbolic IP, the nature of Sports Team's promise is to provide a right to access its IP throughout the license period. That promise includes continuing to support and maintain the IP – i.e. by continuing to undertake those activities from which the utility of the IP is derived, such as playing games and fielding a team. Therefore, revenue from the license is recognized over time. See Example 61 in Topic 606, which is reproduced in section 10.7.40.

Example 10.7.40

Assessing the nature of a team name and logo license – sports team that is no longer active

Modifying Example 10.7.30, Sports Team has not played games in many years and the licensor is Brand Collector, an entity that acquires IP, such as old team or brand names and logos, from defunct companies or those in financial distress. Brand Collector's business model is to license the IP, or obtain settlements from companies that use the IP without permission, without undertaking any ongoing activities to promote or support the IP.

The team name and the logo do not have significant stand-alone functionality and therefore are symbolic IP. Because the license conveys rights to symbolic IP, the nature of Brand Collector's promise to a customer to whom it licenses the IP is to provide a right to access its IP throughout the license period. Because Brand Collector still owns the symbolic IP, the promise to grant the license includes continuing to support and maintain the IP by refraining from activities that would significantly degrade the IP. Accordingly, revenue from the license is recognized over time. [606-10-55-60]

Question 10.7.10

Do contractual restrictions affect whether the license is for functional or symbolic IP?

Interpretive response: No. Contractual restrictions define the attributes of a license and do not affect whether the license provides a right to use or a right to access the entity's IP. These attributes include restrictions (e.g. on time, geography or use), whether the license is exclusive vs. non-exclusive and/or perpetual vs. time-based, and payment terms for the license. [606-10-55-64, ASU 2014-09.BC412]

For example, Example 59 in Topic 606 (reproduced in section 10.10) discusses a license to a symphony recording that includes restrictions on time (two years), geography (Country A only) and use (only in commercials). These restrictions are attributes of the single license in the contract and do not affect the conclusion that the license provides a right to use the entity's IP – i.e. the IP is functional IP.

However, in certain fact patterns contractual provisions characterized as restrictions on time, geography or use may result in a conclusion that the entity has promised to grant multiple licenses to the customer (see Question 10.4.10).

Question 10.7.20

Is a license for the right to access IP a series of distinct goods or services that form a single performance obligation?

Interpretive response: Generally, yes. Identifying a license for the right to access IP as a series can have a significant effect on various aspects of the revenue model. For example, as a series any variable consideration may be allocated to distinct time increments if the criteria in the variable consideration allocation exception are met (see section 6.6). In addition, in a contract modification, a series of distinct goods or services is accounted for on a prospective basis as a termination of an existing contract and creation of a new contract or as a separate contract (see section 11.3.30).

A license for the right to access IP (typically symbolic IP) is a series of distinct time increments (days, months, quarters, etc.) for the following reasons (see section 4.4).

Criteria	Evaluation
Distinct	The customer can benefit from each time increment on its own; and each time increment is separately identifiable from others because one time increment does not significantly affect, modify or customize another. Accessing the license on one day has no effect on accessing the license on another day.
Substantially the same	The customer does not receive different access depending on the time period. The nature of the promise is to provide the customer with continuous access to the license over the contract term.
Transfers over time	The customer simultaneously receives and consumes the benefits (receiving access to the IP) provided by the entity's performance as the entity performs (providing access to the IP).
Same pattern of transfer	The time increments transfer to the customer using the same pattern of transfer.

The FASB has stated that in many right-to-access licenses, the license may constitute a series of distinct goods or services. Further, the TRG discussed the application of the series guidance and agreed that a franchise license considered a right-to-access license is a series of distinct time increments. [ASU 2016-10.BC72, TRG 07-15.39]

10.7.40 FASB examples on nature of promise

Example No.	Description
54	Right to Use Intellectual Property
58	Access to Intellectual Property
61	Access to Intellectual Property

Excerpt from ASC 606-10

• • > Example 54—Right to Use Intellectual Property

55-362 Using the same facts as in Case A in Example 11 (see paragraphs 606-10-55-141 through 55-145), the entity identifies four performance obligations in a contract:

a. The software license
b. Installation services
c. Software updates
d. Technical support.

55-363 The entity assesses the nature of its promise to transfer the software license. The entity first concludes that the software to which the customer obtains rights as a result of the license is functional intellectual property. This is because the software has significant standalone functionality from which the customer can derive substantial benefit regardless of the entity's ongoing business activities.

55-363A The entity further concludes that while the functionality of the underlying software is expected to change during the license period as a result of the entity's continued development efforts, the functionality of the software to which the customer has rights (that is, the customer's instance of the software) will change only as a result of the entity's promise to provide when-and-if available software updates. Because the entity's promise to provide software updates represents an additional promised service in the contract, the entity's activities to fulfill that promised service are not considered in evaluating the criteria in paragraph 606-10-55-62. The entity further notes that the customer has the right to install, or not install, software updates when they are provided such that the criterion in 606-10-55-62(b) would not be met even if the entity's activities to develop and provide software updates had met the criterion in paragraph 606-10-55-62(a).

55-363B Therefore, the entity concludes that it has provided the customer with a right to use its software as it exists at the point in time the license is granted and the entity accounts for the software license performance obligation as a performance obligation satisfied at a point in time. The entity recognizes revenue on the software license performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C.

• • > Example 58—Access to Intellectual Property

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 and disappear regularly and the images of the characters evolve over time. The customer, an operator of cruise ships, can use the entity's characters in various ways, such as in shows or parades, within reasonable guidelines.

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.

55-385 The entity concludes that it has made no other promises to the customer other than the promise to grant a license. That is, the additional activities associated with the license do not directly transfer a good or service to the customer. Therefore, the entity concludes that its only performance obligation is to transfer the license.

55-386 The entity assesses the nature of its promise to transfer the license and concludes that the nature of its promise is to grant the customer the right to access the entity's symbolic intellectual property. The entity determines that the licensed intellectual property (that is, the character names and images) is symbolic because it has no standalone functionality (the names and images cannot process a transaction, perform a function or task, or be played or aired separate from significant additional production that would, for example, use the images to create a movie or a show) and the utility of those names and images is derived from the entity's past and ongoing activities such as producing the weekly comic strip that includes the characters.

55-387 Because the nature of the entity's promise in granting the license is to provide the customer with a right to access the entity's intellectual property, in accordance with paragraph 606-10-55-58A, the entity accounts for the promised license as a performance obligation satisfied over time.

55-388 The entity recognizes the fixed consideration allocable to the license performance obligation in accordance with paragraphs 606-10-55-58A and 606-10-55-58C. The entity considers paragraphs 606-10-25-31 through 25-37 in identifying the method that best depicts its performance in the license. Because the contract provides the customer with unlimited use of the licensed characters for a fixed term, the entity determines that a time-based method would be the most appropriate measure of progress toward complete satisfaction of the performance obligation.

• • > Example 61—Access to Intellectual Property

55-395 An entity, a well-known sports team, licenses the use of its name and logo to a customer. The customer, an apparel designer, has the right to use the sports team's name and logo on items including t-shirts, caps, mugs, and towels for one year. In exchange for providing the license, the entity will receive fixed consideration of $2 million and a royalty of 5 percent of the sales price of any items using the team name or logo. The customer expects that the entity will continue to play games and provide a competitive team.

55-396 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity concludes that the only good or service promised to the customer in the contract is the license. The additional activities associated with the license (that is, continuing to play games and provide a competitive team) do not directly transfer a good or service to the customer. Therefore, there is one performance obligation in the contract.

55-397 To determine whether the entity's promise in granting the license provides the customer with a right to access the entity's intellectual property or a right to use the entity's intellectual property, the entity assesses the nature of the intellectual property to which the customer obtains rights. The entity concludes that the intellectual property to which the customer obtains rights is symbolic intellectual property. The utility of the team name and logo to the customer is derived from the entity's past and ongoing activities of playing games and providing a competitive team (that is, those activities effectively give value to the intellectual property). Absent those activities, the team name and logo would have little or no utility to the customer because they have no standalone functionality (that is, no ability to perform or fulfill a task separate from their role as symbols of the entity's past and ongoing activities).

55-398 Consequently, the entity's promise in granting the license provides the customer with the right to access the entity's intellectual property throughout the license period and, in accordance with paragraph 606-10-55-58A, the entity accounts for the promised license as a performance obligation satisfied over time.

55-399 The entity recognizes the fixed consideration allocable to the license performance obligation in accordance with paragraphs 606-10-55-58A and 606-10-55-58C. This includes applying paragraphs 606-10-25-31 through 25-37 to identify the method that best depicts the entity's performance in satisfying the license. For the consideration that is in the form of a sales-based royalty, paragraph 606-10-55-65 applies because the sales-based royalty relates solely to the license that is the only performance obligation in the contract. The entity concludes that recognizing revenue from the sales-based royalty when the customer's subsequent sales of items using the team name or logo occur is consistent with the guidance in paragraph 606-10-55-65(b). That is, the entity concludes that ratable recognition of the fixed consideration of $2 million plus recognition of the royalty fees as the customer's subsequent sales occur reasonably depict the entity's progress toward complete satisfaction of the license performance obligation.

10.8 License combined with other goods and services

Excerpt from ASC 606-10

• > Licensing

55-57 When a single performance obligation includes a license (or licenses) of intellectual property and one or more other goods or services, the entity considers the nature of the combined good or service for which the customer has contracted (including whether the license that is part of the single performance obligation provides the customer with a right to use or a right to access intellectual property in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A) in determining whether that combined good or service is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and, if over time, in selecting an appropriate method for measuring progress in accordance with paragraphs 606-10-25-31 through 25-37.

10.8.10 Overview

If a license is not distinct, it is bundled with other goods or services into a single combined performance obligation. When a single performance obligation includes a license of IP and one or more other goods or services, the entity considers the nature of the combined good or service for which the customer has contracted – including whether the license provides a customer with a right to use or right to access the entity's IP: [606-10-55-57]

- to determine whether that combined good or service is satisfied over time or at a point in time; and
- to select an appropriate method for measuring progress.

To appropriately depict the entity's performance in satisfying a combined performance obligation, an entity considers the nature of its promise in granting the license that is part of the single performance obligation. For example, assume an entity grants a 10-year license that is not distinct from a one-year service arrangement. Also assume the nature of the entity's promise in granting the license would be a right to access the entity's IP over the 10-year license period if the license were a separate performance obligation. Therefore, it is inappropriate to conclude that the combined performance obligation is satisfied over the one-year service period. [ASU 2016-10.BC66]

Step 5 requires an entity to determine the nature of the performance obligation. When a license is part of a single performance obligation, the entity considers the nature of the entity's promise in granting that license to determine the nature of the combined performance obligation. Therefore, to appropriately recognize revenue when (or as) the entity satisfies its performance obligation, the entity first needs to understand its promise in granting the license and any continuing performance required by the entity. [ASU 2016-10.BC68]

Topic 606 includes Example 11 (Case B) and Example 56 (Case A) that illustrate these considerations (see the excerpt in section 10.6). The basis for conclusions further describes their interaction with determining the nature of the overall promise.

Excerpt from ASU 2016-10

BC68. Considering the nature of the entity's promise in granting a license that is part of a single performance obligation is part of the overall requirement within Step 5 of the revenue model (see paragraph 606-10-25-33) to determine the nature of the good or service (which may be a combined item, including a combined item that includes a license) in order to determine whether that good or service is satisfied over time or at a point in time and the appropriate measure of progress to apply. It is not a separate step or evaluation. Considering the nature of the entity's promise in granting the license within a single performance obligation also is necessary to apply the principle of recognizing revenue when (or as) an entity satisfies its performance obligation and, therefore, is already an implied requirement of the guidance. The Board observed that it is not possible to appropriately recognize revenue when (or as) the entity satisfies its performance obligation if the entity does not first understand whether its promise in granting the license requires continued performance by the entity. For example:

a. It is only possible to conclude that the combined license and customization services performance obligation in Example 11, Case B, is completely satisfied over the customized installation service period if one concludes that the license provides the customer with a right to use the entity's software. It is only based on that conclusion that the entity has completely satisfied the single performance obligation at the point in time the customization of the software is complete. In contrast, if the license were deemed a right to access the entity's software, the entity would adopt a different measure of progress toward complete satisfaction of the performance obligation, recognizing revenue over a longer period and in a different pattern, which would reflect the entity's continuing performance obligation to provide access to the software over the license period after completion of the customized installation services.
b. In Example 56, Case A, it is only by determining the nature of the entity's promise in granting the license within the single license/manufacturing service performance obligation that the entity can appropriately apply the principle of recognizing revenue when (or as) the entity satisfies its performance obligation to the customer. If the license provides a right to use the entity's drug patent, the entity's performance is complete under the single performance obligation when the manufacturing service is complete. In contrast, if the license were to provide a right to access the entity's drug patent, the performance obligation is not completely satisfied until the end of the license period such that some portion of the transaction price would be recognized after the manufacturing service is complete.

10.9 Timing and pattern of revenue recognition

Excerpt from ASC 606-10

• > Licensing

55-58 In evaluating whether a license transfers to a customer at a point in time or over time, an entity should consider whether the nature of the entity's promise in granting the license to a customer is to provide the customer with either:

a. A right to access the entity's intellectual property throughout the license period (or its remaining economic life, if shorter)

b. A right to use the entity's intellectual property as it exists at the point in time at which the license is granted.

55-58A An entity should account for a promise to provide a customer with a right to access the entity's intellectual property as a performance obligation satisfied over time because the customer will simultaneously receive and consume the benefit from the entity's performance of providing access to its intellectual property as the performance occurs (see paragraph 606-10-25-27(a)). An entity should apply paragraphs 606-10-25-31 through 25-37 to select an appropriate method to measure its progress toward complete satisfaction of that performance obligation to provide access to its intellectual property.

55-58B An entity's promise to provide a customer with the right to use its intellectual property is satisfied at a point in time. The entity should apply paragraph 606-10-25-30 to determine the point in time at which the license transfers to the customer.

55-58C Notwithstanding paragraphs 606-10-55-58A through 55-58B, revenue cannot be recognized from a license of intellectual property before both:

a. An entity provides (or otherwise makes available) a copy of the intellectual property to the customer.
b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property. That is, an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.

10.9.10 Overview

There are two critical concepts in determining the timing of revenue recognition for a license of IP. First, the timing and pattern of revenue recognition for a distinct license depends on the nature of the performance obligation (see section 10.7).

Type of license	Timing and pattern of revenue
Right to access (typically symbolic IP)	**Over time.** The entity applies the general guidance for measuring progress toward the complete satisfaction of a performance obligation satisfied over time in selecting an appropriate measure of progress. [606-10-55-58A]
Right to use (functional IP)	**Point in time.** The entity applies the general guidance on performance obligations satisfied at a point in time to determine the point in time at which the license transfers to the customer. [606-10-55-58B]

For right-to-access licenses, entities need to select an appropriate measure of progress that depicts how the performance obligation is satisfied over time. Entities need to make similar judgments that it would make to determine the measure of progress for any other performance obligations satisfied over time (see section 7.4). [606-10-55-58A]

Second, for both right-to-access and right-to-use licenses, revenue cannot be recognized before both: [606-10-55-58C]

— the entity provides or otherwise makes available a copy of the IP to the customer; and
— the beginning of the period during which the customer can use and benefit from the license.

If the customer cannot use and benefit from the IP then by definition the customer does not control the license. For example, if the entity transferred a license to the customer on December 1, Year 1 but the customer was unable to use the IP until January 1, Year 2, the customer does not control the license until January 1, Year 2. While the entity's performance may appear to be complete at December 1, Year 1, revenue is recognized only when (or as) the customer obtains control of a good or service. [ASU 2014-09.BC414]

Example 10.9.10
Right-to-access license

ABC Corp. enters into a contract with Customer on November 15, Year 0 to grant Customer a five-year license to its IP (sports logo), with the license period beginning on January 1, Year 1 and ending December 31, Year 5. ABC provides Customer with a copy of the IP on December 1, Year 0. ABC determines that the license provides a right to access the IP.

Because the license provides Customer with a right to access ABC's IP, ABC recognizes the revenue from the license over the five-year term (from January 1, Year 1 to December 31, Year 5) as it satisfies its performance obligation to provide Customer with access to the IP. ABC cannot begin to recognize revenue until January 1, Year 1 when Customer can begin to use and benefit from the license. [606-10-55-58C]

Example 10.9.20
Right-to-use license

Modifying Example 10.9.10, the license provides Customer with a right to use ABC's IP (feature movie).

Because the license provides a right to use its IP, ABC recognizes the revenue from the license on January 1, Year 1. This date is the first point in time at which Customer:

— has obtained control of the license based on an evaluation of the general guidance on performance obligations satisfied at a point in time; and
— is able to use and benefit from the license. [606-10-55-58C]

Question 10.9.10

What is the appropriate measure of progress for a right-to-access license?

Interpretive response: Multiple approaches may be acceptable for a right-to-access license (symbolic IP) depending on the nature of the entity's promise for the IP. Topic 606 categorizes these various approaches as output and input methods. An entity needs to consider all the facts and circumstances in selecting the appropriate measure of progress. For further discussion, see section 7.4. [606-10-25-31 – 25-37, 55-16 – 55-21, 55-58A]

A time-elapsed measure of progress is often appropriate for a license of symbolic IP. This is because the customer simultaneously receives and consumes the benefits of the entity's performance of providing access and supporting the IP. As such, if the entity provides the same access and support throughout the license term, recognizing revenue ratably over the term typically depicts the entity's performance in satisfying the performance obligation.

Additionally, even if the customer has access to the IP evenly throughout the license term, sometimes the customer does not benefit from the license evenly over the contract term. For example, another measure of progress may be more appropriate if there is seasonality, periods of higher use by the customer or periods requiring the entity to undertake greater activities to support the IP.

Similarly, an output-based measure is often appropriate in licenses with sales- or usage-based royalties when those royalties correlate directly with the value to the customer of the entity's performance. For example, an entity may recognize royalties as earned when the customer's subsequent sales or usage occurs based on applying the as-invoiced practical expedient. See section 7.4.50 for a discussion of when that guidance would apply. Similarly, an output based measure based on sales or usage could be appropriate even if the entity does not use the as-invoiced practical expedient but this would require an entity to estimate the total consideration and recognize that amount in proportion to the sales or usage that has occurred to the total estimated sales or usage. [ASU 2016-10.BC72]

When the license includes royalties the entity also needs to consider the royalty exception and variable consideration allocation exception.

— The royalty exception (see section 10.11) requires an entity to recognize revenue at the later of when the sales or usage occurs or satisfaction of the performance obligation. The application of this exception may also result in recognition as the sales or usage occurs. See section 10.11.50 for further discussion of the application of the royalty exception for a right-to-access license.

— The variable consideration allocation exception may require an entity to allocate the fees to the period in which the sales or usage occurs. This allocation would result in a similar outcome to the as-invoiced practical expedient.

Example 10.9.30
Measure of progress symbolic IP

Sporting Co. enters into a two-year contract with Network to license the rights to broadcast a live sporting event, which will take place once during the contract term, for a fixed fee of $50 million. The rights include the ability to use certain trademarks, taglines and other marketing materials throughout the two years.

Sporting Co. concludes that the license is symbolic IP because the rights do not provide significant stand-alone functionality, and Network only benefits from Sporting Co.'s ability to support and maintain the IP by putting on the event.

The event occurs only during two weeks of the contract term. During and around that time, Network makes significantly greater use of those rights to advertise the upcoming coverage. In addition, Network obtains greater benefits from access to the IP during that period because it earns advertising revenues as the event occurs while it rarely earns advertising revenues from the IP during the intervening periods.

In this example, rather than a time-elapsed measure of progress, Sporting Co. uses an output measure of progress that reflects the pattern of the customer's greater usage and benefit from the IP. This would likely result in a pattern or recognition with more revenue being recognized during and around the time of the event and less revenue in the periods before and after the event.

Similarly, Sporting Co. might use an input-based measure that reflects its efforts in maintaining and supporting the IP if that method better depicts its progress toward complete satisfaction of the performance obligation.

Example 10.9.40
Time-elapsed measure of progress symbolic IP

ABC Corp. enters into a contract with Customer to license the rights to ABC's trade name for five years for $1 million. ABC concludes that the license does not provide significant stand-alone functionality and the utility of the trade name is primarily due to the association with ABC. As such, the license is for symbolic IP and the right to access that license is recognized over time.

ABC determines that using a time-elapsed measure of progress is the most appropriate method of measuring its progress. This is because Customer benefits from the license evenly over the contract term, and ABC's efforts to maintain and support the trade name are expended evenly throughout the contract term.

Example 10.9.50
Output based measure of progress symbolic IP

Assume the same facts as Example 10.9.40, except that instead of the fee being fixed, Customer will pay a royalty to ABC equal to 5% of Customer's sales of ABC's product.

In this example, ABC concludes that recognizing revenue when Customer's subsequent sales or usage occurs based on the as-invoiced practical expedient (see section 7.4.50) is an appropriate method of measuring progress; this is because it is a direct measurement of the value that Customer obtained to date from the license.

As such, each year ABC recognizes revenue equal to 5% of the sales achieved by Customer. The recognition of the sales-based royalties is also consistent with the royalty recognition exception discussed in section 10.11.

Alternatively, even if ABC does not use the as-invoiced practical expedient, the variable consideration allocation guidance (see section 6.6) may be applicable as the right to access the IP is a series of distinct services (see Question 10.7.20). If the criteria to allocate that consideration to each day is met, it would result in recognizing revenue when Customer's subsequent sales or usage occurs.

Question 10.9.20
Over what time period is revenue recognized for a perpetual license of symbolic IP?

Interpretive response: A license to symbolic IP is satisfied over the shorter of the license period and the remaining economic life of the IP. Therefore, when the performance obligation is a perpetual license of symbolic IP, an entity will need to estimate the economic life of the IP to determine the period over which the performance obligation is satisfied. [606-10-55-58(a)]

However, there is no guidance on how an entity should determine the revenue recognition period for a perpetual license of symbolic IP with an indefinite economic life (e.g. some brand or trade names). One acceptable approach may be to perform a discounted cash flow analysis that indicates the time period for which a substantial portion of the present value of the future cash flows has been captured. For example, an entity might consider the guidance in ASC section 350-30-35 on determining the useful life of an intangible asset in evaluating the period over which to recognize revenue.

10.10 Renewals of IP

Excerpt from ASC 606-10

• > Licensing

55-58C Notwithstanding paragraphs 606-10-55-58A through 55-58B, revenue cannot be recognized from a license of intellectual property before both:

a. An entity provides (or otherwise makes available) a copy of the intellectual property to the customer.
b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property. That is, an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.

• • > Example 59—Right to Use Intellectual Property

• • • > Case A—Initial License

55-389 An entity, a music record label, licenses to a customer a recording of a classical symphony by a noted orchestra. The customer, a consumer products company, has the right to use the recorded symphony in all commercials, including television, radio, and online advertisements for two years in Country A starting on January 1, 20X1. In exchange for providing the license, the entity receives fixed consideration of $10,000 per month. The contract does not include any other goods or services to be provided by the entity. The contract is noncancellable.

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. The term of the license (two years), the geographical scope of the license (that is, the customer's right to use the symphony only in Country A), and the defined permitted uses for the recording (that is, use in commercials) are all attributes of the promised license in this contract.

55-391 In determining that the promised license provides the customer with a right to use its intellectual property as it exists at the point in time at which the license is granted, the entity considers the following:

a. The classical symphony recording has significant standalone functionality because the recording can be played in its present, completed form without the entity's further involvement. The customer can derive substantial benefit from that functionality regardless of the entity's further activities or actions. Therefore, the nature of the licensed intellectual property is functional.
b. The contract does not require, and the customer does not reasonably

expect, that the entity will undertake activities to change the licensed recording.

Therefore, the criteria in paragraph 606-10-55-62 are not met.

55-392 In accordance with paragraph 606-10-55-58B, the promised license, which provides the customer with a right to use the entity's intellectual property, is a performance obligation satisfied at a point in time. The entity recognizes revenue from the satisfaction of that performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Additionally, because of the length of time between the entity's performance (at the beginning of the period) and the customer's monthly payments over two years (which are noncancellable), the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

• • • > Case B—Renewal of the License

55-392A At the end of the first year of the license period, on December 31, 20X1, the entity and the customer agree to renew the license to the recorded symphony for two additional years, subject to the same terms and conditions as the original license. The entity will continue to receive fixed consideration of $10,000 per month during the 2-year renewal period.

55-392B The entity considers the contract combination guidance in paragraph 606-10-25-9 and assesses that the renewal was not entered into at or near the same time as the original license and, therefore, is not combined with the initial contract. The entity evaluates whether the renewal should be treated as a new license or the modification of an existing license. Assume that in this scenario, the renewal is distinct. If the price for the renewal reflects its standalone selling price, the entity will, in accordance with paragraph 606-10-25-12, account for the renewal as a separate contract with the customer. Alternatively, if the price for the renewal does not reflect the standalone selling price of the renewal, the entity will account for the renewal as a modification of the original license contract.

55-392C In determining when to recognize revenue attributable to the license renewal, the entity considers the guidance in paragraph 606-10-55-58C and determines that the customer cannot use and benefit from the license before the beginning of the two-year renewal period on January 1, 20X3. Therefore, revenue for the renewal cannot be recognized before that date.

55-392D Consistent with Case A, because the customer's additional monthly payments for the modification to the license will be made over two years from the date the customer obtains control of the second license, the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

10.10.10 Overview

Recognition of revenue from customer renewals of a license are subject to the same conditions as recognition of revenue from the original license. Specifically, an entity cannot recognize revenue from the renewal of a license of IP before

(1) it provides (or otherwise makes available) a copy of the IP to the customer and (2) the beginning of the period in which the customer may use and benefit from the right to access or use the IP. [606-10-55-58C]

Accordingly, an entity does not recognize revenue for a license renewal until the beginning of the renewal period. This would be the case in a renewal of a right-to-use license even when the customer has already been provided with the IP. As a result of this specific guidance, revenue for a renewal of a right-to-use license is not recognized until the beginning of the renewal period rather than when the parties agree to the renewal. The reasoning for this is similar to the example of film rights being granted in the United States and Canada with the stipulation that the film not be broadcast in Canada for six months after the agreement is reached (see Example 10.4.10). Similarly, the renewal of a license is a new license and therefore revenue cannot be recognized before the customer can use and benefit from the license, which cannot be before the beginning of the license period. [ASU 2016-10.BC50]

Example 10.10.10●
License renewal

ABC Corp. enters into a three-year term license of software with Customer that commences on January 1, Year 1. On June 30, Year 3, both parties agree to extend the license for two years effective January 1, Year 4.

ABC does not recognize the renewal license fee as revenue on June 30, Year 3. Instead, it recognizes the fee as revenue on January 1, Year 4, when the two-year extension period begins and Customer can use and benefit from the software under the renewal right.

10.11 Sales- or usage-based royalty exception

10.11.10 Overview

There is an exception to the general revenue model when variable consideration is in the form of sales- or usage-based royalties attributable to licenses of IP. This exception is referred to as either the royalty exception or the royalty recognition constraint.

The FASB decided that an entity should not recognize any revenue for the variable amounts related to a royalty until the uncertainty is resolved – i.e. when a customer's subsequent sales or usage occurs. This exception requires entities to recognize sales- or usage-based royalties at the later of when the sales or usage occurs or the performance obligation is satisfied or partially satisfied rather than estimate the royalties subject to the variable consideration guidance and recognize as the performance obligations are satisfied. [606-10-55-65, ASU 2014-09.BC415, ASU 2016-10.BC70]

10.11.20 Scope of royalty exception

Excerpt from ASC 606-10

• • > Sales-Based or Usage-Based Royalties

55-65A The guidance for a sales-based or usage-based royalty in paragraph 606-10-55-65 applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

55-65B When the guidance in paragraph 606-10-55-65A is met, revenue from a sales-based or usage-based royalty should be recognized wholly in accordance with the guidance in paragraph 606-10-55-65. When the guidance in paragraph 606-10-55-65A is not met, the guidance on variable consideration in paragraphs 606-10-32-5 through 32-14 applies to the sales-based or usage-based royalty.

• • > Example 60—Sales-Based Royalty Promised in Exchange for a License of Intellectual Property and Other Goods and Services

55-393 An entity, a movie distribution company, licenses Movie XYZ to a customer. The customer, an operator of cinemas, has the right to show the movie in its cinemas for six weeks. Additionally, the entity has agreed to provide memorabilia from the filming to the customer for display at the customer's cinemas before the beginning of the six-week airing period and to sponsor radio advertisements for Movie XYZ on popular radio stations in the customer's geographical area throughout the six-week airing period. In exchange for providing the license and the additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for Movie XYZ (that is, variable consideration in the form of a sales-based royalty).

55-394 The entity concludes that the license to show Movie XYZ is the predominant item to which the sales-based royalty relates because the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the related promotional goods or services. The entity will recognize revenue from the sales-based royalty, the only fees to which the entity is entitled under the contract, wholly in accordance with paragraph 606-10-55-65. If the license, the memorabilia, and the advertising activities were separate performance obligations, the entity would allocate the sales-based royalties to each performance obligation.

The royalty exception applies only when the: [606-10-55-65A]

— royalty relates only to a license of IP; or
— the license of IP is the predominant item to which the royalty relates.

The exception does not apply to legal sales of IP or scenarios when the license is not the predominant item. Section 10.2 discusses when a license of IP exists.

Often it will be clear when the exception applies because the royalty relates solely to a license of IP. However, licenses of IP are often bundled with other goods or services that may or may not be distinct, with the consideration taking the form of a sales- or usage-based royalty for all goods or services in the contract. For example:

— software licenses are commonly sold with PCS and other services (e.g. implementation services) or hardware in which there is a single consideration in the form of a sales- or usage-based royalty;

— franchise licenses are frequently sold with consulting or training services or equipment, with ongoing consideration in the form of a sales-based royalty;

— biotechnology and pharmaceutical licenses are often sold with R&D services and/or a promise to manufacture the drug for the customer, with a single consideration in the form of a sales-based royalty; or

— licenses to digital media and a promise for promotional activities may be sold with a single consideration in the form of a sales-based royalty.

Even if the royalty does not relate solely to the license of IP, the royalty exception still applies when the license is the predominant item to which the royalty relates. 'Predominant' is not defined. However, the license may be the predominant item when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates. As a consequence, significant judgment may be required to determine whether a license is the predominant item in an arrangement. [606-10-55-65A, ASU 2016-10.BC77]

Question 10.11.05●

Can the royalty exception apply to a portion of a royalty?

Interpretive response: No. The royalty exception applies either to the entire royalty or to none of the royalty. An entity cannot split a royalty into a portion that is subject to the royalty exception and a portion that is subject to the general guidance on variable consideration. However, if the royalty relates to two or more performance obligations satisfied at different times, an entity will need to allocate the consideration between those performance obligations and apply the royalty exception to each of them, recognizing revenue at the later of when the sales or usage occurs or the respective performance obligation is satisfied or partially satisfied. [606-10-55-65B, ASU 2016-10.BC75]

Question 10.11.10

Does the royalty exception apply if no single license is predominant?

Interpretive response: It depends. If, together, two or more of the licenses to which the royalty relates are predominant – i.e. the royalty relates predominantly to those multiple licenses when considered in aggregate – the royalty exception applies to that royalty. [ASU 2016-10.BC75]

Excerpt from ASU 2016-10

BC75 To enhance understandability and promote consistency in application, the Board decided to clarify that:

a. An entity should not account for a single royalty under two constraint models. That is, the entity should not split a single royalty between a portion to which the royalties recognition constraint would apply and a portion to which the general constraint on variable consideration (in paragraphs 606-10-32-11 through 32-13) would apply. However, this amendment does not affect the requirement to allocate fees due from a sales-based or usage-based royalty to the performance obligations (or distinct goods or services) in the contract to which the royalty relates, regardless of the constraint model the entity is required to apply (see Example 35, Case B and Example 60 in Topic 606, which demonstrate that application of the royalties recognition constraint does not change the requirement to allocate the transaction price to the performance obligations in the contract).
b. A sales-based or usage-based royalty is promised in exchange for a license and, therefore, the royalties recognition constraint applies whenever a license is the sole or predominant item to which the royalty relates. This would include situations in which no single license is the predominant item to which the royalty relates but the royalty predominantly relates to two or more licenses promised in the contract.

Question 10.11.20

Can the royalty exception apply when a license is not distinct from other goods or services?

Interpretive response: Yes, but only if the license is considered the predominant item to which the royalty relates. The FASB decided not to restrict the royalty exception to a license that is a separate performance obligation because of the usefulness of the information from applying the exception. [ASU 2016-10.BC77]

Generally, when a license is not distinct from other goods or services, the royalty exception applies when the nature of the promise is to ultimately transfer IP. For example, if software and customization services are combined, the nature of the promise may be that of modified IP and subsequent royalties would relate to sales or usage of the modified IP. Similarly, when services are not distinct from a franchise license, but rather are inputs into fulfilling the entity's promise to transfer symbolic IP, the IP would be the predominant item.

In contrast, when the nature of a combined promise is a supply of a tangible product with embedded IP, any subsequent royalties would generally not be predominantly related to the IP. For further discussion of licenses and supply arrangements, see Question 10.11.68.

Question 10.11.25

Does the royalty exception apply for an agent if revenue is based on royalties from the customer's license of IP?

Interpretive response: It can. In certain arrangements, an owner of IP (the principal) contracts with an agent to sell licenses to the IP. In return for selling its licenses to its IP, the IP owner pays the selling agent a percentage of the sales- or usage-based royalties the IP owner earns from the end consumer. For example, a film studio may contract with a distributor to license a film to theaters on its behalf in return for a percentage of royalties received from theaters based on ticket sales.

We believe that the selling agent could apply the sales-based royalty exception in this scenario if, and only if, the agency service is directly related to the licensor's provision of the IP and the license of IP is the predominant item to which the royalties relate. This is notwithstanding that the selling agent is not the party responsible for fulfilling the promise to transfer the license.

Instead of applying the royalty exception, we believe the selling agent could apply the general guidance on estimating variable consideration. This is because paragraph 606-10-55-65 could be read to suggest that the royalty exception should apply only when it is promised in exchange for a license, not *arranging for* the provision of a license by another entity.

An agent should be consistent in its application of the guidance to similar arrangements.

If the agency services do not relate directly to the licensor's provision of the IP – e.g. they instead relate to the licensor or another party's provision of a service – or if the license of IP is not the predominant item to which the royalties relate, the royalty exception does not apply and the selling agent must apply the general guidance on estimating variable consideration (see section 5.3).

Question 10.11.30

Is a promise to provide future updates, upgrades and enhancements a license of IP for purposes of the royalty exception?

Interpretive response: Yes. Whether specified or unspecified, a promise to provide updates, upgrades and enhancements – as well as rights to use specified or unspecified additional IP – is fundamentally a promise to provide the customer with a right to use updated, upgraded or enhanced IP. Therefore, when considering whether a sales- or usage-based royalty relates predominantly to one or more licenses of IP (see Question 10.11.10), we believe rights to specified or unspecified updates, upgrades or enhancements (as well as rights to use specified or unspecified additional IP) should be considered licenses of IP.

Question 10.11.40

How does an entity distinguish between an option to acquire an additional license and a usage-based royalty?

Interpretive response: A license is just an example of a promised good or service. Consequently, a provision that permits a customer to obtain control of *additional licenses* is subject to the same customer option guidance as any other provision that permits a customer to obtain additional goods or services that are not licenses. Therefore, the entity needs to determine if the option conveys a material right to the customer that is a performance obligation or is a marketing offer that is accounted for as a separate contract (see chapter 8). In contrast, a customer's usage of a license that it already controls may result in an additional usage-based fee, which is subject to the royalty exception.

An entity examines the contract to determine whether it includes an option for the customer to acquire additional licenses or merely results in an additional usage-based fee to the entity.

— A contract likely includes an option to acquire additional licenses if the contract provision (1) describes an option for the customer to acquire incremental rights or capabilities to make use of the license (i.e. additional goods or services) and (2) each exercise of that option is a separate purchasing decision by the customer that would obligate the entity to transfer control of the incremental rights or capabilities to the customer.

— A contract likely includes a usage-based fee if the contract provision merely describes how the customer will compensate the entity for the use of the rights and capabilities that it already controls. For example, each time the customer uses a license that it already controls, it entitles the entity to additional compensation.

In determining whether a contract provision describes an option to acquire additional licenses or is a usage-based fee, an entity undertakes a similar evaluation as it would for any other goods or services (see Questions 5.3.10 and 5.3.20). This determination frequently requires judgment because the two types of provisions are often worded similarly in contracts. However, due to the unique nature of licenses, we believe the following are some additional factors to consider in making this distinction.

— **The customer is required to execute an additional contract** (whether characterized as a purchase order, an addendum, an amendment, or papered as either a modification of the existing contract or a termination of the existing contract and creation of a new contract). This typically suggests an affirmative, additional purchasing decision to acquire incremental rights and capabilities that the customer does not already control. In contrast, when the customer already controls rights under an existing contract, it would not need to enter into an additional contract to obtain an additional license and any additional payments may be a usage-based royalty.

— **The customer is required to make an affirmative request of the entity.** This may suggest that the customer is making an affirmative decision to request additional rights or capabilities from the entity. In contrast, when a customer already controls the rights, it would typically not need to make such a request.

— **An *incremental* right or capability usually *exists concurrently* with the existing right(s) that has previously been transferred to the customer.** For example, in Example 61B in Topic 606 (reproduced in section 10.4), the customer obtains the incremental right to embed the entity's software into another class of its consumer products one year after obtaining the initial right to embed the entity's software in the first class of consumer products. That right increases the customer's rights under the contract and the customer's ability to derive benefit from use of the software. The example concludes that the customer now has rights to embed the vendor's software into *two* classes of consumer products for the rest of the term. In other words, the incremental right existed together with the initial rights for the rest of the term. In contrast, usage of a license that the customer controls typically occurs and is consumed – e.g. a transaction is processed, a call is fielded or a product is sold that includes the embedded software. One 'usage' is not additive to another.

— **An incremental right, once obtained, will frequently be granted for the remainder of the term of the original right(s) of use and/or have to be cancelled.** For example, a customer that decides to add 100 user licenses may have a continuing obligation to pay for those additional licenses (e.g. additional periodic license fees or PCS fees) until it elects to terminate those rights. Termination includes not electing to renew; Topic 606 does not distinguish between decisions to renew and decisions not to terminate. In contrast, usage typically occurs and resets each measurement period – i.e. the usage occurs and ends on its own. For example, while an entity might expect a customer to process at least a minimum number of transactions during a given measurement period, those transactions occur and end, and it is only *new* transactions that trigger additional usage-based fees to the entity in the next measurement period. [ASU 2014-09.BC391]

— **An option to acquire additional rights is in the customer's control.** The usage of existing rights may be outside the control of those making purchasing decisions. For example, usage may be triggered by the customer's customers, or may be the result of employees far from the procurement process using tools that they have been provided to process transactions, conduct research or produce reports, etc.

Example 10.11.10
Option to acquire additional licenses vs. usage-based fee

Sports Team enters into a contract to license its logo to Customer for five years beginning at contract inception. Under the contract, Customer has the right to print the logo on coffee mugs that Customer produces. Customer will pay $100,000 upfront and $0.50 per mug produced using the logo.

The contract also provides Customer with an option to purchase the right to print the logo on T-shirts at the end of Year 1 for an additional $500,000. After Customer exercises its right it will be required to pay $1.00 per T-shirt produced.

Sports Team concludes that:

- the provision permitting Customer to acquire the right to print the logo on T-shirts for an additional $500,000 is a customer option to acquire an additional license;
- the $0.50 per mug fee is a usage-based royalty that links the contract consideration to Customer's right to access the logo it has transferred (and continues to transfer) to Customer; and
- the $1.00 per T-shirt fee is a usage-based royalty that links the contract consideration to Customer's right to access the logo.

The $0.50 per mug fee is a usage based royalty because Customer controls access to the logo to use for mugs as of contract inception. When Customer uses the logo, there is not an additional purchasing decision that then requires Sports Team to transfer control of additional rights to the Customer.

The right to print the logo on T-shirts is incremental from the right to use the logo on mugs. Customer is required to make an affirmative request that is a separate purchasing decision to exercise the option. Sports Team transfers control of additional rights when Customer begins to benefit from those rights after Customer exercises its contractual right after Year 1. The incremental right then exists concurrently with the right to use the logo on mugs for the remainder of the contract term.

The $1.00 per T-shirt fee is usage-based royalty because after Customer obtains control of the right to use the logo to product T-shirts, each usage of that right is not an additional purchasing decision that then requires Sports Team to transfer control of additional rights to the Customer. Customer does not need to make an affirmative request to Sports Team to use the license.

Example 10.11.20
User-based provision that is a usage-based fee

Network enters into a three-year contract to license its media content to Cable Company, whereby Cable Company will pay Network a fixed upfront fee of $10,000 plus a $5 fee for each of Cable Company's subscribers each month.

Network has determined that its promise is a license of media content and not a service to transmit the content. This is based on an assessment that the Cable Company obtains and controls the media content before it is transferred to the subscribers.

Network concludes that the user-based fee is a usage-based royalty, rather than a customer option to acquire incremental rights (beyond those transferred at contract inception) to obtain and distribute the media content to subscribers.

Network considers the following in making this judgment.

— Cable Company does not have to obtain anything from Network to broadcast the content to additional subscribers. Further, Network does not transfer control of additional rights for each subscriber.

— Cable Company does not execute an additional contract with Network when it adds a new subscriber.

— A new subscriber in a given month, which triggers the user-based fee, does not create an ongoing obligation to Network for the remainder of the license term. Rather, the potential fee resets each month. For example, if Subscriber #1 signs up for service with Cable Company in Month 1 of the arrangement and cancels after that first month, Customer will owe only the $5 user-based fee for Subscriber #1 for Month 1.

— Cable Company does not obtain an incremental right that increases the overall capabilities with each subscriber. The rights that Cable Company controls are not different in a month in which it has 100 subscribers or 500 subscribers.

Question 10.11.45

How does an entity account for additional fees identified through an audit of customer usage?

Interpretive response: It depends. Licenses often have contractual provisions entitling the licensor to audit a customer's use of the IP to identify usage that is beyond the scope of what is allowed in the contract or to ensure the customer is properly reporting its royalty payments.

The primary issue is the timing of when the fees resulting from the audit should be recorded. This includes audits after the balance sheet date but before the financial statements are issued (or available to be issued), which means that the guidance in Topic 855 (subsequent events) is relevant.

To determine the appropriate accounting, the entity starts by determining whether the additional usage is an additional license or a sales- or usage-based royalty subject to the royalty exception (see Question 10.11.40).

Additional license

The original license agreement may include options for the customer to purchase additional user licenses on the same terms and conditions as the original license. In that case, the customer obtains control of the additional user licenses through exercise of its contractual option, and the entity will be entitled to additional consideration. If the customer does not issue a purchase order or notify the entity, that does not change the entity's enforceable rights to the consideration.

In contrast, if the original license does not include options, the contract may not provide enforceable rights when the unauthorized usage occurs.

Original license includes options

If an audit has *not* occurred, we believe an entity generally should not record an estimate of additional unknown licenses at the end of each period unless there is:

- an established history of customers with contractual options adding user licenses and not communicating those additions timely; or
- information about a particular customer that provides the entity with the ability to estimate.

This approach is consistent with the additional consideration being variable consideration, similar to an unpriced change or contract claim (see chapter 11). In considering the variable consideration guidance (including the constraint), absent the history or specific customer information, the estimate would generally be zero. In contrast, when a history or specific information exists, that information provides a basis for the entity to include an amount in the transaction price when considering the variable consideration guidance (including the constraint).

When the entity performs an audit after the balance sheet date but before the financial statements are issued (or available to be issued), it needs to consider whether the audit gives rise to a recognized or unrecognized subsequent event under Topic 855. For a more detailed discussion of subsequent events, see chapter 9 of KPMG Handbook, Financial statement presentation.

When the original agreement includes options, we believe the audit should be considered a recognized subsequent event, and the additional fees should be recognized in the period of usage rather than the period the audit is concluded. This is because the audit confirms the condition that existed at the balance sheet date – i.e. the enforceable right to the consideration.

Original license does not include options

When the original contract does not provide the right to acquire additional licenses or specific monetary remedies for unauthorized use, the entity needs to evaluate whether enforceable rights and obligations exist when the contract does not specifically address this use. In performing this evaluation, we believe entities should consider Question 3.6.10, which discusses a continuation of service after a contract has expired.

In a scenario with unauthorized use, we believe that a customer generally will need to agree to a new contract after the audit is concluded for revenue to be recognized, because the nature of the transaction calls into question whether the contract existence criteria are met (see section 3.2). Specifically, there is uncertainty about the customer's commitment to its contractual obligations and the collectibility of any license fees not paid upfront. Therefore, no revenue is recognized until that event occurs.

Similarly, if a contract does not exist at the balance sheet date, the contract entered into after the balance sheet date but before the financial statements are issued (or available for issuance) is a nonrecognized subsequent event. This is because the new contract represents new facts and circumstances; it does not confirm a condition that existed at the balance sheet date.

Sales- or usage-based royalty

As discussed in Question 10.11.70, if the consideration to which the entity is entitled from a sales- or usage-based royalty is not known in time for an entity's financial reporting, the entity estimates the royalties to which it is entitled using the model for estimating variable consideration. When the additional usage is subject to the royalty exception, the results of the audit will likely cause an entity to adjust its estimate of the royalties earned.

If the audit occurs after the balance sheet date but before the financial statements are issued (or available for issuance), the entity considers Topic 855 to evaluate whether information gained from an audit results in a recognized or nonrecognized subsequent event. Generally, when the audit confirms usage that occurred before the end of the reporting period, the audit is considered a recognized event. This is because it confirms a condition or estimate that existed on the balance sheet date – i.e. the estimated amount of usage that already occurred.

Example 10.11.25
User license audits

On January 1, Year 1, Software Co entered into a license agreement with Customer. The agreement gives Customer the right for 500 users to use Software Co's proprietary software at a price of $100 per user.

Under the license agreement, Customer may purchase additional user licenses, subject to the same terms and conditions as the original user licenses, for $100 per user. Without purchasing additional user licenses, usage of the software by more than 500 users is prohibited and is considered noncompliance with the contract (and potentially piracy).

Each user represents a separate license. Because the price per additional user license equals the price of the original user licenses, the option to acquire additional user licenses does not provide Customer with a material right.

Software Co has contractual audit rights related to Customer's use of its software.

The dates in the following scenarios are all in Year 1.

Scenario 1: Audit is a recognized subsequent event

On June 1, Customer allows 100 additional users to begin using the software (i.e. there are now a total of 600 users), but does not communicate this to Software Co. On July 15, Software Co performs a license audit and identifies the additional users. On August 15, Customer issues a purchase order for $10,000 for the amount owed for the additional user licenses.

In this scenario, Customer obtained control of the 100 additional user licenses on June 1. At that date, Customer has already obtained (1) a copy of the software and (2) the ability to use and benefit from those additional user licenses (see section 10.9.10). Customer also had a contractual right to obtain the licenses.

Software Co prepares financial statements for the period ending June 30 that are issued on July 30. The audit on July 15, occurs before the financial statements are issued (or available for issuance). The audit provides information about a recognized subsequent event because Customer obtained control of the 100 additional user licenses on June 1 through exercise of its contractual option.

Therefore, the revenue for the 100 additional user licenses is recognized in Software Co's June 30 financial statements. As a next step, Software Co needs to consider whether there is a history of concessions that may indicate the additional fee is variable and consider the guidance on variable consideration.

Scenario 2: Audit is an unrecognized subsequent event

Assume the same facts as Scenario 1, except that Software Co does not undertake license audits regularly and does not audit Customer before the June 30 financial statements are issued (or made available for issuance).

Further, historically Software Co's customers do not add user licenses without communicating their take-down of such licenses timely. Software Co's license audits rarely uncover significant unreported license usage.

Software Co considers the variable consideration guidance and does not recognize estimated additional license revenue in its June 30 financial statements. This decision is based on the following reasons.

— No subsequent event has occurred – i.e. no license audit occurs before the financial statements are issued (or made available for issuance).

— Software Co's lack of history of additional licenses not being communicated, or specific information suggesting an issue with this contract, indicates that the amount of additional license revenue for unreported licenses to which Software is entitled through the second quarter of Year 1 is $0.

If Software Co had different historical information, or contract-specific information that pointed to additional licenses, it would likely be appropriate for Software to estimate (subject to the constraint) the revenue to which it expects to be entitled for the user licenses Customer added, but did not communicate, as of June 30.

Scenario 3: Additional users not allowed under original contract

Assume the same basic facts as Scenario 1, except that the license agreement does not allow Customer to obtain additional users. Therefore, use of the software by more than 500 Customer users is a violation of the agreement. To increase its user licenses, Customer must enter into a new contract with Software Co.

On June 1, Customer violates the agreement by providing 100 additional users (making 600 users in total) access to Software Co's software. On July 15, Software performs a license audit and identifies the additional users.

On August 15, Customer and Software Co reach an agreement under which Customer will pay for the additional 100 user licenses. Accordingly, Customer issues a purchase order for $10,000 and Software Co formally grants 100 additional user licenses.

Software Co concludes that no contract exists until the additional license amendment is agreed on August 15. This is because it lacks evidence that Customer is committed to its obligations or that Software Co will grant Customer the license until the final terms are agreed. Therefore, Software Co does not recognize revenue until that date. The audit does not confirm an event that existed at the balance sheet date – the contract for the additional user licenses did not yet exist.

Question 10.11.50

Is a milestone payment subject to the royalty exception?

Interpretive response: In general, a fixed payment constitutes a sales- or usage-based royalty only if it is determined solely by reference to a sales- or usage-based threshold – e.g. a fixed amount is payable to the entity once a cumulative sales or usage threshold is reached.

In contrast, if a fixed payment is determined (solely or partially) based on metrics or conditions that are not sales- or usage-based (and that are substantive), it is not a sales- or usage-based royalty for purposes of determining whether the royalty exception applies.

For example, a contract that entitles an entity to a $5 million payment after its customer has reached $50 million in sales is subject to the exception because the payment is based on the customer's sales. In contrast, a contract in which a payment is contingent on the customer achieving milestones (such as regulatory approval of a drug) is not subject to the exception because the payment is not based on the customer's sales or use.

Question 10.11.55

Is a milestone payment for the license of IP that is based solely on the first commercial sale subject to the royalty exception?

Interpretive response: Generally, yes. An entity may license IP to a customer and be entitled to a milestone payment on the customer's first sale of a product using the entity's IP. As discussed in Question 10.11.50, a payment determined solely by reference to a sales- or usage-based threshold is subject to the royalty exception.

For example, an entity licenses rights to a drug compound that will require further development before regulatory approval. After regulatory approval, the customer can sell the approved drug to its customers and the first sale will trigger a milestone payment. Because the milestone payment is based on a sales threshold, the entity must apply the royalty exception and recognize the amount at the later of when the sale or usage occurs or the performance obligation is satisfied or partially satisfied.

Question 10.11.60

Is a minimum guaranteed royalty subject to the royalty exception?

Interpretive response: No. The royalty exception applies only to variable consideration. The minimum guarantee is fixed consideration and is subject to the general requirements of Topic 606. See Questions 10.11.110, 10.11.130 and 10.11.140 for additional discussion of guaranteed minimums.

Question 10.11.65

Can an entity apply the royalty exception when the royalty is calculated on a financial metric other than sales?

Interpretive response: It depends on whether the metric is considered 'sales-based'.

In certain licenses, royalties are calculated based on financial statement metrics other than sales. For example, a franchisor may be entitled to a fee based on a fixed percentage of gross profit generated by the franchisee for the entire term of the franchise agreement. The franchise agreement might define gross profit as net sales less costs of goods sold.

When the metric is 'sales-based', we believe the exception should be applied. Determining if the royalty exception is sales-based depends on whether the metric is directly attributable to revenue or sales volumes and how the customer uses the IP.

A metric such as gross profit, defined as sales less cost of goods sold, is generally directly attributable to revenue and sales volumes. To the extent cost of goods sold is clearly defined and its variability is predominantly based on revenue, an entity can apply the royalty exception.

However, the royalty exception may not apply if the royalty calculation includes other items such that a direct correlation to revenue no longer exists, or if it is based predominantly on something other than sales. Examples include calculations incorporating significant fixed costs (e.g. sales department compensation), other adjustments (e.g. decline in value of goods, obsolescence, damage), allocations between multiple goods or services that are not defined or applied consistently, and changes to inventory cost method used.

For other profit metrics (e.g. EBITDA, net income), entities should consider the degree to which the metric is affected by changes in sales versus allocations of other costs when determining whether use of the royalty exception is appropriate.

Question 10.11.68

Does the royalty exception apply in a license and supply agreement when the fees are based on the cost of the products transferred plus a sales-based royalty?

Interpretive response: It depends on whether the royalty is predominantly related to the license of IP. Evaluating whether the license is predominant in these arrangements can be challenging because the sale that triggers the royalty often depends on the entity first transferring control of the product rather than just transferring the license.

To illustrate, ABC Corp. enters into a contract to license a drug compound and manufacture the commercialized product for Customer. Customer will pay ABC the cost of each product it receives, which is invoiced at the time of transfer. Customer will also pay ABC a royalty based on its sales of the commercialized products to end customers. This means that ABC makes no profit on product sales unless it subsequently receives the royalty.

We believe there are different considerations depending on whether the license and products are distinct.

License is not distinct

As discussed in Question 10.11.20, a license does not need to be distinct for the royalty exception to apply. However, the license must be considered the predominant item to which the royalty relates.

In a license and supply arrangement where the license is not distinct, we believe the license generally will not be the predominant item because the nature of the promise in those arrangements is that of a supply agreement and not a license. This is consistent with Topic 606's Example 56 Case A, which states the nature of this type of arrangement is a 'sole sourced supply'. Further, the basis for conclusions also states that the royalty exception is not intended to apply to sales of tangible goods that include IP, which is all the customer is obtaining from an accounting perspective (i.e. the finished product) when the license is not distinct in these circumstances. [606-10-55-370, ASU 2016-10.BC78]

License is distinct

Even when the license is distinct, an entity will still need to determine whether the license is the predominant item to which the royalty relates. When the entity does not make a profit margin on product sales, it indicates that the price charged for the product could be below stand-alone selling price and at least some of the royalty is related to the product. Therefore, entities should consider quantitative and qualitative factors to evaluate whether the royalty is predominantly related to the license.

We believe the following are some of the relevant factors to consider.

— **Stand-alone selling price.** If the entity would allocate a predominant amount of the royalty to the license based on relative stand-alone selling prices, this indicates that the royalty is predominantly related to the license. Even though some of the fee is allocated to the product sale, the predominant amount is allocated to the license. This may occur when the combined profit margin of the royalty plus cost of the product is in excess of a normal manufacturing profit margin for a similar arrangement. In making this determination, entities should consider all payment terms in the arrangement that affect the allocation (e.g. upfront fees).

— **Other suppliers.** The customer may have other suppliers (or has a substantive right to obtain other suppliers) and is paying (or would be obligated to pay) the entity a royalty based on sales of product sourced from other parties. This indicates the royalty predominantly relates to the license because the payment is not dependent on the entity manufacturing the product.
— **Position if arrangement terminated.** The customer might need to pay a similar royalty rate if the supply arrangement was terminated and the customer manufactured the product. If the royalty was significantly reduced or no royalty was paid, it may indicate the royalty predominantly relates to the manufacturing.

10.11.30 Application of royalty exception

Excerpt from ASC 606-10

• • > Sales-Based or Usage-Based Royalties

55-65 Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.
b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

For sales- or usage-based royalties that are attributable to a license of IP, the amount is recognized at the later of: [606-10-55-65]

— when the subsequent sales or usage occurs; and
— the satisfaction or partial satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

In other words, under the royalty exception an entity recognizes revenue from a sales- or usage-based royalty when (or as) the customer's subsequent sales or usage occurs – unless recognition in that manner would accelerate the recognition of revenue ahead of the entity's performance toward complete satisfaction of the performance obligation. See section 10.11.40 for additional considerations on right-to-*use* licenses, and section 10.11.50 on right-to-*access* licenses.

Question 10.11.70

Is it acceptable to recognize revenue from sales- or usage-based royalties on a lag basis?

Interpretive response: No. If the consideration to which the entity is entitled from a sales- or usage-based royalty is not known in time for the entity's financial reporting – e.g. the entity will not receive a royalty report before it must file its Form 10-Q or Form 10-K – the entity estimates the royalties to which it is entitled using the model for estimating variable consideration (see section 5.3).

This conclusion is based on SEC staff remarks. Specifically, Wes Bricker, Deputy Chief Accountant of the SEC's Office of the Chief Accountant, discussed consultations with registrants and indicated, "The standard setters did not provide a lagged reporting exception with the new standard. Accordingly, I believe companies should apply the sales- and usage-based royalty guidance as specified in the new standard. The reporting, which may require estimation of royalty usage, should be supported by appropriate internal accounting controls." [2016 AICPA Conf]

We understand there are two views on whether entities should apply the variable consideration constraint when making this estimate. We believe entities should apply a consistent methodology to estimating these amounts. [ASU 2016-10.BC71]

— **Apply the constraint.** Under this view, entities apply the constraint because once the sale or usage has occurred (1) the royalty recognition constraint no longer applies and (2) the entity needs to estimate the transaction price because the ultimate amount of consideration is unknown.

— **Do not apply the constraint.** Under this view, entities do not consider the constraint because only one constraint model is applied to variable consideration. In the case of sales- or usage-based royalties related to IP, the royalty recognition constraint applies and not the general variable consideration constraint.

Example 10.11.30

Royalties report received after financial statements are issued

Drug Manufacturer enters into a five-year arrangement to license rights to a drug compound to Customer. The license provides Customer with a right to use Drug Manufacturer's IP. The consideration for the license is a sales-based royalty of 5% of Customer's gross sales to end customers of products that include Drug Manufacturer's IP.

Customer uses an extensive distributor network and must receive reports on sales of its products before it can report royalties owed to Drug Manufacturer. This process takes time, such that Customer reports royalties to Drug Manufacturer generally only after Drug Manufacturer issues its quarterly financial reports.

Drug Manufacturer estimates sales for the quarter using a most-likely-amount or expected-value approach (see section 5.5.30) and the constraint on variable consideration. In making its estimate, Drug Manufacturer considers royalties earned in prior periods, royalties earned under similar arrangements and other knowledge about demand for Customer's products from consumers during the period in question.

Regardless of the quality and availability of information, Drug Manufacturer estimates royalties earned subject to the variable consideration constraint because it follows the first view described in Question 10.11.70.

10.11.40 Application of royalty exception to a right-to-*use* license

Excerpt from ASC 606-10

• • > Sales-Based or Usage-Based Royalties

55-65 Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.
b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

• • > Example 35—Allocation of Variable Consideration

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

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.

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.

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.

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

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.

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.

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).

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.

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.

When a single right-to-use license (functional IP) is the only performance obligation in a contract, the royalty exception will typically result in an entity recognizing revenue as the sales or usage occurs (see Questions 10.11.80 to 10.11.100 on the effect of changing royalty rates). That is because a right-to-use license is satisfied at a point in time and customer's sales or usage occurs after it obtains control of that license. However, when a right-to-use license is the predominant item and there are other performance obligations satisfied at different times an entity will need to allocate that consideration to the different performance obligations (see Questions 10.11.120 and 10.11.130). [ASU 2016-10.BC75]

Question 10.11.80

In a right-to-use license, does a declining royalty rate that applies retrospectively preclude the recognition of royalties as the customer's sales or usage occurs?

Background: In some tiered-pricing structures, the customer will be granted a refund or credit related to royalties previously paid once the customer reaches a lower pricing tier. For example, an arrangement may require the customer to pay $0.10 per usage during the first year of the contract or until a certain volume of usage has occurred and then $0.08 per usage thereafter. In addition, the contract may require the entity to provide the customer with a rebate for the extra $0.02 it has paid per usage while it was still within the higher pricing tier.

Interpretive response: When there is a retrospective adjustment to a royalty rate, the entity estimates the ultimate royalty rate that will apply to each subsequent sale or usage. The potential rebate is variable consideration (i.e. consideration payable to the customer); therefore, we believe the entity recognizes only that portion of the per-usage fee to which it expects to be entitled. In the example, this means that if the entity expects to provide a rebate of $0.02 per usage for each usage it initially bills at $0.10, it does *not* recognize $0.10 per usage. The entity instead recognizes only the amount of that $0.10 to which it ultimately expects to be entitled, which includes consideration of the general constraint on variable consideration with respect to that variability in the per-usage price (see section 5.3).

Example 10.11.40
Declining royalties – retrospective basis

Drug Manufacturer enters into a five-year arrangement to license a drug formula to Customer. The license provides Customer with a right to use Drug Manufacturer's drug formula in its products. The consideration for the license is a sales-based royalty of Customer's gross sales to end customers of products that include Drug Manufacturer's drug formula, structured as follows.

Product sales	Royalty rate
0 – 10,000	10%
10,001 – 20,000	9%
20,001 – 30,000	8%
30,001 – 40,000	7%
> 40,000	6%

When Customer crosses into a new pricing tier, it receives a refund of the prior royalties it paid per unit (for all units) in excess of the rate applicable in the new pricing tier.

Drug Manufacturer estimates the number of units it expects Customer to sell that include its drug formula. Using an expected-value method, Drug Manufacturer estimates that Customer will sell 29,000 units, and concludes it is probable that Customer will not sell any more than 33,000 units.

If Customer sells 29,000 units, Drug Manufacturer would be entitled to 8% of Customer's gross sales price for all of those 29,000 units. However, if Customer sells 33,000 units, Drug Manufacturer would be entitled to 7% of Customer's gross sales price for those 33,000 units.

Drug Manufacturer concludes that it should recognize 7% per Customer product sale until it becomes probable Customer will not sell at least 30,001 units. If, for example, at the end of Year 2, it becomes probable that Customer will not sell more than 30,000 units, Drug Manufacturer recognizes a cumulative-effect adjustment to recognize previously deferred royalties to reflect that:

— it now expects to be entitled to 8% per Customer product sale; and
— use of that rate does not carry the risk of a significant revenue reversal.

Question 10.11.90

In a right-to-use license, does a royalty rate that declines on a prospective basis affect how the royalty is recognized?

Interpretive response: No. Some licensing arrangements provide tiered pricing whereby a customer will pay a lower royalty rate later in the contract. For example, an arrangement may require the customer to pay $0.10 per usage during the first year of the contract or until a certain volume of usage has occurred, and then $0.08 per usage thereafter. This type of pricing scheme does not provide the customer with a material right because a sales- or usage-based fee is variable consideration and not an optional purchase (see Question 5.3.30).

In a right-to-use license (functional IP), the entity recognizes the contractually owed royalty each time a subsequent usage occurs. In the example, this means that the entity recognizes $0.10 in revenue per usage for as long as that is the enforceable amount owed per usage, and recognizes $0.08 in revenue per usage after the customer reaches the defined threshold. This result occurs in a right-to-use license because the entity's performance has already occurred; therefore, the subsequent sales or usage occurs after the performance obligation has been satisfied. See Question 10.11.160 for the effect of a declining royalty right in a right-to-access license. [606-10-55-65]

Example 10.11.50

Declining royalties – prospective basis

Drug Manufacturer enters into a five-year arrangement to license a drug formula to Customer. The drug formula is functional IP and provides Customer with a right to use license. The consideration for the license is a sales-based royalty of Customer's gross sales to end customers of products that include the drug formula, structured as follows.

Year	Royalty rate
1	10%
2	8%
3	6%
4	4%
5	2%

Drug Manufacturer is not required to refund or adjust the price for any portion of a royalty once it is earned.

Drug Manufacturer does *not* assume a weighted-average royalty rate based on the expected sales and does not consider whether the lower royalty rate in later years of the contract provides Customer with a material right – i.e. because each additional product sold using the drug formula is not an optional purchase by Customer.

Drug Manufacturer recognizes revenue as the subsequent sales of products that include Drug Manufacturer's drug formula occur based on the royalty rate applied to that sale in the contract.

Question 10.11.100

In an increasing royalty rate scenario for a right-to-use license, should the entity recognize revenue at the expected 'blended' rate?

Interpretive response: No. The royalty exception precludes recognition of royalty amounts before the customer's subsequent sales or usage occurs. Therefore, it would be inappropriate to recognize royalties at an anticipated higher, 'blended' rate. [606-10-55-65(a)]

Example 10.11.60

Increasing royalty rate

Software Provider enters into a five-year arrangement to license software to Customer. The software license provides Customer with a right to use the Software Provider's software. The consideration for the license is a sales-based royalty on gross sales at the following rates.

Product sales	Royalty rate
0 – 10,000	2%
10,001 – 20,000	4%
> 20,000	5%

Software Provider expects, based on relevant, objective evidence, that Customer will sell between 26,000 and 29,000 products that include its software. The lower initial royalty rate was agreed to by Software Provider to permit Customer to sell products initially at a lower price point to generate demand.

Despite the fact that Software Provider has relevant, objective evidence suggesting that, on a blended rate basis, it will be entitled to more than 2% per product sold, it does not estimate a blended rate to apply to the first 10,000 unit sales of Customer's product. Rather, it recognizes a royalty of 2% on each sale of a Customer product until 10,000 products are sold.

Question 10.11.110

When is a guaranteed minimum royalty promised in exchange for a license to functional IP recognized?

Interpretive response: A minimum guaranteed amount that is not subject to other forms of variability, such as a price concession, is fixed consideration and therefore is recognized in the same manner as any other fixed consideration – i.e. it should be recognized at the point in time when the customer obtains control of the license of functional IP. This is the case regardless of the amount of the minimum. Often the fees related to the guaranteed minimum are received over a number of years after a license of functional IP is transferred to the customer and therefore entities need to consider whether a significant financing component is present (see section 5.5) or the existence of the extended payment terms suggest a price concession may ultimately be granted to the customer (see section 5.3). [TRG 11-16.58]

Any royalties earned in excess of the minimum guaranteed amount are accounted for as variable consideration when the customer's subsequent sales or usage occurs, subject to the sales- or usage-based royalties recognition constraint. [606-10-55-65(a)]

Example 10.11.70

License of functional IP with a guaranteed minimum

Film Studio enters into a five-month arrangement to license a movie to Customer. The consideration for the license is a sales-based royalty of 5% of Customer's gross sales from showing the movie with a minimum guaranteed amount of $5 million.

The licensed movie is functional IP and provides the customer with a right to use the IP; therefore, Film Studio recognizes revenue as it transfers control of the license at a point in time.

The $5 million fixed consideration is not subject to the royalty exception and is included in the transaction price. At the point in time control of the license is transferred to Customer, the $5 million guaranteed amount is recognized as revenue. Any royalties in excess of the $5 million minimum guaranteed amount are recognized when Customer's subsequent sales occur.

Question 10.11.120

Under the royalty exception, how does an entity allocate and recognize revenue from a sales- or usage-based royalty between a right-to-use license and a performance obligation satisfied over time?

Interpretive response: An entity may enter into a contract with a customer to grant the customer a license to functional IP and provide one or more other services – e.g. when-and-if-available upgrades or enhancements, rights to additional products or content, or R&D services – that are satisfied over time. If the only consideration in the contract is a sales- or usage-based royalty, the question arises as to how to apply the royalty exception to the contract when the license(s) is (are) the predominant item(s) to which that sales- or usage-based royalty relates.

Example 60 in Topic 606 (reproduced in section 10.11.20) illustrates that Topic 606 requires the entity to allocate the sales- or usage-based royalty to the separate performance obligations in the contract. This allocation occurs based on the stand-alone selling prices of the performance obligations. Because the royalty is the only consideration in the contract, the entity cannot allocate the royalty entirely to one of the performance obligations in the contract (see Question 6.6.40).

If a license is a right-to-use license and therefore is transferred to the customer before royalties are earned – i.e. the entity's performance in transferring control of the license is complete prior to royalties being earned – the entity recognizes the portion of each royalty earned that is allocated to the license as the customer's subsequent sale or usage occurs. [606-10-55-65(a)]

Recognition of the portion of each royalty allocated to a performance obligation satisfied over time often, but not always, occurs when the customer's subsequent sales or usage occurs. This is because there are a number of pathways in Topic 606 that can result in recognition of royalties allocated to a service obligation that is satisfied over time. The following are examples.

1. If the allocated portion of the royalty reasonably reflects the value to the customer of the entity's performance to which the earned royalties relate, it would be reasonable to recognize the allocated portion of the royalty earned when the customer's subsequent sales or usage occurs based on applying the as-invoiced practical expedient. Section 7.4.50 addresses considerations relevant to determining whether an entity can apply that expedient.

2. If the service obligation is a series of distinct services (e.g. most promises to provide upgrades or additional products on a when-and-if-available basis will be a series of distinct services), allocation of the service portion of the earned royalties to each distinct service period – e.g. each day or month that the service is being provided – may be permitted based on the variable consideration allocation exception. Section 6.7 discusses the relevant considerations in determining whether an entity should allocate variable consideration to the distinct goods or services within a series.

3. The 'later of' provision in the royalty exception also comes into play as it "is merely intended to ensure that the royalties guidance does not subvert one of the key principles of Topic 606, which is to recognize revenue only when (or as) an entity satisfies a performance obligation." Further, "An entity recognizes revenue from a sales-based or usage-based royalty when (or as) the customer's subsequent sales or usage occurs unless recognition in that manner would accelerate the recognition of revenue for the performance obligation to which the royalty solely or partially relates ahead of the entity's performance toward complete satisfaction of the performance obligation based on an appropriate measure of progress." [ASU 2016-10.BC71]

Example 57 and Example 61 in Topic 606 (see excerpt in section 10.11.50 and 10.7.40, respectively) each illustrate a scenario in which the entity recognizes a sales-based royalty that relates solely to a performance obligation satisfied over time when the customer's subsequent sales occur. Each example does so on the basis that "recognition of the royalty fees as the customer's subsequent sales occur reasonably depict the entity's progress toward complete satisfaction of the license performance obligation," rather than with reliance upon either the as-invoiced practical expedient or the variable consideration allocation exception. Therefore, even if neither of the approaches outlined in (1) and (2) apply, recognition of the royalties allocated to the over-time performance obligation would still be recognized when the customer's subsequent sales or usage occurs if the royalties are expected to become due in a manner that reasonably approximates an appropriate measure of progress for measuring satisfaction of the performance obligation. [ASU 2016-10.BC71]

It may be the case, however, that none of the three approaches are appropriate. For example, this may occur because the royalty rate changes during the contract in a manner that does not reflect changing value to the customer of the entity's services. [ASU 2016-10.BC71]

In that case, we believe either of the two following approaches would be acceptable.

— The entity estimates total expected royalties that will be earned and allocated to the over-time performance obligation(s) using the expected-value or most-likely-amount approach (see section 5.3.30). However, the entity would *not* subject that estimate to the constraint on variable consideration because the royalty exception applies and both the royalty exception and variable consideration constraint are not applied to the same amount. The entity recognizes revenue using an appropriate measure of progress applied against that estimate of earned and allocated royalties, adjusting the estimate each reporting period. In a contract to provide a customer with a license and a service satisfied over time for which the only consideration is a sales- or usage-based royalty, the entity would estimate total royalties it will earn over the license period (e.g. $100,000), determine the portion of that amount allocable to the service (e.g. $20,000) and recognize that $20,000 over the service period using an appropriate measure of progress – subject to the requirement that cumulative revenue recognition for the service should never exceed 20% of royalties earned based on the customer's subsequent sales or usage.

— The portion of the royalty amount earned each period during which the over-time performance obligation will be satisfied (e.g. $2,000 in the first quarter of the software-related service period) is recognized using an appropriate measure of progress over the remainder of the period the performance obligation will be satisfied. For example, if $100 in royalties are earned and allocated to a software-related service on Day 1 of a three-year service period, that $100 is recognized over the entire three-year service period; if $200 in royalties are earned and allocated to the software-related service on the first day of Year 2 of the three-year service period, that $200 is recognized over the remaining two years of the service period. Under this approach, the entity does not estimate future royalties to be earned.

Example 10.11.80
Sales-based fees in a technology licensing arrangement with future upgrades when-and-if-available

Tech Company enters into a three-year arrangement to license its technology to Customer along with a promise to provide when-and-if-available upgrades developed during the term. Tech Company will receive fees based on Customer's sales. There is no guaranteed minimum for the sales-based fees.

The following additional factors are relevant.

- Tech Company concludes that the license to the technology and the when-and-if-available upgrades are distinct from each other; therefore, the contract includes two performance obligations (the license and the promise to provide when-and-if-available upgrades).
- The license is functional IP and provides Customer with a right to use Tech Company's technology. The three-year term commences immediately upon transfer to Customer of the license provided at contract inception. Therefore, Customer obtains control of the license on the contract inception date.
- The promise to provide when-and-if-available upgrades constitutes a series of distinct service periods; see section 4.4 for more information on determining whether the distinct goods in a contract are accounted for as a series.

Tech Company concludes that the royalty exception applies to the sales-based royalty because the license of IP is the predominant item to which the royalty relates. Consistent with Question 10.11.30, the when-and-if-available upgrades also represent future licenses of IP. Because the combined initial license and future when-and-if-available upgrades are the only performance obligations in the contract, they are the predominant items. Therefore, despite the fact that Tech Company may be able to reasonably estimate a minimum amount of sales-based fees to which it will be entitled from transferring the license to Customer – e.g. on the basis of similar licensing arrangements with other customers – it is prohibited from recognizing the sales-based fees before Customer's actual sales occur. [606-10-55-65(a)]

Because there are two separate performance obligations, Tech Company determines the stand-alone selling prices for the license and the when-and-if-available upgrades, and allocates the sales-based fees to those two performance obligations. In this example, assume the stand-alone selling prices of the license and the upgrades are $200,000 and $50,000, respectively.

Therefore, each period when royalties are earned, 80% of those royalties are allocated to the technology license ($200,000 / $250,000) that was transferred to Customer at contract inception and 20% of those royalties are allocated to the when-and-if-available upgrades.

The 80% portion allocated to the license is recognized as revenue when Customer's sales occur because the license performance obligation is completely satisfied at contract inception. [606-10-55-65(a)]

The 20% portion of royalties earned each period that is allocated to the when-and-if-available upgrades is also recognized as Customer's sales occur. That is because Tech Company concludes that it meets the criteria to allocate the royalties to the periods in which the sales occur as follows:

— the 20% portion of the royalties earned specifically relates to Tech Company's transfer of the when-and-if-available upgrades based on consideration of the terms of the contract and the stand-alone selling price of the service; and

— allocating those royalties to each distinct service period (e.g. each month or even each day) within the series is consistent with the allocation objective (see section 6.7). This is because the customer benefits more from the license in periods of greater sales. [606-10-32-40]

Question 10.11.130

How is the transaction price allocated in an arrangement that includes sales- or usage-based royalties subject to a guaranteed minimum?

Interpretive response: An entity may enter into a contract with multiple performance obligations that consist of a license of IP and another good or service that is transferred over a different time period. If requirements to allocate variable consideration entirely to one performance obligation are not met, an entity allocates the sales- or usage-based royalties to multiple performance obligations. The assessment can be particularly challenging when the contract includes fixed consideration, which can be in the form of a minimum guaranteed royalty.

Topic 606 is not clear about how an entity allocates that consideration to its performance obligations when the contract includes sales- or usage-based royalties predominantly associated with a license of IP and a guaranteed minimum. Multiple approaches could be acceptable if they are consistent with the allocation objective (see section 6.2) and application of the royalty exception. We believe the following are examples of acceptable approaches.

Approach 1: Allocate the fixed consideration and variable consideration separately based on relative stand-alone selling prices

Approach 1 is consistent with Example 35, Case B in Topic 606, which illustrates allocating royalties and fixed consideration to two distinct licenses; see Example 35 reproduced in section 10.11.40. In that example, the entity allocates the fixed consideration to the performance obligations at contract inception on a relative stand-alone selling price basis and then allocates the royalties on a relative basis when the sales or usage occurs. The same relative allocation percentage is used for the fixed and variable consideration.

Approach 2: Estimate the total transaction price (including royalties) and allocate that amount to each performance obligation subject to a cumulative recognition constraint

Under Approach 2, the entity estimates an unconstrained transaction price (that includes estimated royalties and fixed consideration) and allocates that amount to each performance obligation on a relative stand-alone selling price basis. Further, under this approach the entity applies the royalty exception on a cumulative basis. This means that when an entity satisfies or partially satisfies a performance obligation, it recognizes the lesser of the amount allocated to the performance obligation and the consideration to which it is currently entitled under the contract (inclusive of the fixed fees and royalties that it has already earned). Approach 2 is consistent with View A in Question 10.11.140.

Under Approach 2, an entity continuously updates its estimate of the total consideration to which it expects to be entitled. However, the entity does not apply the variable consideration constraint (see section 5.3.40). This is because the variable amounts are subject to the royalty exception rather than the variable consideration constraint. However, this approach could result in a reversal of revenue if the entity's estimates change significantly as a result of re-allocating the decrease in consideration to performance obligations that have been previously satisfied (see Example 10.11.100).

Regardless of the approach an entity uses, it needs to disclose significant judgments made in applying the guidance in Topic 606 regarding the determination and timing of revenue recognition. Moreover, it should apply the approach consistently to similar contracts (see section 15.8).

Example 10.11.90

Allocation of guaranteed minimum among multiple performance obligations

Tech Company enters into a three-year arrangement to license its technology to Customer along with a promise to provide when-and-if-available upgrades developed during the license term.

Tech Company concludes that the license and promise to provide when-and-if-available upgrades are two distinct performance obligations.

— The license provides Customer with a right to use the technology, which is a performance obligation satisfied at a point in time.

— The right to when-and-if-available upgrades is a performance obligation satisfied over time because Customer simultaneously receives and consumes the benefits of having access to when-and-if-available upgrades continuously throughout the contract term.

Tech Company receives a royalty of 10% of Customer's sales subject to a minimum guaranteed amount of $10,000. Tech Company estimates that the total consideration (fixed plus variable) will be $50,000.

Tech Company estimates the stand-alone selling price of the license and when-and-if-available upgrades to be $15,000 and $35,000, respectively. Tech Company concludes that the royalty is predominantly associated with a license of IP because both performance obligations are related to providing IP (see Question 10.11.30).

Customer's gross sales and the related royalties earned each year are shown in the table. This information is not known at the beginning of the contract.

	Year 1	Year 2	Year 3	Total
Gross sales	$150,000	$250,000	$100,000	**$500,000**
Royalties	$ 15,000	$ 25,000	$ 10,000	**$ 50,000**

Approach 1: Allocate fixed and variable consideration separately

Tech Company allocates the fixed fee (guaranteed minimum) of $10,000 on a relative stand-alone selling price basis as future usage and sales occur.

Performance obligation	Stand-alone selling price	%	Allocation of guaranteed minimum
License	$15,000	30%	$ 3,000
Upgrades	$35,000	70%	$ 7,000
Total	**$50,000**	**100%**	**$10,000**

The estimated variable royalty (in excess of the minimum) of $40,000 is allocated between the two performance obligations on a relative stand-alone selling price basis as future usage and sales occur.

Tech Company recognizes the variable amounts allocated to the when-and-if-available upgrades in the period the amounts are earned because the performance obligation is a series of distinct time periods (see section 4.4) and Tech Company meets the criteria to allocate the fees directly to the distinct periods in which the sales occur as follows:

— the fees relate to the customer's past usage and the license and when-and-if-available upgrades; and

— the allocation is consistent with the allocation objective because the fee is consistent from period to period and the greater usage of the customer reflects additional value to the customer (see section 6.7). [606-10-32-40]

The following table summarizes the allocation and recognition for each performance obligation during the three-year contract term.

	Inception	End of Year 1	End of Year 2	End of Year 3	Total
Fixed					
License	$3,000[1]	-	-	-	**$ 3,000**
Upgrades	-	$2,333[2]	$ 2,333[2]	$ 2,334[2]	**$ 7,000**
Variable					
License	-	$1,500[3]	$ 7,500[5]	$ 3,000[7]	**$12,000**
Upgrades	-	$3,500[4]	$17,500[6]	$ 7,000[8]	**$28,000**
Cumulative revenue					
License	$3,000	$4,500	$12,000	$15,000	**$15,000**
Upgrades	-	$5,833	$25,666	$35,000	**$35,000**

Notes:

1. $10,000 minimum × 30% allocation. This amount is recognized immediately upon transfer of the license because it is functional IP recognized at a point in time.
2. $10,000 minimum × 70% allocation × 1/3 complete. Only a portion is recognized each period because this amount is recognized over time.
3. $5,000 royalty above the minimum ($15,000 – $10,000) × 30% allocation.
4. $5,000 royalty above the minimum ($15,000 – $10,000) × 70% allocation.
5. $25,000 additional royalty × 30% allocation.
6. $25,000 additional royalty × 70% allocation.
7. $10,000 additional royalty × 30% allocation.
8. $10,000 additional royalty × 70% allocation.

Approach 2: Allocate fixed and variable consideration together

Tech Company allocates the $50,000 estimated transaction price on a relative stand-alone selling price basis as follows:

- $15,000 to the license; and
- $35,000 to the when-and-if-available upgrades.

When (or as) the performance obligations are satisfied, Tech Company recognizes as revenue the lesser of the amount allocated to the performance obligations satisfied or the amount that is no longer subject to the royalty constraint.

	Inception	Year 1	Year 2	Year 3	Total
Allocated to:					
License	$15,000[1]	-	-	-	**$15,000**
Upgrades	-	$11,666[3]	$11,667[3]	$11,667[3]	**$35,000**
Cumulative	*$15,000*	*$26,666*	*$38,333*	*$50,000*	n/a
Royalty due:					
Annual	$10,000[2]	$ 5,000[4]	$25,000[5]	$10,000[6]	**$40,000**
Cumulative	*$10,000*	*$15,000*	*$40,000*	*$50,000*	n/a

	Inception	Year 1	Year 2	Year 3	Total
Lesser of amount allocated to satisfied PO and royalties due	$10,000	$15,000	$38,333	$50,000	n/a
Less: previously recognized revenue	-	$(10,000)	$(15,000)	$(38,333)	n/a
Revenue recognized	**$10,000**	**$ 5,000**	**$23,333**	**$11,667**	**$50,000**

Notes:

1. The license is functional IP that is transferred at a point in time. As such, the performance obligation is satisfied upon transfer and the amount allocated to that performance obligation is $15,000.
2. There is a guaranteed minimum of $10,000 in the contract.
3. $35,000 allocated to the upgrades / 3 years.
4. $15,000 in royalties earned during Year 1 – $10,000 minimum already recorded.
5. $25,000 additional royalties earned during Year 2.
6. $10,000 additional royalties earned during Year 3.

Example 10.11.100

Allocation of guaranteed minimum among multiple performance obligations – revised estimates

Assume the same facts as in Example 10.11.90. At the beginning of Year 2, Tech Company revises its estimate of the transaction price to $25,000 as follows:

— Year 1 - $15,000
— Year 2 - $5,000
— Year 3 - $5,000.

Approach 1: Allocate fixed and variable consideration separately

Under Approach 1, Tech Company does not need to adjust the amount of revenue recognized because it only accounts for the variable consideration once usage occurs. The table illustrates the amount recognized under the revised estimate.

	Inception	End of Year 1	End of Year 2	End of Year 3	Total
Fixed					
License	$3,000	-	-	-	**$ 3,000**
Upgrades	-	$2,333	$ 2,333[1]	$ 2,334[1]	**$ 7,000**
Variable					
License	-	$1,500	$ 1,500[2]	$ 1,500[2]	**$ 4,500**
Upgrades	-	$3,500	$ 3,500[3]	$ 3,500[3]	**$10,500**

	Inception	End of Year 1	End of Year 2	End of Year 3	Total
Cumulative Revenue					
License	$3,000	$4,500	$ 6,000	$ 7,500	**$ 7,500**
Upgrades	-	$5,833	$11,666	$17,500	**$17,500**

See Example 10.11.90 for an explanation of the figures at inception and at the end of Year 1.

Notes:

1. $10,000 minimum × 70% allocation × 1/3 complete. Only a portion is recognized each period because this is recognized over time.
2. $5,000 additional royalty × 30% allocation.
3. $5,000 additional royalty × 70% allocation.

Approach 2: Allocate fixed and variable consideration together

Under Approach 2, Tech Company makes a cumulative adjustment based on the updated estimate and reallocates the $25,000 estimated transaction price on a relative stand-alone selling price basis as follows:

- $7,500 (30%) to the license; and
- $17,500 (70%) to the upgrades.

	Inception	End of Year 1	True-up	End of Year 2	End of Year 3	Total
Allocated to:						
License	$15,000	-	$ (7,500)[1]	-	-	**$7,500**
Upgrades	-	$11,667	$ (5,833)[2]	$ 5,833[2]	$ 5,833[2]	**$17,500**
Cumulative	*$15,000*	*$26,667*	*$13,334*	*$19,167*	*$25,000*	n/a
Royalty earned:						
Annual	$10,000	$ 5,000	-	$ 5,000[3]	$ 5,000[4]	**$25,000**
Cumulative	*$10,000*	*$15,000*	*$15,000*	*$20,000*	*$25,000*	n/a
Lesser of amount allocated to satisfied PO and royalties earned	$10,000	$15,000	$13,334	$19,167	$25,000	n/a
Less: previously recognized revenue	-	$(10,000)	$(15,000)	$(13,333)	$(19,167)	n/a
Revenue recognized	**$10,000**	**$ 5,000**	**$(1,666)**	**$ 5,833**	**$ 5,833**	**$25,000**

See Example 10.11.90 for an explanation of the figures at inception and at the end of Year 1.

Notes:

1. The revised revenue allocation for the license is \$7,500. As such, the amount already recognized is reduced to equal \$7,500.
2. The revised revenue allocation for the upgrades is \$17,500. As such, the amount already recognized is reduced to equal \$5,833, and thereafter an additional \$5,833 (\$17,500 × 1/3) is recognized each year.
3. \$5,000 additional royalties earned during Year 2.
4. \$5,000 additional royalties earned during Year 3.

10.11.50 Application of royalty exception to a right-to-*access* license

Excerpt from ASC 606-10

• • > Sales-Based or Usage-Based Royalties

55-65 Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.
b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

• • > Example 57—Franchise Rights

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 fixed fee of \$1 million, as well as a sales-based royalty of 5 percent of the customer's sales for the term of the license. The fixed consideration for the equipment is \$150,000 payable when the equipment is delivered.

• • • > Identifying Performance Obligations

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 consumers' changing preferences and implementing product improvements, pricing strategies, marketing campaigns, and operational efficiencies to support the franchise name. However, the entity concludes that these activities do not directly transfer goods or services to the customer.

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 each distinct. This is because the customer can benefit from each good or service (that is, the license and the equipment) on its own or together with other resources that are readily available (see paragraph 606-10-25-19(a)). The customer can benefit from the license together with the equipment that is delivered before the opening of the franchise, and the equipment can be used in the franchise or sold for an amount other than scrap value. The entity also determines that the promises to grant the franchise license and to transfer the equipment are separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b). The entity concludes that the license and the equipment are not inputs to a combined item (that is, they are not fulfilling what is, in effect, a single promise to the customer). In reaching this conclusion, the entity considers that it is not providing a significant service of integrating the license and the equipment into a combined item (that is, the licensed intellectual property is not a component of, and does not significantly modify, the equipment). Additionally, the license and the equipment are not highly interdependent or highly interrelated because the entity would be able to fulfill each promise (that is, to license the franchise or to transfer the equipment) independently of the other. Consequently, the entity has two performance obligations:

a. The franchise license
b. The equipment.

• • • > Allocating the Transaction Price

55-378 The entity determines that the transaction price includes fixed consideration of $1,150,000 and variable consideration (5 percent of the customer's sales from the franchise store). The standalone selling price of the equipment is $150,000 and the entity regularly licenses franchises in exchange for 5 percent of customer sales and a similar upfront fee.

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 allocating the sales-based royalty (as well as the additional $1 million in fixed consideration) to the franchise license would be consistent with an allocation based on the entity's relative standalone selling prices in similar contracts. Consequently, the entity concludes that the variable consideration (that is, the sales-based royalty) should be allocated entirely to the performance obligation to grant the franchise license.

• • • > Licensing

55-380 The entity assesses the nature of the entity's promise to grant the franchise license. The entity concludes that the nature of its promise is to provide a right to access the entity's symbolic intellectual property. The trade name and logo have limited standalone functionality; the utility of the products developed by the entity is derived largely from the products' association with the franchise brand. Substantially all of the utility inherent in the trade name, logo, and product rights granted under the license stems from the entity's past and ongoing activities of establishing, building, and maintaining the franchise brand. The utility of the license is its association with the franchise brand and the related demand for its products.

55-381 The entity is granting a license to symbolic intellectual property. Consequently, the license provides the customer with a right to access the entity's intellectual property and the entity's performance obligation to transfer the license is satisfied over time in accordance with paragraph 606-10-55-58A. The entity recognizes the fixed consideration allocable to the license performance obligation in accordance with paragraph 606-10-55-58A and paragraph 606-10-55-58C. This includes applying paragraphs 606-10-25-31 through 25-37 to identify the method that best depicts the entity's performance in satisfying the license (see paragraph 606-10-55-382).

55-382 Because the consideration that is in the form of a sales-based royalty relates specifically to the franchise license (see paragraph 606-10-55-379), the entity applies paragraph 606-10-55-65 in recognizing that consideration as revenue. Consequently, the entity recognizes revenue from the sales-based royalty as and when the sales occur. The entity concludes that recognizing revenue resulting from the sales-based royalty when the customer's subsequent sales occur is consistent with the guidance in paragraph 606-10-55-65(b). That is, the entity concludes that ratable recognition of the fixed $1 million franchise fee plus recognition of the periodic royalty fees as the customer's subsequent sales occur reasonably depict the entity's performance toward complete satisfaction of the franchise license performance obligation to which the sales-based royalty has been allocated.

In contrast to right-to-use licenses (functional IP), a right to access license (symbolic IP) is satisfied over time. As such, the entity may only have a partially satisfied performance obligation when the customer's subsequent sales or usage occurs. As a result, an entity will need to consider whether recognizing revenue as the sales or usage occurs results in revenue recognized in that manner that accelerates recognition ahead of the entity's performance toward complete satisfaction of the performance obligation. [ASU 2016-10.BC71]

In many right-to-access license arrangements that include royalties, an entity may be able to recognize revenue for those royalties as the subsequent sales or usage occurs. This is because an output-based measure of progress based on the sales or usage would not accelerate revenue ahead of the entity's expected performance. See Questions 10.11.120, and 10.11.140 to 10.11.160, for further discussion of the interaction between the measures of progress and royalty exception. [ASU 2016-10.BC72]

For right-to-access licenses, recognizing royalties as usage occurs may be appropriate in the following instances (not exhaustive). [ASU 2016-10.BC72, 606-10-32-40]

— The royalties due each period correlate directly with the value to the customer of the entity's performance completed to date. In this case, using the as-invoiced practical expedient (see Question 10.9.10) would be appropriate.

— When the combination of recognition of (1) a portion of the fixed fee and (2) the royalties earned each period does not accelerate revenue ahead of the entity's performance as demonstrated in Examples 57 and 61 of Topic 606.

— When the entity meets the requirements to allocate the royalty to the period in which the sales or usage occurs in accordance with the variable consideration allocation exception (see section 6.7 on allocating variable consideration). A right-to-access license is a series of distinct service periods and the guidance on allocating variable consideration may require an entity to allocate the sales- or usage-based fees to each period.

Revenue recognition might be inappropriately accelerated ahead of the entity's performance when the royalty rate declines over the license period in a manner that does not reflect the changing value to the customer. For example, consider a license that provides the customer with a right to access IP for three years in which the entity receives 8% of sales until cumulative sales equal $1 million, then receives 4% up to the next $3 million, and 2% after that. In that case, recognition of royalties as they are due could subvert the recognition principle if it results in amounts recognized ahead of performance. The entity would be limited to the lower of the two amounts in this example. [ASU 2016-10.BC71]

The above guidance addresses the recognition of sales- or usage-based royalties and not when such amounts are included in the transaction price under Step 3. As a result, the constraint on variable consideration in determining the transaction price does not apply. [ASU 2016-10.BC71]

Question 10.11.140

How is revenue for a minimum guaranteed royalty promised in exchange for a right-to-access license recognized?

Interpretive response: The TRG generally agreed that Topic 606 does not prescribe a single approach for recognizing revenue for a right-to-access license when the contract includes royalties with a minimum guarantee. Rather, an entity chooses the approach that appropriately considers all of the principles in Topic 606, including the royalty exception, selecting measures of progress and the variable consideration allocation exception. The TRG discussed three views it generally deems to be acceptable in a fact pattern consisting of a five-year license of symbolic IP with a 5% royalty subject to a fixed minimum amount. [TRG 11-16.58]

View A: Estimate total expected royalties and apply a measure of progress subject to the royalties recognition constraint

Under View A, an entity estimates the total consideration (both fixed and variable) to which it expects to be entitled under the contract and applies a measure of progress to the unconstrained estimate. However, the cumulative revenue recognized cannot exceed the amount the entity would be entitled to receive (including the minimum guarantee) at any point in time. [TRG 11-16.58]

Under View A, an entity applies the royalty exception on a cumulative basis and chooses a measure of progress that depicts its performance. The measure of progress could be a time-elapsed measure of progress or an output-based measure of progress as sales or usage occurs based on the value to the customer. [TRG 11-16.58]

Under this view, an entity continuously updates its estimate of the total consideration to which it expects to be entitled, but it does not apply the general variable consideration constraint (see section 5.3.40). However, this view could result in a reversal of revenue if the entity applies a time-elapsed measure of progress.

For example, assume an entity enters into a five-year license in which it estimated it would receive $100 over the five years subject to a minimum guarantee of $20. After two years, the entity has earned $40 of royalties and recognized $40 under a time-elapsed measure of progress ($100 × 2/5). At that point, the entity reduces its estimate of the transaction price to $50 and it records a revenue reversal of $20 to reflect its measure of progress ($50 × 2/5) and the updated estimate. However, if an entity selects an output-based measure that corresponds with the sales or usage, a change in estimate does not result in a reversal because there is a corresponding change in the measure of progress. [TRG 11-16.58]

Changing the example, assume that the entity earns $1 for each sale or usage of the IP. As of Year 2, the entity still recognizes $40 because the performance obligation is 40% complete ($40 / $100) at that time. When the entity reduces its estimate of the transaction price to $50, the entity also adjusts its measure of progress to 80% complete ($40 / $50); therefore, $40 would still be the amount of revenue recognized to date.

View B: Recognize the minimum guaranteed amount using a measure of progress and recognize variable amounts when the minimum is exceeded

Under View B, an entity recognizes the minimum guarantee over the contract term based on a measure of progress and recognizes variable amounts only when the royalties exceed the minimum guarantee. [TRG 11-16.58]

Under this view, the recognition constraint on sales- or usage-based royalties is applied to each variable amount rather than on a cumulative basis. As a result, no variable amounts are recognized until the cumulative royalties exceed the minimum. An entity applies a measure of progress to the minimum amount and does not account for the variable amounts until they become unconstrained. [TRG 11-16.58]

When a variable amount becomes unconstrained, it will often meet the criteria to be allocated to and recognized in the period that a sale or usage occurs. That is because a license of symbolic IP is a series of distinct goods or services and the variable consideration allocation exception may require the entity to allocate the royalty to each distinct service once it becomes unconstrained. [TRG 11-16.58]

Further, in many situations this method would not accelerate revenue ahead of the entity's performance even if the variable consideration allocation guidance was not met. For example, if the entity uses a time-elapsed measure of progress, the recognition would be 'slower than straight-line' recognition if the customer does not exceed the minimum amount until after the entity completes a substantive amount of performance (see View B in Example 10.11.110). [TRG 11-16.58]

View C: As-invoiced practical expedient applied to Views A and B

The main difference between View A and View B is the unit of account when applying the royalty exception. However, under either view an entity may be able to recognize revenue (including the minimum guarantee) as sales or usage occurs by applying the as-invoiced practical expedient to recognize revenue as the entity has the right to bill the customer. This approach would *only be appropriate* when an entity has evidence that it will exceed the minimum royalties, and the amount billed corresponds directly to the output or value transferred to the customer. That is because the as-invoiced practical expedient does not require an entity to precisely estimate total royalties for purposes of measuring progress toward completion. In contrast, in order to apply an output based measure based on the sales and usage (described in View A above) when the minimum is not exceeded, an entity needs to estimate the total expected royalties. See Question 7.4.80 on applying the as-invoiced practical expedient when there is a minimum amount. [TRG 11-16.58]

Applying as-invoiced practical expedient is consistent with the recognition constraint on sales-based royalties because the variable amounts are not recognized until the uncertainty is resolved (when the underlying sales or usage occurs) and would not accelerate recognition ahead of performance if performance is correlated directly to the customer's usage of the license. [TRG 11-16.58]

Approaches that are not appropriate

In contrast, the following approaches would not be appropriate: [TRG 11-16.58]

— applying multiple measures of progress to a single performance obligation, such as one measure for fixed consideration and a different measure for variable consideration;

— applying a measure of progress to a portion of the transaction price and a breakage model to any amount of the guarantee in excess of the customer's usage. A customer for symbolic IP does not have a right to additional goods or services because the entity is providing the customer with access to its IP over the entire term of the arrangement; or

— ignoring that the royalty recognition constraint in paragraph 606-10-55-65 includes guidance about recognizing revenue at the later of two events.

Regardless of which approach an entity uses, it is required to disclose significant judgments made in applying the guidance in Topic 606 regarding determination and timing of revenue recognition, and the approach should be applied consistently to similar fact patterns (see section 15.8). [TRG 11-16.58]

Example 10.11.110
License of symbolic IP with a guaranteed minimum

Sports Team licenses its team's trademark to Apparel Company for five years. Apparel Company agrees to pay a sales-based royalty of 5% of its gross sales; however, the contract guarantees that the Sports Team will receive a minimum of $5,000 for the five years. The trademark is symbolic IP.

Apparel Company's gross sales and the related royalties earned each year are shown below. This information is not known at the beginning of the contract.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Gross sales	$15,000	$30,000	$40,000	$20,000	$60,000	**$165,000**
Royalties	$750	$1,500	$2,000	$1,000	$3,000	**$8,250**

View A: Estimate total expected royalties and apply a measure of progress subject to the royalties recognition constraint

Sports Team estimates royalties of $8,250 / 5 years = $1,650 per year.

However, the cumulative revenue earned cannot exceed the $5,000 minimum guarantee unless the amount to which the entity is entitled is greater than $5,000. Therefore, in Year 4, the cumulative sales to date are $105,000 of which 5% is $5,250. Because Sports Team has already recognized $4,950 through Year 3, it is allowed to recognize only $300 in Year 4 ($5,250 – $4,950).

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Billings	$750	$1,500	$2,000	$1,000	$3,000	**$8,250**
Annual revenue	$1,650	$1,650	$1,650	$300	$3,000	**$8,250**
Cumulative revenue	$1,650	$3,300	$4,950	$5,250	$8,250	n/a

View B: Recognize the minimum guaranteed amount using a measure of progress and recognize variable amounts when the minimum is exceeded

Sports Team uses a time-based measure of progress to recognize the minimum guarantee.

- Years 1 – 3: $5,000 / 5 years = $1,000. No variable amount is recognized because the threshold (sales of $100,000) has not yet been exceeded.
- Year 4: ($5,000 / 5 years) + ($5,250 cumulative royalties – $5,000 minimum guarantee) = $1,250.
- Year 5: ($5,000 / 5 years) + ($8,250 cumulative royalties – $250 already recognized – $5,000 minimum guarantee) = $4,000.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Billings	$750	$1,500	$2,000	$1,000	$3,000	**$8,250**
Annual revenue	$1,000	$1,000	$1,000	$1,250	$4,000	**$8,250**
Cumulative revenue	$1,000	$2,000	$3,000	$4,250	$8,250	n/a

View C: As-invoiced practical expedient

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Billings	$750	$1,500	$2,000	$1,000	$3,000	**$8,250**
Annual revenue	$750	$1,500	$2,000	$1,000	$3,000	**$8,250**
Cumulative revenue	$750	$2,250	$4,250	$5,250	$8,250	n/a

Question 10.11.150

How does a declining royalty rate affect the recognition of revenue in a right-to-access license?

Interpretive response: It depends. An entity recognizes revenue from a sales- or usage-based royalty when (or as) the customer's subsequent sales or usage occurs – unless this method would accelerate the recognition of revenue ahead of the entity's performance in satisfying the performance obligation. When the royalty rate declines, recognizing revenue as the sales or usage occurs may accelerate revenue ahead of the entity's performance unless the changes in price reflects the change in value to the customer. [606-10-55-65, ASU 2016-10.BC71]

A royalty rate could decline in a number of ways. For example:

— the contract includes different rates for different periods (e.g. 10% of sales in Year 1, 8% in Year 2 and 6% in Year 3);

— the rates change based on exceeding cumulative sales thresholds (e.g. 8% of sales until cumulative sales equal $1 million, then 4% up to the next $3 million and 2% after that); or

— the rate changes based on a contingent event.

To recognize the variable amounts when the sales or usage occurs, the entity evaluates (1) whether the changes in price reflect the changing value to the customer and (2) both of the following:

— The measure of progress used:

  – If the entity uses an output-based measure of progress based on as-invoiced practical expedient, it evaluates whether the change in price is commensurate with changes in value to the customer (see Questions 7.4.60 and 7.4.90).

  – If the entity uses another measure of progress, recognition of the royalties when the customer's subsequent sales or usage occurs may be appropriate if the royalties are expected to become due in a manner that reasonably approximates that measure of progress or does not accelerate revenue ahead of the entity's performance. To make this determination, an entity estimates the total expected royalties, similar to the method described in View A of Question 10.11.140.

— The variable consideration allocation exception. A right-to-access license is a series of distinct services (see Question 10.7.20), and therefore an entity considers whether it is required to allocate variable amounts to the distinct time periods within the performance obligation. If the entity meets the criteria to allocate the royalties to the periods in which the sales or usage occurs in accordance with the variable consideration allocation exception, the entity still would be able to recognize the royalties when the sales or usage occurs. See Question 6.7.50 and 6.7.60 for further details on how changing prices affects the variable allocation requirements.

If the declining rates do not reflect changes in the value to the customer or meet the variable consideration allocation guidance, the entity may need to defer some portion of the royalty over the remaining performance obligation.

Example 10.11.120
License of symbolic IP with a declining royalty rate

Franchisor enters into a five-year franchise agreement with Franchisee. The license agreement states that Franchisee will pay Franchisor 10% of the first $50,000 in net sales, 8% of the net sales between $50,000 and $100,000 and 6% thereafter.

Franchisee's net sales and the related royalties earned each year are shown in the table. This information is not known at the beginning of the contract.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Annual sales	$20,000	$20,000	$40,000	$20,000	$40,000	**$140,000**
Cumulative sales	$20,000	$40,000	$80,000	$100,000	$140,000	n/a
Royalties due	$2,000[1]	$2,000[1]	$3,400[2]	$1,600[3]	$2,400[4]	**$11,400**

Notes:

1. $20,000 × 10%.
2. ($10,000 × 10%) + ($30,000 × 8%) = $3,400 [cumulative net sales fall between two brackets].
3. ($20,000 × 8%) = $1,600 [cumulative net sales are between $50,000 and $100,000].
4. ($40,000 × 6%) = $2,400 [cumulative net sales are over $100,000].

Franchisor concludes the following.

— The only performance obligation is the license of symbolic IP and is a right-to-access license recognized over time.

— A time-based measure of progress is most appropriate for the license.

— It is not appropriate to allocate the variable amounts directly to the period a sale or usage occurs because the tiered pricing indicates that the criteria in paragraph 606-10-32-40(a) has not been met (see Question 6.7.50).

As a result, Franchisor estimates the total transaction price of $11,400 and recognizes the transaction price ratably over the five-year period.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Time-elapsed revenue	$2,280	$2,280	$2,280	$2,280	$2,280	**$11,400**

However, Franchisor is subject to the royalty exception. As such, each period Franchisor recognizes the lesser of the straight-line revenue for the period or the actual royalties earned as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Cumulative royalties	$2,000	$4,000	$7,400	$9,000	$11,400	n/a
Cumulative time-elapsed revenue	$2,280	$4,460	$6,840	$9,120	$11,400	n/a
Lesser of cumulative royalties or time-elapsed revenue	**$2,000**	**$4,000**	**$6,840**	**$9,000**	**$11,400**	n/a
Previously recognized cumulative revenue	-	$(2,000)	$(4,000)	$(6,840)	$(9,000)	n/a
Annual revenue recognized[1]	**$2,000**	**$2,000**	**$2,840**	**$2,160**	**$2,400**	**$11,400**

Note:
1. Represents the difference between 'Lesser of cumulative royalties or time-elapsed revenue' and 'Previously recognized cumulative revenue'.

Question 10.11.160
How does an increasing royalty rate affect the revenue recognition for a right-to-access license?

Interpretive response: An entity recognizes revenue from a sales- or usage-based royalty when (or as) the customer's subsequent sales or usage occurs – unless this method would accelerate the recognition ahead of the entity's performance in completing the performance obligation. [606-10-55-65]

In general, an increasing rate would not cause revenue to be recognized ahead of the entity's performance if the entity is using a measure of progress that results in recognizing revenue as the sales or usage occurs. In fact, it would be inappropriate to use an output measure based on an average royalty rate during the contract term because that would result in an entity recognizing variable amounts before the sales or usage occurs. In all right-to-access licenses, an entity has to ensure that it does not recognize revenue ahead of its performance. [606-10-55-65]

11. Contract modifications

Detailed contents

Examples

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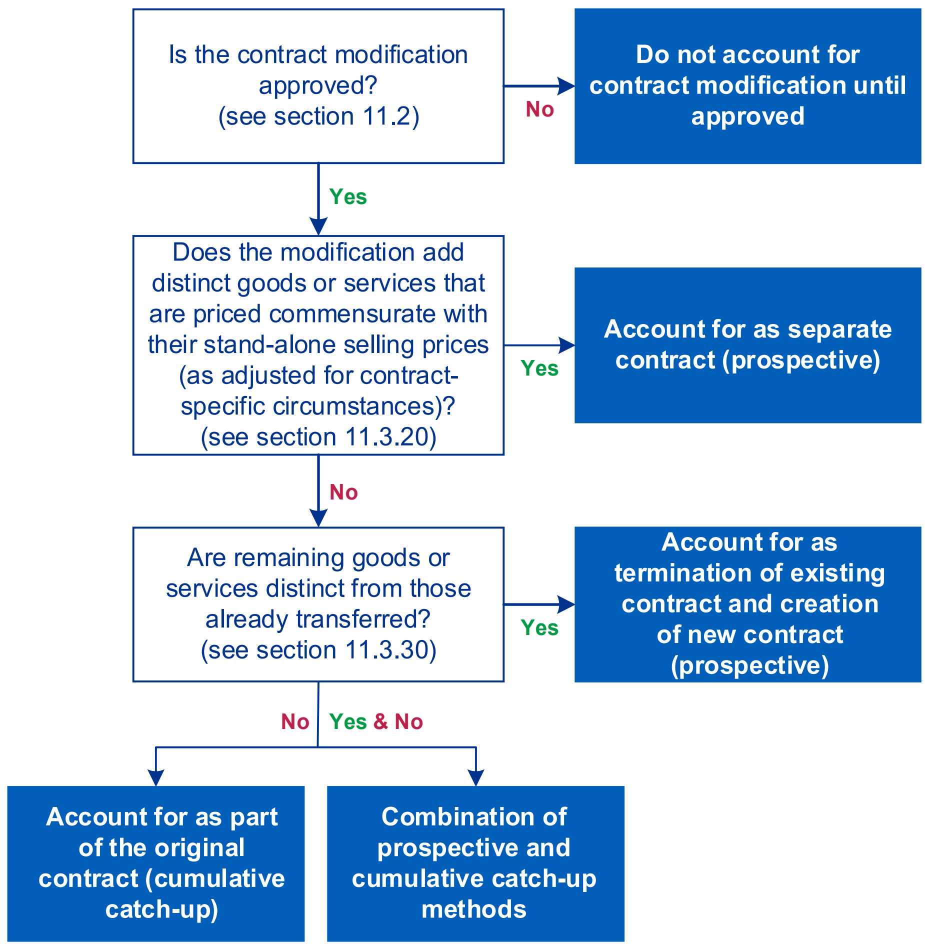
Examples

11.1 How the standard works

The contract modification guidance applies when the parties approve a change in the scope or price of a contract. The key decision points to consider when determining how to account for a contract modification are illustrated in the following decision tree.



11.2 Identifying a contract modification

Excerpt from ASC 606-10

> Contract Modifications

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.

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.

11.2.10 Overview

A contract modification occurs when the parties approve a change in the scope and/or price of a contract. In practice, a contract modification may be described as a change order, a variation or an amendment, but however papered, the substance should be evaluated over the form (see Question 11.2.30). [606-10-25-10]

However, not all changes in price are contract modifications. The facts and circumstances causing the change in transaction price affects whether the pricing change is accounted for as a contract modification. The resolution of variability in the amount of expected consideration is accounted for as a change in transaction price (see Question 6.8.10) [606-10-32-42 – 32-45]

A contract modification is considered approved when changes to the scope or price of the contract either alter the parties' existing enforceable rights and obligations or create new ones. Approval in this context could be written, oral or implied by customary business practices. However, the evaluation focuses more on whether a change to the parties' rights and obligations is enforceable under law. [606-10-25-10]

Determining whether the new or amended rights and obligations are enforceable requires an analysis of all relevant facts and circumstances, including the terms of the contract and applicable laws and regulations (see Question 11.2.10). This may require significant judgment in some jurisdictions or for some modifications – particularly if the parties to the contract have a dispute about the scope or the price (see Question 11.2.70 for further details).

Without approval (as described in Question 11.2.10) of a modification, the original contract remains in effect and continues to be accounted for under Topic 606. However, approval of both a change in scope and change in price is not necessary to trigger the contract modification guidance. Approval can occur if the parties have approved a change in scope but have not yet determined the corresponding change in price – i.e. an unpriced change order. In this instance, the contract modification guidance is applied and the modified transaction price that is yet to be determined is deemed to be variable consideration. This means the entity estimates the change to the transaction price by applying the guidance on estimating variable consideration and constraining the transaction price (see sections 5.3.30 and 5.3.40). [606-10-25-11]

Example 9 in Topic 606 (reproduced below) illustrates a situation in which a contract modification occurs even though one party contests the change. In this example, the entity makes a claim for compensation due to a delay in its ability to perform, but the customer initially disputes the claim. Nevertheless, once the entity determines that the claim is enforceable under the contract terms, it treats the contract as having been modified. Therefore, even though the customer did not approve the change in the traditional sense, the contract is deemed modified once the entity determines that the legally enforceable rights under the contract have changed.

Excerpt from ASC 606-10

• • > Example 9—Unapproved Change in Scope and Price

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.

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.

Question 11.2.10

When is a contract modification approved?

Interpretive response: Approval occurs when the legally enforceable rights and obligations of a contract change. In general, determining that a modification has been approved is consistent with the determination made in Step 1 about whether a contract exists. That is because without meeting the contract existence criteria in Step 1, it is questionable that the new or amended rights and obligations are enforceable. The contract existence criteria are explained in section 3.2.

The assessment of whether a modification exists may require significant judgment in some jurisdictions or for some arrangements, particularly if the parties to the contract have a dispute about the scope or price. Where there is significant uncertainty about enforceability, written approval or legal representation may be required to support a conclusion that the parties to the contract have approved the modification.

When assessing the enforceability of the modifications and the contract existence criteria for a contract modification, we believe some additional, relevant considerations (not exhaustive) are:

— the contractual terms and conditions are commensurate with the uncertainty, if any, about the customer or the entity performing in accordance with the modification – i.e. about the customer paying for or approving the modifications or about the entity being able to successfully fulfill its obligations;

— there is a history of the customer (or other similar customers) not fulfilling its obligations in similar modifications under similar circumstances; or

— the entity has previously chosen not to enforce its rights in similar modifications with the customer (or other similar customers) under similar circumstances.

Question 11.2.20

Is a modified contract reassessed under the contract existence criteria in Step 1?

Interpretive response: In general, we believe the contract existence criteria are applied to a modified contract to determine that (1) any new rights and obligations are enforceable and substantive and (2) any modifications to the existing rights and obligations do not render those existing rights and obligations unenforceable or nonsubstantive. In addition, if a modification of a contract is not deemed a separate contract (see section 11.3.30), then the modification would likely constitute a significant change in facts and circumstances. In that case, Topic 606 requires a reassessment of the contract existence criteria. [606-10-25-5]

We believe that any *new* rights and obligations are evaluated through the same lens as the original rights and obligations in the contract to determine whether they are enforceable and substantive.

That being said, we would typically expect an existing contract and customer relationship to affect the scrutiny an entity applies in reassessing the contract existence criteria. For example, the entity's prior evaluation of credit-worthiness when assessing the original contract and the customer's timely payment of contract fees to date would likely influence the entity's evaluation as to whether the customer is committed to performing its obligations under the modified contract and whether collectibility is probable.

If a contract modification is determined to be a separate contract, we do not believe an entity needs to reassess the contract existence criteria with respect to the original contract.

Question 11.2.30

If the parties enter into a new contract at or near the same time as terminating the original contract, is the new contract a modification?

Interpretive response: Yes, if the substance is a change in the scope or price of the original contract. When an entity and customer change the scope or price of a contract, the change is accounted for as a modification regardless of its form. The form of that change in scope or price does not have to be papered as a modification of the existing contract. An entity could terminate a contract and enter into a new contract and achieve the same economic result as modifying an existing contract.

Consider the following examples that are structured differently but have the same economic outcome:

— **Scenario 1.** ABC Corp. enters into a contract to provide distinct monthly services to Customer for three years in exchange for $300 paid upfront. After the first year, ABC and Customer agree to amend the contract to add two additional years of service for an additional $600 paid at the date of the amendment; assume there is not a significant financing component in either the original agreement or the modified agreement. After the amendment, ABC will provide Customer with services for four more years and receive additional consideration of $600.

— **Scenario 2.** ABC enters into a contract to provide distinct monthly services to Customer for three years for $300 paid upfront. After the first year, ABC and Customer agree to terminate the original contract with no refund payable to Customer and enter into a separate four-year contract to provide the same services for $600 in additional consideration paid at the date the new contract is entered into; assume there is not a significant financing component in either the first or second contract. After the new contract is entered into, ABC will provide Customer with services for four more years and receive consideration of $600.

If entities were able to avoid the modification guidance by entering into separate contracts, the timing of revenue recognized could be significantly different for economically equivalent arrangements. For example, if the scenarios above are accounted for according to the form rather than the substance, the accounting would be as follows; assume ABC is using a time-elapsed measure of progress and has a contract liability of $200 at the end of the first year.

— Scenario 1 would be accounted for as a modification. The modification would be accounted for on a prospective basis and ABC would not reverse the contract liability (see section 11.3.30). ABC would recognize $200 over each of the remaining four years (($600 additional consideration + $200 contract liability) / 4).

— Scenario 2 would require accounting for the termination of the original contract and the new contract separately. ABC would account for the termination of the original contract by recognizing the contract liability into revenue and then accounting for the new contract separately by recognizing the $600 over the four years of service. ABC would recognize a $350 ($200 reversal plus $150 of the new contract) in the first year of the new contract and $150 in the last three years.

To evaluate whether the substance of a new contract is a change in scope or price of a terminated contract, we believe the contract combination guidance in Step 1 needs to be evaluated to determine if the new and terminated contract are in substance a single modified contract. We believe this is appropriate because the change in price and scope of the terminated contract (i.e. the termination) occurs at or near the same time the new contract is entered into. That is, we believe the date the terms of one contract change and the date the new contract is entered into are relevant to the contract combination guidance rather than the date the terminated contract was originally entered into. After that determination, the modification guidance is applied to determine the appropriate accounting.

Similarly, we believe that when a contract is modified (including terminations) an entity needs to consider the contract combination guidance to determine whether other contracts entered into at or near the same time as the modification should be combined with the modification. This ensures that the modification is accounted for according to its substance and not its form.

The contract combination guidance requires that contracts entered into at or near the same time with the customer should be combined when: [606-10-25-9]

- the contracts are negotiated as a package with a single commercial objective;
- the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- the goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation (see section 3.7).

Question 11.2.40

Is the exercise of a customer option that is a marketing offer, and not a material right, a modification of the existing contract?

Interpretive response: No. The TRG generally agreed that an entity could account for the exercise of an option *that grants the customer a material right* either:

- as a continuation of the current contract by allocating the additional consideration to the goods or services underlying the option; or
- as a contract modification. [TRG 03-15.32]

A customer option (including a renewal option) that is considered a marketing offer is not the same as one that provides the customer with a material right. Therefore, we do not expect entities to analogize to the TRG discussion for this circumstance. In general, we believe a customer option that is a marketing offer is not a part of the original contract and should not be evaluated using the modification guidance upon exercise; rather, the exercise of the option should be treated as a new contract.

Further, even if the price of the marketing offer is lower than the stand-alone selling price for the same good or service on the exercise date (e.g. because the stand-alone selling price has increased since the original offer was made), the entity still does not adjust its accounting for the original contract or another existing contract. This is because the determination of whether an option provides the customer with a material right is made at contract inception. An entity does not re-evaluate whether the option subsequently becomes a material right on the date it exercises the option. If the negotiated terms of the original contract that contains an option do not convey a material right to the customer, the exercise of that option constitutes a new contract.

See Question 8.4.10 for a discussion of the accounting for the exercise of an option that is a material right.

Question 11.2.50

How are unpriced change orders evaluated to determine whether the contract has been modified?

Interpretive response: Change orders are modifications of an original contract that effectively change the provisions of the contract. Some change orders are approved by the entity and customer on a timely basis, while others are not approved until later, perhaps even after completion of the project. Approval – whether related to the change in scope, price, or both – can occur in a variety of ways as long as the approval is substantive and creates legally enforceable rights and obligations for both parties. [606-10-25-10]

Unpriced change orders often occur when the parties agree on a change to be made to the scope of a contract (e.g. changing the original design, quantity or nature of a good or service), but the extent of effort necessary to effect the change is not known initially.

To account for an unpriced change order as a contract modification, both parties need to approve the change in the scope of the contract. Also, the entity needs to have an expectation that (1) the change in price will be agreed to by the customer and (2) the changed fees once agreed to are probable of collection.

The entity evaluates whether these two conditions are met consistent with the manner in which it evaluates whether a contract exists under Step 1. Specifically, the entity's analysis of its expectation that the *price of the contract modification will be approved* should be consistent with how it evaluates under Step 1 whether a customer is committed to perform under a contract and fulfill its obligations under the contract – i.e. to pay for its goods or services (see section 3.2).

The entity's assessment for whether the *changes in fees are probable of collection* should be consistent with how it evaluates collectibility under Step 1. Generally, we would expect collectibility to be less of a consideration given the existing contract and customer relationship. However, if there has been a significant deterioration in the customer's credit standing, it may be necessary to reassess whether there is still an existing contract with the customer.

The FASB clarified that its intention is not to preclude revenue recognition for unpriced change orders if the scope of the work has been approved and therefore the entity has a right to payment for the additional work performed. To this end, it affirmed that the consideration does not need to be fixed to identify the payment terms. An entity's expectation that the price of the modification will be approved could be based on a framework in the existing contract (e.g. master contract or other governing agreement), the entity's historical experience with the customer or with similar contracts, or the entity's understanding of the law in the relevant jurisdiction. [ASU 2014-09.BC39]

Topic 606 does not specify how an entity should arrive at that expectation; it only specifies that the entity needs to have that expectation to conclude that an unpriced change order alters the parties' enforceable rights and obligations in the contract. The specific facts and circumstances often drive an entity's conclusion as to whether it can account for an unpriced change order as an approved contract modification, or whether it needs to wait until the change order is more formally approved (e.g. through a dually signed amendment).

Therefore, an entity needs processes and internal controls to identify and account for contract modifications on an ongoing and consistent basis. Specifically, it needs a process to support its conclusions on (1) the approval of the change in scope, (2) an estimated price for the change order in accordance with the variable consideration guidance (see section 5.3), and (3) its expectation of payment. Such processes and internal controls are particularly important to entities operating in industries with long-term construction and production contracts.

Example 11.2.10
Assessing whether a contract modification is approved – unpriced change order

Shipbuilder is an experienced shipbuilder and agrees to build a cruise ship for Customer; work begins on January 1, Year 1.

On January 1, Year 3, Customer informs Shipbuilder that it wishes to amend the specifications of the new cruise ship to accommodate 50 additional staterooms. Shipbuilder determines that to meet the request it needs to redesign three of the decks and purchase additional materials.

Shipbuilder and Customer discuss these changes and start preparing an amendment to the contract.

To determine whether the contract modification has been approved before the amendment has been executed, Shipbuilder assesses whether communications between the parties have created new, or changed existing, enforceable rights and obligations under the contract.

Scenario 1: Contract modification approved

Shipbuilder has previously built 11 cruise ships for Customer – this is the 12th.

Shipbuilder considers the following.

— Although Shipbuilder and Customer have not executed a contract amendment or formal change order for the additional materials, design services, or the construction labor necessary to complete the requested redesign, changes of this nature are common.

— Shipbuilder's experience with Customer as well as other similar contracts is that when changes resulting from redesign have occurred, customers have compensated Shipbuilder for the incremental costs plus a margin, as long as Shipbuilder has been able to demonstrate that the additional costs are reasonable given the scope of the changes.

— Despite the fact that there has been no formal written agreement on the change in scope or price, after consultation with its legal counsel, Shipbuilder determines that there is legal precedent for enforceability of similar types of oral arrangements in the jurisdiction, thereby changing the enforceable rights and obligations of the contract.

— Shipbuilder has significant, relevant history with Customer through 11 previous shipbuilding contracts, which supports a conclusion that

Customer will agree to pay Shipbuilder for additional costs along with a reasonable margin.

- Shipbuilder fully expects that Customer will agree to, and be able to pay, the incremental fees in this specific case.
- Considering all relevant facts and circumstances, Shipbuilder has the necessary documentation to support its conclusion that enforceable rights and obligations have been established.

Shipbuilder therefore concludes that the contract modification has been approved.

Scenario 2: Contract modification not approved

Shipbuilder has not previously built a cruise ship for Customer.

Shipbuilder considers the following.

- There is an absence of legal precedent in the jurisdiction related to oral agreements of this nature or Shipbuilder's counsel cannot make a determination as to the enforceability of the unpriced change order as a matter of law.
- This is Shipbuilder's first project with Customer, so Shipbuilder lacks relevant history or an established business practice with Customer to support a conclusion that there is an agreement that Customer will pay Shipbuilder for additional costs along with a reasonable margin to create enforceable rights and obligations in the contract.
- Previous experience with Customer on this project has shown it to be reluctant or even unwilling to pay for incremental costs and related margin on any scope changes before formal approval, which has usually been given only after extensive negotiations.

Shipbuilder therefore concludes that the contract modification has not been approved.

Question 11.2.60

In the case of an unpriced change order that is a contract modification, is the expected payment that has not yet been approved variable consideration?

Interpretive response: Yes. Until the parties agree on the price for the change order, the estimated fees are considered variable consideration. Once an unpriced change order is determined to be a contract modification, the entity estimates the variable consideration to which it expects to be entitled (subject to the constraint on variable consideration) and updates the transaction price. [606-10-25-11]

In applying the constraint on variable consideration to a contract modification, the entity could consider the following factors, which are derived from those an entity would use in applying the constraint on variable consideration (see section 5.3.40):

- whether a lengthy period of time is expected before the amount of consideration to be paid relative to the change order can or will be determined;
- whether there are factors that could affect the amount of consideration to which the entity would be entitled, and whether those factors are substantially in the control of the entity – e.g. whether the entity controls the timeline to complete the change order when the amount of consideration to which it will be entitled depends thereon; and
- whether the consideration to be paid for completing the change order is objectively determinable from the framework in a master services agreement or other governing document, rather than subjective – e.g. based largely on the success of a subsequent negotiation.

When there is an expectation of payment and the estimated fees are constrained, but the entity expects to recover its costs to fulfill the change order, the entity should include the amount of the costs it expects to recover from additional variable consideration as additional transaction price resulting from the contract modification (i.e. a zero profit margin). The entity updates the transaction price as it has more information about the amount of variable consideration to which it expects to be entitled.

Example 11.2.20
Accounting for a contract modification resulting from an unpriced change order

ABC Corp. enters into a contract with Customer to construct a specialized asset (Product P). The consideration for the customized product is $1,000,000. ABC has determined that constructing Product P is a single performance obligation and that revenue is recognized over time using a cost-to-cost measure of progress toward complete satisfaction of the performance obligation. The original project plan calls for completion of the project in 18 months.

At inception, ABC expects the following.

Transaction price	$1,000,000
Expected costs	(800,000)
Expected profit (20%)	**$ 200,000**

After 15 months of the project, Customer requests that ABC make a complex change to the planned customization of Product P, and ABC concludes that the change to the customization is not distinct from the performance obligation in the original contract. ABC agrees and begins the work immediately, which it expects to complete within five to six months.

The additional transaction price to be paid for the change will be negotiated subsequently. ABC expects that it will get paid for the incremental efforts, and therefore concludes that the contract has been modified.

At the date of modification, ABC has incurred $600,000 of the estimated $800,000 in costs to be incurred in completing the customization project (i.e. the project is 75% complete before modification), and therefore has recognized the following.

Revenue	$750,000
Costs	(600,000)
Gross profit	**$150,000**

ABC estimates that the change order will increase total costs by $200,000 and expects that it will be entitled to additional fees of $300,000. ABC uses a most-likely-amount approach (see section 5.3.30) to estimate the variable consideration included in the transaction price and believes that it has sufficient experience in fulfilling change orders on similar contracts. ABC believes that its experience is relevant and predictive because whether it completes the project timely is largely within its control. Moreover, it believes the contract provides a reasonable basis from which to negotiate the change order consideration without a wide range of subjectivity. In addition, the period to complete the order is not lengthy compared to ABC's typical projects or other change orders.

Although ABC is confident in its estimate of $300,000, there is a risk that it will ultimately settle for a lower amount. However, ABC concludes that it is unlikely that it will be entitled to less than $240,000 for the change order, consistent with the 20% profit margin expected in the original contract. That is, it is probable that a reversal greater than $60,000 will not occur.

ABC considers whether it needs to constrain its most likely $300,000 estimate to $240,000. ABC concludes that because $60,000 ($300,000 – $240,000) is only 4.6% of the total contract price and that $60,000 will be recognized over time (i.e. over the five to six months remaining in the project), the potential cumulative revenue reversal that would result would not be significant (see section 5.3.40).

Therefore, based on the quality of its estimate, and because any potential cumulative revenue reversal would not be significant, ABC does not constrain its most likely estimate of $300,000 and adds that amount to the transaction price for the contract. The accounting for the modification is discussed in section 11.3.

Question 11.2.70

When does a contract claim result in a contract modification?

Background: A contract claim is typically described as an amount a contractor seeks to collect from customers or other parties in excess of the agreed contract price. Claims may arise from customer-caused delays, errors in specifications or design, contract terminations, change orders that are in dispute or unapproved on both scope and price, or other causes of unanticipated additional costs.

Interpretive response: Topic 606 requires a contract claim to be evaluated under the modification guidance to determine whether it creates new enforceable rights and obligations or changes existing enforceable rights and obligations.

Assessing whether a claim gives rise to a contract modification depends on several factors and may require a detailed understanding of the entity's legal position, which may require third-party advice. Legal advice may be warranted even when a master services agreement or other governing document prescribes the claim resolution process under the contract.

The assessment may be more straightforward if an objective framework for resolution exists – e.g. if the contract includes a defined list of cost overruns that will be eligible for reimbursement and a price list or rate schedule. Conversely, the mere presence of a resolution framework – e.g. a requirement to enter into binding arbitration instead of litigation – generally does not negate an entity's need to obtain legal advice to determine whether its claim is enforceable. Having a legal basis to assert a claim does not necessarily mean the right is enforceable. If enforceable rights do not exist for a contract claim, then a contract modification has not occurred and no additional contract revenue is recognized until either approval or legal enforceability is established.

When a contract claim represents an unpriced contract modification under Topic 606, the expected change in price from the claim is variable consideration. See Question 11.2.60 for how to apply that guidance.

An entity's accounting for costs incurred before approval of a contract modification depends on the nature of the costs. In some circumstances, those costs are expensed as they are incurred. In other circumstances, an entity needs to consider whether the expectation of costs without a corresponding increase in the transaction price requires it to recognize a loss contract provision (see section 13.2). Or, a contract modification may be considered a specifically anticipated contract such that the costs incurred before approval of the contract modification (i.e. pre-contract costs) are capitalized if the fulfillment cost criteria in paragraph 340-40-25-5 are met, which *may* be the case if the costs relate to fulfilling goods or services that are distinct from those in the original contract (see section 12.5).

11.3 Accounting for a contract modification

11.3.10 Overview

Having determined that a contract has been modified, an entity then determines the appropriate accounting for the modification. A contract modification is treated as either a separate contract or part of the existing contract. Moreover, modifications are accounted for prospectively when the remaining goods or services are distinct, on a cumulative catch-up basis when the remaining goods or services are not distinct, or as a combination of the two approaches when the remaining goods or services are both distinct and non-distinct. [606-10-25-12 – 25-13]

Example 11.3.10
Contract modification

Contractor enters into a contract with Customer to build a road for $1,000. During construction of the road, Customer requests that a section of the road be widened to include two additional lanes. Contractor and Customer agree that the price will increase by $200.

In evaluating how to account for the contract modification, Contractor first needs to determine whether the modification adds distinct goods or services.

— If the road widening is not distinct from the construction of the road, it becomes part of a single performance obligation that is partially satisfied at the date of the contract modification, and the measure of progress is updated using a cumulative catch-up method. [606-10-25-13(b)]

— If the road widening is distinct, Contractor needs to determine whether the additional $200 is commensurate with the stand-alone selling price of the distinct good. [606-10-25-12]

— If the $200 reflects the distinct good's stand-alone selling price, construction of the additional two lanes is accounted for separately from the original contract for the road construction. This results in prospective accounting for the modification as if it were a separate contract for the additional two lanes. [606-10-25-12]

— If the $200 does not reflect the distinct good's stand-alone selling price, then the agreement to construct the additional two lanes is combined with the original agreement to build the road and the unrecognized consideration is allocated to the remaining performance obligations (the original road and the additional two lanes). Revenue is recognized when or as the remaining performance obligations are satisfied – i.e. prospectively. [606-10-25-13(a)]

11.3.20 Evaluating whether a modification is a separate contract

Excerpt from ASC 606-10

> Contract Modifications

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.

A contract modification is treated as a separate contract if the modification results in: [606-10-25-12]

— a promise to deliver additional goods or services that are distinct; and

— an increase in the price of the contract by an amount of consideration that reflects the entity's stand-alone selling price of those additional goods or services adjusted to reflect the circumstances of the contract.

When a contract modification meets these criteria, there is no economic difference between an entity entering into a separate contract for additional goods or services or modifying an existing contract. This is because the stand-alone selling price in the modification is commensurate with the price at which an entity would sell a good or service separately to a customer, and there is no discount that needs to be allocated between the new and existing contracts. Therefore, the original contract continues to be accounted for as it was before the modification and the modification is treated as a new contract to which Topic 606 is applied, meaning the new contract is accounted for prospectively. [ASU 2014-09.BC77]

Question 11.3.10

In a modification, is the stand-alone selling price of distinct goods or services evaluated at the modification date or at the original contract's inception?

Interpretive response: The entity uses the stand-alone selling price at the time of the contract modification. The objective of determining whether a contract modification is accounted for as a separate contract is to determine whether there is an economic difference between amending the current contract and entering into a new contract. As a result, the relevant stand-alone selling price is the price at the modification date, as if the modification were a new contract between the entity and a similarly situated customer with whom the entity does not have an existing contract. [ASU 2014-09.BC77]

Example 5 in Topic 606 illustrates when the evaluation is made.

Excerpt from ASC 606-10

• • > Example 5—Modification of a Contract for Goods

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

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.

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.

Question 11.3.20

What evidence is necessary to substantiate that a deviation from stand-alone selling price reflects an appropriate adjustment for the circumstances of a particular contract?

Interpretive response: The second criterion for a contract modification to be accounted for as a separate contract is that "the price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract." [606-10-25-12(b)]

This requires a two-step analysis:

1. Determine the stand-alone selling price of the additional goods or services; and
2. Determine whether a deviation from the stand-alone selling price is 'appropriate' to the circumstances of the specific contract.

These steps are not only important when the parties modify an existing contract, but also in determining whether entering into a new contract while performing under another contract with that same customer should be accounted for as a separate contract or a modification of the existing contract. The new contract could be for different goods or services or an extension of the term of the existing contract before it is complete. Also see Question 11.2.30.

Consider the following scenario.

— An entity and a customer enter into a three-year service contract to provide a single performance obligation that is a series of distinct services (see section 4.4).

- With nine months remaining in the original term, the entity and the customer enter into a three-year renewal of their existing contract.
- The price for the three-year renewal is below the pricing in the original contract, and the three-year renewal for service is distinct from the original three-year service arrangement. The renewal under this type of contract could be structured as an amendment to the existing contract or as a separate contract.

Because in this scenario the new contract is for a distinct good or service, the key analysis is the comparison of the additional consideration to the stand-alone selling price and any appropriate adjustments.

Step 1: Determine the appropriate stand-alone selling price

In general, the stand-alone selling price used for this determination is the same as that used for other purposes in Topic 606. However, it is important to consider that the stand-alone selling price for the additional goods or services may be different in a subsequent or modified contract than the stand-alone selling price in a contract with a new customer.

If an entity frequently concludes that its sales to existing customers are below stand-alone selling price for new customers, it should consider whether existing customers are a different class of customer from new customers such that the stand-alone selling prices of its goods or services are different for that class of customer. The stand-alone selling price of a good or service is often different for different classes of customers. For example, entities may sell goods or services at different prices to new customers versus renewing customers or customers with contracts for many of the entity's products or services versus those with only a few or one.

The selling price to an existing customer may frequently be lower than the price for a new customer because the entity avoids the sales related costs that it would incur with a new customer. In addition, a service provider may incur significant set-up costs for a new customer that it does not recover through set-up or implementation services fees. A new customer may also require significantly more customer support.

In addition to lower costs related to existing customers, a customer may become a different class of customer through the modification. For example, a customer with an existing minimum purchase guarantee of 1,000 units may expand its business and add an additional 1,000 units to its minimum purchase guarantee. The stand-alone selling price of a 1,000 unit purchase to a customer that will now guarantee the purchase of 2,000 units may be lower than the stand-alone selling price granted a customer that only guarantees a purchase of 1,000 units.

Step 2: Determine whether a deviation from stand-alone selling price is 'appropriate' to the circumstances of the particular contract

In principle, we believe that for a deviation from the stand-alone selling price to be an adjustment that is appropriate to the circumstances of the particular contract, it needs to result from a negotiation between the entity and the customer that is separate from and unrelated to the original contract.

In other words, the terms and conditions for the additional goods or services, including the adjustment from stand-alone selling price, need to be:

— unrelated to the entity's performance under the original contract;
— separate from the pricing or payment terms of the original contract; and/or
— separate from any contract disputes arising from the original contract.

This is consistent with the objective of determining whether a contract modification should be accounted for as a separate contract (i.e. when there is no substantive economic difference between modifying the existing contract and entering into a separate contract). [ASU 2014-09.BC77]

Judgment is frequently necessary to evaluate whether a deviation from stand-alone selling price reflects:

— an appropriate adjustment based on particular contract circumstances; or
— suggests that the contract for the additional goods or services – whether in the form of an amendment, addendum or new contract – is modifying the terms and conditions of an existing contract.

If structured as a new contract, the entity also needs to evaluate whether the original and new contracts are accounted for as a single contract based on the contract combination guidance (see section 3.7).

We believe the following factors (not exhaustive) are relevant in determining whether the new contract negotiation between the entity and the customer, resulting in the adjustment to (i.e. a discount from) the stand-alone selling price, creates a new contract that is separate from the original contract.

— **Competitive negotiation process.** The customer actively seeking bids from, or being solicited by, other vendors for the same or similar goods or services may support a view that the deviation from stand-alone selling price was the result of a substantive negotiation unrelated to the original contract. In this instance, the entity would have a valid business reason for offering the discounted price. Additional evidence that suitable alternatives are being offered by other vendors at broadly consistent prices may support that the price of the additional goods or services are the result of a substantive negotiation.

— **Evidence of performance issues or payment disputes.** There may have been performance issues on the part of the entity (e.g. poor service or significant operating downtime) or payment disputes on the part of the customer arising from the original contract. Examples of payment disputes include the customer disputing amounts invoiced for services provided under the original contract, including disputes related to the measurement of variable consideration, such as whether a performance bonus was or was not earned or service level penalties were or were not incurred. Such issues/disputes generally create a presumption that at least some portion of the deviation from the stand-alone selling price is related to those issues/disputes, affecting the accounting for the original contract (see Question 11.3.30). Conversely, the absence of any such issues may indicate (but is not determinative) that the negotiation between the entity and the customer that resulted in additional consideration below the stand-alone selling prices of the additional goods or services is separate from the original contract.

— **History of price or other concessions.** A history of granting concessions to its customers significantly elevates the burden of evidence an entity needs to substantiate that selling a distinct good or service at a price below its stand-alone selling price was for a valid business reason unconnected to the original contract. In such cases, the evidence would need to demonstrate that the discount from stand-alone selling price was for a business reason unrelated to the original contract, and that the discount is proportional to that reason.

— **Changes to the remaining terms of the original contract.** Changes in the price, scope or billing terms for the remaining goods or services in the original contract typically indicate that the additional goods and services and the remainder of the original contract were not separately negotiated. Rather, the additional goods and services were agreed to in contemplation of the changes to the original contract (see Question 11.2.30). However, just because the remaining terms of the original contract were not changed does not mean the additional goods or services should be accounted for as a separate contract.

— **Set-up or other costs.** The absence of, or lower, costs to obtain or fulfill the contract may suggest a reason for a lower stand-alone selling price for renewal of existing customers. However, contract-specific cost considerations may also exist that result in the entity selling an additional good or service at a discount from the stand-alone selling price for that class of customer. For example, a customer with internal capabilities that perform work typically performed by the entity may justify a correspondingly lower contract price than for similar customers who are unable to perform that work.

The following additional factors may also provide corroborative evidence that the additional goods or services were negotiated without considering the original contract.

— **Period of time between original contract inception and new terms.** The greater the period between original and new contract inception and/or between the payment for the goods or services provided under the original contract and new contract inception, the more likely it may be that the terms and conditions of the new contract were negotiated separate from, and are not affected by, the original contract.

— **Other observable prices.** The stand-alone selling price of the good or service may be based on a narrow range of observable prices. However, the entity may have a substantive number of stand-alone sales that are outside of that narrow range. Instances where the price for the distinct good or service in the new contract is consistent with prices established in separately negotiated contracts, even if those prices are outside of the range used to establish stand-alone selling price, may support that a discount from stand-alone selling price is unrelated to the original contract.

— **Customary business practices.** The entity's process for negotiating and entering into the new or amended contract with the customer being consistent with its customary business practice for entering into contracts with new customers – e.g. similar negotiation timeline, similar contract pricing guidelines for the entity's salespeople – may support the position that the new contract negotiation is unrelated to the original contract. For example, the fact that a service provider is negotiating a renewal a few months before the end of the current contract term may be customary practice because the entity wants to maintain its share of the market.

Example 11.3.20

Service arrangement renewal accounted for as a separate contract

Payment Processor enters into a contract with Customer to provide its payment processing services for three years for a fee of $1,500 per month. The payment processing services are a single performance obligation comprising a series of distinct services. The contract does not include stated renewal options.

With six months remaining in the contract, Payment Processor and Customer enter into a new contract that extends the service for an additional three years at $1,300 per month. $1,300 is below the range Payment Processor has established as the stand-alone selling price for its payment processing services for similar customers entering into contract renewals. The remaining term of the original contract remains unchanged, and Payment Processor will continue to charge $1,500 per month for the remaining six months.

Should the old and new contracts be combined?

In evaluating whether the new contract is a separate contract or a modification of the original contract, Payment Processor first concludes that the new contract and the original contract would not be combined under the contract combination guidance because they were not entered into at or near the same time (executed approximately 2.5 years apart).

Is the additional service distinct?

Next, Payment Processor concludes that the additional three-year payment processing services are distinct from the original three-year payment processing services obligation. This is based on the following:

— Customer can clearly benefit from each payment processing service period separately.

— Payment Processor can provide the payment processing services for any period of time independent from providing it for any other period of time.

— There is no integration, customization or modification of the payment processing services in one period with or by those provided in another period.

Is the pricing appropriate to the separate contract?

Payment Processor evaluates whether the discount from the stand-alone selling price for this class of customer represents an adjustment from stand-alone selling price that is unrelated to the original contract.

Payment Processor concludes that this discount is an adjustment unrelated to the original contract based on the following.

— While Payment Processor is not aware of Customer soliciting bids from other payment processing service providers, Payment Processor understands Customer to be price-sensitive and there are other readily available payment processing service providers that Customer could employ. Specifically, new competitors have entered the market since the original contract was executed, indicating that Payment Processor operates in a competitive market. Payment Processor has a business objective to retain or enhance its market share even as the market becomes more competitive.

— Payment Processor has no history of granting price or other concessions to its customers. Moreover, there have been no significant service issues or payment disputes between Payment Processor and Customer during the current contract term.

— There are no changes to terms or conditions of the original contract resulting from the renewal contract.

— The negotiation and execution timeframe for the renewal contract, although occurring before the existing three-year payment processing services period expires, is for a valid business reason. Specifically, Customer needs to have time to change solutions if the two parties cannot agree on renewal terms. Therefore, the timing of negotiations does not alone imply those negotiations included potential modifications to the remainder of the original contract.

Based on the facts and circumstances in this case, Payment Processor concludes that the renewal contract with Customer is a separate contract, rather than a modification of the original contract. Consequently, the accounting for the original contract is not affected by the renewal. Therefore, Payment Processor recognizes revenue of $1,500 per month for the remaining six months in the original contract, and then $1,300 per month for the three years in the new contract.

Question 11.3.25

How should an entity account for a blend-and-extend modification?

Interpretive response: It depends. Entities sometimes enter into contract modifications whereby the period of a contract is extended in exchange for a new blended price throughout the remaining term. For example, after one year of a three-year contract priced at $100 per year, an entity and customer agree to extend the contract for two years and change the price for the remaining four years (original two remaining, plus two added) to $50.

In a typical blend-and-extend modification, the extension adds distinct goods or services (e.g. additional units of electricity or time increments that constitute a series). Therefore the modification would be accounted for as either a separate contract or the termination of an existing contract and the creation of a new contract (see section 11.3.30) depending on the price of distinct additional goods or services (assuming that a concession related to past performance is not included in the modification – see Question 6.8.10).

However, if the extension adds goods or services that are not distinct, an entity accounts for a contract modification with either a cumulative catch-up adjustment or by using a combination of the methods of modification accounting (see section 11.3.30).

Is the price of the added goods commensurate with stand-alone selling price?

To determine whether the modification should be accounted for as a separate contract, an entity evaluates whether the price of the additional distinct goods or services is commensurate with their stand-alone selling price (as adjusted for contract-specific circumstances). If the price of the additional distinct goods or services is not commensurate with stand-alone selling price, the modification is accounted for as a termination of the existing contract and creation of a new contract. If the price is commensurate, the modification is a separate contract.

The typical issue in a blend-and-extend modification is whether the stand-alone selling price should be compared to the overall increase in the contract value or the blended contractual cash selling price of the added goods or services.

When the overall price increase is not commensurate with the stand-alone selling price of the additional goods or services, the modification should be accounted for as a termination of an existing contract and the creation of a new contract. That is because neither the overall price nor the blended stated price would be commensurate with the stand-alone selling price.

The guidance is less clear when the overall increase in contract value is commensurate with the stand-alone selling price of the additional distinct goods or services, but the blended contractual cash selling price is not. In these cases, we believe the following approaches are acceptable.

Approach 1: Added services treated as a separate contract

Under this approach, an entity compares the overall contract price increase to the stand-alone selling price. This approach is based on a narrow reading of the condition in paragraph 606-10-25-12(b), which states that the "price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services …"

Under this approach, when the price of the *entire contract* increases in an amount that is consistent with the stand-alone selling price for the additional goods or services, the modification is treated as a separate contract. The entity uses the stand-alone selling price to account for the added goods or services, and the original contract price to account for the remaining items in the original contract. As a consequence, for accounting purposes the original contract remains unchanged even though the pricing in the agreement was modified. [606-10-25-12(b)]

Approach 2: Termination of existing contract and creation of a new contract

Under this approach, an entity compares the stated contract price of the additional goods or services to their stand-alone selling price. This approach is based on the basis for conclusions, which states a modification is accounted for as a separate contract when the "*pricing* for those goods or services reflects their stand-alone selling price." See section 11.3.30 for a discussion of modifications accounted for as the termination of an existing contract and creation of a new contract. [ASU 2014-09.BC77]

Example 11.3.25 illustrates a blend-and-extend modification under the two approaches.

Example 11.3.25
Blend-and-extend contract modification

Power Co enters into a non-cancellable four-year contract with Customer to deliver 1 MWh of electricity per year for $60 per MWh.

At the beginning of Year 3 (two years remaining in the contract), Power Co and Customer agree to a blend-and-extend modification to add two additional years to deliver 1 MWh each year. The modification increases the remaining term to four years.

Market prices have declined since inception of the original contract and the market price at the modification date is $50/MWh. The overall contract price is increased based on the then-current market price for the added services ($100 for the two additional years at $50/Mwh) and blended with the pricing for the remaining term of the original contract.

As a result, the modified contract has four years remaining, priced at $55/MWh:

$$((\$60/\text{MWh} \times 2) + (\$50/\text{MWh} \times 2)) / 4.$$

Power Co concluded that the original contract has a single performance obligation satisfied over time that is a series of distinct services and that the additional services are therefore distinct. As of the modification date, Power Co had recognized $120 of revenue using an output-based measure of progress and there were no contract assets or liabilities.

Because the overall price increased by the market price (i.e. $100 price increase represents the stand-alone selling price for the two additional Mwh) but the blended contractual price of $55/Mwh is not commensurate with stand-alone selling price, Power Co could account for the modification under either of the approaches described in Question 11.3.25.

Approach 1: Added services treated as a separate contract

Power Co concludes that the overall contract price increases by the market price ($100), which is commensurate with the stand-alone selling price for the two additional MWh. Therefore, Power Co accounts for the additional services as a separate contract.

	Year 3	Year 4	Year 5	Year 6
Revenue remaining on original contract	$60	$60	-	-
Revenue on new contract	-	-	$50	$50
Cash received	55	55	55	55
End-of-year contract asset/(liability)	**$ 5**	**$10**	**$ 5**	**$ 0**

Approach 2: Termination of existing contract and creation of a new contract

Power Co concludes that the blended contract pricing of $55/MWh (i.e. the stated pricing for the additional 2 MWh) is not commensurate with the stand-alone selling price of $50/MWh. Therefore, Power Co accounts for the modification as a termination of the existing contract and a creation of a new contract.

	Year 3	Year 4	Year 5	Year 6
Revenue on new contract	$55	$55	$55	$55
Cash received	55	55	55	55
End-of-year contract asset/(liability)	**$ 0**	**$ 0**	**$ 0**	**$ 0**

Question 11.3.30

When additional goods or services are priced at a discount because of past performance issues, how should the entity account for that modification?

Interpretive response: Whether a discount from the stand-alone selling price of additional goods or services in a modification relates to past performance, as opposed to future services, depends on the particular facts and circumstances. A discount that relates to the entity's past performance is accounted for as a change in the transaction price for that contract even if that discount is priced into the modified contract on a prospective basis (see Question 6.8.10). Example 5, Case B in Topic 606 (reproduced below) illustrates the accounting for a modification that adds additional goods or services and negotiates a discount related to past performance issues.

That Example states that the minor defects in the initial 60 products transferred to the customer were 'unique'. Although not stated explicitly, we believe this fact suggests there was no expectation of defects at contract inception to indicate that some of the consideration was variable – i.e. there was no expectation of future concessions for defective products. Further, we believe the 'unique' description of the defects is intended to suggest no defects are expected in the products remaining to be transferred to the customer after the modification, and therefore that there is no variable consideration in the modified contract – i.e. for possible further concessions for additional defects.

In contrast, the entity likely would have concluded that the transaction price of the original contract included variable consideration if:

- the defects were not unique to the 60 products initially transferred to the customer, such that there was a reasonable chance at contract inception that some of the products transferred would be defective; and
- the entity had previously provided similar concessions when products were defective.

The occurrence of the defects in the first 60 products transferred, and the granting of the $900 credit for those defective products, should raise questions about whether the transaction price for the remaining 90 products not yet transferred at the modification date includes variable consideration. These questions should be raised even if there was no expectation of defects when the original contract was entered into or any expectation of granting a concession in the event there were defects.

Excerpt from ASC 606-10

• • > Example 5—Modification of a Contract for Goods

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

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.

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.

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}.

Example 11.3.30

Contract to extend network service arrangement that includes a discount for past performance issues

Telco enters into a contract with Customer to provide its network service for one year in exchange for $100 per month. The network service is a single performance obligation that comprises a series of distinct services. Telco recognizes revenue over time using a time elapsed measure of progress. The contract does not include stated renewal options.

With three months remaining in the contract, Telco and Customer enter into a new contract that extends the service for an additional year at $95 per month. $95 is below the stand-alone selling price for the network service of $105 for this class of customer. The remaining term of the original contract remains unchanged, and the entity will continue to charge $100 per month for the remaining three months. There are no changes to other terms or conditions of the original contract.

During the first eight months of the initial contract Customer experienced service issues that were unanticipated at contract inception. The service issues arose due to customer-specific circumstances that had not arisen previously in other customer contracts. Concurrent with the negotiation of the network service renewal, Customer communicates that it believes it should be entitled to compensation for those service issues even though the contract did not provide for service level penalties. Both Customer and Telco believe that as of Month 9 of the initial contract, the service issues have been resolved and will not recur.

Telco and Customer's contract did not stipulate a penalty related to the service issues and Telco has no history of providing service level concessions when none are stipulated in the contract. As such, Telco did not expect to provide a concession to Customer when it entered into the original contract. It agrees to do so in this case because it believes its arrangement with Customer will attract other similar customers to its network service solution.

As outlined in Question 11.3.20, performance issues and/or payment disputes generally create a presumption that at least some portion of the discount in a new contract, such as in this example, is related to those performance issues or payment disputes that need to be overcome by other evidence.

Consequently, Telco accounts for the modification as follows.

— First, Telco concludes that it should account for the entire discount from stand-alone selling price of $10 per month ($105 – $95) in the renewal contract as compensation for the past performance issues encountered in the first eight months of the original contract term.

  Telco concludes that this is reasonable because the total discount of $120 ($10 per month × 12 months) for the renewal equals 15% of the fees paid by Customer for the first eight months of deficient service under the original contract ($120 discount / $800 consideration for 8 months ($100 per month × 8 months)). This level of discount is a reasonable service-level credit in the marketplace – e.g. when compared to entities that have explicit service-level provisions in their contracts.

As a result, when the contract modification is agreed, Telco takes the $120 cumulative discount on the renewal and reduces revenue recognized for the eight distinct months of network service it provided and for which there were service issues. The offsetting side of that revenue reversal is a contract liability, which will be recognized into revenue as the renewal period network service is provided. Assume Telco concludes there is no significant financing component.

- After reflecting the discount as a change to the transaction price for the first eight months of network service provided under the original contract, the remaining monthly consideration of $105 reflects the stand-alone selling price of the network service for the 12-month renewal period. Consequently, Telco does not adjust its accounting for the remaining three months of the original 12-month contract term – Telco continues to recognize $100 per month.
- Telco accounts for the 12-month renewal as a separate contract. Telco recognizes $105 in revenue each month for the network service provided during the renewal period, comprising the $95 Telco will bill the customer plus $10 each month reversed from the $120 contract liability established earlier.
- Because Telco believes that the initial service issues have been completely resolved and will not recur going forward, Telco does not expect to provide any further concessions to Customer, either for the remainder of the original contract term or for the renewal period. Similarly, Customer would not validly expect further concessions. Therefore, there is no variable consideration to account for in the remainder of the original contract or the renewal contract based on currently understood facts and circumstances.

Question 11.3.40

How should an entity evaluate the criterion in paragraph 606-10-25-12(b) when the stand-alone selling price of the additional distinct good or service is highly variable or uncertain?

Interpretive response: Even when a contract modification that adds one or more goods or services with a highly variable or uncertain stand-alone selling price, an entity still needs to determine whether the consideration for those additional goods or services reflects these stand-alone selling prices. This evaluation may require significant judgment because a comparison of the additional consideration to a stand-alone selling price (or even a narrow range of stand-alone selling prices) is not possible. [606-10-25-12(b)]

An entity needs to consider all relevant, available evidence in determining whether the amount of additional consideration promised for the good or service reflects its stand-alone selling price (as adjusted for particular contract circumstances). The following are two possible approaches (not exhaustive):

- Compare the additional consideration for the good or service (or bundle thereof) against the range of stand-alone selling prices for that good or service (or bundle) estimated in previous contracts with similar customers. It may be, in some arrangements, that only the added goods or services, as a bundle, have a highly variable or uncertain stand-alone selling price – e.g. a modification may add goods or services that, as a bundle, have a highly variable stand-alone selling price.
- Evaluate whether the additional consideration for the good or service (or bundle thereof) provides a discount to the customer that is incremental to the range of discounts reflected in the pricing of the goods or services in the original contract.

Sometimes, the original contract may have been modified multiple times before the most recent modification was approved. In such cases, when applying this second approach, the discount in the modification should be compared against the discount(s) offered in the contract(s) or amendment(s) last entered into before the current modification date.

For example, assume the original contract with the customer for a five-year software license and two years of post-contract support (PCS) priced the license at a 60% discount from list price and the PCS at its stand-alone selling price. However, the parties have subsequently entered into a number of additional contracts to grant the customer (1) the right to use additional software products or (2) additional users or capacity, and related PCS on both.

Assume that at the time of the current modification, the customer's active licenses (i.e. those that have been renewed multiple times, as well as new licenses added in the most recent previous amendment) were priced at a 70% discount from list price, while the related PCS is priced at stand-alone selling price. That discount of 70%, while incremental to the discount in the amendment that preceded it, was considered an 'appropriate' adjustment to the stand-alone selling price (see Question 11.3.20). Therefore, when applying the second approach to the current modification adding a new license and PCS, it would meet the criterion in paragraph 606-10-25-12(b) if the additional consideration resulting from the modification provides the customer with no more than a 70% discount from the list price of the new license (assuming the PCS is priced at stand-alone selling price).

If the discount from list price in either of these two examples exceeds 60% and 70%, respectively, that would not *automatically* mean the criterion in paragraph 606-10-25-12(b) is not met. The entity would still consider whether the incremental discount in this instance is an appropriate adjustment to the stand-alone selling price (see Question 11.3.20).

Whatever approach an entity adopts, we would expect it to be applied consistently in similar circumstances. Also, to the extent the entity's approach relies on established list prices, those list prices need to be substantive. In addition, changes to the price list should be subject to the entity's internal controls (including who can authorize its updating), and there should be a process and controls for identifying any triggers resulting in adjustments to the price list.

Example 11.3.40

Evaluating whether additional consideration reflects the stand-alone selling prices of added goods and services

ABC Corp. sells a perpetual software license to software Product A to Customer along with three years of technical support and rights to when-and-if available updates/upgrades (collectively, PCS).

The contract price for the license and the PCS is $400,000 and $216,000, respectively, which is paid upfront. ABC does not sell its software licenses to Product A separately from PCS, but sells Product A PCS separately through renewals.

The list price for the Product A license is $1,000,000; so the contract price for the license is a 60% discount from list price. ABC's price list is substantive and well controlled. ABC has a customary business practice to sell Product A PCS for one year at 18% of the contractual license fee (so 54% for three years), and a substantial history of selling one-year PCS renewals on a stand-alone basis at that price.

Two years after entering into the contract for the Product A license and PCS, ABC and Customer enter into an amendment to grant Customer a perpetual license to software Product B along with one year of PCS. The contract prices are $300,000 and $60,000, respectively. The list price for the Product B license is $600,000; so the contract price for the license is a 50% discount from list price. ABC has a customary business practice to sell one year of Product B PCS to customers similar to Customer for 20% of the contractual license fee, and a substantial history of selling PCS renewals on a stand-alone basis at that price.

ABC has concluded that the stand-alone selling price for a perpetual Product B license is highly variable.

Product B has been licensed on a perpetual basis to many similar customers within the last few months, always bundled with one year of PCS.

Alternative 1

The Product B PCS is being sold at its stand-alone selling price (consistent with Example 6.3.10). Therefore, ABC compares the discount from list price offered on the Product B license in its previous Product B perpetual license sales to the discount from list price given to Customer.

The discount from list price in the previous Product B perpetual license sales is calculated as the difference between:

— the estimated stand-alone selling price established for the Product B license; and
— the then-current ABC list price.

From this process, ABC determines that the normal range of discounts it has previously provided from the list price on perpetual licenses of Product B is 40% to 60%. Therefore, the 50% discount from list price is not incremental to the entity's 'normal' discount range. Together with the fact that the PCS is priced at its observable stand-alone selling price, and assuming the Product B license and related PCS are distinct from the Product A license and PCS promised in the original contract, ABC accounts for the Product B license/PCS amendment as a separate contract in accordance with paragraph 606-10-25-12.

Alternatively, if the normal range of discounts ABC previously provided from the list price on perpetual licenses of Product B was lower than the 50% discount offered to Customer (e.g. 25% to 40%), ABC would generally account for the amendment as a contract modification. In other words, unless the difference reflects an appropriate adjustment to the stand-alone selling price of the license to reflect particular contract circumstances (see Question 11.3.20) the amendment is treated as a contract modification, rather than as a separate contract.

Alternative 2

ABC compares the discount from list price granted on the Product B license of 50% to the 60% discount from list price provided on the Product A license in the original contract with Customer.

Consequently, again assuming the Product B license and related PCS are distinct from the Product A license and PCS promised in the original contract, ABC accounts for the Product B license/PCS amendment as a separate contract in accordance with paragraph 606-10-25-12.

If the discount from list price offered on the license to Product B was more than 60%, ABC would generally account for the amendment as a modification to the original contract – i.e. unless the difference reflects an appropriate adjustment for the particular contract circumstances (see Question 11.3.20).

11.3.30 Modification is not a separate contract

Excerpt from ASC 606-10

> Contract Modifications

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.

If the modification does not meet the criteria to be considered a separate contract, it is accounted for as (1) a termination of the existing contract and creation of the new contract, (2) part of the existing contract, or (3) a combination of both. There is an important distinction between a modification that is considered a separate contract and one that is accounted for as a termination of the existing contract and creation of a new contract. Specifically, in a modification that is considered a separate contract, the original contract continues to exist alongside the new, separate contract. In contrast, in a modification that is accounted for as a termination and creation of a new contract, the original contract no longer exists. [606-10-25-13]

The accounting model depends on whether the remaining goods or services under the modified contract are distinct from those goods or services transferred to the customer before the modification. The remaining goods or services under the modified contract refers to the combination of (1) the goods and services from the original contract that had not transferred to the customer as of the contract modification date and (2) any additional goods or services added to the contract by the modification. [606-10-25-13]

An entity evaluates whether the remaining goods or services are distinct even if they are part of a single performance obligation. When the remaining goods or services are a part of a single performance obligation that is considered a series of distinct goods or services, the remaining items in that performance obligation are considered distinct. [ASU 2014-09.BC79, BC115]

As a result, identifying a performance obligation as a series of distinct goods or services or distinct increments of time (see section 4.4) can significantly affect the accounting for contract modifications. The FASB observed that modifications to a single performance obligation comprising a series of distinct goods or services should be accounted for prospectively, as either a separate contract or as a termination of an existing contract and creation of a new contract. Although the distinct goods or services (or time increments) in a series are accounted for as a single performance obligation, the entity considers the distinct goods or services in the contract separately to apply the contract modification guidance. [ASU 2014-09.BC79]

Termination of an existing contract and creation of a new contract

If the remaining goods or services are distinct from the goods or services transferred to the customer before the modification, the existing contract has been terminated and a new contract exists for accounting purposes. The modification in this instance is accounted for prospectively. [606-10-25-13(a)]

The entity does not reallocate the change in the transaction price to performance obligations that are completely or partially satisfied on or before the date of the contract modification – i.e. there is no cumulative catch-up adjustment. Prospective accounting ensures that the entity does not open up the accounting for previously satisfied performance obligations (or distinct goods or services in a series) and avoids reversing previously recognized amounts. [606-10-25-13(a), ASU 2014-09.BC78]

Instead, the amount of consideration allocated to the remaining performance obligations is equal to:

— the consideration included in the estimate of the transaction price of the original contract that has not been recognized as revenue (which therefore excludes the amount of any contract asset existing at the modification date – see Question 11.3.50); plus/minus

— the increase/decrease in the consideration promised by the contract modification. [606-10-25-13(a)]

Excerpt from ASC 606-10

• • > Example 7—Modification of a Services Contract

55-125 An entity enters into a three-year contract to clean a customer's offices on a weekly basis. The customer promises to pay $100,000 per year. The standalone selling price of the services at contract inception is $100,000 per year. The entity recognizes revenue of $100,000 per year during the first 2 years of providing services. At the end of the second year, the contract is modified and the fee for the third year is reduced to $80,000. In addition, the customer agrees to extend the contract for 3 additional years for consideration of $200,000 payable in 3 equal annual installments of $66,667 at the beginning of years 4, 5, and 6. The standalone selling price of the services for years 4 through 6 at the beginning of the third year is $80,000 per year. The entity's standalone selling price at the beginning of the third year, multiplied by the additional 3 years of services, is $240,000, which is deemed to be an appropriate estimate of the standalone selling price of the multiyear contract.

55-126 At contract inception, the entity assesses that each week of cleaning service is distinct in accordance with paragraph 606-10-25-19. Notwithstanding that each week of cleaning service is distinct, the entity accounts for the cleaning contract as a single performance obligation in accordance with paragraph 606-10-25-14(b). This is because the weekly cleaning services are a series of distinct services that are substantially the same and have the same pattern of transfer to the customer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

55-127 At the date of the modification, the entity assesses the additional services to be provided and concludes that they are distinct. However, the price change does not reflect the standalone selling price.

55-128 Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(a) as if it were a termination of the original contract and the creation of a new contract with consideration of $280,000 for 4 years of cleaning service. The entity recognizes revenue of $70,000 per year ($280,000 ÷ 4 years) as the services are provided over the remaining 4 years.

Cumulative catch-up adjustment

If the modification does not add distinct goods or services, then the entity accounts for it on a combined basis with the original contract, as if the additional goods or services were part of the initial contract. The modification is recognized as either an increase in, or reduction of, revenue at the date of the modification – i.e. a cumulative catch-up adjustment. [606-10-25-13(b)]

The cumulative catch-up adjustment requires an entity to update the transaction price and the measure of progress toward complete satisfaction of the performance obligation, both of which may change as a result of the modification. This approach is particularly relevant in contracts to provide customized goods such as construction, customized software or equipment because a modification to those types of contracts typically does not result in the transfer of additional goods or services that are distinct from those promised in the existing contract. [ASU 2014-09.BC80]

The following example from Topic 606 illustrates the accounting for a modification on a cumulative catch-up basis.

Excerpt from ASC 606-10

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

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

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.

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

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.

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.

Combination of the methods

If the remaining goods or services in the modified contract consist of both (1) goods or services that are distinct from the goods or services transferred before the modification and (2) goods or services that are not distinct from goods or services transferred before the modification, then the entity accounts for the modification under a combination of the methods. Topic 606 provides no additional guidance on how to apply this method; as a result significant judgment is necessary. See Question 11.3.80 for further discussion.

Question 11.3.50

When a modification is accounted for as a termination of an existing contract and creation of a new contract, is a contract asset that exists at the modification date written off?

Interpretive response: No. The TRG agreed that a contract asset that exists at the modification date should not be written off even though the existing contract is deemed to be terminated. Rather, any contract asset (in which case there would be no contract liability) is carried forward to the modified contract, less any impairment resulting from the modification to the contract. An impairment may result from a modification if there is a loss of contractual fees for a cancelled good or service or a change in the transaction price. The TRG observed that a writeoff of the contract asset would result in a reversal of previously recognized revenue, which would be inconsistent with a *prospective* accounting model and the FASB's conclusions. [ASU 2014-09.BC78, TRG 04-16.51]

When a modification is accounted for prospectively, the guidance provides a formula to determine the amount of consideration allocated to the remaining performance obligations. The first element of this formula is the transaction price in the original contract *less* what has already been recognized as revenue. Amounts that have already been recognized as revenue are included in a contract asset. Therefore, to calculate the consideration to be allocated to the remaining performance obligations the entity reduces the transaction price by the amount of the contract asset that has been recognized (see Example 11.3.50). [TRG 04-16.51]

Example 11.3.50

Contract asset in a modification accounted for prospectively as a termination of the original contract and the creation of a new contract

Cleaner enters into a two-year contract to clean Customer's offices on a weekly basis. Cleaner charges a monthly fee of $10,000 during Year 1 and $15,000 in Year 2. Therefore, the transaction price for the contract is $300,000.

Cleaner concludes that the cleaning service performance obligation is satisfied over time (see section 7.3) and uses a time-elapsed measure of progress to recognize revenue (see section 7.4.40). Cleaner further concludes that the single performance obligation is a series of distinct services.

In Year 1, Cleaner recognizes $150,000 of revenue ($300,000 total transaction price × 50% completion), which results in a contract asset of $30,000 because Cleaner has been entitled to bill only $120,000 through the end of Year 1 – i.e. further billings are conditional upon Cleaner providing the cleaning service in Year 2.

At the beginning of Year 2, Cleaner and Customer agree to modify the contract to provide Customer with additional cleaning services for additional office spaces for Year 2 for $5,000 per month. This additional consideration is a significant discount from the stand-alone selling price for access to that cleaning service of $10,000 per month.

Cleaner concludes that the discount from stand-alone selling price is not an appropriate adjustment for the contract's particular circumstances (see Question 11.3.20). The additional consideration for the added distinct service does not reflect its stand-alone selling price, and the difference cannot be attributed to an appropriate adjustment. Therefore, the modification is not a separate contract. [606-10-25-12]

Next, Cleaner determines whether the modified contract is a termination or a continuation of the existing contract. Because the cleaning service provided under the original contract is a series of distinct services, the remaining services to be provided from the original cleaning services and the additional cleaning services to be provided from the added office spaces are each distinct from the cleaning service already provided before the modification. Consequently, the modification is accounted for prospectively as a termination of the existing contract and creation of a new contract. [606-10-25-13(a)]

The consideration allocated to the remaining performance obligations is calculated as follows.

Transaction price in original contract	$300,000
Less: Consideration previously recognized as revenue	150,000
Plus: Consideration promised in modification	60,000
Total remaining revenue to be recognized	**$210,000**

The consideration allocated to the remaining performance obligations of $210,000 is less than the amount of consideration Cleaner will receive under the modified contract of $240,000 (($15,000 + $5,000) × 12 months). The difference between the future billings and the amount that will be recognized as revenue ($30,000) will reduce the contract asset that exists at the modification date as amounts are billed in excess of revenue recognized.

The following table illustrates the revenue that will be recognized and the contract asset balance that will exist throughout the remainder of the modified contract.

12 remaining months of the modified contract	Billing	Revenue recognized	Adjustment to contract asset	Contract asset balance
Beginning balance on modification				$30,000
End of Month 1	$ 20,000	$ 17,500	$ 2,500	27,500
End of Month 2	20,000	17,500	2,500	25,000
End of Month 3	20,000	17,500	2,500	22,500
End of Month 4	20,000	17,500	2,500	20,000
End of Month 5	20,000	17,500	2,500	17,500
End of Month 6	20,000	17,500	2,500	15,000
End of Month 7	20,000	17,500	2,500	12,500
End of Month 8	20,000	17,500	2,500	10,000
End of Month 9	20,000	17,500	2,500	7,500
End of Month 10	20,000	17,500	2,500	5,000
End of Month 11	20,000	17,500	2,500	2,500
End of Month 12	20,000	17,500	2,500	-
Total	**$240,000**	**$210,000**	**$30,000**	

Question 11.3.60

How does an entity account for a modification that decreases the scope of a contract?

Interpretive response: The accounting for a modification that decreases the scope of the contract depends on whether the goods or services yet to be provided are distinct from those already provided.

A decrease in scope may involve any of the following:

— the complete termination of the contract such that the entity has no obligation to transfer goods or services to the customer;

— cancelling one or more, but not all, of the goods or services promised under the original contract – e.g. an entity and a customer may agree to terminate services being provided by the entity if the customer decides to hire a new employee and take the services in-house; or

— partially terminating one or more of the goods or services – e.g. shortening a contracted service period.

A scope decrease modification can never be accounted for as a separate contract because only modifications that add distinct goods or services can create separate contracts. Therefore, the modification is either a termination of the existing contract and creation of a new contract or a continuation of the existing contract, depending on whether the remaining goods or services in the existing contract are distinct from those goods and services transferred before the modification. [606-10-25-12(a), 25-13]

If the remaining goods or services are distinct from those transferred on or before the date of the contract modification, the modification is accounted for prospectively as a termination of the existing contract and the creation of a new contract. For example, if the performance obligation is a series (see section 4.4), the remaining services to be provided are distinct from those already provided. [606-10-25-13(a)]

If the remaining goods or services are not distinct from those transferred on or before the date of the contract modification, the modification is accounted for on a cumulative catch-up basis as a continuation of the existing contract – e.g. a contract to complete in-process construction of a hospital. [606-10-25-13(b)]

Termination penalty in a partial termination

A partial termination may relate to a customer exercising an option to terminate the contract. As discussed in Question 3.8.20, a substantive termination penalty evidences that rights and obligations exist throughout the term to which the penalty applies – i.e. that a termination option during that period is not substantive. Once the contract term is established, the entity accounts for the contract on that basis – i.e. the entity's accounting for the contract ignores the termination option(s) and the transaction price of the contract does not include the termination penalty.

If the contract is subsequently terminated (whether immediately, or with effect in the future but before the initially determined contract term expires), the termination is accounted for as a contract modification even though the terms and conditions of the contract have not been changed (see Example 11.3.80). The substantive termination penalty that the customer is then obligated to pay is consideration promised as part of the contract modification.

Example 11.3.60
Decrease in scope of construction contract

ABC Corp enters into a contract with Customer to build a commercial building. Customer agrees to make progress payments throughout the customization period, which is expected to be approximately 18 months. The transaction price is fixed at $1,000,000. ABC concludes that the single performance obligation is satisfied over time.

At contract inception, ABC expects the following.

Transaction price	$1,000,000
Expected costs	(600,000)
Expected profit (40%)	**$ 400,000**

ABC applies a cost-to-cost input measure of progress to the combined performance obligation. After eight months of the contract, ABC has satisfied 40% of its performance obligation measured on the basis of costs incurred ($240,000) relative to total expected costs ($600,000).

The cumulative revenue and costs recognized for the first eight months are as follows.

Revenue	$400,000
Costs	(240,000)
Gross profit	**$160,000**

At the beginning of Month 9, Customer notifies ABC that it intends to scale back the scope of the project due to budgetary concerns and changes some of the specific designs and customizations in the building, thereby reducing the scope of the work. As a result, ABC and Customer agree to a price reduction of $100,000.

At the date of the modification, the remaining construction to be performed is not distinct from ABC's performance to date. ABC updates the transaction price and measure of progress. At the modification date, ABC expects the following.

Transaction price	$900,000
Expected costs	(550,000)
Expected profit (38.8%)	**$350,000**

At the modification date, ABC has satisfied 43.6% of its performance obligation, measured on the basis of the costs incurred ($240,000) relative to total updated costs ($550,000). The cumulative revenue and costs recognized at the modification date are as follows.

Revenue	$392,727
Costs	(240,000)
Gross profit	**$152,727**

As a result, ABC records a downward revenue adjustment of $7,273 (i.e. $400,000 – $392,727) at the date of the contract modification.

Example 11.3.70
Partial termination of service contract – no customer termination right

ABC Corp enters into a three-year contract with Customer to provide maintenance services at $2,000 per month. The contract does not provide Customer with a termination right. ABC concludes the contract has a single performance obligation that consists of a series of distinct services. ABC also concludes the performance obligation is satisfied over time and uses a time-elapsed measure of progress to recognize the transaction price.

At the end of Year 1, ABC has recognized $24,000 of revenue ($72,000 transaction price × 1/3 complete).

At the beginning of Year 2, competition in the market has changed the price for these maintenance services. Both parties agree to shorten the remaining term of the contract from two years to one year. As part of this contract modification, Customer agrees to pay a negotiated termination penalty of $12,000.

Because the performance obligation is a series of distinct services, the service periods after the modification are distinct from those before the modification. Therefore, the modification is accounted for prospectively as a termination of the original contract and the creation of a new contract. [606-10-25-13(a)]

Consequently, ABC allocates consideration to the remaining distinct service periods based on the original contract consideration that had not yet been recognized as revenue plus the consideration promised as part of the modification.

ABC had not yet recognized $48,000 ($72,000 transaction price – $24,000 recognized as revenue in Year 1) of the original transaction price. The consideration received as part of the modification includes the penalty of $12,000 and a reduction of the monthly payments of $24,000. As such, ABC recognizes $36,000 ($48,000 + $12,000 – $24,000) prospectively over the remaining year of the modified contract. [606-10-25-13(a)]

Example 11.3.80

Partial termination of service contract – customer termination right

Assume the same facts as Example 11.3.70, except the contract includes a termination clause that allows Customer to shorten the contract by one year (i.e. cancel the third year of the maintenance services) at any time during the first two years. If Customer exercises its termination right, it is required to pay a contractually specified termination penalty of $12,000. ABC concludes the penalty is substantive and therefore considers the contract to have a three-year term (see Question 3.8.20).

At the beginning of Year 2, Customer decides to exercise its option to cancel Year 3 of the contract and pay the substantive termination penalty. ABC accounts for this partial termination as a contract modification because the scope of the contract decreases.

Consistent with the termination payment negotiated as part of the modification in Example 11.3.70, Customer's termination payment is accounted for as promised consideration under the modified contract and recognized prospectively as consideration received as part of the contract modification. ABC recognizes $36,000 ($24,000 contractual payment for Year 2 + $12,000 termination payment) prospectively over the remaining year of the modified contract.

Question 11.3.70

How should an entity account for a contract modification that consists of a change in price only?

Interpretive response: An entity accounts for a contract modification that affects only the price of a contract in the same way as a modification that results in decreased scope (see Question 11.3.60). However, an entity would first need to evaluate whether a decrease in price is a result of past performance issues (see Question 11.3.30).

The change in price is accounted for either prospectively or on a cumulative catch-up basis depending on whether the remaining promised goods or services to be delivered as of the date of the modification are distinct from those goods or services delivered before the modification. This type of modification cannot be accounted for as a separate contract because it does not add distinct goods or services. [606-10-25-12(a), 25-13]

If the remaining goods or services are distinct from those transferred on or before the date of the contract modification, the modification is accounted for prospectively. Examples of remaining goods or services that are distinct from those transferred include remaining units of a product to be transferred or remaining distinct service periods that are part of a series. [606-10-25-13(a)]

If the remaining goods or services are not distinct from those transferred on or before the date of the contract modification (e.g. services to complete a construction contract), the modification is accounted for on a cumulative catch-up basis. [606-10-25-13(b)]

Any pattern (or customary business practice) of granting price reductions to existing contracts, with no changes to the scope of the contract (e.g. adding or reducing goods or services) generally creates variable consideration in future contracts (see section 5.3).

Example 11.3.90

Price decrease – marketing services

Advertiser provides technology-based marketing solutions to Customer for which Customer pays a fixed monthly fee. Advertiser and Customer enter into a contract for Advertiser to provide Customer with marketing solution services for three years. Advertiser concludes that the marketing solution services represent a single performance obligation consisting of a series of distinct service periods – i.e. each period (day, week, month, quarter) within the contract term is distinct from the others.

At the end of Year 1, Advertiser and Customer agree to decrease the monthly fee on a prospective basis. The decrease results from technological advances and competition in the marketplace. The change in price is not attributable to prior service issues. Further, Advertiser has not previously granted price decreases without a commensurate change in scope of the contract; therefore, a price change was not expected at contract inception – i.e. there was no variable consideration in the original contract.

The modification does not result in a separate contract because no additional goods or services are added. Because the marketing solution services performance obligation is a series of distinct service periods, the services not yet provided as of the date of the modification are distinct from the services already provided to Customer. Consequently, Advertiser accounts for the modification prospectively, as a termination of the existing contract and the creation of a new contract.

Advertiser recognizes the remaining consideration to be paid for Years 2 and 3 of the contract plus any consideration received from Customer but not yet recognized as revenue (i.e. any contract liability balance) over the remaining two-year marketing solution services period. [606-10-25-12 – 25-13]

Question 11.3.80

What is the appropriate accounting for modifications that include some goods or services that are distinct from those provided pre-modification and some that are not distinct?

Interpretive response: A contract modification that is not treated as a separate contract may include a combination of goods or services that are distinct from those provided on or before the modification date and some that are not distinct. [606-10-25-13(c)]

In those circumstances, the guidance requires an entity to account for the effects of the modification on the unsatisfied (including partially satisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of the modification guidance. However, Topic 606 does not provide guidance on how to determine and allocate the remaining consideration in a contract modification of this type. [606-10-25-13(c)]

We believe one acceptable approach is to first calculate the remaining consideration, using the approach in paragraph 606-10-25-13(a) (see section 11.3.30), and allocate that consideration to the remaining goods or services using the general Step 4 allocation model. *After* that, the entity recognizes a cumulative catch-up adjustment to a performance obligation that, post-modification, includes goods or services from the original contract and goods or services added by the modification.

The cumulative catch-up adjustment generally applies an updated measure of progress to the sum of (1) the remaining consideration allocated to the partially satisfied performance obligation and (2) the revenue already recognized on that performance obligation.

The entity accounts for the goods or services added by the modification that are distinct from the goods or services provided on or before the date of the modification as separate performance obligations.

Revenue recognized for transferred goods or services (i.e. fully satisfied goods or services) that are distinct from the remaining performance obligations is not altered by the modification. We believe that any approach that results in the reversal of previously recognized revenue associated with a transferred good or service that is distinct – e.g. a good for which control had previously transferred or distinct services that had already been provided as part of a series – from the remaining goods or services would not be consistent with the objectives of the modification guidance (assuming a discount was not provided for past performance issues – see Question 11.3.30).

Example 11.3.100

Partially satisfied performance obligation and additional distinct goods or services (combination of methods)

ABC Corp. enters into a contract with Customer to build a specialized asset for consideration of $1,000,000, which is consistent with the stand-alone selling price of similar assets. ABC determines that the building of the specialized asset is a single performance obligation satisfied over time (see section 7.3) using a cost-to-cost measure of progress.

At the end of Year 1, ABC has satisfied 30% of its performance obligation. Therefore, ABC has recognized $300,000 of revenue.

At the beginning of Year 2, the parties agree to change some of the specifications of the customized asset and increase the consideration by $100,000. Additionally, ABC agrees with Customer to deliver Product P for $120,000 in addition to the specialized asset.

The specialized asset and Product P are distinct goods. The price of Product P is significantly discounted from its stand-alone selling price of $150,000, a discount that is not the result of adjustments that are appropriate to the circumstances of this contract (see Question 11.3.20).

Because the price of Product P does not reflect its stand-alone selling price and the discount from that price is not the result of adjustments that are appropriate to the circumstances of the contract, Product P cannot be accounted for as a separate contract. Therefore, both the customized asset and the distinct Product P are considered part of the same contract when accounting for the modification.

ABC concludes that Product P is distinct from previously transferred goods and services but the remaining performance for the specialized asset is not. ABC accounts for the modification as described in Question 11.3.80 as follows.

Step 1: Calculate the remaining consideration

Remaining consideration on original contract not yet recognized as revenue	$700,000
Change order	100,000
Product P	120,000
Total remaining consideration	**$920,000**

Step 2: Allocate the remaining consideration between the Product P and the specialized asset

Assume the stand-alone selling price for the remaining specialized asset is $900,000. ABC allocates the remaining consideration to the specialized asset and Product P as follows.

	Stand-alone selling prices	Selling price ratio (rounded)	Price allocation
Remaining for the specialized asset	$ 900,000	85.71%	$788,571
Product P	150,000	14.29%	131,429
Total	**$1,050,000**		**$920,000**

Step 3: Record a cumulative catch-up adjustment for the partially satisfied performance obligation

For the partially satisfied performance obligation (customized asset), ABC accounts for the contract modification as part of the original contract. Therefore, ABC updates its measure of progress and estimates that it has satisfied 27.4% of its performance obligation after revising its cost-to-cost measure of progress for the revised expected costs.

As a consequence, ABC records the following adjustment, which reduces revenue previously recognized: $1,732 = (27.4% complete × $1,088,571[1] modified transaction price allocable to the customized asset) – $300,000 revenue recognized to date.

When ABC transfers control of Product P, it recognizes revenue in the amount of $131,429.

Note:

1. Calculated as $300,000 + $788,571.

11.4 Modification of licenses of IP

11.4.10 Overview

A license that grants the customer the rights to access the entity's IP (symbolic IP) or the right to use the entity's IP (functional IP) may grant rights restricted to time, geography and/or use or may grant rights that are effectively unlimited – e.g. perpetual, worldwide and unlimited as to use. Examples of such restrictions include:

— providing rights only to access or use IP for a specified term;
— limiting access or use of IP to particular territories; and
— limiting access or use of IP to specified uses – e.g. embedding in a particular class of customer product only.

See Question 10.7.10 for a discussion of contractual restrictions.

A modification may change the customer's rights to use the entity's IP. It could increase or decrease the customer's rights to use or access or use the IP, or grant the customer rights to use or access different IP (i.e. grant a new license). Moreover, a modification typically, but not always, involves a change in consideration.

For example, the entity and the customer could agree to expand the customer's rights to use the entity's brand name for additional fixed fees or additional sales-based royalties. This would be analogous to the Example 61 Case B in Topic 606 (see section 10.4), in which the additional rights permitted the customer to embed the entity's software in additional classes of the customer's products.

As another example, an entity and its customer could agree to decrease the customer's rights by imposing new restrictions on how the customer can employ the entity's IP in return for a decrease in the license (and/or service) fees to be paid over the remainder of the license period. Alternatively, the parties could agree to shorten the license term either for a reduction of license fees or a refund of license fees already paid.

See KPMG Handbook, Revenue for software and SaaS, for more detailed discussion and analysis of contract modifications of software licensing arrangements.

Question 11.4.10

What is the appropriate accounting for a modification that adds rights granted under a license of IP?

Background: A license of IP refers to the customer's rights to use the entity's IP, which may be effectively unlimited (e.g. perpetual, worldwide and unlimited as to use) or restricted as to time, geography or use. A license will frequently provide rights of use for only a defined term and may limit the customer's use of the IP to specific territories or uses (e.g. embedding in a particular class of customer product only).

A modification may change the customer's rights to use the entity's IP. A modification could increase or decrease the customer's rights to use the IP or grant the customer rights to use different IP. A modification typically, but not always, involves a change in consideration.

This Question addresses modifications that add rights to the contract. For example, in a modification that adds rights, the entity and customer could agree to add incremental time, geography, additional uses or licenses to different IP. Question 11.4.15 discusses modifications that revoke rights to previously granted IP.

Interpretive response: Any increase in rights that creates an obligation for the entity to transfer an additional right to use or access its IP creates an additional distinct license. Because a license is a bundle of rights to use IP, any additional incremental right granted to a customer represents one or more additional distinct licenses, even if those additional rights relate to use of the same IP.

For example, a modification to expand a customer's right to embed the entity's software (which is functional IP) in an additional class of the customer's consumer products is an additional software license granted to the customer even though the customer already has other rights to use the same software product – i.e. the modification grants a right in addition to the software license granted in the original contract. Similarly, the right to use a sports team's logo (symbolic IP) on additional merchandise is an additional license.

The additional license is typically distinct from the original license(s) and related services. Therefore, the accounting for the modification depends on whether the pricing of the additional license is commensurate with stand-alone selling price after considering appropriate adjustments.

- **Price commensurate with stand-alone selling price.** In this case, the modification granting the additional license(s) is accounted for as a separate contract (see section 11.3.20). [606-10-25-12]
- **Price not commensurate with stand-alone selling price.** In this case, the modification granting the additional license(s) is typically accounted for prospectively as a termination of the original contract and creation of a new contract. In that case, any previously recognized revenue is not adjusted (see section 11.3.30). [606-10-25-13]

Question 11.4.15

What is the appropriate accounting for a modification that decreases rights granted under a nonexclusive license of functional IP?

Background: Question 11.4.10 discusses modifications that add rights in a modification. A modification could also decrease a customer's rights to use IP, as in the following examples where the parties agree to:

- impose new restrictions on how the customer can employ the entity's IP in return for a decrease in the fees to be paid over the remainder of the license period;
- shorten the license term either for a reduction of fees or a refund of fees already paid;
- reduce the number of seat/user licenses in exchange for a reduction in fees; or
- convert the customer's on-premise software license to SaaS with the customer forfeiting the rights to the on-premise software.

This Question is limited to the accounting for modifications that decrease a customer's license rights to nonexclusive licenses of functional IP and not contracts where an explicit *or implicit* customer right to return, exchange or convert its license rights was a part of the original contract (see discussion of implied rights below). For other types of functional IP (e.g. exclusive licenses), significant judgment is required to evaluate the nature of the modification and account for revoked rights under Topic 606 based on facts and circumstances of that arrangement.

Interpretive response: A modification revoking previously transferred rights of use for nonexclusive IP (e.g. a software license) is generally accounted for as a right of return (like the return of a good). Return rights are discussed in section 5.4. However, there is an alternative view that the entity should account for the modification prospectively, without recognizing any revenue reversal, consistent with other prospective modifications that do not result in revenue reversals. [ASU 2014-09.BC78]

Issue 2 of EITF Issue 19-B, Revenue Recognition—Contract Modifications of Licenses of Intellectual Property, was added to the FASB agenda to address this diversity in practice in the accounting for the revocation of licensing rights (including conversion of term software licenses to SaaS). The FASB subsequently removed the project from its technical agenda without amending US GAAP. As a result, diversity in practice remains. Absent renewed action by the FASB, or guidance form the SEC staff, we believe either approach is acceptable and should be applied consistently to similar modifications.

Return approach

If the license is nonexclusive, such as a license to software, a return generally results in a revenue reversal at the modification date because an entity does not record an asset for returned IP.

The amount attributed to revoked rights is a matter of judgment that depends on the facts and circumstances. In most cases, we expect that amount would consider the revenue initially recognized for those revoked rights (e.g. the portion of the transaction price originally allocated to that license) and the rights that have already been 'consumed' if a portion of the license term has passed before the cancellation. However, in general we would not expect the reversal to result in the entity recognizing revenue in excess of stand-alone selling price for the remaining goods or services.

While we would generally expect a cancellation of nonexclusive IP (e.g. a software license) to result in a revenue reversal under the return approach, that may not *always* be the case. If there is evidence to support that no refund, credit or price reduction was issued for the value of the canceled rights, it would typically be appropriate not to record a revenue reversal.

The following are examples of when no reversal may be appropriate in a right of return approach.

— A license is cancelled and accompanied only by the addition of a distinct good or service for which the customer will pay an *incremental* amount of consideration that is commensurate with observable stand-alone selling price.

— A license is cancelled within a larger contract but no additional items are added in the modification, and the consideration excluding a potential reversal to be allocated to the remaining goods or services after the cancellation reflects the stand-alone selling prices. For example, the modified contract includes a number of other licenses not being cancelled and PCS for those remaining licenses with no added goods or services.

— A perpetual license is canceled after the expiration of its economic life and there is no other evidence suggesting that the entity issued a refund, credit or price reduction for any remaining value of the license.

In addition, there may be other more limited scenarios where there is evidence that there is no value ascribed to the license.

Prospective approach

Under the prospective approach, if the only modification is a reduction in license rights, the existing contract is deemed terminated and a new contract created. Consequently, the remaining unrecognized transaction price is allocated to the remaining performance obligations in the new contract (e.g. PCS over remaining licenses or new SaaS) and no previously recognized revenue is reversed. This may result in revenue recognized for post-modification performance obligations significantly below stand-alone selling price.

Importantly, this approach only applies to a license rights reduction. If a license rights reduction is coupled with other modifications to the contract, there may still be a cumulative revenue effect at the modification date depending on the nature of those other modifications (see Question 11.3.80).

Implied rights

A pattern of entering into modifications that permit a customer to reduce its license rights should be considered by an entity when entering into new or modifying other existing contracts. Such a pattern likely suggests there is an implicit right of return or option in these contracts at their inception.

If a refund liability for a license or a material right has previously been established, the subsequent exercise by the customer of its return right or conversion option is not a contract modification. Therefore, once a pattern of entering into these types of modifications emerges, an entity will generally be looking to the guidance on returns or implied promises rather than modifications.

Example 11.4.05
Contract modification revoking rights previously transferred

ABC Corp. enters into a contract with Customer to transfer a license to software product T and provide technical support and unspecified updates, upgrades and enhancements (collectively, PCS) for a three-year period.

The following additional facts are relevant.

- The contract price for the license is $200,000 per year, while the contract price for the PCS is $120,000 per year (both fees paid annually in advance). In this example, payment of the license fee over time does not create a significant financing component.
- The contract term is determined to be three years because the parties have enforceable rights and obligations for the full three years – there are no cancellation or termination provisions.
- The PCS is determined to be a single performance obligation, while the software license and the PCS are determined to be separate performance obligations.
- The contract prices represent the stand-alone selling prices for each performance obligation. The stand-alone selling price of the bundled term license and PCS is highly variable.

— The software license is transferred to Customer at contract inception.

— The PCS is satisfied over time, using a time-based measure of progress.

ABC records the following journal entry for Year 1.

	Debit	*Credit*
Cash	320,000	
Contract asset	400,000	
PCS revenue		120,000
License revenue		600,000
To recognize revenue on transferred software license, and establish contract asset and contract liability.		

At the beginning of Year 2, ABC and Customer modify the contract; canceling Customer's license to product T and the related PCS, and converting that arrangement to a SaaS subscription for the remaining two years of the contract; under the subscription, Customer will not have the right to take possession of the product T software (i.e. will not take product T on-premise). As part of the modification, Customer will continue to make annual payments of $320,000 in advance, which represents the observable stand-alone selling price of the SaaS at the modification date.

There were no customer cancellation or return rights in the original contract, nor was there any reason (e.g. ABC's customary business practices) for Customer or ABC to *infer* that a right to cancel (i.e. return) the product T license at contract inception existed. Consequently, ABC did not establish a refund liability at contract inception and both the cancellation of the product T license and the addition of the SaaS subscription at the beginning of Year 2 are modifications of the original contract.

Because the modification adds a distinct SaaS subscription priced at its stand-alone selling price but also cancels rights in the original contract, ABC accounts for the SaaS subscription prospectively as a termination of an existing contract and creation of a new contract. ABC accounts for the contract modification under either the return or prospective approach discussed in Question 11.4.15 as follows.

Return approach

ABC reverses the full amount of the contract asset associated with the revoked license to product T because that reversal results in ABC recognizing revenue for SaaS equal to observable stand-alone selling price.

As a result of the modification, ABC records the following entry at the beginning of Year 2.

	Debit	*Credit*
Cash	320,000	
License revenue[1]	400,000	
Contract asset		400,000
Contract liability		320,000
To recognize effect of modification.		

Note:

1. Because the SaaS subscription is being sold at its observable stand-alone selling price, the entire existing $400,000 contract asset is determined to be attributable to the revoked product T license rights.

ABC will recognize $320,000 in SaaS revenue in each of Years 2 and 3 as the performance obligation is satisfied over time, using a time-based measure of progress.

Prospective

ABC does not reverse any amounts associated with the revoked license or adjust the existing contract asset and the remaining transaction price of $240,000 ($640,000 remaining payments – $400,000 contract asset). To prospectively account for the modification, ABC records the following entry in each of Years 2 and 3.

	Debit	*Credit*
Cash	320,000	
Contract asset		200,000
SaaS Revenue		120,000
To recognize payment received and SaaS revenue on a prospective basis		

Question 11.4.17

What is the appropriate accounting for a modification that decreases rights granted under a license of symbolic IP?

Background: A decrease in a customer's rights to access a license of symbolic IP may change the goods or services that *remain to be provided* under a contract, if the arrangement has distinct service periods remaining under the contract term. This is because a license of symbolic IP is typically considered a series of distinct license periods (see Question 10.7.20).

Interpretive response: As discussed in section 11.3.30, an entity accounts for a modification to a series prospectively. Such a modification is accounted for similar to a decrease in scope in a contract that is considered a series. See Question 11.3.60 and Examples 11.3.70 to 11.3.80.

Question 11.4.20

When a modification to a license extends the term, can an entity recognize revenue allocated to the extended period before that period begins?

Interpretive response: No. Topic 606 contains an explicit renewal recognition requirement to recognize revenue attributable to an extension or renewal of a term license no sooner than the beginning of the extension or renewal period (see section 10.10). [606-10-55-58C]

This requirement applies regardless of whether the extension or renewal is structured as an extension or renewal, as an amendment, or as a termination of the original license and creation of a new license. Whatever rights of use are *retained* by the customer and extended as to duration after the 'termination' would remain subject to the renewal recognition requirements. Therefore, whatever portion of the modified transaction price relates to the extension or renewal period rights cannot be recognized until the extension or renewal period commences. [606-10-55-58C]

A license to IP is a contracted bundle of rights to use or access that IP. Therefore, in conjunction with a contract modification that 'terminated' the original license, new rights to use the IP may be granted to the customer that it did not control before the modification. For example, the modification may permit the customer to use the entity's IP for an additional purpose – e.g. the right to show a movie in a different geography. In that case, the portion of the post-modification transaction price allocated to that additional right is recognized when the customer obtains control over that incremental right (see section 10.10). [606-10-55-58C]

Example 11.4.10

Functional IP term license terminated and new license granted

Scenario 1: Extension of existing license

On January 1, Year 1, Film Studio enters into a three-year contract with Customer granting Customer the exclusive right to air a movie in the United States during the term of the contract. There were no other promised goods or services in the contract. Film Studio provides a copy of the movie to Customer immediately, on January 1, Year 1, and Customer has the right to air the movie in the United States immediately. The fee for the license is $3,000 paid upfront.

On January 1, Year 3, Film Studio and Customer enter into an amendment of their license agreement, which immediately terminates the original three-year license and grants a new four-year license to the same movie. No other goods or services are added to the arrangement through the amendment. Other than the extension of the term, the customer's rights to use the movie are unchanged between the original license and the new license. The fee for the new license is $3,000, payable at the time the amendment is entered into.

In substance, the original license is not terminated. Customer retains the same rights to use the movie post-modification as it had pre-modification. Therefore, the modification adds a distinct three-year renewal license that commences on January 1, Year 4 – i.e. subsequent to the end of the original license period.

Because the original license had already been transferred, the only additional promised good or service in the modified agreement is the three-year renewal license, which is distinct from the promised goods or services previously transferred. As a result, regardless of whether the modification is accounted for as a separate contract or termination of an existing contract and creation of a new contract, Film Studio allocates the $3,000 entirely to the three-year license renewal.

The $3,000 in renewal revenue is recognized under the renewal recognition requirement when Customer obtains control of the three-year renewal license, which is January 1, Year 4 (see section 10.10). Even though Customer pays for the renewal license before obtaining control of that license, Film Studio does not need to consider whether there is a significant financing component resulting from the advance payment because the period of time between payment and transfer of the license is one year or less. If that period of time were greater than one year, Film Studio would need to consider whether the advance payment of the license fee creates a significant financing component (see section 5.5). [606-10-55-58C, 32-15]

Scenario 2: Extension of existing license plus a new license

Assume the same facts as in Scenario 1 except that on January 1, Year 3, Film Studio and Customer amend their license agreement to immediately terminate the original three-year license and grant Customer both:

1. the continued exclusive right to air the movie in the United States for four years from the date of the amendment (a three-year extension from the original term); and
2. a new exclusive right to air the movie in Canada for four years.

Customer already has a copy of the movie and is permitted to exercise both rights immediately upon execution of the amendment. Customer agrees to pay $8,000 upon execution of the amendment.

In substance, the original license is not terminated in this example; Customer retains the same rights to use the movie in the United States post-modification as it had pre-modification. However, the modification adds two additional promised licenses subsequent to the amendment:

- a three-year renewal license for Customer to exclusively air the movie in the United States; and
- a four-year license for Customer to exclusively air the movie in Canada.

Film Studio concludes that the two additional promised licenses are distinct from each other and from the original license. It is reasonable for Film Studio to conclude it is providing two additional distinct licenses because:

- Customer can benefit from each license on its own and the promise to transfer each license is separately identifiable – i.e. neither license customizes or modifies the other;

— Film Studio can transfer each license independently of the other; and

— the two licenses do not provide a combined functionality or utility.

There is no remaining, unrecognized consideration from the original contract because the entire performance obligation was satisfied on January 1, Year 1 and the additional goods added in the modification are distinct from the previously transferred goods or services. Therefore, the amount of consideration to be allocated to the remaining performance obligations (i.e. the two distinct licenses) is the $8,000 promised in the amendment. The portion allocated to the three-year United States renewal license is recognized at the beginning of the renewal license term (January 1, Year 4), and the portion allocated to the new four-year Canada license is recognized on January 1, Year 2 – i.e. when Customer obtains control over its right to air the movie in Canada.

Example 11.4.20

Symbolic IP license terminated and new license granted

On January 1, Year 1, ABC Corp. enters into a three-year contract granting Customer the right to use its trade name over three years in the United States for a $3 million upfront fee. ABC provides Customer with access to the IP immediately, on January 1, Year 1. There are no other performance obligations in the contract.

The trade name is symbolic IP satisfied over time. ABC concluded that a time-elapsed measure of progress was appropriate and recognized $2 million in revenue over the first two years.

On January 1, Year 3, ABC and Customer amend their license agreement by immediately terminating the original three-year license and granting a new four-year license to the trade name in the United States and Europe. No other goods or services are added to the arrangement through the amendment. The fee for the revised term of the license is an upfront payment of $5 million.

In substance, the original license is not terminated in this example. Customer retains the same rights to the trade name in the United States post-modification as it had pre-modification. However, the original license period still has distinct time increments that have not been transferred for which the Customer has rights to access the symbolic IP. Therefore, the amended contract contains the following distinct licenses:

— one year remaining of the original license term;

— a distinct three-year renewal license for the trade name in the United States that commences on January 1, Year 4 – i.e. subsequent to the end of the original license period; and

— a distinct four-year license to the trade name in Europe.

The stand-alone selling price of the licenses are:

— trade name in the United States is $1 million per year ($3 million for a three-year renewal); and

— trade name in Europe $500,000 per year ($2 million over four years).

The price of the contract increased by $5 million, which is commensurate with the stand-alone selling price of the added licenses. As a result, the three-year renewal license in the United States and four-year license to the trade name in Europe are accounted for as separate contracts.

ABC does not begin recognizing the fees allocated to the renewal license in the United States ($3 million) until the renewal term commences on January 1, Year 4. It begins recognizing the fees allocated to the license in Europe on January 1, Year 3 and recognizes them over the four-year license term using the same time-elapsed measure of progress. Further, it continues to account for the original license as if nothing had changed and recognizes the $1 million remaining from the original contract over the last year of the original term.

Note: If the additional consideration was not commensurate with the stand-alone selling price of the good or service and the difference was not appropriate for the circumstances of the contract, ABC would account for the modification as the termination of the existing contract and creation of a new contract. As a result, it would need to consider whether the stand-alone selling price for the remaining terms of the original and renewal licenses in the United States were the same. If they were not, ABC would allocate consideration to the remaining original term and renewal period on a different basis and would not recognize any amounts for the renewal term until the renewal license period commenced.

Question 11.4.30

How does an entity account for a customer transferring a license of symbolic IP to a third party?

Interpretive response: Some licenses of symbolic IP can be transferred to a third party. This is common in franchise arrangements where the original franchisee can sell its rights under the franchise arrangement. We believe the transfer should be treated in one of the following ways, depending on the facts and circumstances.

— **Continuation of the contract with the original customer.** The entity accounts for the contract as if the customer did not change. Therefore, it accounts for the contract as if the existing contract is untouched or as a modification of the contract with the same customer. Because a license of symbolic IP is a series, any modifications would be accounted for prospectively (see section 11.3.30). An existing contract asset or liability (e.g. initial upfront fee that has not been recognized) is not adjusted.

— **Termination of the license with the original customer and entering into a new license with a different customer.** The contract with the original customer is terminated. Any contract asset or liability at that point is recognized immediately as an adjustment to revenue. The license with the new customer is deemed to be a new substantive contract rather than a continuation or modification of an agreement with an existing customer.

To decide between the two approaches, an entity needs to evaluate (1) the extent to which the rights and obligations of the original license have substantively changed and (2) whether the transfer triggers substantial change in the projected future cash flows.

Substantial judgment may be required to conclude on the accounting for transfers of rights between customers. Entities may for example consider the following, in addition to other factors that are relevant in the particular circumstances.

Factor	Example	Potential indication of: Continuation or modification	Potential indication of: Termination
Transferability of the existing license	The existing contract specifies that the right is transferrable with no or only perfunctory restrictions.	✓	
Customary business practices	It is rare that the entity denies the transfer right: this may indicate that approval rights contained in the contract are non-substantive.	✓	
Transfer fee	Payment of a de minimis transfer fee.	✓	
	Payment of a substantial transfer fee.		✓
Change in credit risk of the customer	Significant change in the credit risk of the customer acquiring the right as compared to the existing customer.		✓
Extension or reduction of the term	Extension of the agreement beyond the existing contract term.		✓
Change in royalty rate or other terms and conditions	Change in the royalty rate to reflect market conditions at the date of transfer.		✓

12. Contract costs

Detailed contents

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12.4 Practical expedient for costs of obtaining a contract

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12.10 Deferred and other costs

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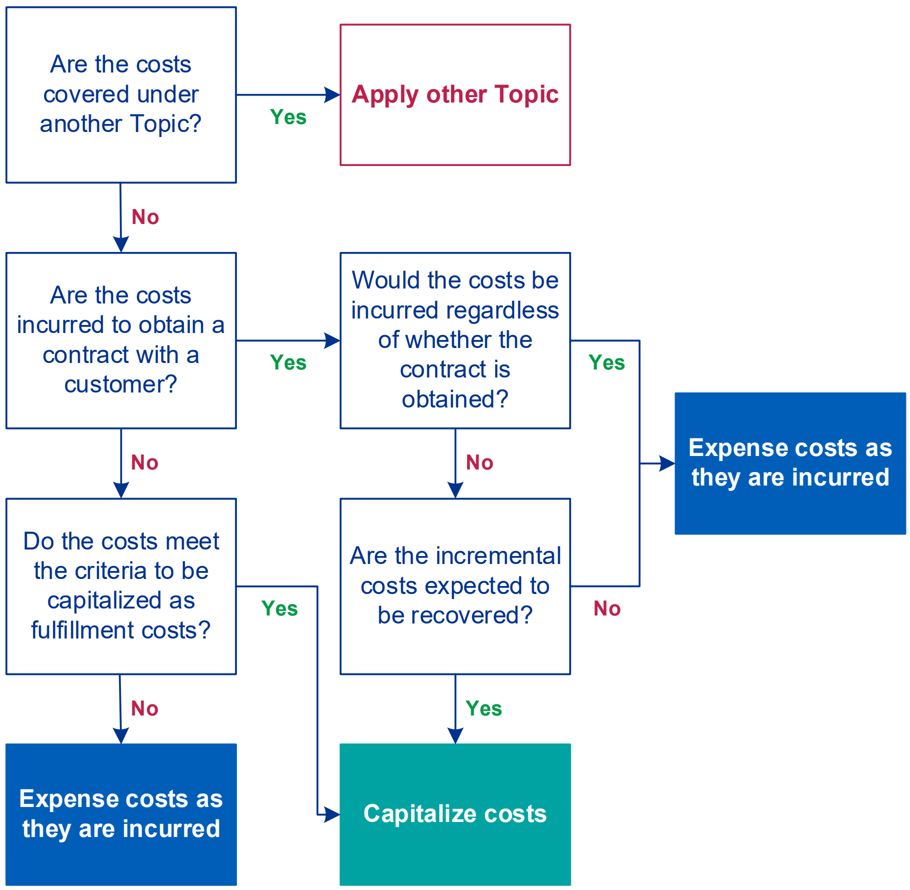
12.1 How the standard works

Contract costs in the context of the revenue standard refers to costs to obtain a contract (acquisition costs) and costs to fulfill a contract (fulfillment costs) in the scope of Topic 606. If costs to fulfill a revenue contract with a customer are not in the scope of another Topic, they are analyzed under the guidance in Subtopic 340-40 as follows.



12.2 Scope of contract cost guidance

Excerpt from ASC 606-10

> **Transactions**

15-5 Subtopic 340-40 on other assets and deferred costs from contracts with customers includes guidance on accounting for the incremental costs of obtaining a contract with a customer and for the costs incurred to fulfill a contract with a customer if those costs are not within the scope of another Topic (see Subtopic 340-40). An entity shall apply that guidance only to the costs incurred that relate to a contract with a customer (or part of that contract) that is within the scope of the guidance in this Topic.

Excerpt from ASC 340-40

05-1 This Subtopic provides accounting guidance for the following costs related to a contract with a customer within the scope of Topic 606 on revenue from contracts with customers:

a. Incremental costs of obtaining a contract with a customer
b. Costs incurred in fulfilling a contract with a customer that are not in the scope of another Topic.

05-2 Paragraphs presented in bold type in this Subtopic state the main principles. All paragraphs have equal authority.

> Overall Guidance

15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic (see Section 340-10-15), with specific qualifications and exceptions noted below.

> Transactions

• > Incremental Costs of Obtaining a Contract with a Customer

15-2 The guidance in this Subtopic applies to the incremental costs of obtaining a contract with a customer within the scope of Topic 606 on revenue from contracts with customers (excluding any consideration payable to a customer, see paragraphs 606-10-32-25 through 32-27).

• > Costs Incurred in Fulfilling a Contract with a Customer

15-3 The guidance in this Subtopic applies to the costs incurred in fulfilling a contract with a customer within the scope of Topic 606 on revenue from contracts with customers, unless the costs are within the scope of another Topic or Subtopic, including, but not limited to, any of the following:

a. Topic 330 on inventory
b. Paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements
c. Subtopic 350-40 on internal-use software

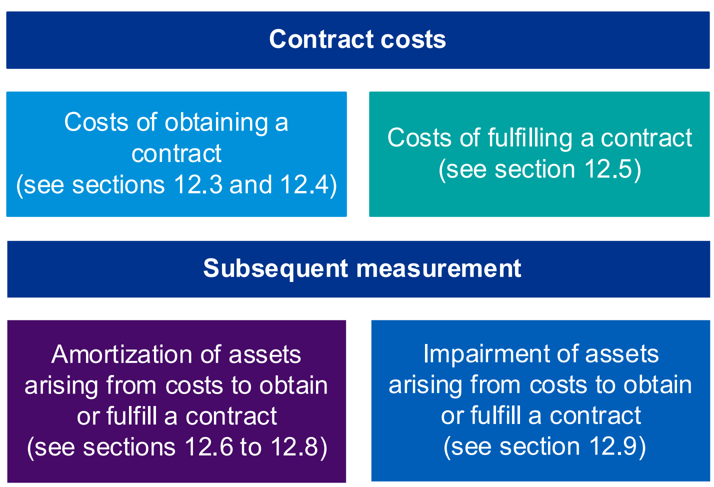
d. Topic 360 on property, plant, and equipment
e. Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed.

Subtopic 340-40 provides guidance on certain costs associated with contracts with customers. It does not provide comprehensive cost guidance, but instead it applies only when other Topics do not apply. For example, Subtopic 340-40 does not affect the recognition of the cost of goods sold when a contract transfers inventory to a customer. [606-10-15-5, 340-40-15-3]

If acquisition costs or fulfillment costs meet the criteria in Subtopic 340-40 to be capitalized, the entity recognizes a contract cost asset. In an individual contract, an entity could recognize a contract cost asset related to:

— the incremental cost of obtaining a contract (contract acquisition asset); and/or
— fulfilling the contract (fulfillment cost asset).

This chapter addresses Subtopic 340-40 in the following sections.



Question 12.2.01

How does an entity determine whether costs are contract costs in the scope of Subtopic 340-40?

Interpretive response: An entity evaluates whether the costs relate to a contract with a customer in the scope of Topic 606. See section 2.2 on scope of Topic 606.

If the costs relate to a contract with a customer, the entity determines whether the costs are in scope of Topics and Subtopics other than Subtopic 340-40. Question 12.2.02 contains a list of common costs that are in the scope of a Topic or Subtopic other than Subtopic 340-40.

If other US GAAP precludes or requires recognition of an asset arising from a particular cost, that guidance is followed instead of Subtopic 340-40. For example, if Topic 730 specifies that R&D costs are to be expensed as incurred, they are not evaluated for capitalization under Subtopic 340-40 even if they would meet its capitalization criteria. [ASU 2014-09.BC307]

If the contract costs are not in the scope of a Topic or Subtopic other than Subtopic 340-40, see sections 12.3 to 12.5 to determine if they meet the capitalization criteria in Subtopic 340-40, or if they are expensed as incurred.

Question 12.2.02

What are common costs in the scope of Topics or Subtopics other than Subtopic 340-40?

Interpretive response: The following types of costs that may relate to customer contracts (not exhaustive list) are in the scope of Topics or Subtopics other than Subtopic 340-40.

Type of cost	Authoritative literature
Credit-card related costs	Subtopic 310-10, *Receivables — Overall* Subtopic 310-20, *Receivables — Nonrefundable Fees and Other Costs*
Inventory costs	Topic 330, *Inventory*
Pre-production costs related to long-term supply arrangements	Subtopic 340-10, *Other Assets and Deferred Costs — Overall*
Intangible assets, including internal-use software development costs and website development costs	Topic 350, *Intangibles — Goodwill and Other*
Costs of property, plant, and equipment	Topic 360, *Property, Plant, and Equipment*
Start-up costs	Subtopic 720-15, *Other Expenses — Start-Up Costs*
Advertising costs	Subtopic 720-35, *Advertising Costs*
Research and development costs	Topic 730, *Research and Development*
Cable television initial subscriber installation costs and reconnection costs	Subtopic 922-360, *Entertainment — Cable Television — Property, Plant, and Equipment* Subtopic 922-720, *Entertainment — Cable Television — Other Expenses*
Film costs	Subtopic 926-20, *Entertainment — Films, Other Assets — Film Costs*
Insurance acquisition costs	Topic 944, *Financial Services — Insurance*
Upfront commissions paid to third-party brokers who distribute fund shares to investors	Subtopic 946-720, *Other Expenses — Distribution Costs for Funds*
Real estate project costs	Topic 970, *Real Estate — General*

Type of cost	Authoritative literature
External-use software development costs	Subtopic 985-20, *Software — Costs of Software to Be Sold, Leased, or Marketed*

Question 12.2.03

Are advertising costs in the scope of Subtopic 340-40?

Interpretive response: It depends. Subtopic 340-40 provides guidance about when to capitalize costs to obtain a customer, which includes advertising costs. It requires the costs of direct-response advertising to be expensed as they are incurred because they are not incremental costs to obtain a specific contract. However, there is specific guidance on when the costs of direct-response advertising can be capitalized for insurance entities in the scope of Topic 944. [340-40-25-2, 25-3, 944-30-25-1AA]

The general guidance on advertising costs, including when to recognize a liability for those costs, including costs related to cooperative advertising arrangements, is included in Subtopic 720-35.

Question 12.2.10

Can an entity apply the portfolio approach when evaluating contract costs under Subtopic 340-40?

Interpretive response: Yes. Topic 606 and Subtopic 340-40 are both generally applied to an individual contract with a customer. However, Topic 606 includes a practical expedient that permits an entity to apply Topic 606 to a portfolio of contracts with similar characteristics if the entity reasonably expects that the financial statement effects of applying Topic 606 to that portfolio would not differ materially from applying it to the individual contracts (see section 2.5). Even though Subtopic 340-40 does not include a similar provision, we believe the practical expedient is available for costs in the scope of Subtopic 340-40. [606-10-10-4]

Topic 606 does not provide specific guidance on how an entity assesses whether the results of a portfolio approach would differ materially from applying the guidance on a contract-by-contract basis. However, the FASB did not intend for entities to have to quantitatively evaluate the accounting outcomes from applying a portfolio approach versus not applying a portfolio approach. [ASU 2014-09.BC69]

In some circumstances when applying Topic 606 or Subtopic 340-40, an entity will develop estimates using a portfolio of data to account for a specific contract with a customer. This practice is not the same as applying the portfolio approach. Instead, it is simply a way of developing estimates necessary to apply the provisions in Topic 606 or Subtopic 340-40.

For example, an entity may use historical data from a population of similar contracts to develop estimates relevant to accounting for contract costs. Such estimates could include estimates about expected customer lives or collectibility, which is important under Subtopic 340-40 because it affects the 'amount of consideration that the entity expects to receive' when assessing impairment of contract cost assets (see section 12.9). When using a portfolio of data to develop relevant accounting estimates (as opposed to using a portfolio approach), there is no requirement to demonstrate that the effect of using that portfolio of data would not differ materially from developing the estimate on a customer- or contract-specific basis.

12.3 Costs of obtaining a contract

Excerpt from ASC 340-40

• > Incremental Costs of Obtaining a Contract

25-1 An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

25-2 The incremental costs of obtaining a contract are those that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

25-3 Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

25-4 As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

• • > Example 1—Incremental Costs of Obtaining a Contract

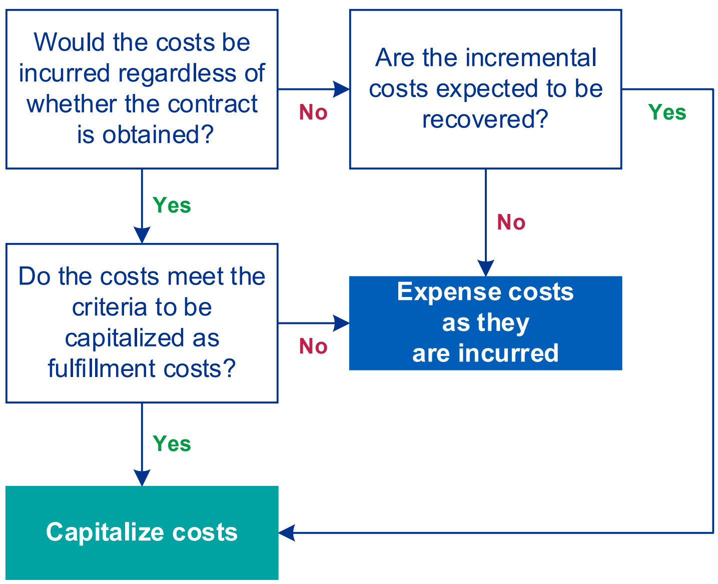
55-2 An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new **customer**. The entity incurred the following costs to obtain the contract:

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**

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.

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.

The following decision tree explains how to evaluate costs to obtain a contract and when to recognize a contract acquisition asset.



Question 12.3.01

When are costs of obtaining a contract incremental?

Interpretive response: A cost is incremental only if the act of both parties approving the contract triggers the entity's liability for that cost. For example, a sales commission incurred only as a result of obtaining that contract is an incremental cost.

Costs incurred by the entity in trying to obtain a contract or in negotiating a contract regardless of whether the contract is approved are not incremental and therefore are expensed as incurred, unless:

— another applicable Topic prescribes a different treatment;
— the costs qualify for capitalization as fulfillment costs under Subtopic 340-40; or
— the costs are explicitly chargeable to the customer regardless of whether the contract is obtained and recovery is expected.

For example, costs related to sales efforts and non-contingent legal fees incurred to draft a contract would be incurred regardless of whether the contract is obtained and therefore are not incremental costs even if the parties approve the contract. [340-40-25-2, TRG 11-16.57]

Example 1 in Subtopic 340-40 illustrates these principles. In that example an entity obtains a contract and incurs the following costs in the process: external legal fees for due diligence, travel costs to deliver the proposal, and sales commissions. Only the sales commissions are capitalized because the other costs (travel costs and legal fees) would still be incurred regardless of whether the parties ultimately approve the contract. Only the sales commission costs would be avoided by the customer ultimately deciding not to approve the contract. See Questions 12.3.20 to 12.3.120 for further discussion of types of costs that are incremental. [340-40-55-2 – 55-4]

Question 12.3.02

When are incremental costs of obtaining a contract capitalized?

Interpretive response: An entity capitalizes incremental costs to obtain a contract as a contract acquisition asset if it expects to recover those costs. Incremental costs could be recoverable through either:

— direct or explicit reimbursement by the customer under the contract (direct recovery); or

— the net cash flows expected from the margin built into the contract and any specifically anticipated future contracts (such as renewals) with the customer (indirect recovery).

However, even if the costs are explicitly reimbursed by the customer, the entity considers the net cash flows from the contract to determine if the overall contract costs are recoverable. That is, a direct reimbursement of a cost may not be sufficient on its own to support recoverability if overall the contract is a loss. [340-40-25-1]

Subtopic 340-40 does not address the timing of when an entity recognizes a cost in the financial statements (i.e. when a liability is incurred). An entity applies other applicable GAAP to determine when to recognize a cost and then evaluates Subtopic 340-40 or other applicable cost guidance to determine whether the cost is recognized immediately as an expense or is capitalized as a contract acquisition asset. The incremental cost is recognized in the financial statements when the liability is incurred, regardless of whether that cost is capitalized or expensed. [TRG 01-15.23]

See section 12.4 for a discussion of a practical expedient that permits entities to expense incremental costs of obtaining a contract that meet the capitalization criteria when the amortization period of the contract acquisition asset would be one year or less.

Question 12.3.03

What is the effect of commission plan structures on the recognition of incremental costs?

Interpretive response: Determining when to recognize a liability and whether that cost is incremental can be challenging. That is because many commission plan structures are complex and an additional commission may be payable, or the original amount may be adjusted at a future date. Examples of these situations include (not exhaustive):

- commissions contingent on future events (including continued employment by the commission recipient) (see Questions 12.3.30, 12.3.40 and 12.3.60);
- commissions subject to clawback (see Question 12.3.60);
- tiered commissions subject to a threshold (see Question 12.3.80);
- commissions earned on contract modifications (see Question 12.3.100); and
- commissions paid for renewal of the contract (see Question 12.3.110).

When accounting for commissions and similar plans, entities reporting interim financial information under Topic 270 frequently make estimates in assigning costs and expenses to interim periods so that interim results more closely reflect anticipated annual results. For example, entities will frequently estimate certain employee bonuses, and accrue a proportion thereof during interim periods, even though the entity will not owe the bonus to the employees if they terminate employment or specified metrics are not met for the year. Such amounts, if related to obtaining a customer contract, would result in recognizing a contract cost asset if recoverable (see Example 12.3.40). [270-10-45-4(b)]

Question 12.3.10

Is capitalizing incremental costs of obtaining a contract optional?

Interpretive response: No. The FASB concluded that comparability would be reduced by allowing a policy election under which an entity could choose to capitalize or expense contract costs with disclosure of the accounting policy election. Consequently, it decided not to allow entities a policy election with respect to incremental costs of obtaining a contract. Instead, it included a practical expedient allowing costs to be expensed if the contract cost asset's amortization period is one year or less (see section 12.4). [340-40-25-1, 25-4]

Question 12.3.20
Can the cost of fringe benefits be an incremental cost of obtaining a contract?

Interpretive response: Yes. Fringe benefit costs incurred as a direct result of obtaining a contract are generally capitalized if they are expected to be recovered and they would not have been incurred if the contract had not been obtained. [340-40-25-1]

Careful consideration is needed when determining the incremental amount of fringe benefit costs. For example, if a 401(k) match is 5% of compensation (salary and commission) up to the first $50,000 and the salary of the salesperson is $50,000, a January sale resulting in a $50,000 commission generally would not result in an incremental 401(k) cost. The 401(k) match paid in the earlier part of the year due to a commissioned sale merely accelerates the fringe benefit costs otherwise expected to be paid and is not an incremental cost to obtain a contract. The same is true for payroll taxes that the employer will need to pay for the sales commission (assuming the employee was not already above the relevant IRS caps).

Some examples of fringe benefit costs that may be considered incremental costs of obtaining a contract, provided those costs were part of a preexisting plan, are:

- an additional defined contribution pension payment an employer makes solely as a result of an employee's increased compensation level that was driven by obtaining a contract;
- additional Social Security taxes (up to the annual maximum), Medicare taxes, federal and/or state unemployment taxes that are paid based on the increase in an employee's base pay from obtaining a contract.

Conversely, fringe benefits incurred regardless of whether the contract had been obtained are not capitalized. For example, we generally do not expect health insurance payments to be an incremental cost to obtaining a contract. Moreover, if the employee's compensation was already over the Social Security caps when the employee earned the sales commission, there are no Social Security taxes to treat as incremental costs.

Question 12.3.30
If a commission will be paid only as an entity invoices the customer, is the commission an incremental cost at contract inception?

Interpretive response: Yes, assuming the commission recipient has no substantive future performance requirements (see Question 12.3.40). The timing of a commission payment does not affect whether it is a cost incremental to obtaining the contract. Invoicing the customer in accordance with the contract – e.g. at the beginning of each year of the contract – is not a performance requirement.

The entity accrues the entire commission at contract inception and recognizes a corresponding contract cost asset unless the practical expedient applies. If the commission will be paid out over an extended period of time, the liability recognized by the entity is generally discounted to its present value.

Question 12.3.40

Are commissions that are conditional on future performance or service by the recipient of the commission incremental costs of obtaining a contract?

Interpretive response: Generally, no. The premise of the guidance about the cost of obtaining a contract is that when a liability is incurred solely because a contract with a customer was obtained it is an incremental cost of obtaining a contract (i.e. the cost would not have been incurred if the contract had not been obtained).

Conversely, if an action other than the parties approving the contract triggers the liability, the cost in question is not an incremental cost of obtaining the customer contract because the liability was not incurred solely as a result of obtaining the contract. This applies regardless of the form of the commission (e.g. cash or equity).

Consequently, a contract acquisition asset is not recognized if the entity does not incur a liability (or obligation) when the contract is approved because future service is required by the commission recipient to earn the payment. In that case, unless the cost is a fulfillment cost, other Topics govern whether an asset that is not a contract acquisition cost asset is recognized. The same would be true if the obligation was to issue equity securities.

We are aware of some arrangements in which commissions are due and payable to the salesperson partially at contract inception – e.g. 50% or 60% of the commission is due at contract inception – and the remainder only once the initial year's fee is paid by the customer. If the salesperson discontinues their employment between contract inception and when the first-year fee is paid by the customer, the entity does not owe the second portion of the commission payment. In general, if the period between contract inception and customer payment is not significant, the service requirement would not be deemed substantive.

Provided that the service period between contract inception and customer payment is not significant – and there are no other substantive requirements of the salesperson – we would not preclude an entity from recognizing either:

- the entire commission liability at contract inception and corresponding contract cost asset; or
- a contract cost asset at the time of the first payment and an additional contract cost asset at the time of the subsequent payment.

In this context, it is a matter of judgment whether the service period between contract inception and customer payment is significant; in making this assessment, both qualitative and quantitative factors are considered.

- The qualitative factors are based on the purpose of the arrangement – e.g. is the arrangement designed only to address the entity's cash management issues? If yes, this tends to a conclusion that the service period is not significant.
- The quantitative factors consider the length of the commission's deferral – a shorter service period tends to a conclusion that the service period is not significant.

Example 12.3.10
Salesperson performance requirement

ABC Corp. enters into a three-year service contract with Customer. In return for obtaining the contract with Customer, ABC agrees to pay its salesperson a commission of $120,000. The $120,000 commission will be paid in three installments of $40,000 each.

Each installment is payable to the salesperson at the beginning of each year of the contract provided that the salesperson is still employed by ABC at that time. In effect, this creates a double trigger with respect to the second and third commission payments. ABC concludes that the additional trigger (the service period) is a substantive performance requirement.

As a result, ABC does not accrue the second and third payments on obtaining the customer contract. And those amounts, when accrued, are not incremental costs of obtaining a contract and are expensed unless another Topic requires them to be capitalized. Only the initial payment of $40,000 is an incremental cost of obtaining the contract because only that payment is accrued as a result of the contract having been obtained.

If no renewals are specifically anticipated (see Question 12.7.10), the $40,000 is amortized over the three-year contract term, which is consistent with the transfer of the service to which the incremental cost of obtaining the contract relates.

Sections 12.6 to 12.8 discuss amortization of contract cost assets in further detail.

Question 12.3.50
Is a payment that depends only partially on obtaining a contract with a customer an incremental cost of obtaining a contract?

Interpretive response: No. A fixed amount owed to an employee (e.g. a fixed salary for a sales manager) that is not owed directly as a result of entering into a contract with a customer, even if that fixed amount was established based on an assumption of sales activity with customers, does not qualify for capitalization under Subtopic 340-40.

Similarly, a payment (whether characterized as a bonus, incentive payment, or otherwise) based on substantive operating metrics (such as net or operating income, EBITDA or gross margin) does not qualify for capitalization even if those metrics are significantly affected by sales activities. Conversely, a payment based solely on metrics such as new customer sales or bookings, is an incremental cost of obtaining a contract (see Question 12.3.70). [TRG 11-16.57]

Commission and bonus plans are often widely varied and complex. Therefore, such plans will need to be carefully analyzed to determine whether payments thereunder should be capitalized under Subtopic 340-40.

Question 12.3.60

Are commissions subject to *customer* performance after the contract is obtained capitalizable?

Interpretive response: Yes. A commission plan that pays a salesperson in installments over the contract period may stipulate that the salesperson will not be paid further installments if the customer does not fulfill its obligation to pay the entity under the contract. A commission plan may also pay the salesperson his or her commission upfront but be subject to clawback if the customer does not fulfill its obligation to pay under the contract.

The TRG generally agreed that customer non-performance is not a consideration in determining whether costs to obtain a contract that otherwise meet the criteria for capitalization should be capitalized. This is because, for a contract with a customer to exist under Topic 606, both parties to the contract need to be committed to perform their respective obligations. Consequently, the accounting for incremental costs of obtaining the contract should follow that conclusion. [TRG 01-15.23, 606-10-25-1(a)]

If circumstances subsequently change, raising doubt about whether the customer will perform its future obligations, then the entity:

- reassesses whether a valid contract between the parties remains (assuming the entity still has remaining performance obligations to fulfill under existing contracts); and
- assesses the contract acquisition asset for impairment in accordance with paragraph 340-40-35-3 (see section 12.9).

If a previously paid commission is clawed back or an existing commission liability is reversed, the offsetting entry to the cash received or the liability relieved will generally be to the contract acquisition asset. However, if the cash received or the liability relieved is greater than the unamortized balance of the related asset (e.g. because the contract acquisition asset was previously impaired), the difference is recognized as an offset to operating expense.

Question 12.3.70
Can costs incurred in relation to a pool of contracts be capitalized?

Interpretive response: Yes, as long as the costs are based solely on obtaining the customer contract and are recoverable. Some entities structure their commission plans to pay their salespeople based on a cumulative bookings amount or cumulative contract value for contracts that a salesperson obtains during a given period. A commission under such a plan is capitalizable if the amount payable does not also relate to other substantive actions of the salesperson, such as his or her performance against personal development goals or reducing other costs of obtaining customers or contracts. [TRG 11-16.57]

Other entities structure their commission plans based on an entity- or business unit-wide cumulative booking or contract value target. For example, as illustrated in Example 12.3.20, a commission pool may be established by an entity based entirely on customer contracts obtained at an aggregate level. Individual salesperson commissions may or may not directly correlate to their contributions to the aggregate target. For example, when allocated, Salesperson 1's commission may equal 5% of the value of customer contracts they obtained, but Salesperson 2's commission may equal 8% of the value of the customer contracts they obtained. We do not believe how an entity allocates its commissions to its salesforce affects whether the commissions are incremental costs of obtaining a contract. Regardless of how an entity chooses to allocate such amounts, if the costs are incurred solely because customer contracts were obtained, they should be capitalized under Subtopic 340-40.

In each situation described above, an entity needs to develop a consistent, systematic and rational approach for amortizing such costs – i.e. determining what the goods or services are to which the capitalized amounts relate. The entity may use a portfolio approach in this instance (see Question 12.2.10).

Example 12.3.20
Incremental costs of obtaining a pool of contracts

ABC Corp. has a commission plan whereby all of its salespeople are paid an annual amount based on whether the sales department achieves certain bookings targets. Each salesperson is assigned a commission amount that varies based on the achievements of the sales department as a whole in terms of obtaining new and renewal customer contracts.

For example, Jane Salesperson will earn $10,000 if ABC obtains $10 million in new bookings, $17,000 if ABC obtains $15 million in new bookings, or $25,000 if ABC obtains $20 million in new bookings. In contrast, Joe Salesperson will earn $8,000, $13,000, or $19,000, respectively, depending on which, if any, cumulative bookings target is met. The amount Jane or Joe will earn based on the entity-wide bookings target does not necessarily correlate with their contributions to meeting the bookings target.

ABC follows the appropriate liabilities guidance in determining whether and when to accrue amounts related to its commission plan. As it accrues the annual commission payout, ABC concludes that the respective costs are incremental costs of obtaining customer contracts. The sole reason ABC is accruing the respective commission liability is because it is obtaining, or expects to obtain, customer contracts. The fact that the commission amount is determined for a pool of customer contracts, rather than on an individual contract basis, does not change that the commission amounts are incremental to obtaining customer contracts and therefore in the scope of Subtopic 340-40.

Question 12.3.80

Is a commission paid only after achieving a cumulative target an incremental cost of obtaining a contract, and when would it be recognized as an asset?

Interpretive response: The commission is recognized as a cost when a liability is incurred and capitalized at that time if recoverable.

The TRG generally agreed that Subtopic 340-40 does not change when an entity should accrue a commission-related liability. Subtopic 340-40 provides guidance only as to whether the cost should be capitalized or expensed as incurred (unless addressed by other topics).

Most TRG members agreed that if the amount accrued is incremental to obtaining a customer contract and is expected to be recovered, then it should result in a contract acquisition asset. Whether an accrual relates to a cumulative contract acquisition target (such as X number of contracts, $XX in collective customer booking or total contract value) or an individual contract does not affect whether the cost is capitalized under Subtopic 340-40. [TRG 01-15.23, TRG 11-16.57]

We understand there may be diversity in how entities accrue the cost of commissions over interim periods in similar plans. For example, some entities accrue commissions over interim periods based on their expectation of the total commissions in an annual plan. Other entities may determine that a liability does not exist until each specified threshold is triggered. The timing of liability recognition could determine whether commissions achieved on meeting certain thresholds are allocated to multiple contracts or the contract that triggers the threshold being met. [TRG 01-15.23]

Example 12.3.30

Commission plan with tiered thresholds – cumulative effect

ABC Corp. has a commission plan whereby once a cumulative threshold based on a number of contracts is reached, a commission is paid as a percentage of the cumulative value of that contract and the preceding contracts, taking into account any commission already paid.

Number of contracts	Commission
1–10 contracts	1% of value of contracts
11–20 contracts	4% of value of contracts 1-20
21+ contracts	7% of value of contracts 1-20+

As contracts 1–10 are obtained, ABC owes the salesperson only 1% of the contract value, which would be the *minimum* incremental cost of obtaining each of those contracts. However, the applicable liabilities guidance may result in ABC accruing cost in addition to the 1% because of an expectation of paying additional commissions related to those contracts when other expected contracts are obtained. ABC capitalizes those additional amounts as incremental costs of obtaining customer contracts, if the one-year practical expedient does not apply or has not been elected.

In this example, ABC initially accrues 1% based on the applicable liabilities guidance when it enters into Contracts 1–4. However, by the time ABC enters into Contract 5, it expects that it will enter into at least 11 contracts. At that point, ABC adjusts its expectations and on entering into Contract 5, ABC capitalizes a 4% commission related to Contract 5 and an additional 3% commission related to Contracts 1–4 because 1% was already capitalized.

Note: We understand there may be diversity in how entities accrue the cost of commissions over interim periods in similar plans, which is not addressed by the guidance in Subtopic 340-40.

Example 12.3.40

Commission plan with tiered thresholds – prospective effect

ABC Corp. has a commission plan whereby once a cumulative threshold number of contracts is reached, a higher commission rate is paid on each subsequent contract for the remainder of the year.

Number of contracts	Commission
1–10 contracts	1% of value of contracts 1-10
11–20 contracts	4% of value of contracts 11-20
21+ contracts	7% of value of contracts 21+

ABC owes only 1% of the contract value when the salesperson obtains each of Contracts 1–10. However, ABC has a policy under Topic 270 for interim reporting purposes of accruing commissions based on its expectation of the annual commissions. [270-10-45-4(b)]

ABC estimates its full-year expectation of the salesperson obtaining 30 contracts and accrues the weighted average of a 4% commission as each contract is obtained. The amounts accrued in interim periods will be trued up to the annual result.

ABC capitalizes each commission amount recognized as the liability is accrued as a contract acquisition asset – assuming the one-year practical expedient does not apply or has not been elected.

Note: We understand there may be diversity in how entities accrue the cost of commissions over interim periods in similar plans, which is not addressed by the guidance in Subtopic 340-40.

Question 12.3.90

Can commissions paid to non-sales personnel be incremental costs to obtain a contract?

Interpretive response: Yes, if that sales commission is *directly attributable to, and incremental from,* obtaining a contract, those amounts are required to be capitalized if they are recoverable and the practical expedient is not applied.

For example, if a regional sales manager or any higher-level executive, such as a senior or executive vice president, earns a commission that is directly attributable to obtaining one or more customer contracts, the entity recognizes a contract acquisition asset for that commission, just as it would for any commission paid to the 'direct' sales representative. Therefore, if the direct sales representative earns a commission of 5% of the contract value and their supervisor and a sales assistant each get a 1% commission on that contract, the entity recognizes a contract acquisition asset for each of those commissions – i.e. 7% of the contract value.

Some have questioned whether this conclusion extends to a commission paid to non-sales staff. For example, assume a person outside of the sales group, with no direct or indirect support role in selling to customers, also earns 1% of the contract value as commission. We do not think the employee's role within the organization or distance from the customer negotiation affects whether the commission is an incremental cost to obtain a contract with a customer. Therefore, in this example, the 1% commission paid to the non-sales employee is capitalized if it is incremental to obtaining the customer contract and is expected to be recovered.

Question 12.3.100

Are commissions earned on contract modifications that are not treated as separate contracts capitalized?

Interpretive response: Yes. The TRG agreed that, regardless of how the contract modification is accounted for, incremental costs of obtaining the modification should be accounted for in the same manner as incremental costs of obtaining a customer contract. [TRG 01-15.23]

Example 12.3.50
Commission paid on contract modification

Manufacturer enters into a contract with Customer to transfer machinery and to customize that machinery for Customer's needs. Manufacturer pays its salesperson a commission based on the contract price. That commission is incremental to obtaining the contract with Customer and is expected to be recovered.

Before completing the machinery customization, Manufacturer and Customer modify the contract through a change order. Under the change order, Manufacturer will develop an additional customized feature for Customer for an additional fee. As a result of obtaining the change order, the salesperson will obtain an additional commission.

Even though the contract modification may not be accounted for as a separate contract, the increase in the contract price results in a cost – i.e. the commission paid to the salesperson – that is incremental to obtaining the modified contract. Therefore, it is capitalized just as the initial commission was capitalized.

Question 12.3.110
Should an entity capitalize commissions paid to obtain contract renewals?

Interpretive response: Yes, assuming the commissions are incremental costs expected to be recovered. An entity's commission plan may provide its employees with a commission for each new (initial) contract obtained with a customer, and for each renewal contract (i.e. the renewal of existing contracts). For example, a commission may be paid to a salesperson who obtains an initial contract to provide a service to a customer, but also to a salesperson who obtains a contract from an existing customer renewing the service agreement.

A renewal contract is no less of a contract than an initial contract with a new customer. Therefore, if a commission is paid to obtain a renewal contract, and that commission is incremental to obtaining that contract and is recoverable, the cost is capitalized just as any cost is capitalized to obtain a contract with a new customer, unless the practical expedient applies and has been elected.

Question 12.3.120
Are fees paid to a third party used to generate sales and provide professional services an incremental cost of obtaining a contract?

Interpretive response: It depends. An entity may use a third party to both generate sales and to provide professional services (e.g. implementation services) to its customers. If that is the case, the entity allocates the fee on a systematic and rational basis based on the nature of the activities performed by the third party. For example:

— Any portion of the fees paid to the third party that are incremental to obtaining the customer contract *alone* (i.e. attributable only to reselling the contract) is accounted for in the same way as other incremental costs of obtaining a contract with a customer.

— Any portion of the fees that relate to the third party performing set-up activities is accounted for consistently with internal costs the entity would incur to perform those set-up activities (see Question 12.5.10).

— Any portion of the fees that relate to the third party providing services to the customer on the entity's behalf (i.e. for which the entity is the principal for those services) is accounted for in the same manner as other fulfillment costs the entity would otherwise incur to fulfill its promise to provide those services to the customer (see Question 12.5.20).

Determining whether any portion of a third-party fee in an arrangement in which the third party provides services on behalf of the entity is solely incremental to obtaining the customer contract requires judgment. Just as for commissions paid to employees (see Questions 12.3.40 and 12.3.50), costs that are incremental to obtaining a contract with a customer include only those costs that are incurred solely as a result of obtaining the contract. If payment of the entire fee is contingent on successfully performing the services (or set-up activities), then no part is incremental to obtaining the customer contract.

12.4 Practical expedient for costs of obtaining a contract

Excerpt from ASC 340-40

• > Incremental Costs of Obtaining a Contract

25-4 As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

The FASB acknowledged that, in some cases, the cost of capitalizing incremental costs of obtaining a contract may outweigh the benefits. As a result, the guidance includes a practical expedient when the amortization period for that asset would have been less than a year. [ASU 2014-09.BC297]

Whether an entity uses the practical expedient is an accounting policy choice and can be made when the amortization period associated with the asset that would otherwise have been recognized is one year or less (see section 12.7). If an entity elects to apply the practical expedient, then it applies the practical expedient across all of its business units or segments and to all contracts that qualify for the expedient (regardless of whether the contract that qualifies is a new contract with a customer or a renewal contract).

Question 12.4.10

Are contract renewals considered when determining whether the practical expedient applies?

Interpretive response: Yes. The practical expedient applies to the period over which the costs are amortized, not over the contract period. If contract renewals are anticipated (see section 12.7) and would be included in the amortization period of a contract acquisition asset if it were capitalized, those renewals factor into whether the practical expedient is available. [340-40-25-4]

For example, if a service provider incurs incremental costs to obtain a one-year contract with a customer for which renewals of that one-year contract are anticipated *and* the service provider will not pay commensurate commissions for those renewals (see Question 12.7.20), the amortization period for the initial service contract commission is greater than one year and the practical expedient is not available.

Question 12.4.20

Can the practical expedient apply to commissions for renewals of a contract if it does not apply to the commission for the initial contract?

Interpretive response: Yes. An entity may find that its renewal contracts qualify for the practical expedient but not its initial contracts.

The commission on an initial contract, even one with a term of one year or less, may not qualify for the practical expedient if the amortization period of the asset would be greater than one year. This involves evaluating whether (1) renewals are specifically anticipated (see Question 12.7.10) and (2) commissions paid on renewals are not commensurate with the initial contract commissions (see Question 12.7.20). However, if the renewal period is one year or less and renewal commissions are commensurate with each other (even if not commensurate with initial contract commissions), the renewal commissions qualify for the practical expedient. When the practical expedient is elected for those renewal commissions, the entity expenses the commissions as incurred.

Question 12.4.30

Can the practical expedient apply if one or more (but not all) of the goods or services will be satisfied in one year or less?

Interpretive response: Generally, no. The assessment of whether the practical expedient applies is made at the contract level. Generally, if a commission paid for a contract relates to multiple goods or services and one or more of those goods or services will be satisfied after one year from when the cost is incurred, which may include goods or services that will be provided under a specifically anticipated future contract, then the practical expedient does not apply. For example, the practical expedient does not apply to a commission paid for obtaining a contract that includes a car and bundled two-year contract for free oil changes that are accounted for as a service-type warranty (see section 4.5).

In contrast, the practical expedient may apply to a commission paid on a contract with goods or services that will be transferred to the customer over a period greater than one year if the contract acquisition costs relate only to those goods or services that will be transferred to the customer in one year or less.

Question 12.4.40

Can an entity apply the practical expedient if the amortization period would be slightly greater than one year?

Interpretive response: No. Entities may have administrative or other reasons, such as standard billing practice, that result in a contract term slightly greater than 12 months – e.g. 12 months and 15 days. This may be the case even if the contract period is intended to approximate one year. The practical expedient is a bright-line exception to the contract cost capitalization requirement in Subtopic 340-40. As with other exceptions in the accounting literature, it is applied narrowly as written by the FASB. Consequently, costs for which the amortization period would extend beyond one year, no matter by how much, are not eligible for the practical expedient. [340-40-25-4]

Example 12.4.10

Practical expedient when amortization period is slightly longer than one year

When ABC Corp. enters into an arrangement with a customer in which the contract term and services begin at a date that is other than the first of the month, the contract term is set so that the end date is the end of the month one year after the effective date. Therefore, unless the effective date is on the first of the month, the contract term and period the services are provided over will be greater than one year.

ABC enters into a contract with Customer on December 10, Year 1. Based on ABC's administrative practices, even though the effective date of a contract is December 10, Year 1, the contract term will end on December 31, Year 2. ABC has a commission policy for which its salespeople are paid 5% of sales at the time a contract is entered into, and this cost is amortized over at least the one year and three week service period of the initial contract.

In this example, ABC cannot apply the practical expedient to expense commissions as incurred because the amortization period is longer than one year.

Question 12.4.50

If the incremental costs of obtaining a contract are incurred before transferring goods or services, when does the practical expedient's one-year amortization period begin?

Interpretive response: While not explicitly stated in Subtopic 340-40, we believe the amortization period for purposes of applying the practical expedient begins when the costs are incurred. The amortization period in this respect does not refer solely to the period of time over which the goods or services will be provided.

For example, if an entity incurs $10,000 in contract acquisition costs as a result of executing a contract on December 1, Year 1, and expects to satisfy the single performance obligation in the contract over an 11-month period beginning April 1, Year 2, those costs are not eligible to be expensed when incurred on December 1, Year 1 using the practical expedient. Therefore, if the entity in this example is a calendar-year public reporting entity, the full, unamortized amount of those contract acquisition costs should be reflected in the entity's December 31, Year 1 and March 31, Year 2 balance sheets.

Question 12.4.60

What happens if an entity applies the practical expedient but subsequently determines that the amortization period is greater than one year?

Interpretive response: The entity considers the guidance in Topic 250 on accounting changes and error corrections. If changes in circumstances lead the entity to change its earlier estimate as to the timing of the satisfaction of the performance obligation, there is no adjustment for costs previously expensed because changes in accounting estimates are accounted for prospectively.

However, if the determination that the amortization period would be less than a year was attributable to a misunderstanding of the facts and circumstances that existed at contract inception and were reasonably available to management at that time, an accounting error has occurred. The error in this case led to the entity inappropriately expensing the contract acquisition costs. In that case, the entity assesses the materiality of the error and related correction to current and prior periods to determine the appropriate process for correcting the error.

See section 3.4 and chapter 4 of KPMG Handbook, Accounting changes and error corrections, for additional guidance on changes in accounting estimates and error corrections.

12.5 Costs of fulfilling a contract

Excerpt from ASC 340-40

• > Costs to Fulfill a Contract

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.

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.

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).

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).

• • > Example 2—Costs That Give Rise to an Asset

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

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

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**

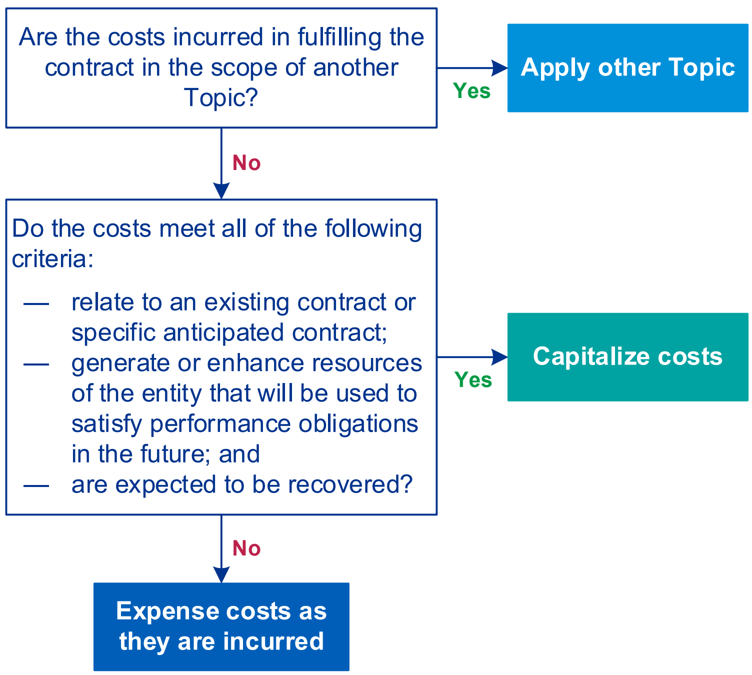
55-8 The initial setup costs relate primarily to activities to fulfill the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

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.

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.

12.5.10 Overview

Subtopic 340-40 also applies to costs to fulfill a contract unless those costs are in the scope of other guidance (see section 12.2). Unlike costs of obtaining a contract, there is no practical expedient whereby an entity can elect to expense costs that meet the criteria to be capitalized but the amortization period is one year or less. The following decision tree illustrates the steps an entity takes in determining when to recognize a fulfillment cost asset. [340-40-25-5, 25-6]



12.5.20 Costs relate to an existing contract or specific anticipated contract

A fulfillment cost asset could relate to both existing contracts and specifically anticipated contracts. Specifically anticipated contracts include anticipated contracts, contract renewals, or unpriced change orders expected to be approved. For example, after securing the contract, an entity may incur costs to provide set-up activities that do not provide a service to the customer. In other scenarios, entities may incur fulfillment costs in anticipation of winning a contract but before finalizing the contract. In either case, the entity needs to evaluate costs that relate directly to those contracts. [340-40-25-5]

Examples of costs related to existing or anticipated contracts that may or may not be capitalized when the specified criteria are met: [340-40-25-7, 25-8]

Direct costs that are eligible for capitalization if other criteria are met ✓	Costs required to be expensed when they are incurred ✗
Direct labor – e.g. employee wages	**General and administrative costs** – unless explicitly chargeable under the contract
Direct materials – e.g. supplies	**Costs that relate to satisfied performance obligations**
Allocation of costs that relate directly to the contract – e.g. depreciation and amortization	**Costs of wasted materials, labor or other contract costs**
Costs that are explicitly chargeable to the customer under the contract	**Costs that do not clearly relate to unsatisfied performance obligations**
Other costs that were incurred only because the entity entered into the contract – e.g. subcontractor costs	

Example 12.5.10
Contract fulfillment costs in a specifically anticipated service contract

Servicer provides consulting services. Servicer previously entered into a master services agreement (MSA) with Customer, under which it was named a preferred provider. Under the MSA, Servicer expects to enter into a number of individual contracts (e.g. multiple statements of work) with Customer.

Servicer will be reimbursed for certain costs incurred in anticipation of, and related to, future contracts regardless of whether the contracts are ultimately executed. Servicer incurs labor costs in anticipation of a specific contract with Customer. A portion of those costs are subject to the reimbursement provisions of the MSA, while some are not. Servicer has performed similar services in anticipation of similar contracts for Customer in the past. Customer has fulfilled its obligations under the MSA in each case.

In this example, Servicer capitalizes the labor costs that the MSA specifies Servicer will be reimbursed for regardless of whether there is an executed contract because those costs are explicitly reimbursable.

For costs that are not explicitly reimbursable under the MSA, Servicer evaluates its historical experience, and the nature of work and expense incurred for Customer. It concludes that the costs should be capitalized because they:

— are directly attributable to a specifically anticipated future contract;
— represent the enhancement of resources that will be used in satisfying a future performance obligation (the services under the anticipated contract); and
— are expected to be recovered.

Servicer's accounting for the costs and the reimbursements from Customer varies depending on whether Servicer obtains the specific contract to which the incurred costs relate.

- If the contract is not ultimately obtained, capitalized costs that will not be reimbursed are expensed once it is clear the contract will not be obtained. Any capitalized costs to which Servicer is entitled to reimbursement will be converted from a contract cost asset to a receivable at that time.
- In contrast, if the contract is obtained, all of the capitalized pre-contract costs are accounted for consistently with other capitalized fulfillment costs, and the reimbursement for those costs becomes part of the transaction price of the obtained contract.

12.5.30 Costs generate/enhance resources that will be used to satisfy performance obligations

Only costs that give rise to resources that will be used in satisfying performance obligations in the future are eligible for recognition as assets. In contrast, costs that relate to satisfied (or partially satisfied) performance obligations are expensed as incurred regardless of whether they are recoverable. [340-40-25-5(b), 25-8(c)]

This ensures that an entity is precluded from deferring costs merely to normalize profit margins while satisfying a performance obligation by allocating revenue and costs evenly over the life of the contract. [ASU 2014-09.BC308]

Question 12.5.05

Should mobilization costs be capitalized under Subtopic 340-40?

Interpretive response: It depends. Mobilization costs are costs incurred to transport equipment or materials to a location where the contract with the customer will be fulfilled.

An entity should first evaluate mobilization costs to determine whether they are in the scope of another Topic. For example, costs to acquire new equipment are accounted for under Topic 360, and costs to acquire inventory are accounted for under Topic 330. [340-40-15-5]

Mobilization costs not addressed under other topics are in the scope of Subtopic 340-40. Whether these costs are capitalized will generally depend on whether they are incurred before the entity has begun satisfying the related performance obligation or while the performance obligation is satisfied.

When they are incurred *before* the entity has begun satisfying the related performance obligation, we believe the costs will generally be capitalizable if they are recoverable. Such costs relate directly to a contract or anticipated contract and enhance the resources of the entity (equipment, materials, personnel) used to satisfy the future performance obligation. [340-40-25-5]

When the costs are incurred while satisfying the performance, the costs are expensed as incurred. Such costs relate to a partially satisfied performance obligation. If the entity uses an input measure based on costs incurred, the entity also needs to consider whether these costs should be included in determining the measure of progress. [340-40-25-8]

Example 12.5.15

Mobilization costs incurred in a construction arrangement

Builder enters into a contract with Customer to construct an office building. Builder determines that there is one performance obligation in the contract (construction of the building) that is satisfied over time.

Builder incurs mobilization costs to bring heavy equipment to the building site before it begins satisfying the performance obligation. Builder first determines that these costs are not in the scope of another topic, noting that the costs are not part of the cost of property, plant and equipment under Topic 360 and no inventory will be recognized under Topic 330.

Builder determines that the mobilization costs meet the capitalization criteria because they are directly related to the contract with the customer, are expected to be recovered, and enhance resources controlled by Builder (i.e. the heavy equipment) that will be used to satisfy the Builder's performance obligation (construction of the building).

Builder therefore capitalizes the mobilization costs related to the heavy equipment and amortizes the asset over time, consistent with the transfer of control of the construction service for the building.

12.5.40 Costs expected to be recovered

Fulfillment costs must be recoverable to be capitalized. These costs could be recoverable through direct or explicit reimbursement by the customer under the contract (direct recovery) or through the net cash flows expected from the margin built into the contract and specifically anticipated future contracts (such as renewals) with the customer (indirect recovery). Even if the costs are explicitly reimbursed by the customer, however, the entity should consider the net cash flows from the contract to determine if the overall contract costs are recoverable. For example, a direct reimbursement of a cost may not be sufficient on its own to support recoverability if overall the contract is a loss. [340-40-25-5(c)]

Question 12.5.10
Are costs related to fulfilling set-up activities capitalized under Subtopic 340-40?

Interpretive response: Yes, if all the criteria for capitalizing fulfillment costs are met. Entities often incur costs related to set-up activities before transferring a promised good or service to the customer. Set-up activities that do not transfer a promised good or service to the customer should be distinguished from costs incurred to fulfill a promised good or service (see Question 4.2.70).

An entity capitalizes costs related to set-up activities because those costs do not relate to satisfying a performance obligation, provided that those costs: [340-40-25-5]

— directly relate to a customer contract (or specific anticipated customer contract);
— generate or enhance resources of the entity; and
— are expected to be recoverable.

Set-up activities frequently, but not always, generate or enhance resources of the entity to permit them to provide goods or services to the customer, and generate revenues from those goods or services, in the future.

Costs incurred to fulfill a promised service are discussed in Question 12.5.20.

Question 12.5.20
Are direct costs incurred in satisfying a present performance obligation eligible for capitalization?

Interpretive response: Generally no, unless the costs are addressed by another Topic. Fulfillment costs not in the scope of another Topic are capitalizable if they generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future. [340-40-25-5]

However, costs that relate to satisfied (or partially satisfied) performance obligations in the contract (i.e. costs that relate to past performance) are expensed as incurred. [340-40-25-8(c)]

This means that contract costs incurred in fulfilling a promised good or service are not capitalizable unless they are either:

— pre-contract costs incurred in anticipation of providing a good or service under a contract with a customer in the future; or
— costs incurred to permit the entity to fulfill a performance obligation that will be satisfied in the future.

Contract costs incurred in fulfilling a performance obligation satisfied over time are expensed as incurred even if that results in recognizing fulfillment costs ahead of or after recognizing the related revenue. This might occur, for example, if the entity determines that an appropriate measure of progress for the performance obligation is a measure other than cost-to-cost and fulfillment costs are greater in earlier (or later) stages of the project. The TRG made clear that an appropriate measure of progress applied to a performance obligation satisfied over time should not result in the recognition of work in process (or a similar asset) from an entity's performance under a specific contract. [TRG 04-16.53]

We believe this would include situations in which performance has commenced (i.e. the entity has performed part of a service), but the single measure of progress that the entity has concluded is appropriate for the performance obligation does not yet result in revenue being recognized. In those cases, the fulfillment costs to satisfy the performance obligation are expensed as incurred on the basis of paragraph 340-40-25-8(c), even if it occurs in the infrequent circumstance where costs are incurred before revenue is recognized on the performance obligation based on the measure of progress selected.

The preceding paragraph notwithstanding, some may not view fulfillment costs incurred before revenue is recognized (based on the single measure of progress selected) as related to a satisfied or partially satisfied performance obligation – i.e. they do not 'fail' the criterion in paragraph 340-40-25-8(c) – such that the costs might, in limited circumstances, qualify for capitalization under paragraph 340-40-25-5 (i.e. if those criteria are all met, including that those costs generate or enhance resources of the entity).

The discussion in this question applies equally to fulfillment costs that are reimbursable under the terms of the customer contract – e.g. travel-related expenses or costs of supplies incurred by the entity in fulfilling professional services that are reimbursable by the customer. For a discussion of the accounting of the customer's reimbursement of such expenses, see Question 5.2.10.

Example 12.5.20
Costs incurred in a SaaS arrangement

SaaS Provider enters into a contract to provide Customer with access to its SaaS for three years.

As part of the contract, SaaS Provider will:

1. before commencement of the SaaS term, set up the user interface that Customer will need to access the online application;
2. undertake data conversion and migration activities for Customer to configure and move the relevant data from Customer's current on-premise solution to SaaS Provider's hosted environment; and
3. provide training to relevant Customer personnel on best practices for efficient use of SaaS Provider's hosted application.

SaaS Provider evaluates each of the activities to determine the accounting for the related costs.

The set-up of the user interface provides no incremental benefit to Customer beyond permitting Customer to access the hosted application. Therefore, SaaS Provider concludes that (1) is a set-up activity rather than a promised service to Customer. Consequently, assuming the set-up activities are directly identifiable to the contract with Customer and are expected to be recoverable, SaaS Provider capitalizes a contract fulfillment cost asset for those set-up costs.

In contrast, (2) and (3) are services that provide Customer with incremental benefits beyond just access to the hosted application. The data conversion and migration activities would otherwise need to be performed by Customer or another service provider. The training of Customer's personnel is also a promised service because the training will permit Customer to more effectively use SaaS Provider's hosted application. In both cases, SaaS Provider's activities are doing more than simply setting up or enabling Customer's access to the SaaS. Assuming (as would typically be the case) that both of these services are distinct and are satisfied over time, the costs of fulfilling those services do not qualify for capitalization under Subtopic 340-40 and therefore are expensed as incurred.

Question 12.5.30

Are learning curve costs eligible for capitalization under Subtopic 340-40?

Interpretive response: Generally, no. Some contracts have significant learning curve costs that decrease over time as process and knowledge efficiencies are gained. For example, in a typical manufacturing process, an entity producing widgets becomes more efficient in its production process over time.

Topic 606 addresses the accounting for the effect of learning curve costs when two conditions are met:

- the performance obligation is satisfied over time; and
- an entity has a single performance obligation to deliver a specified number of units. [ASU 2014-09.BC313]

The FASB noted that when a performance obligation is satisfied over time an entity is likely to select a method for measuring progress (e.g. cost-to-cost method) that would result in more revenue and expense recognized earlier in the contract when the first units are produced because this is when more of the costs are incurred. The FASB believed that this effect is appropriate because of the greater value of the entity's performance in the earlier part of the contract, and if only one unit was sold then the entity would sell it for a higher price. Further, when control passes to the customer as costs are incurred, it would be inappropriate to capitalize those costs because they relate to past performance. Therefore, if these conditions exist and the cost-to-cost method is used, then generally learning curve costs are not capitalized. [ASU 2014-09.BC314]

In other cases, if the contract is for multiple performance obligations that are each satisfied at a point in time, an entity principally accounts for the costs of these performance obligations under other Topics. For example, if an entity promises to transfer multiple pieces of equipment, each performance obligation is satisfied at the point in time that a piece of equipment is transferred. In this instance, the entity applies the inventory guidance to account for its costs to fulfill the contract. This is because an entity incurring costs to fulfill a contract without also satisfying a performance obligation over time is often creating an asset in the scope of other guidance, such as inventory. [ASU 2014-09.BC312–BC315]

Question 12.5.40

If a contract generates an upfront loss because variable consideration is fully or partially constrained, can an entity defer the related costs?

Interpretive response: No. In certain circumstances, an upfront loss may arise because the revenue from a transaction is constrained or the allocation of transaction price to a performance obligation is limited to an amount that is lower than the cost of goods transferred to the customer. In these cases, it is not appropriate for an entity to defer the upfront loss.

For example, an entity sells goods with a cost basis of $100,000 for stated consideration of $120,000 that is subject to a risk of price concession in the future. The entity determines that the contract is not a loss contract (see section 13.2) and a loss accrual is not required under other applicable guidance. The entity constrains the transaction price and concludes that $90,000 is probable of not resulting in a significant revenue reversal. When control transfers, the entity recognizes revenue of $90,000 and costs of $100,000. This results in an upfront loss until the uncertainty associated with the variable consideration is resolved.

However, in some instances entities can capitalize upfront payments to customers (see section 5.7).

Question 12.5.50

If an initial sale results in a loss but there is an expectation that subsequent sales will be profitable, can the initial loss be capitalized?

Interpretive response: No. Sometimes an entity may offer a discounted price on a good or service to establish or enhance a customer relationship or to encourage future purchases. These types of arrangements could result in a loss on the initial sale depending on what the discounted price is compared to the cost. It is not appropriate to defer that loss based on an anticipation that subsequent profitable contracts will be entered into with the customer.

In contrast, in some instances entities can capitalize and defer upfront payments to customers (see section 5.7).

12.6 Amortization of contract cost assets

Excerpt from ASC 340-40

> Amortization and Impairment

35-1 An asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in paragraph 340-40-25-5(a)).

35-2 An entity shall update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates. Such a change shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

An entity amortizes the contract acquisition asset and/or fulfillment cost asset in a contract on a systematic basis, consistent with the pattern of transfer of the good(s) or service(s) to which the asset relates. The amortization guidance applies equally to contract acquisition assets and fulfillment cost assets. However, each asset could have different amortization patterns or periods depending on the transfer of goods or service to which each asset relates. [340-40-35-1]

The goods or services to which a contract cost asset relates can include the goods or services in an existing contract *and* those to be transferred under a specifically anticipated contract – e.g. goods or services to be provided following the renewal of an existing contract. [340-40-35-1]

Question 12.6.10
Where should the amortization of contract costs be classified in the income statement?

Interpretive response: SEC guidance on income statement classification requires costs and expenses applicable to sales and revenues to be presented separately from selling, general and administrative expenses. [S-X Rule 5-03]

Subtopic 340-40 does not have specific presentation guidance that would override that guidance. The fact that Subtopic 340-40 may require capitalization of certain costs does not change the nature of those costs, and their classification in the income statement is the same as it would be for similar costs that are not capitalized.

Consequently, amortization of costs to obtain a contract will generally be classified as selling, general and administrative expense, while amortization of costs to fulfill a contract will generally be classified as costs of sales.

12.7 Amortization period

The amortization period used for a contract cost asset is consistent with the concept of useful life under other Topics, which is defined as the period over which an asset is expected to contribute directly or indirectly to future cash flows. As a result, the amortization period for a contract cost asset includes anticipated renewal periods (see Question 12.7.10) when the entity concludes that it will continue to benefit from the contract cost asset over a period that is longer than the stated contract period. Benefits from the contract cost asset are the net cash flows (margin) the entity will earn from transferring goods or services to the customer. [ASU 2014-09.BC309]

If renewals are anticipated, a contract fulfillment cost asset will generally have a useful life that includes those anticipated renewals. A contract acquisition asset will also generally have a useful life that includes those anticipated renewals, unless the entity incurs incremental costs (e.g. incremental commissions) to obtain the renewals that are commensurate with the incremental costs incurred (the commissions paid) to obtain the initial contract (see Question 12.7.20). [ASU 2014-09.BC309, TRG 11-16.57]

The TRG agreed that the amortization period for a contract cost asset is not necessarily the same as an average customer life for the entity's goods or services to which the contract cost asset relates. However, it expressed the view that the average customer life for the goods or services to which the contract cost asset relates may be a reasonable application of Subtopic 340-40 as long as the average customer life is not 'inconsistent with the amortization guidance in paragraph 340-40-35-1'. Based on this discussion, the average customer life may be inconsistent with the amortization guidance if the entity has a very long average customer life (e.g. 20 years), but the good or service that will be transferred to the customer has an economic life shorter than that – e.g. the software being licensed or accessed in a SaaS arrangement is shorter than the average customer life. [TRG 11-16.57]

If including the anticipated contract extends the amortization period beyond one year, then the entity is not eligible for the practical expedient for the incremental costs of obtaining a contract. For example, assume a cable television company incurs incremental costs to obtain contracts with customers that have an initial term of one year; however, a significant portion of the customers renew the contracts at the end of the initial term. In this case, the entity cannot assume that it is eligible for the practical expedient, but instead must determine the amortization period. See section 12.4 on the practical expedient.

Question 12.7.10
When is a renewal of a good or service specifically anticipated?

Interpretive response: Subtopic 340-40 does not specify how an entity should determine whether one or more contracts are specifically anticipated.

Relevant factors to consider may include the entity's history with that customer (e.g. in other contracts) and customer class, and predictive evidence derived from substantially similar contracts. In addition, an entity should consider available information about the market for its goods or services beyond the initial contract term – e.g. whether it expects the service still to be in demand when renewal would otherwise be anticipated and expected availability of competitor goods and services (including switching costs, and barriers to switching to another service provider).

Judgment will be involved in determining whether renewals of goods or services are anticipated, but an entity should apply consistent estimates and judgments across similar contracts.

Example 12.7.10
Amortization period for contract cost assets

Telco enters into a one-year contract with Customer to provide telephone services for $30 per month. Telco pays its salesperson a 5% commission ($18) and incurs set-up costs of $150 directly related to the contract. Telco does not pay commissions on renewal and does not incur the set-up costs again if Customer renews the telephone services.

Telco's ongoing fulfillment costs of providing the services for the one-year initial service period are $50, which is in line with its expected costs of providing the services in the future. Based on customer-specific facts and other circumstances, Telco anticipates that Customer will renew the contract for an additional three years – i.e. it expects to provide four years of services in total.

Telco concludes that its acquisition costs ($18) and its set-up costs ($150) are recoverable by the margin it expects to earn on the contract and the specifically anticipated renewals; therefore, it capitalizes those amounts as contract cost assets.

Because Telco anticipates that Customer will enter into three one-year renewals and it will not incur similar costs to obtain or set up those renewals, Telco expects to benefit from its contract acquisition and contract fulfillment cost assets over a period that includes the initial term plus the specifically anticipated renewal periods (four years in total). Therefore, Telco amortizes those assets over four years in a manner consistent with the transfer of the services to Customer.

Question 12.7.20
When is a commission paid for the renewal of a good or service commensurate with a commission paid on the initial good or service?

Interpretive response: Determining if a commission paid for the renewal of a good or service is commensurate is important because it could affect the amortization period of a contract acquisition asset. [ASU 2014-09.BC309]

The TRG agreed that evaluating whether a renewal commission is commensurate with an initial commission should be based on the economic benefits expected to be obtained from the commission payment. Some stakeholders suggested that entities should evaluate whether the comparative level of effort expended by the employee or third party was commensurate with the commission they were paid; however, the TRG agreed that level of effort should not be used in the evaluation. [TRG 11-16.57]

The renewal commission is commensurate with the initial commission if the expected economic benefits (the net cash flows or margin) an entity expects to obtain from providing goods or services during a renewal period are roughly equal to the economic benefits the entity expects to obtain from providing those same goods or services during the initial period. Entities do not in general pay substantially different amounts for the same asset. Therefore, a substantively larger initial contract commission represents, both practically and conceptually, a prepayment for the economic benefits that the entity anticipates receiving from the renewal contracts, justifying an amortization period for the initial contract acquisition asset that includes the renewal periods.

Entities frequently pay commissions to salespeople or third parties for both initial contracts and renewal contracts. It is also common for the commissions paid for the initial contract to be greater in amount than commissions paid for a renewal contract. For example, the entity may pay a commission of 5% of the total contract value for an initial contract and only 1% of the total contract value for a renewal of the same good or service.

Consequently, in the common scenario in which an entity pays larger commissions for initial contracts than for renewal contracts, those lower renewal commissions are considered to be commensurate with the higher initial contract commissions only if the economic benefits the entity will derive (i.e. the margin it will earn) from the initial contract significantly exceeds those it expects to derive from the renewal contracts.

Example 12.7.20

Determining whether a commission paid for a renewal is commensurate

Service Provider generally provides its services under a one-year contract, with multiple options to renew the services annually after each one-year term expires.

Service Provider has a compensation plan that pays its sales staff commissions for obtaining and renewing contracts. Under this plan, a sales person receives a 5% commission on any initial contract obtained, and a 1% commission on renewal contracts obtained. The sales personnel who earn commissions on the initial contract differ from the personnel who earn commissions on the renewal contracts because different departments deal with each.

In determining commission rates to be paid on obtaining initial and renewal contracts, Service Provider factors in the effort necessary to secure the initial and renewal contracts by the applicable sales team and the average annual compensation that the sales personnel (both initial and renewal team) should receive, among other factors.

Obtaining an initial contract generally requires a significant amount of effort from the sales staff. The sales effort can vary, but generally requires several hours (spanning over several months). There is generally significantly less effort required to secure the renewal, which may only involve making a few phone calls or sending an email to confirm the customer wants to renew. Service Provider has a low attrition rate – historically greater than 90% of all one-year contracts are renewed for at least two additional years.

Service Provider agrees to provide services for one year to Customer for $100,000. Customer has the option to renew the service at the end of each year for $100,000 per year. Based on its compensation plan, Service Provider pays a $5,000 commission for obtaining the initial contract, and a $1,000 commission for obtaining each renewal contract.

Service Provider concludes the following.

— The $5,000 initial commission should be capitalized as an incremental cost of obtaining a contract.

— Each $1,000 renewal commission should also be capitalized when incurred as incremental costs of obtaining the renewal contract(s) – i.e. assume Service Provider did not apply the practical expedient to the renewal commissions (see Question 12.4.20).

The following are the relevant economics of the arrangement under three different scenarios. Under each scenario, the revenues that will be earned by Service Provider are the same, as are the commissions paid. The only difference is in Service Provider's costs to provide the service and consequently the gross margin it will earn from the initial versus the renewal contracts.

Scenario 1

	Initial contract	Expected renewal #1	Expected renewal #2
Revenue	$100,000	$100,000	$100,000
Cost of services	(30,000)	(30,000)	(30,000)
Gross margin (exclusive of commission costs)	**$ 70,000**	**$ 70,000**	**$ 70,000**
Commission paid	$ (5,000)	$ (1,000)	$ (1,000)

Scenario 2

	Initial contract	Expected renewal #1	Expected renewal #2
Revenue	$100,000	$100,000	$100,000
Cost of services	(10,000)	(50,000)	(50,000)
Gross margin (exclusive of commission costs)	**$ 90,000**	**$ 50,000**	**$ 50,000**
Commission paid	$ (5,000)	$ (1,000)	$ (1,000)

Scenario 3

	Initial contract	Expected renewal #1	Expected renewal #2
Revenue	$100,000	$100,000	$100,000
Cost of services	(42,000)	(30,000)	(30,000)
Gross margin (exclusive of commission costs)	**$ 58,000**	**$ 70,000**	**$ 70,000**
Commission paid	$ (5,000)	$ (1,000)	$ (1,000)

In Scenarios 1 and 3, the renewal commission is not commensurate with the initial commission. This is because the commission paid is five times greater than the renewal commissions that will be paid, but the economic benefits (the margin) that Service Provider expects to obtain from the renewal contracts are equal (Scenario 1) or greater (Scenario 3) than the economic benefits that Service Provider expects to obtain from the initial contract. Therefore, the substantially greater initial contract commission is a partial prepayment for the economic benefits Service Provider specifically anticipates receiving from the renewal periods.

In Scenario 2, the economic benefits that Service Provider will derive (the margin) from the initial contract significantly exceed those it expects to derive from the renewal contracts. Consequently, the commissions to be paid for each of the three contracts – i.e. initial contract and two renewals – are commensurate with each other. This scenario is presented to illustrate the notion of 'commensurate'; however, we would expect this scenario to be rare in practice.

The amortization of the 5% initial commission that results in each scenario presented above is addressed in Question 12.7.30.

Question 12.7.30

When the amortization period includes specifically anticipated renewal periods, how is the contract acquisition asset amortized?

Interpretive response: We believe there are two acceptable approaches to amortizing a contract acquisition asset when the amortization period includes specifically anticipated renewal periods, as long as the approaches are consistently applied to substantially similar circumstances.

— The entire contract acquisition asset is amortized over the period that includes the specifically anticipated renewal periods.

— Only the portion of the contract acquisition asset that is incremental to the renewal commission the entity would normally pay is amortized over the period that includes the specifically anticipated renewal periods.

As illustrated in Example 12.7.20, entities will frequently pay commissions for initial contracts that are significantly greater than the commissions they will pay for contract renewals. In that example, the entity (Service Provider) pays a 5% commission for the initial contract and only a 1% commission for each renewal of that contract.

In Scenario 2 (which likely will be rare), in which the 1% renewal commission is determined to be commensurate with the initial 5% commission, the amortization period for the 5% initial contract commission does *not* include the two specifically anticipated one-year renewal periods. Consequently, the 5% initial contract commission is amortized in its entirety over the initial one-year contract term consistent with Service Provider's provision of the services to its customers.

In Scenarios 1 and 3, the amortization period for the initial contract acquisition asset includes the two specifically anticipated one-year renewal periods because the 1% renewal commission is not commensurate with the 5% initial contract commission. Consequently, we believe Service Provider should apply one of the following approaches and disclose the approach taken.

— Amortize the *entire* 5% initial contract commission over the initial contract period *plus* the two specifically anticipated renewal periods. Assuming a time-elapsed or time-based measure of progress for the service, this approach would result in recognizing more sales expense during the two renewal periods. That is because in the renewal periods Service Provider is amortizing the initial contract commission asset and the 1% renewal commission, unless it elects the practical expedient for the renewal commissions.

— Amortize only the *portion* of the initial contract commission determined to be incremental to the renewal commission over the initial contract period plus the two specifically anticipated renewal periods, while recognizing the remainder of the initial contract commission over only the initial one-year contract period. (**Note:** it is not permissible to apply the one-year practical expedient to that portion of the overall initial commission – see Question 12.4.30). Applied to Scenarios 1 and 3, this results in recognizing equal contract cost amortization during the initial and the two anticipated renewal periods, assuming Service Provider uses a time-elapsed or time-based measure of progress for the service and Service Provider does not elect the practical expedient for the renewal commissions (see Question 12.4.20).

We believe an entity's decision is an accounting policy election that should be disclosed in accordance with paragraph 340-40-50-2. Example 12.8.20 illustrates an application of both approaches.

12.8 Amortization pattern

An entity amortizes a contract cost asset on a systematic basis consistent with the transfer to the customer of the goods or services to which the asset relates. In many cases, this may be straightforward when the contract has a single good or service. However, in other cases contracts will have goods or services that have different patterns of transfer and the amortization pattern will need to reflect the transfer of all the goods or services to which the asset relates. [340-40-25-5]

Question 12.8.10

If a contract cost asset relates to more than one distinct good or service, is an entity required to allocate that asset among those distinct goods or services?

Interpretive response: No. While it is always acceptable to allocate a contract cost asset among the distinct goods or services to which it relates, the TRG generally agreed that it is also reasonable to amortize a contract cost asset using a single measure of progress considering all of the distinct goods or services to which the asset relates. [TRG 11-15.23]

In the view of most TRG members, this approach may be more operable for some entities because it does not require the entity to undertake an allocation exercise for contract costs in the contract. The FASB expressed that (1) it did not believe this approach should result in a significantly different pattern of amortization of the contract cost asset from that which would result from allocating the asset to all of the distinct goods or services to which it relates, and (2) that use of the 'single measure' approach would not change an entity's requirement to consider anticipated future contracts (such as contract renewals) when determining the goods or services to which the contract cost asset relates – i.e. the amortization period for the asset. [TRG 11-15.23]

When determining a single measure of progress to apply to amortization of a contract cost asset, we believe the guidance in Topic 606 for determining the measure of progress used for a performance obligation satisfied over time may be appropriate (see section 7.4). Conversely, we believe that a measure of progress that is not acceptable for recognizing revenue on the goods or services to which the asset relates is also not acceptable in amortizing a contract cost asset. Consistent with determining a single measure of progress for a combined performance obligation, determining a single measure of progress for a contract cost asset that relates to multiple goods or services – whether those goods or services are a single performance obligation or separate performance obligations – may require significant judgment and there may be more than one acceptable measure of progress that could be selected. [606-10-25-31 – 25-37, 55-16 – 55-21]

We expect an entity to either allocate contract cost assets among the distinct goods or services (or bundles of distinct goods or services) to which they relate or apply a single measure of progress approach consistently to similar circumstances.

Question 12.8.20

If an entity uses the single measure of progress approach to amortize contract cost assets that relate to multiple distinct goods or services, would straight-line amortization be appropriate?

Interpretive response: It depends. As discussed in Question 12.8.10, an entity is not required to allocate contract cost assets to each distinct good or service to which they relate. However, if the entity does not allocate a contract cost asset to each distinct good or service to which it relates, it nonetheless uses a single measure of progress that is consistent with the transfer to the customer of the goods or services to which the contract cost asset relates. [340-40-35-1]

If straight-line amortization is not consistent with the transfer of the goods or services to which the contract relates, it would not be an appropriate method. For example, if a significant amount of revenue and/or margin will be recognized at or near contract inception, we believe the amortization approach should also recognize a commensurate portion of the cost upfront. That is, it is inappropriate not to recognize expense upfront when a significant portion of the economic benefits expected to be derived from the contract cost asset *are* recognized upfront (e.g. straight-line amortization would be inappropriate).

Example 12.8.10

Allocation and amortization of contract cost assets

ABC Corp. enters into a contract with Customer to sell equipment. ABC also agrees to provide maintenance for two years. The total, fixed transaction price is $100,000. ABC pays a commission of $20,000 to its salesperson for obtaining the contract (assume no renewals are expected).

The equipment and maintenance are determined to be separate performance obligations. The equipment is transferred to Customer at contract inception and the maintenance has a two-year term commencing on transfer of control of the equipment. Additionally:

— The relative stand-alone selling prices of the equipment and the maintenance are $80,000 and $20,000, respectively.
— The expected cost of the equipment is $40,000, and the expected cost for each year of maintenance is $2,000 (total of $44,000).

ABC has elected to not allocate contract cost assets to the separate performance obligations in arrangements of this nature. Instead, ABC will amortize the contract cost asset using one measure for the transfer of the goods or services to which the contract cost asset relates.

In considering whether an output or input method best achieves this objective, ABC concludes that a cost-based input method appropriately reflects the transfer of control of the goods or services to which the contract cost asset relates when using a single measure. Therefore, upon transfer of control of the equipment, ABC will amortize $18,181 of the $20,000 initial contract cost asset because 91% of the contract fulfillment costs have been incurred ($40,000 /

$44,000). The remaining balance of the contract cost asset of $1,819 will be amortized over the two-year maintenance services period as the remaining fulfillment costs are incurred.

Other measures, besides a cost-based input measure, may also be acceptable provided that they also result in amortization of the contract cost asset that is generally consistent with the pattern of transfer to the customer of the goods or services to which the asset relates. For example, ABC could amortize the contract cost asset in proportion to the revenue or gross margin to be recognized.

It would not be appropriate in this example for ABC to amortize the entire contract cost asset on a straight-line basis, i.e. using a time-based or time-elapsed measure over the two-year maintenance services period (e.g. $10,000 per year) without amortizing a significant portion of the contract cost asset upfront. This is because the resulting recognition of expense would not be consistent with the transfer to the customer of the goods or services to which it relates.

Question 12.8.30

What approaches are acceptable for allocating a contract cost asset to the distinct goods or services to which it relates?

Interpretive response: Subtopic 340-40 requires a contract cost asset to be amortized on a systematic basis (which is not necessarily on a straight-line basis) that is consistent with the transfer to the customer of the goods or services to which the asset relates. As outlined in Question 12.8.10, this may be accomplished by allocating the contract cost asset among the distinct goods or services to which it relates or by applying a single measure of amortization considering the pattern of transfer of all of the distinct goods or services to which the asset relates.

If an entity chooses to allocate a contract cost asset, there may be multiple acceptable approaches to doing so because the amortization guidance in Subtopic 340-40 is not specific in this respect. However, whatever approach is used should be applied consistently to similar circumstances.

Relative stand-alone selling price approach

An entity would generally be permitted to allocate a contract cost asset on a relative stand-alone selling price basis. If there are no specifically anticipated renewals (see Question 12.7.10), the relative allocation of the contract cost asset would follow the allocation of the transaction price to the performance obligations (or distinct goods or services) in the contract.

However, additional complexity will arise if renewals of a good or service are specifically anticipated and the entity does not pay commissions on contract renewals that are 'commensurate' with the commissions it pays on initial contracts (see Question 12.7.20). This is because the goods or services to which the contract commission being evaluated relates include those anticipated renewals.

For example, assume an entity enters into a contract for equipment and one year of maintenance. The entity anticipates the customer will renew maintenance for three additional annual periods, but does not pay a commission for the renewals. In that case, the entity will allocate the initial contract commission asset to the equipment and four annual maintenance periods on a relative stand-alone selling price basis. If the entity pays a non-commensurate commission for renewals, those expected renewal commissions are factored into the allocation of the initial contract commission asset. Example 12.8.20 illustrates this scenario (Approach 1).

Alternative approaches

We believe these alternative approaches *could* be acceptable depending on the facts and circumstances (not necessarily exhaustive).

— **Economic benefits based allocation.** Rather than allocating a contract cost asset to distinct goods or services on the basis of their stand-alone selling price, it may be appropriate to look at the economic benefits (the margin) the entity expects to obtain from transferring the good or service. For example, two goods or services may have equal stand-alone selling prices but very different margins, and because an entity generally pays a commission to obtain future economic benefits in the form of the margin it earns from providing the goods or services to which the commission relates, we believe it is reasonable to allocate the commission to the related goods or services on a relative margin basis. Consistent with the relative stand-alone selling price approach, the entity would factor into the allocation approach the margin that will be earned from specifically anticipated renewals for which commensurate commissions are not paid. This approach is illustrated in Approach 2 in Example 12.8.20.

— **Specific allocation basis.** There may be circumstances in which an entity can objectively determine that a contract cost asset relates specifically to one or more distinct goods or services in a contract, but not all. In that case, it may be reasonable to allocate the contract cost asset entirely to that (or those) distinct goods or services. Evaluating whether a contract cost asset relates specifically to a distinct good or service might be similar to evaluating whether a variable payment relates specifically to the entity's efforts to satisfy a performance obligation or transfer a distinct good or service under the criteria for the variable consideration allocation exception. Section 6.6 includes discussion of the guidance.

Example 12.8.20
Allocation and amortization of contract cost assets

ABC Corp. enters into a contract with Customer to sell equipment. ABC also agrees to provide maintenance for two years. The total, fixed transaction price is $200,000. ABC pays a commission of $20,000 to its salesperson for obtaining the contract.

ABC anticipates Customer will renew maintenance for three additional years after the initial two-year period. ABC sales personnel are paid a commission for obtaining a renewal of 2% of the renewal fees. ABC concludes the commissions are not commensurate because it will earn the same benefits (i.e. margin) from each year of promised and anticipated maintenance.

The equipment and maintenance are determined to be separate performance obligations. The equipment is transferred to Customer at contract inception and the maintenance has a two-year term commencing on transfer of control of the equipment. In addition, the following facts are relevant.

— The relative stand-alone selling prices of the equipment and the maintenance are $120,000 (60% of total stand-alone selling price) and $80,000 (40% of total stand-alone selling price), respectively.

— The contractual fee for each anticipated renewal is $40,000.

— The margin ABC expects to earn on the equipment is $40,000, while ABC expects to earn a margin of 20,000 each year it provides maintenance.

Approach 1 – Relative stand-alone selling prices

ABC elects to allocate the contract acquisition cost asset on a relative stand-alone selling price basis. Looking solely to the relative stand-alone selling prices of the equipment and two years of maintenance in the enforceable contract, $12,000 (60% × $20,000) of the contract acquisition cost asset would be allocated to the equipment and $8,000 (40% × $20,000) would be allocated to the maintenance. However, because the amortization period includes specifically anticipated renewals, it must also allocate the costs to the renewal periods. ABC makes the following allocation.

Good or service	Relative stand-alone selling price	% Allocation	Allocation of expected commissions
Equipment	$120,000	37.5%	$ 8,400
2-year initial maintenance	80,000	25.0%	5,600
Year 3 renewal	40,000	12.5%	2,800
Year 4 renewal	40,000	12.5%	2,800
Year 5 renewal	40,000	12.5%	2,800
	$320,000	**100.0%**	**$22,400**[1]

Note:

1. Calculated as $20,000 + (2% × $40,000) × 3 years.

At contract inception, ABC becomes obligated to pay a commission of $20,000. Because control of the equipment transfers to Customer at contract inception, ABC expenses $8,400 of the $20,000 commission cost, and recognizes a contract acquisition cost asset of $11,600. ABC amortizes $5,600 of that contract acquisition cost asset to sales expense over the two-year initial maintenance term, leaving a remaining balance of $6,000 at the end of Year 2. At the beginning of each of Years 3 to 5, ABC adds to the contract cost asset by $800 (for each renewal commission), while amortizing $2,800 of that contract cost asset to sales expense during each of those years.

Approach 1(a) – The conclusion in Question 12.7.30 permits a variation of the accounting outlined in the preceding paragraph. Following the discussion in that question, it would be permissible for ABC to amortize the initial contract acquisition cost asset of $11,600 allocated to maintenance ($20,000 commission – $8,400 allocated to the equipment) over the expected five-year term ($2,320 per year). This would result in ABC recognizing $2,320 in amortized sales expense in each of Years 1 and 2, but recognizing $3,120 of expense in each of Years 3-5 ($2,320 + $800 = $3,120).

Approach 2 – Relative margins

ABC elects to allocate the capitalized contract cost asset on a relative margin basis. Consequently, ABC aggregates the initial commission of $20,000 and the expected renewal commissions of $2,400 ($800 for each of the three anticipated annual renewals) and allocates them on the following basis to the equipment and the expected maintenance.

Good or service	Relative margin	% Allocation	Allocation of expected commissions
Equipment	$ 40,000	28.5%	$ 6,400
2-year initial maintenance	40,000	28.5%	6,400
Year 3 renewal	20,000	14.3%	3,200
Year 4 renewal	20,000	14.3%	3,200
Year 5 renewal	20,000	14.3%	3,200
	$140,000	**100.0%**	**$22,400**

At contract inception, ABC becomes obligated to pay a commission of $20,000. Because control of the equipment transfers to Customer at contract inception, ABC expenses $6,400 of the $20,000 commission cost, and recognizes a contract acquisition cost asset of $13,600 ($20,000 commission – $6,400 allocated to the equipment). ABC amortizes $6,400 of that contract acquisition cost asset to sales expense over the two-year initial maintenance term, leaving a remaining balance of $7,200 at the end of Year 2. At the beginning of each of Years 3 to 5, ABC adds to the contract acquisition cost asset by $800 (for each renewal commission), while amortizing $3,200 ($7,200/3 + $800) of that contract acquisition cost asset to sales expense in each of those years.

Approach 2(a) – Consistent with Approach 1(a), a variation of the accounting outlined in the preceding paragraph would be for ABC to amortize the initial contract acquisition cost asset of $13,600 over the expected five-year term ($2,720 per year). This would result in ABC recognizing $2,720 in amortized sales expense in each of Years 1 and 2, but recognizing $3,520 of such expense in each of Years 3–5 (i.e. $2,720 + the $800 commission specific to that year's maintenance renewal).

Question 12.8.40

Can contract cost assets be allocated solely to a good or service that is not distinct?

Interpretive response: No. We do not believe an entity can allocate a contract cost asset to a good or service (or bundle of goods and services) if that good or service (or bundle) is not distinct.

If a good or service (or bundle) is not distinct from the other goods or services in the contract, the economic benefits and costs associated with that good or service are not separately identifiable from the economic benefits and costs of the other goods and services from which it is not distinct. Consequently, amortization of a contract cost asset should be on a systematic basis based on the expected attribution of the distinct goods or services.

The distinct goods or services may include a bundle of goods or services, or distinct goods or services that are part of a single performance obligation under the series guidance in paragraph 606-10-25-14(b). If the distinct good or service to which the contract cost asset (or portion thereof) relates is transferred to the customer over time, the entity needs to use a single measure of progress to amortize the contract cost asset that is consistent with its single measure of progress used to recognize revenue on the related performance obligation.

Question 12.8.50

Is a contract cost asset amortized consistent with the expected pattern of transfer of the related good or service or the expected pattern of revenue recognition?

Interpretive response: The related goods or services. Subtopic 340-40 requires a contract cost asset to be amortized on a systematic basis consistent with the transfer to the customer of the goods or services to which the asset relates. [340-40-35-1]

The expected pattern of *revenue recognition* for a good or service may differ from the pattern of *transfer* to the customer of that good or service if the consideration to which the entity expects to be entitled is variable. The pattern of revenue recognized does not affect the amortization of a contract cost asset. For example, assume an entity transfers a distinct license of functional IP in exchange for a sales- or usage-based royalty. The *portion* of contract cost asset that relates to the distinct license should be fully expensed on transfer of control of that license without regard to when the entity expects to be able to recognize expected sales or usage-based royalties.

However, a portion of the total contract cost asset in this example may relate to other promised goods or services (e.g. when-and-if-available upgrades), including goods or services that will be provided under one or more specifically anticipated contracts (e.g. expected renewals). Unless a single measure of progress approach is used for amortization of the contract cost asset (see Question 12.8.10), only the portion of the contract cost asset that relates to the distinct license is expensed on transfer of control of that license; the remainder is amortized consistent with the transfer of the other goods or services to which it relates.

Question 12.8.60

Is the amortization period and pattern for contract cost assets and the revenue recognition pattern for nonrefundable upfront fees symmetrical?

Interpretive response: No. The amortization period and the amortization pattern for contract cost assets and the revenue recognition pattern for nonrefundable upfront fees are not symmetrical under Subtopic 340-40 and Topic 606.

The revenue recognition pattern for nonrefundable upfront fees is based on the existing contract plus any renewals for which the initial payment of the upfront fee provides a material right to the customer. Therefore, the recognition period and recognition pattern for these items may not align, even if the contract cost asset and nonrefundable upfront fees are related to the same contract. [606-10-55-50 – 55-53]

12.9 Impairment of contract cost assets

Excerpt from ASC 340-40

> Amortization and Impairment

35-3 An entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 exceeds:

a. The amount of consideration that the entity expects to receive in the future and that the entity has received but has not recognized as revenue, in exchange for the goods or services to which the asset relates ("the consideration"), less
b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses (see paragraphs 340-40-25-2 and 340-40-25-7).

35-4 For the purposes of applying paragraph 340-40-35-3 to determine the consideration, an entity shall use the principles for determining the transaction price (except for the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk. When determining the consideration for the purposes of paragraph 340-40-35-3, an entity also shall consider expected contract renewals and extensions (with the same customer).

35-5 Before an entity recognizes an impairment loss for an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5, the entity shall recognize any impairment loss for assets related to the contract that are recognized in accordance with another Topic other than Topic 340 on other assets and deferred costs, Topic 350 on goodwill and other intangible assets, or Topic 360 on property, plant, and equipment (for example, Topic 330 on inventory and Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed). After applying the impairment test in paragraph 340-40-35-3, an entity shall include the resulting carrying amount of the asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 in the carrying amount of the asset group or reporting unit to which it belongs for the purpose of applying the guidance in Topics 360 and 350.

35-6 An entity shall not recognize a reversal of an impairment loss previously recognized.

An entity recognizes an impairment loss to the extent that the carrying amount of the asset exceeds the recoverable amount. The recoverable amount is defined as the: [340-40-35-3]

— amount of consideration expected to be received in the future and that the entity has received but has not recognized as revenue (i.e. a contract liability), in exchange for the goods or services to which the asset relates, less

— costs that relate directly to providing those goods or services and that have not been recognized as expenses.

When assessing a contract cost asset for impairment: [340-40-35-4]

— The amount of consideration included in the impairment test is based on an estimate of the amounts that the entity expects to receive, which includes amounts the entity expects to receive under specifically anticipated future contracts – e.g. renewals of consulting services. To estimate this amount, the entity uses the principles for determining the transaction price, with two key differences:

  – it does *not* constrain any estimate of variable consideration – i.e. it includes its estimate of variable consideration (determined in accordance with paragraphs 606-10-32-5 to 35-9), regardless of whether including this amount could result in a significant revenue reversal if it is adjusted; and

  – it adjusts the amount to reflect the effects of the customer's credit risk.

— The consideration the entity expects to receive includes both the amount of consideration that it has already received, but has not recognized as revenue, and the amount that it expects to receive in exchange for the goods or services to which the contract cost asset relates less the costs that relate directly to providing those goods or services that have not been recognized as expense.

The specific contract cost asset impairment guidance in Subtopic 340-40 is applied *after* existing asset-specific impairment guidance, such as Topic 330 regarding inventory, but *before* applying the impairment guidance applicable to long-lived identifiable assets and goodwill. [340-40-35-5]

Sequencing of impairment testing is as follows.

1	Asset-specific working capital impairment guidance (e.g. Topic 330)
2	Contract cost asset (e.g. Subtopic 340-40)
3	Long-lived identifiable assets and goodwill (Topics 350 and 360)

Example 12.9.10
Impairment of a contract cost asset

Transaction Processor enters into a contract to provide Customer with transaction processing for three years in exchange for $0.02 per transaction. An estimated 10 million transactions are expected to occur annually. Therefore, Transaction Processor expects to receive $200,000 per year.

Transaction Processor incurs $20,000 in incremental costs to obtain the contract and $100,000 in costs for customer-specific set-up activities to fulfill the contract. The $120,000 of costs are capitalized and are being amortized over the three-year period in which Customer will benefit.

Customer's transaction volume declines significantly and Customer approaches Transaction Processor at the end of Year 2 to renegotiate the fee, because of significant economic hardships faced by Customer. Transaction Processor agrees to reduce the fee to $0.01 per transaction for the final year. Transaction volume for Year 3 is estimated to be 3 million. Therefore, the remaining transaction price is estimated to be $30,000.

Transaction Processor determines that there are no impairment losses related to the contract that are recognized under other asset-specific impairment guidance (i.e. other than goodwill; intangible assets; property, plant and equipment). Transaction Processor then evaluates the unamortized contract cost asset of $40,000 ($120,000 less $80,000 amortized costs) for impairment and recognizes an impairment loss of $20,000. This represents the difference between the unconstrained variable consideration that it expects to receive less the costs that relate directly to providing those services ($30,000 consideration less $10,000 of costs) and the $40,000 unamortized contract cost asset.

Question 12.9.10
Are sales- and usage-based royalties considered when testing a contract cost asset for impairment?

Interpretive response: Yes, the 'remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates' includes the entity's *unconstrained* estimate of all variable consideration, including sales- and usage-based royalties, to which the entity expects to be entitled, reduced for any amounts it does not expect to receive (collect) from the customer. For a discussion of an entity's unconstrained estimate of variable consideration, see section 5.3.

When a license is not distinct or is not transferred at the beginning of the contract, and a significant portion of the contract fees are in the form of a sales- or usage-based royalty, an entity estimates expected royalties to assess impairment of a contract cost asset – even though it might not have to estimate those amounts for revenue recognition or disclosure purposes. Another example in which an entity may not estimate the transaction price for recognition or disclosure purposes is when it applies the as-invoiced recognition practical expedient to recognize revenue (see section 7.4.50).

Question 12.9.20

Are the remaining estimated contract costs used in the impairment assessment discounted?

Interpretive response: Possibly, in some cases. For certain long-term contracts that have a significant financing component, the estimated transaction price may be discounted (see section 5.5).

Topic 606 does not prescribe whether to discount the estimated remaining costs of directly providing those goods or services when performing the impairment test. Even though the contract cost asset is not presented on a discounted basis in the entity's balance sheet, an entity's decision about whether to discount estimated remaining costs of providing the goods or services should be consistent with the measurement of the remaining transaction price.

Question 12.9.30

How often does an entity assess its contract cost assets for impairment?

Interpretive response: Subtopic 340-40 does not specify how often an entity should assess its contract cost assets for impairment. We believe, similar to assessing impairment of long-lived assets under Section 360-10-35, entities should assess the contract cost assets for impairment whenever events or changes in circumstances indicate that the carrying amount of a contract cost asset may not be recoverable.

Such events or changes in circumstances may include the following:

— contract modifications, including changes in price, contract terminations, and scope changes;

— changes in expectations as to whether customers will renew/extend existing contracts, or specific goods or services in a contract, to which contract cost assets relate;

— changes in estimates of expected costs to fulfill one or more performance obligations in a contract; and/or

— changes in estimates of the amount of consideration that the entity expects to receive from the customer (e.g. collectibility).

12.10 Deferred and other costs

As discussed in section 12.2, the guidance in Subtopic 340-40 only applies when the costs are not in the scope of other Topics or Subtopics. This section discusses other costs that may be related to customer contracts but not in the scope of Subtopic 340-40.

Excerpt from ASC 340-10

05-1 The Other Assets and Deferred Costs Topic includes the following Subtopics:

a. Overall
b. Insurance Contracts That Do Not Transfer Insurance Risk.
c. Contracts with Customers

05-2 The Overall Subtopic addresses the accounting and reporting for certain deferred costs and prepaid expenses. The guidance in this Subtopic is limited to a discussion of the nature of prepaid expenses and preproduction costs related to long-term supply arrangements. The specific guidance for many other costs that have been deferred is included in various other financial, broad, and industry Topics. References to certain, but not all, of the guidance in other Topics are included in this Subtopic.

> Deferred Costs Addressed in this Subtopic

05-3 The following provides background regarding certain items included in this Subtopic.

• > Nature of Prepaid Expenses

05-4 Prepaid expenses are a category of assets that are typically used up or expire within the normal operating cycle of an entity. The term derives from the fact that they are paid in advance of their use or consumption.

05-5 Prepaid expenses include items such as the following:

a. Insurance
b. Interest
c. Rents
d. Taxes
e. Unused royalties
f. Current paid advertising service not yet received
g. Operating supplies.

• > Preproduction Costs Related to Long-Term Supply Arrangements

05-6 Manufacturers often incur preproduction costs related to products they will supply to their customers under long-term supply arrangements. For example, the manufacturer may incur costs to perform certain services related to the design and development of the products it will sell under long-term supply arrangements and may incur costs to design and develop molds, dies, and other tools that will be used in producing those products. While practice varies from industry to industry, the supplier may be contractually guaranteed reimbursement of design and development costs, implicitly guaranteed reimbursement of design and development costs through the pricing of the product or other means, or not guaranteed reimbursement of the design and development costs incurred under the long-term supply arrangement.

> Overall Guidance

15-1 The Scope Section of the Overall Subtopic establishes the pervasive scope for all Subtopics of the Other Assets and Deferred Costs Topic. Unless explicitly addressed within specific Subtopics, the following scope guidance applies to all Subtopics of the Deferred Costs and Other Assets Topic.

> Entities

15-2 The guidance in the Other Assets and Deferred Costs Topic applies to all entities.

• > Preproduction Costs Related to Long-Term Supply Arrangements

25-1 Design and development costs for products to be sold under long-term supply arrangements shall be expensed as incurred. Design and development costs for molds, dies, and other tools that a supplier will own and that will be used in producing the products under a long-term supply arrangement shall be capitalized as part of the molds, dies and other tools (subject to an impairment assessment under the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10) unless the design and development is for molds, dies, and other tools involving new technology, in which case, the costs shall be expensed as incurred in accordance with Subtopic 730-10.

25-2 Design and development costs for molds, dies, and other tools that a supplier will not own and that will be used in producing the products under the long-term supply arrangement shall be capitalized (subject to an impairment assessment under the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10) if the supply arrangement provides the supplier the noncancelable right (as long as the supplier is performing under the terms of the supply arrangement) to use the molds, dies, and other tools during the supply arrangement. Otherwise, those design and development costs shall be expensed as incurred, including costs incurred prior to the supplier's receiving the noncancelable right to use the molds, dies, and other tools during the supply arrangement.

25-3 If a contractual guarantee for reimbursement exists for design and development costs that otherwise would be expensed based on the guidance in this Section, those costs shall be recognized as an asset as incurred. For purposes of this Subtopic, contractual guarantee means a legally enforceable agreement in which the amount of reimbursement can be objectively measured and verified.

25-4 See Examples 1 through 4 (paragraphs 340-10-55-2 through 55-5) for preproduction costs related to long-term supply arrangements.

• • > Example 1— Entity Agrees to Reimburse Supplier up to a Maximum Amount

55-2 This Example illustrates the recognition guidance in paragraphs 340-10-25-1 through 25-3. It is assumed that the design and development costs would be expensed under that guidance absent a reimbursement arrangement. It is also assumed that the supply arrangement is legally enforceable. An entity enters into a long-term arrangement with a supplier in which the entity agrees to reimburse the supplier for preproduction design and development costs incurred under the arrangement, up to a maximum reimbursement of $1,000,000. Under this arrangement, the amount of reimbursement for design and development costs can be objectively measured and verified. The supplier shall recognize the design and development costs as an asset as costs are incurred, up to a maximum of $1,000,000.

• • > Example 2— Entity Agrees to Pay Supplier Specified Amount per Part

55-3 This Example illustrates the recognition guidance in paragraphs 340-10-25-1 through 25-3. It is assumed that the design and development costs would be expensed under that guidance absent a reimbursement arrangement. It is also assumed that the supply arrangement is legally enforceable. An entity enters into a long-term arrangement with a supplier in which the entity agrees to pay the supplier $55 per part for the first 200,000 parts produced and $50 for every part thereafter. No agreement exists concerning reimbursement of the supplier's design and development costs if fewer than 200,000 parts are produced under the arrangement. Under this arrangement, the amount of reimbursement for design and development costs cannot be objectively measured and verified. The supplier shall expense the preproduction design and development costs as incurred.

• • > Example 3— Entity Agrees to Pay Supplier Specified Amount per Part Plus Reimbursement if Minimum Amount Not Produced

55-4 This Example illustrates the recognition guidance in paragraphs 340-10-25-1 through 25-3. It is assumed that the design and development costs would be expensed under that guidance absent a reimbursement arrangement. It is also assumed that the supply arrangement is legally enforceable. An entity enters into a long-term arrangement with a supplier in which the entity agrees to pay the supplier $55 per part for the first 200,000 parts produced and $50 for every part thereafter. The arrangement provides that if fewer than 200,000 parts are produced, the supplier will be reimbursed for design and development costs incurred under the arrangement, up to a maximum reimbursement of $1,000,000 reduced by $5 per part for each part produced under the supply arrangement. For example, if 190,000 parts are produced under the supply arrangement, in addition to the $55 per part received for the parts produced, the supplier would be reimbursed for design and development costs incurred under the arrangement, up to a maximum of $50,000 [$1,000,000 - ($5 × 190,000)]. Under this agreement, the amount of reimbursement for design and development costs can be objectively measured and verified. The supplier shall recognize the design and development costs as an asset as costs are incurred, up to a maximum of $1,000,000.

• • > Example 4 — Entity Agrees to Pay Supplier Specified Amount per Part Plus Specified Amount per Part Not Produced if Minimum Not Produced

55-5 This Example illustrates the recognition guidance in paragraphs 340-10-25-1 through 25-3. It is assumed that the design and development costs would be expensed under that guidance absent a reimbursement arrangement. It is also assumed that the supply arrangement is legally enforceable. An entity enters into a long-term arrangement with a supplier in which the entity agrees to pay the supplier $52.50 per part. The arrangement requires that a minimum of 400,000 parts be produced. If fewer than 400,000 parts are produced under the arrangement, the supplier will receive a payment of $52.50 per part not produced under the arrangement, up to a maximum of 400,000 parts. Under this arrangement, the amount of reimbursement for design and development costs cannot be objectively measured and verified. The supplier shall expense the design and development costs as incurred.

Subtopic 340-10 contains guidance specific to:

— prepaid expenses (prepayments); and
— pre-production costs related to long-term supply arrangements.

Pre-production costs – background

Suppliers of specialized products (such as automotive suppliers) may agree to incur pre-production costs related to the design and development of products to be sold under long-term supply arrangements or costs to design and develop molds, dies, or other specialized tools (tooling assets) that will be used for the production of customized products for supply to customers.

Some long-term supply arrangements require a supplier to undertake efforts in upfront engineering and design to create new technology or adapt existing technology or product design to the needs of the customer. Further, these pre-production activities are often a prerequisite for delivering goods or services under a production contract.

Tooling assets will often be unique to a customer's needs and cannot be used by or for supply of products ordered by any other customer. The need and use of such tooling assets will generally be agreed between the parties in a tooling arrangement either annexed to or executed separately from the long-term supply contract.

These long-term supply arrangements take various forms and often do not contractually commit the customer to purchase any minimum volume of parts ultimately manufactured by the supplier.

Some industries use terms such as nonrecurring engineering (NRE) instead of pre-production design and development activities. The remainder of this section uses the term pre-production design and development activities.

See Question 4.2.80 to determine if pre-production activities are a promised good or service or administrative task.

Question 12.10.10

When does the prepayment guidance in Subtopic 340-10 apply?

Interpretive response: If a cost is in the scope of a Topic that requires it to be expensed as incurred, the entity nonetheless has to defer the cost if it is a prepayment. A prepayment is a cost incurred in advance for items that are typically consumed or will expire during the entity's operating cycle. A prepayment is deferred and expensed as consumed by the entity. [340-10-05-4]

The prepayment guidance can apply to any type of costs – pre-production costs under long-term supply arrangements (Subtopic 340-10), contract costs (Subtopic 340-40) and costs under any other Topics. For example, a prepaid commission may be recognized as a prepaid asset under Subtopic 340-10 when an entity pays cash before it incurs the commission liability. At the time the commission liability is incurred, the entity evaluates whether the prepaid asset is deferred as a contract cost asset or expensed as incurred under 340-40.

Other examples of prepaid expenses are insurance, interest, rents, taxes, unused royalties, current paid advertising service not yet received and operating supplies. [340-10-05-5]

Question 12.10.20

Can an entity analogize to Subtopic 340-10 to account for costs similar to pre-production costs?

Interpretive response: No. The guidance on pre-production costs related to long-term supply contracts in Subtopic 340-10 was not superseded by Subtopic 340-40. Therefore, if pre-production costs (e.g. tooling) are clearly in scope of Subtopic 340-10, they are accounted for under Subtopic 340-10. In contrast, if pre-production costs are not in the scope of Subtopic 340-10, an entity assesses whether the costs are in scope of other guidance and if not, the entity does not analogize to Subtopic 340-10 but rather applies Subtopic 340-40 to costs to obtain or fulfill a customer contract.

Question 12.10.30

Are pre-production costs related to long-term supply arrangements in the scope of Subtopic 340-40?

Interpretive response: It depends. An entity first evaluates whether the contract is in the scope of Topic 606.

Contract is in scope of Topic 606

The supplier next evaluates whether the pre-production activities are either performance obligations or a part of a bundled performance obligation, and if so it accounts for them under Topic 606 accordingly. See Question 4.2.80 for further discussion of identifying these types of activities as promised goods or services. For example, if the activities are a performance obligation satisfied over time, the costs may be expensed as incurred if the entity uses a cost-to-cost method to measure progress toward completion of the performance obligation.

In contrast, if the pre-production activities are considered set-up activities or administrative tasks (i.e. not a performance obligation), the entity follows Subtopic 340-10 (not Subtopic 340-40) when the activities are related to a long-term supply contract to determine if the costs are capitalized or expensed. The accounting for any reimbursement would follow Topic 606.

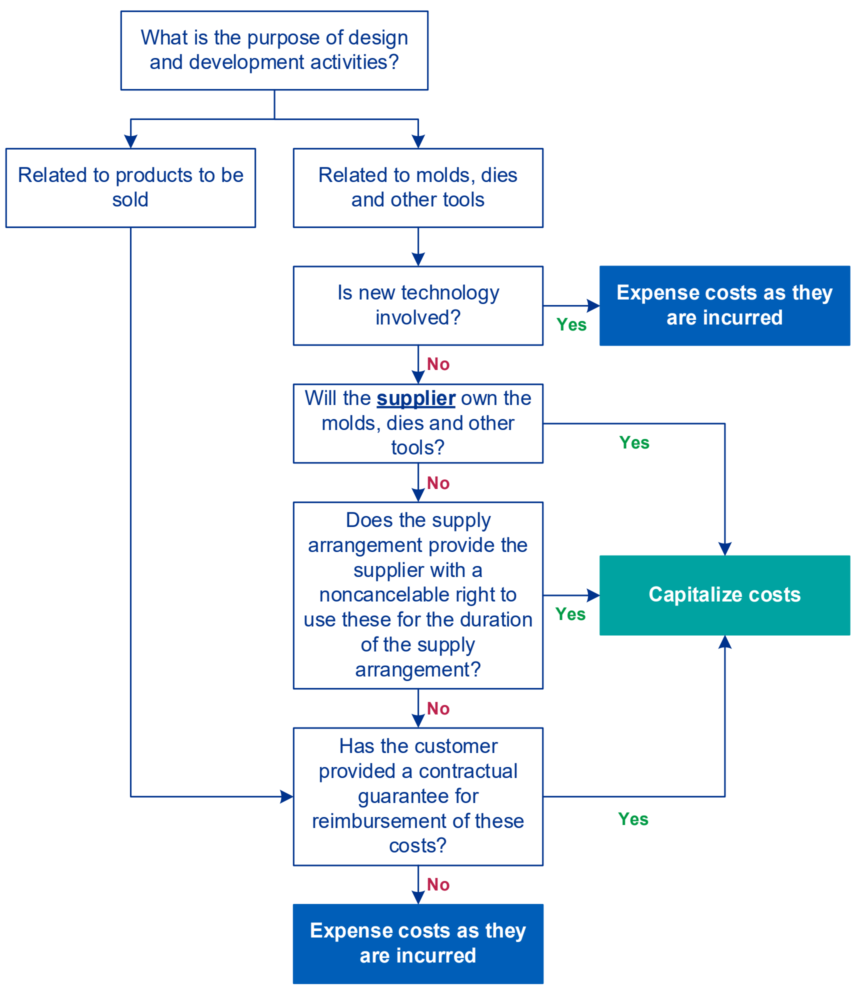
Contract is not in scope of Topic 606

If the pre-production activities are not considered part of a contract with a customer in the scope of Topic 606, then the supplier evaluates what other guidance applies to the pre-production activities and how to account for the costs, including Subtopic 340-10 on pre-production costs related to long-term supply contracts.

Question 12.10.40

How are design and development costs under a long-term supply arrangement accounted for under Subtopic 340-10?

Interpretive response: A supplier expenses pre-production design and development costs related to long-term supply arrangements as incurred unless certain conditions are met, as depicted in the following decision tree. [340-10-25-1]



Question 12.10.50

How are design and development costs for tooling that will be used to manufacture products under a long-term supply arrangement accounted for under Subtopic 340-10?

Background: Tooling arrangements vary widely, but often require the supplier to design and develop the tooling assets. They also often include clauses that either:

— require the customer to make lump-sum payments to the supplier for tooling, separate from the price for the products to be supplied; or

— provide a cost recovery mechanism for the supplier-developed tooling assets, which could be implicit or stated explicitly as a per unit amount in the price of the products to be sold to the customer. There is only a contractual guarantee for the reimbursement of the costs if the price per unit is explicit and the customer is required to pay the remaining unreimbursed cost if minimum purchases are not made.

When suppliers are incurring costs to design and develop tooling, a key accounting issue is whether the costs are to be capitalized or expensed as incurred.

Interpretive response: It depends. A supplier expenses design and development costs for tooling as incurred unless certain conditions are met, as discussed below and as depicted in the decision tree in Question 12.10.40.

Design and development costs incurred by a supplier to produce tooling assets that it will use to manufacture products under a long-term supply arrangement are expensed as R&D costs under Topic 730 if those assets represent new technology. [340-10-25-1, 730-10-25-1, 730-10-55-1(g)]

When a supply arrangement contains a legally enforceable contractual guarantee for the customer to reimburse the costs to design and develop tooling assets that the supplier will **not** own, the supplier capitalizes the costs incurred up to the amount guaranteed. This occurs only if the amount of reimbursement can be objectively measured and verified. [340-10-25-3]

If neither of the above situations apply, a supplier capitalizes design and development costs for tooling assets if:

— it will own the tooling assets; or
— it has a noncancelable right to use the tooling assets that it does not own for the duration of the arrangement.

13. Loss contracts

Detailed contents

13.1 How the standard works

Neither the revenue standard nor other US GAAP contains comprehensive, general guidance on the accounting for loss contracts (also known as onerous contracts) or on other contract losses. When deliberating the revenue standard, the FASB stated that it was not aware of any pressing practice issues in this area. Therefore, it concluded that the piecemeal guidance in US GAAP should continue to be used for recognizing losses on contracts with customers. Although the specific provisions for loss recognition generally have not changed, amendments were made to align the terminology in the loss recognition guidance with the principles of Topic 606, resulting in some differences in the amount and timing of certain losses.

13.2 Recognizing losses from contracts with customers

The guidance on loss contracts in other US GAAP ('loss contracts guidance') focuses on types of contracts and industry-specific arrangements. This means that an entity accrues losses *only* when a contract is in the scope of other US GAAP that contains requirements for the accrual of a loss on a contract. An entity should not accrue losses on contracts outside the scope of the loss contracts guidance by analogizing to it. As a result, certain entities applying the revenue and cost recognition guidance to a contract in Topic 606 will also need to consider the scope of the loss contracts guidance to determine when recognition of a loss contract is required.

Recognition of revenue and related costs	+	Recognition of losses on contracts
— Apply Topic 606 to a contract with a customer to determine revenue. — Apply relevant guidance (e.g. Topics 330 and 360, Subtopics 340-10 and 340-40) to determine cost.		— Apply other US GAAP based on the type of contract or the entity's industry to determine how to recognize a loss on the contract. — If no other US GAAP applies, do not recognize a loss on the contract.

US GAAP addresses the recognition of losses on the following revenue arrangements.

ASC reference	Losses on …
605-20	Separately priced extended warranty and product maintenance contracts
605-35	Construction- and production-type contracts
985-605	Certain software arrangements
954-440-35-1 – 35-3	Continuing care retirement community contracts
954-450-30-3 – 30-4	Prepaid healthcare services
980-350-35-3	Certain long-term power sales contracts
912-20-45-5	Certain federal government contracts

If a contract with a customer falls in the scope of one of these other US GAAP provisions, the entity applies the relevant guidance to determine whether a loss should be recognized. If a contract is not in the scope of these industry- or transaction-specific requirements, a loss on the contract is not recognized in advance of it actually being incurred.

13.3 Separately priced extended warranties and product maintenance contracts

Excerpt from ASC 605-20

> Transactions

15-2 The guidance in this Subtopic applies to the following service activities and arrangements:

a. Separately priced **extended warranty** and **product maintenance contracts**.

> Separately Priced Extended Warranty and Product Maintenance Contracts

25-6 A loss shall be recognized on extended warranty or product maintenance contracts if the sum of expected costs of providing services under the contracts and any asset recognized for the incremental cost of obtaining a contract exceeds the related unearned revenue (**contract liability**). Extended warranty or product maintenance contracts shall be grouped in a consistent manner to determine if a loss exists. A loss shall be recognized first by charging to expense any recognized asset for the incremental costs of obtaining a **contract**, determined in accordance with the guidance in paragraphs 340-40-25-1 through 25-4 for contracts within the scope of Topic 606 on **revenue** from contracts with **customers**. If the loss is greater than the recognized asset for the incremental costs of obtaining a contract, a liability shall be recognized for the excess.

The loss recognition guidance in Section 605-20-25 applies to:

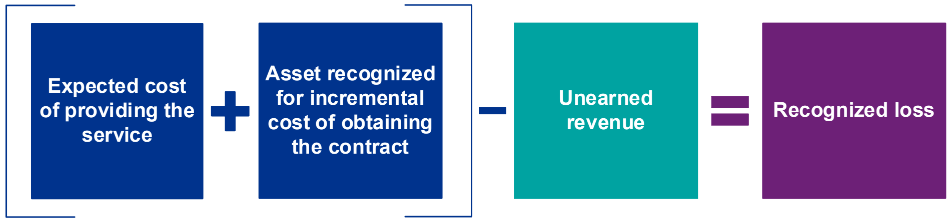
— separately priced contracts for an extended warranty; and

— product maintenance contracts that provide warranty protection or product services, and whose contract price is not included in the original price of the product covered by the warranty or service. [605-20-15-2(a)]

These warranties are service-type warranties and therefore a performance obligation under Topic 606 (see section 4.5). However, not all service-type warranties under Topic 606 are in the scope of the loss recognition guidance in Section 605-20-25; this is because warranties can constitute a separate performance obligation under Topic 606 without being separately priced.

When an entity has a separate performance obligation for a service-type warranty that is not separately priced, the loss recognition guidance in Section 605-20-25 does not apply. For example, an entity does not apply this guidance if it promises to provide a customer with a service-type warranty but does not provide the customer with the option to purchase that service for a stated amount separate from the product.

Under this loss recognition guidance, the recognized loss on an extended warranty is computed as follows.



Unearned revenue in this computation could include both fixed and variable consideration and is not limited to the recorded contract liability. Losses are first charged directly to operating expense by writing off any assets relating to the incremental costs of obtaining a contract. Any additional losses are accrued as a liability. [605-20-25-6]

Example 13.3.10

Loss on separately priced contract for an extended warranty

Manufacturer sells a separately priced extended warranty for $1,000 on January 1, Year 1. Manufacturer incurs a commission to the sales personnel of $20. The extended warranty is for five years and is determined to be a single performance obligation.

Manufacturer determines that the appropriate measure of progress for this stand-ready obligation is time elapsed and will record revenue on a straight-line basis. Manufacturer expects the total cost of providing the service to be $500.

At December 31, Year 1, Manufacturer observes that similar services are costing more than originally forecasted. Manufacturer now expects the cumulative cost of providing the service to be $1,200, of which $300 has been incurred in the current year.

Manufacturer records the following journal entries.

	Debit	*Credit*
Cash	1,000	
Other asset (capitalized commission)	20	
Contract liability		1,000
Commission payable		20
To record sale of warranty on January 1, Year 1.		

	Debit	Credit
Cost of sales	300	
Contract liability	200	
Commission expense	4	
Cash/Accounts payable		300
Service revenue		200
Other asset (capitalized commission)		4
To record provision of warranty service in Year 1.		

Before recognizing a loss, Manufacturer has the following account balances.

Account	*Debit/(Credit)*
Other asset (capitalized commission)	$ 16
Contract liability	$(800)
Service revenue	$(200)
Cost of sales	$ 300

Manufacturer recognizes that the expected costs of providing the service ($1,200) will be greater than forecasted ($500) and that change in forecasted cost will result in a loss on the contract. As a result, Manufacturer records the following journal entry at the end of Year 1.

	Debit	Credit
Loss on contract	100[1]	
Commission expense	16[2]	
Other asset (capitalized commission)		16
Contract loss accrual		100
To record loss on contract.		

Notes:

1. Calculated as follows: expected service cost ($1,200 – $300 incurred) + asset recognized for incremental cost to obtain contract ($20 – $4 amortized) – unearned revenue ($1,000 – $200 recognized in Year 1) less the capitalized commission of $16.
2. Loss first charged against remaining capitalized commission before recognizing a liability.

If Manufacturer did not separately price and sell the extended warranty and only sold the service bundled with the related product, no loss would be recognized for the contract. This is because the contract would not be in the scope of the loss contract guidance of Subtopic 605-20.

In contrast, if Manufacturer sells a separately priced extended warranty but sold the extended warranty with the related product at a 10% discount on the bundled price, it would determine the Topic 606 revenue allocated to that warranty based on the warranty's stand-alone selling price to compute the loss. This would result in an allocated transaction price of $900 to the service warranty under Topic 606, despite its separately stated price of $1,000, and would result in an additional $100 of loss.

13.4 Construction- and production-type contracts

Excerpts from ASC 605-35

> Entities

15-1 The guidance in this Subtopic applies to all **contractors**.

> Types of Contracts

15-2 The guidance in this Subtopic applies to:

a. The performance of **contracts** for which specifications are provided by the **customer** for the construction of facilities or the production of goods or the provision of related services. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design, engineering, procurement, and construction management (see paragraph 605-35-15-3 for examples). Contracts covered by this Subtopic are binding agreements between buyers and sellers in which the seller agrees, for compensation, to perform a service to the buyer's specifications. Specifications imposed on the buyer by a third party (for example, a government or regulatory agency or a financial institution) or by conditions in the marketplace are deemed to be buyer's specifications.

• > Contracts Covered

15-3 Contracts covered by this Subtopic include, but are not limited to, the following:

a. Contracts in the construction industry, such as those of general building, heavy earth moving, dredging, demolition, design-build contractors, and specialty contractors (for example, mechanical, electrical, or paving). In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, this Subtopic also would be applicable in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant.
b. Contracts to design and build ships and transport vessels.
c. Contracts to design, develop, manufacture, or modify complex aerospace or electronic equipment to a buyer's specification or to provide services related to the performance of such contracts.
d. Contracts for construction consulting service, such as under agency contracts or construction management agreements.
e. Contracts for services performed by architects, engineers, or architectural or engineering design firms.
f. Arrangements to deliver software or a software system, either alone or together with other products or services, requiring significant production,

modification, or customization of software.

• > Types of Contracts Not Covered

15-6 Contracts not covered by this Subtopic include, but are not limited to, the following:

a. Sales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels, if such sales are normally recognized as the sale of goods and if their costs are accounted for in accordance with generally accepted principles of inventory costing.
b. Sales or supply contracts to provide goods from inventory or from homogeneous continuing production over a period of time.
c. Contracts included in a program and accounted for under the program method of accounting. For accounting purposes, a program consists of a specified number of units of a basic product expected to be produced over a long period in a continuing production effort under a series of existing and anticipated contracts.
d. Service contracts of health clubs, correspondence schools, and similar consumer-oriented entities that provide their services to their clients over an extended period.
e. Magazine subscriptions.
f. Contracts of not-for-profit entities (NFPs) to provide benefits to their members over a period of time in return for membership dues.
g. Contracts for which other Topics in the Codification provide special methods of accounting, such as leases.
h. Cost-plus-fixed-fee government contracts, which are discussed in Topic 912, other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered.
i. Federal government contracts within the scope of that Topic.
j. Service transactions between a seller and a purchaser in which, for a mutually agreed price, the seller performs, agrees to perform at a later date, or agrees to maintain readiness to perform an act or acts, including permitting others to use entity resources that do not alone produce a tangible commodity or product as the principal intended result (for example, services, not plans, are usually the principal intended result in a transaction between an architect and the customer of an architect).

> Provisions for Losses on Contracts

25-45 For a contract on which a loss is anticipated, an entity shall recognize the entire anticipated loss as soon as the loss becomes evident.

25-46 When the current estimates of the total amount of consideration that an entity expects to receive in exchange for transferring promised goods or services to the **customer**, determined in accordance with Topic 606, and contract cost indicate a loss, a provision for the entire loss on the contract shall be made. Provisions for losses shall be made in the period in which they become evident.

25-46A For the purpose of determining the amount that an entity expects to receive in accordance with paragraph 605-35-25-46, the entity shall use the principles for determining the transaction price in paragraphs 606-10-32-2 through 32-27 (except for the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration) and allocating the transaction price in paragraphs 606-10-32-28 through 32-41. In addition, the entity shall adjust that amount to reflect the effects of the customer's credit risk.

25-47 If a group of contracts are combined based on the guidance in paragraph 606-10-25-9, they shall be treated as a unit in determining the necessity for a provision for a loss. If contracts are not combined, the loss is determined at the contract level (see paragraph 605-35-25-45). As an accounting policy election, **performance obligations** identified in accordance with paragraphs 606-10-25-14 through 25-22 may be considered separately in determining the need for a provision for a loss. That is, an entity can elect to determine provisions for losses at either the contract level (including contracts that are combined in accordance with the guidance in paragraph 606-10-25-9) or the performance obligation level. An entity shall apply this accounting policy election in the same manner for similar types of contracts.

> Provisions for Anticipated Losses on Contracts

45-1 The provision for loss arises because estimated cost for the contract exceeds estimated revenue. Consequently, the provision for loss shall be accounted for in the income statement as an additional contract cost rather than as a reduction of contract revenue, which is a function of contract price, not cost. Unless the provision is material in amount or unusual or infrequent in nature, the provision shall be included in contract cost and shall not be shown separately in the income statement. If it is shown separately, it shall be shown as a component of the cost included in the computation of gross profit.

The loss recognition guidance for construction- and production-type contracts within Subtopic 605-35 applies to contracts for which the customer provides specifications for the construction of facilities, the production of goods or the provision of related services. If a contract with a customer is a construction- or production-type contract within the scope of Subtopic 605-35, any loss resulting from the contract after application of Topic 606 and Subtopic 340-40 is accounted for under Section 605-35-45. All of the other provisions in Subtopic 605-35 were superseded by Topic 606.

13.4.10 Scope of Subtopic 605-35

Subtopic 605-35 applies only to entities that meet the definition of a contractor. A contractor is defined as "a person or entity that enters into a contract to construct facilities, produce goods, or render services to the specifications of a buyer either as a general or prime contractor, as a subcontractor to a general contractor, or as a construction manager."

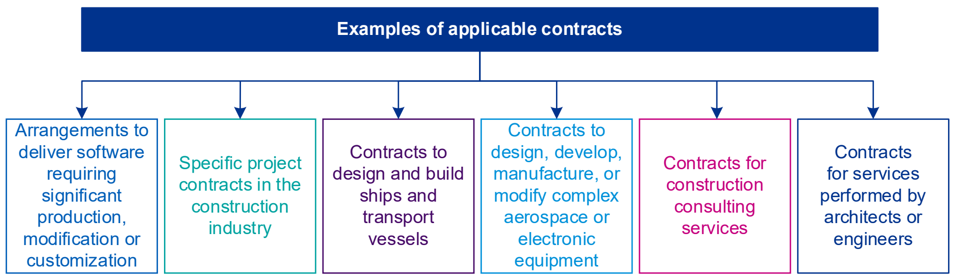
Subtopic 605-35 applies to:

— contracts for construction of facilities or the production of goods;

— contracts for the provision of related services; and

— separate contracts to provide services essential to the construction or production of tangible property, such as design, engineering, procurement and construction management. [605-35-15-1, 605 Glossary]

The following are examples of contracts within the Subtopic's scope. [605-35-15-3]



There are a number of contracts that are not within the scope of Subtopic 605-35. Of note is the exclusion for sales of goods: "sales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels, if such sales are normally recognized as the sale of goods and if their costs are accounted for in accordance with generally accepted principles of inventory costing." [605-35-15-6]

Some arrangements falling within this scope exclusion are accounted for as over-time performance obligations under Topic 606. Therefore, even though over-time performance obligations have characteristics of construction- or production-type contracts in that they too are performed over time, not all over-time performance obligations are covered by the loss recognition guidance in Subtopic 605-35.

13.4.20 Loss recognition provisions

A loss is recognized when the current estimate of the consideration that an entity expects to receive is less than the current estimate of total costs. Subtopic 605-35 allows an entity to make an accounting policy election to identify the unit of account for the loss provision as either at a contract level or at a performance obligation level. This accounting policy election, once made, is applied consistently to similar types of contracts. If an entity uses the contract level for the loss provision, it also combines a group of contracts if they are combined for the purpose of applying Topic 606 (see section 3.7). [605-35-25-47]

The transaction price for loss contracts in the scope of Subtopic 605-35 is determined under Topic 606. However, the provisions of Topic 606 are modified for these contracts. Specifically, the guidance on constraining estimates of variable consideration is not applied when determining the existence or amount of a contract loss. The loss guidance includes a requirement to consider unconstrained variable consideration as a factor when arriving at the projected loss on a contract. This may require an entity to develop different estimates for its revenue recognition and its loss recognition calculations for the same contract. [605-35-25-46A]

The loss on a contract is reported as an additional contract cost (an operating expense), and not as a reduction of revenue or a non-operating expense. An entity recognizes the entire estimated loss as soon as the loss becomes evident. [605-35-25-46, 45-1]

13.5 Software contracts

Excerpt from ASC 605-35

> Entities

15-1 The guidance in this Subtopic applies to all **contractors**.

• > Types of Contracts

15-3 Contracts covered by this Subtopic include, but are not limited to, the following:

f. Arrangements to deliver software or a software system, either alone or together with other products or services, requiring significant production, modification, or customization of software.

Excerpt from ASC 985-605

• > Determining the Need for a Provision for Loss on a Contract

25-7 If it becomes probable that the amount of the transaction price allocated to an unsatisfied or partially unsatisfied performance obligation in accordance with Topic 606 on revenue from contracts with customers will result in a loss on that performance obligation, the loss shall be recognized pursuant to Topic 450.

For software requiring significant production, modification or customization, a loss is determined by applying the loss recognition guidance in Subtopic 605-35 for construction- and production-type contracts described in section 13.4.

For the loss recognition guidance in Subtopic 605-35 to apply, an entity determines whether a good or service is software that requires significant production, modification or customization. Under Topic 606, if installation services result in significant production, modification or customization of the software, then the services and license may not be distinct in the context of the contract, and therefore the services are combined with the license into a single performance obligation. In that situation, the entity applies the Subtopic 605-35 loss recognition guidance to this single performance obligation which may include other non-distinct services. [605-35-15-3(f)]

In addition to applying the loss recognition provisions in Subtopic 605-35, an entity recognizes a loss pursuant to Topic 450 when it is probable that the amount of the transaction price allocated to an unsatisfied or partially unsatisfied performance obligation will result in a loss on that performance obligation. [985-605-25-7]

13.6 Continuing care retirement community contracts

Excerpt from ASC 954-440

> Continuing Care Retirement Community

35-2 If the advance fees and periodic fees charged are insufficient to meet the costs of providing future services and the use of facilities, the continuing care retirement community shall record a liability based on actuarial assumptions (such as mortality and morbidity rates), on estimates of future costs and revenues, and on the specific continuing care retirement community's historical experience and statistical data. The liability is equal to the amount that is expected to be incurred to provide services and the use of facilities to individuals over their remaining lives under continuing care contracts (including resident-care, dietary, health care, facility, interest, depreciation, and amortization costs) in excess of the related anticipated revenues.

35-3 The liability related to continuing-care contracts shall be the present value of future net cash flows, minus the balance of deferred revenue (**contract liability**) (see Topic 606), plus depreciation of facilities to be charged related to the contracts, plus any unamortized incremental costs of obtaining a contract (see Subtopic 340-40), if applicable. The calculation shall be made by grouping contracts by type, such as all contracts with a limit on annual increases in fees, contracts with unlimited fee increases, and so forth. Cash inflows shall include revenue contractually committed to support the residents and inflows resulting from monthly fees including anticipated increases in accordance with contract terms. This shall include third-party payments, contractually or statutorily committed investment income from services related to continuing care retirement community activities, **contributions** pledged by donors to support continuing care retirement community activities, and the volume of deferred nonrefundable advance fees. Cash outflows shall be composed of operating expenses, including interest expense and excluding selling, and general and administrative expenses. Anticipated cost increases affecting these operating expenses shall be considered in determining cash outflows. The expected inflation rate as well as other factors shall be considered in determining the discount rate. In calculating the liability, the specific continuing care retirement community's historical experience or statistical data relating to the residents' life spans shall be used. The life spans used shall be the same as those used to recognize revenue. For a new continuing care retirement community, either relevant data of similar communities in the area or relevant national industry statistics may be used if they are deemed to be representative.

Subtopic 954-440 provides specific loss guidance for contracts with CCRC residents. Specifically, the obligation to provide future services and the use of facilities to current residents is calculated annually to determine whether a liability is recognized. If the advanced fees and periodic fees charged to a resident are insufficient to meet the costs of providing future services and the use of the facilities, then the CCRC recognizes a liability for the excess of the anticipated costs over the anticipated revenue. This amount is generally recognized as an operating expense in the income statement. [954-440-35-2]

While Subtopic 954-440 prescribes the methodology used to calculate a potential loss on CCRC contracts, certain inputs are subject to guidance in other US GAAP. Subtopic 340-40 is relevant for the incremental costs of obtaining a contract. Further, the expected revenue under the contract and contract liability are determined by applying Topic 606. This includes consideration of whether the receipt of an upfront fee is indicative of a significant financing component in the contract. [954-440-35-3]

13.7 Prepaid healthcare service contracts

Excerpt from ASC 954-450

> Prepaid Health Care Services

30-4 Losses under prepaid health care services contracts shall be recognized when it is probable that expected future health care costs and maintenance costs under a group of existing contracts will exceed anticipated future premiums and stop-loss insurance recoveries on those contracts. To determine the need to recognize a loss, contracts shall be grouped in a manner consistent with the provider's method of establishing premium rates, for example, by community rating practices, geographical area, or statutory requirements, to determine whether a loss has been incurred.

Subtopic 954-450 provides specific guidance on loss provisions for prepaid healthcare service contracts. For purposes of applying this guidance, contracts are grouped consistent with how an entity establishes premium rates. It uses the 'probable' threshold for recognizing losses when future healthcare costs and maintenance costs under a group of existing contracts will exceed anticipated future premiums and stop-loss insurance recoveries on those contracts. These losses are generally recognized as an operating expense in the income statement. [954-450-30-4]

13.8 Long-term power sales contracts

Excerpt from ASC 980-350

> Long-Term Power Sales Contracts

35-3 A long-term power sales contract that is not accounted for as a derivative instrument under Topic 815 shall be periodically reviewed to determine whether it is a loss contract in which the loss shall be recognized immediately.

Under the guidance for long-term power sales contracts in Subtopic 980-350, if a contract is not accounted for as a derivative, then it is periodically reviewed to determine whether it is a loss contract. If it is determined to be a loss contract, then the loss is recognized immediately, generally as an operating expense in the income statement. [980-350-35-3]

13.9 Federal government contracts

Excerpt from ASC 912-20

> Income Statement

45-5 A loss on termination of a contract for default shall either be reported as a separate item in the income statement or disclosed in accordance with paragraph 912-20-50-1.

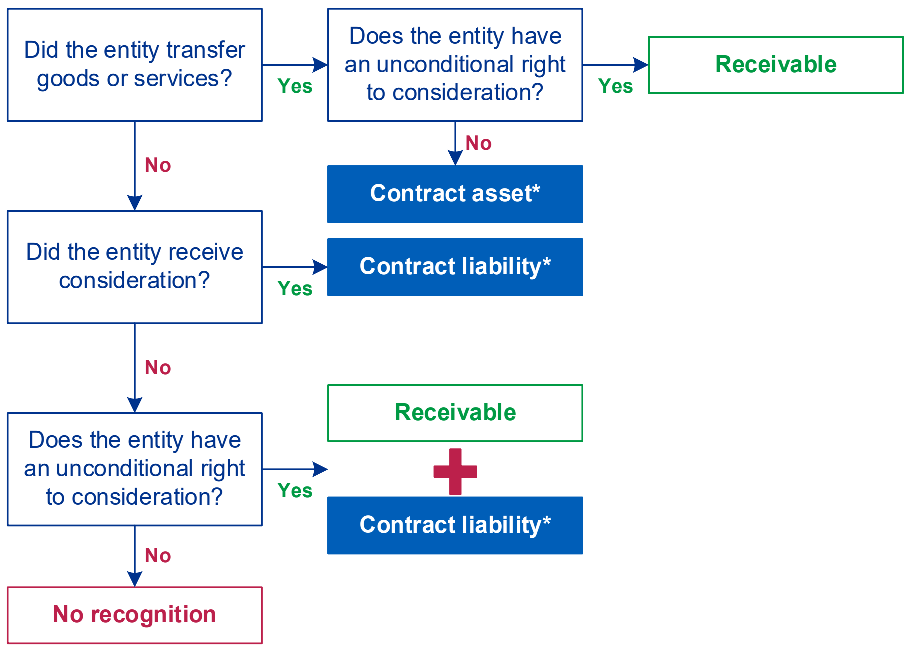
The guidance on federal government contracts in Subtopic 912-20 requires a loss on the termination of a contract for default to be presented as a separate item in the income statement or disclosed under the loss contingency guidance. These losses are generally recognized as an operating expense in the income statement. There is no specific loss recognition guidance for federal government contracts that are fulfilled. Therefore, if such contracts do not fall within the scope of any of the other Subtopics containing loss recognition guidance (e.g. Subtopic 605-35), losses on such contracts are not allowed. [912-20-45-5]

14. Presentation

Detailed contents

14.1 How the standard works

The following decision tree summarizes when an entity presents a contract asset, contract liability and/or a receivable on the balance sheet.



*Contract assets and contract liabilities for a single contract is presented on a net basis at the contract level (see Question 14.2.10)

KPMG Handbook, Financial statement presentation, discusses various presentation requirements included in the codification and SEC regulations. This chapter contains questions and examples specific to presentation requirements in Topic 606.

For disclosure requirements related to contract assets and contract liabilities, see section 15.5.

Excerpt from ASC 606-10

45-1 When either party to a **contract** has performed, an entity shall present the contract in the statement of financial position as a **contract asset** or a **contract liability**, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.

45-2 If a **customer** pays consideration, or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

45-3 If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a **contract asset**, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for impairment in accordance with Topic 310 on receivables. An impairment of a contract asset shall be measured, presented, and disclosed in accordance with Topic 310 (see also paragraph 606-10-50-4(b)).

45-4 A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognize a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with Topic 310. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Topic 310 and the corresponding amount of **revenue** recognized shall be presented as an expense (for example, as an impairment loss).

45-5 This guidance uses the terms *contract asset* and *contract liability* but does not prohibit an entity from using alternative descriptions in the statement of financial position for those items. If an entity uses an alternative description for a contract asset, the entity shall provide sufficient information for a user of the financial statements to distinguish between receivables and contract assets.

Pending Content

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* ¦ Transition Guidance: 326-10-65-1

45-3 … An entity shall assess a contract asset for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).

45-4 … An entity shall account for a receivable in accordance with Topic 310 and Subtopic 326-20. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Subtopic 326-20 and the corresponding amount of **revenue** recognized shall be presented as a credit loss expense.

14.2 Contract assets, contract liabilities and receivables

14.2.10 Overview

Topic 606 requires an entity to present its net position in a contract with a customer on the balance sheet. That position is generally presented as one of the following: [606-10 Glossary, 606-10-45-4]

Term	Meaning
Contract assets	Rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time.
Contract liabilities	Obligations to transfer goods or services to a customer for which the entity has received consideration, or for which an amount of consideration is due from the customer.
Receivables	Unconditional rights to consideration. A right to consideration is unconditional if only the passage of time is required before payment becomes due.

Typically, the trigger for recognizing a contract asset, a contract liability and/or a receivable on the balance sheet is performance by one of the parties. However, an entity recognizes both a receivable and a contract liability prior to performance by either party, if the entity has an unconditional right to payment.

In a simple scenario, an entity transfers control of goods to a customer, at which point the customer owes the consideration to the entity, and the entity recognizes a receivable and revenue. Contract assets and contract liabilities address more complex scenarios where there is an imbalance between the performance by the entity (satisfaction of a performance obligation) and performance by the customer (payment). This is illustrated in Example 14.2.10.

As shown in the decision tree in section 14.1, no amounts are recognized on the balance sheet if:

- the entity has not transferred goods or services;
- the entity has not received consideration; and
- the entity does not have an unconditional right to receive consideration (see Question 14.3.10).

For performance obligations that are satisfied over time, an entity does not recognize work-in-process or its equivalent as an asset because the customer controls the asset as it is created or enhanced. Instead, it recognizes either a contract asset or a receivable as it recognizes revenue. Sections 7.4.20 and 7.4.30 discuss work-in-process.

Presentation of capitalized contract cost assets are discussed in section 14.6.

Question 14.2.10

Are separate contract assets and contract liabilities presented for each performance obligation within a contract?

Interpretive response: No. The unit of account for presenting contract assets and contract liabilities is the contract. Therefore, each contract is presented as a net contract asset or a net contract liability.

Although an entity's accounting system might capture information at the performance obligation level, a single net figure (contract asset or contract liability) should be presented for each contract. Therefore, entities need appropriate processes and controls to allow them to aggregate information at the contract level for presentation purposes. [TRG 10-14.7, ASU 2014-09.BC317]

Example 14.2.10

Presentation of contract assets and liabilities in contracts with multiple performance obligations

On January 1, Year 1, ABC Corp. enters into a contract to transfer Products A and B to Customer in exchange for $1,000. ABC does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to Customer. In addition, the contract includes a two-year service-type warranty related to Product A priced at $100 payable upon the delivery of Product A.

ABC concludes that Product A, Product B and the service-type warranty are the performance obligations in the contract. ABC allocates $400 to Product A, $600 to Product B and $100 to the service-type warranty based on their relative stand-alone selling prices.

ABC concludes that Products A and B are performance obligations satisfied at a point in time and the service-type warranty is satisfied over time.

On June 30, Year 1, ABC transfers control of Product A. It satisfies its performance obligation and recognizes the following journal entry.

	Debit	*Credit*
Contract asset	400	
Revenue		400
To recognize revenue for Product A.		

Upon delivery of Product A, Customer makes the payment for the service-type warranty. Rather than recording a contract liability (obligation to provide the service-type warranty) for the payment received, ABC reduces the contract asset and presents the net contract position of $300 ($400 contract asset recognized upon transfer of Product A less $100 cash received for the service-type warranty).

	Debit	Credit
Cash	100	
Contract asset		100
To record payment for service-type warranty.		

However, for internal tracking purposes ABC could record a contract asset of $400 and a contract liability of $100 and make an adjustment to present the contract on a net basis at the end of each reporting period.

In addition, ABC discloses the transaction price allocated to the remaining performance obligations Product B and the service-type warranty (see section 15.7).

Question 14.2.20

May a contract asset or contract liability be offset against other items on the balance sheet?

Interpretive response: It depends. Topic 606 does not provide offsetting guidance. Therefore, entities should offset contract assets or contract liabilities with other balance sheet items only when guidance outside Topic 606 permits or requires offsetting – e.g. the balance sheet offsetting guidance in Subtopic 210-20 or the aggregation guidance in the SEC's Regulation S-X. See section 3.4 of KPMG Handbook, Financial statement presentation, for further discussion of balance sheet offsetting. [TRG 10-14.7]

This also applies to the offset of a contract liability or a refund liability against a receivable. For further discussion of refund liabilities, see Question 14.4.20.

Question 14.2.30

May total contract assets and total contract liabilities be presented net on the balance sheet?

Interpretive response: No. An entity presents total net contract assets separately from total net contract liabilities, rather than a net position for all contracts with customers.

However, if under the contract combination guidance (see section 3.7) an entity combines two or more contracts and accounts for them as a single contract, then it presents a single contract asset or contract liability for that combined contract. This is consistent with the guidance on the combination of contracts that specifies the unit of account based on the substance of the transaction, rather than its legal form. [TRG 10-14.7]

Question 14.2.40

Should contract assets and contract liabilities be presented in a separate line item on the face of the balance sheet?

Interpretive response: It depends. Topic 606 does not specify whether contract assets and contract liabilities are presented as separate line items on the balance sheet or aggregated with other items – e.g. include contract assets in an 'other assets' balance. Therefore, an entity applies the general principles for presenting financial statements. [ASU 2014-09.BC320]

However, Topic 606 requires an entity to disclose the opening and closing balances of contract assets, contract liabilities and receivables from contracts with customers if they are not otherwise separately presented or disclosed (see section 15.5). This disclosure requirement also applies to interim periods (see section 15.11).

Topic 606 does not prohibit descriptions that differ from contract assets, contract liabilities and receivables if sufficient description and disclosure is made to enable users of the financial statements to understand and differentiate. [ASU 2014-09.BC321]

SEC guidance also requires separate presentation or disclosure of amounts that are in excess of 5% of total current assets, total assets, total current liabilities or total liabilities. Material items in deferred income are required to be separately stated on the balance sheet. For a more detailed discussion of required balance sheet captions, see section 3.2.10 of KPMG Handbook, Financial statement presentation. [S-X Rule 5-02]

Question 14.2.50

Are contract assets and contract liabilities bifurcated and presented as current and noncurrent on a classified balance sheet?

Interpretive response: Yes. An entity applies the general principles for the classification of assets and liabilities as current versus noncurrent on the balance sheet. This may require a contract asset or contract liability to be presented entirely as current, entirely as noncurrent, or partially current and partially noncurrent. See section 3.3 of KPMG Handbook, Financial statement presentation, for further discussion of the general requirements for a classified balance sheet.

The split of contract assets and contract liabilities between current and noncurrent is determined at the contract level. This is because contract assets and contract liabilities for a single contract are presented on a net basis as either a contract asset or a contract liability (see Question 14.2.10).

Determining whether contract assets and contract liabilities should be presented as current or noncurrent may require considerable judgment. An entity should evaluate the contract terms and its specific facts and circumstances, including:

- when payment is due – e.g. based on the payment schedule agreed with the customer, or as future performance obligations are satisfied;
- when it expects to satisfy its performance obligations; and
- how it satisfies its performance obligations – e.g. over time or at a point in time.

For example, an entity would split a contract asset between current and noncurrent based on the payment schedule agreed with the customer. Alternatively, it would bifurcate a contract liability between current and noncurrent based on when it expects to satisfy its performance obligations.

We believe the entity should make this assessment based on the characteristics of the net asset. This would be the case even when a contract has both contract assets and contract liabilities at the performance obligation level. This is because the unit of account is the contract (see Question 14.2.10). For example, if a contract is in a net asset position but at the performance obligation level there are contract assets and contract liabilities, the entity would make the assessment of noncurrent or current based on the characteristics of the net asset. An entity does not present both a contract asset and a contract liability for the same contract.

Example 14.2.20

Presentation of contract assets and contract liabilities in contracts with multiple performance obligations as current vs. noncurrent

Assume the same facts as Example 14.2.10.

At June 30, Year 1, ABC Corp. has the following balances at the performance obligation level:

- contract asset of $400 related to a transfer of Product A to Customer; and
- contract liability of $100 related to a payment received for the service-type warranty upon delivery of Product A.

ABC expects to deliver Product B to Customer on December 31, Year 1 and at that point it will recognize a receivable for Products A and B. ABC also expects to satisfy the service-type warranty over a period of two years from June 30, Year 1.

At June 30, Year 1, ABC presents the net contract asset of $300 even though it has both a contract asset and a contract liability at a performance obligation level (see Question 14.2.10). In addition, ABC needs to determine whether to present the net contract asset as current or noncurrent.

ABC considers the characteristics of the net contract asset and concludes that a presentation of the net contract asset entirely as current is appropriate. Specifically, the entire balance of contract asset of $400 related to Product A is expected to be collected in six months upon the delivery of Product B. The conclusion to present the net contract asset as current is made despite the fact that a portion of the contract liability to satisfy the performance obligation for the service-type warranty itself would be a noncurrent obligation.

At December 31, Year 1, ABC transfers Product B and collects cash of $1,000, and at that time all of the cash is received from Customer. In addition, ABC recognizes $25 of warranty revenue from June 30, Year 1 to December 31, Year 1 using a time-elapsed measure of progress ($100 × 25% complete).

At that time, ABC presents the remaining contract liability of $75 ($100 – $25) on the balance sheet. ABC classifies $50 of the contract liability as current and $25 as noncurrent based on the timing of satisfaction of its performance obligation related to the service-type warranty.

14.3 Distinguishing between contract assets and receivables

14.3.10 Overview

As shown in the decision tree in section 14.1, the factor that determines whether an entity recognizes a contract asset or a receivable is whether it has an 'unconditional' right to consideration.

— A right to consideration is unconditional when only the passage of time is required before payment of that consideration is due. Unconditional rights to consideration are presented as receivables.

— In contrast, if a right to consideration is conditional, that right is presented as a contract asset. [606-10 Glossary, 606-10-45-4]

The distinction between a contract asset and a receivable is important because they convey different information about the risks associated with the entity's rights in a contract. Although a receivable and a contract asset are both subject to credit risk, a contract asset is subject to additional risks, most notably performance risk. [ASU 2014-09.BC323]

Typically, a conditional right to consideration arises when an entity needs to satisfy another performance obligation in the contract to be entitled to the consideration, or because some of the consideration is variable and the conditions for resolving the variability have not yet been met. [ASU 2014-09.BC323]

When a right to consideration becomes unconditional depends on the facts and circumstances surrounding a contract. In many cases, an unconditional right to consideration arises when an entity satisfies a performance obligation by transferring goods and services and invoices the customer. However, the act of invoicing the customer is not determinative as to whether the entity has an unconditional right to consideration (see Question 14.3.20). [ASU 2014-09.BC325]

In other cases, an entity may have an unconditional right to consideration before it satisfies a performance obligation. For example, an entity may enter into a non-cancellable contract that requires the customer to pay the consideration prior to the entity transferring goods or services – e.g. non-cancellable telecom or cable TV services that are billed in advance of the services. In this example, the entity has an unconditional right to consideration on the date that payment is due, and therefore recognizes a receivable on that date along with a contract liability; however, the entity recognizes revenue only after it transfers goods or services. [ASU 2014-09.BC325]

Example 39 in Topic 606 illustrates the difference between a contract asset and a receivable.

Excerpt from ASC 606-10

• • > Example 39—Contract Asset Recognized for the Entity's Performance

55-287 On January 1, 20X8, an entity enters into a contract to transfer Products A and B to a customer in exchange for $1,000. The contract requires Product A to be delivered first and states that payment for the delivery of Product A is conditional on the delivery of Product B. In other words, the consideration of $1,000 is due only after the entity has transferred both Products A and B to the customer. Consequently, the entity does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to the customer.

55-288 The entity identifies the promises to transfer Products A and B as performance obligations and allocates $400 to the performance obligation to transfer Product A and $600 to the performance obligation to transfer Product B on the basis of their relative standalone selling prices. The entity recognizes revenue for each respective performance obligation when control of the product transfers to the customer.

55-289 The entity satisfies the performance obligation to transfer Product A.

Contract asset	$400	
Revenue		$400

55-290 The entity satisfies the performance obligation to transfer Product B and to recognize the unconditional right to consideration.

Receivable	$1,000	
Contract asset		$400
Revenue		$600

Question 14.3.10

How should an entity evaluate whether it has an unconditional right to payment before satisfying a performance obligation in the contract?

Interpretive response: An entity may enter into a non-cancellable contract that provides unconditional rights to payment for services that it has not yet completed or services that it will provide in the near future. For example, it may be entitled to bill in advance for a software license and the related maintenance, or for a renewal of the maintenance, before the related service period begins.

When determining whether an entity should record a receivable (and a corresponding contract liability), the contract terms and facts and circumstances supporting the existence of the unconditional right to payment should be evaluated. These factors include the entity's legal right to bill and collect the receivable and normal billing practices and terms.

Question 14.3.20

Should an entity record a receivable if it has satisfied its performance obligation before having the right to invoice the customer?

Interpretive response: It depends. The act of invoicing the customer does not indicate whether the entity has an unconditional right to payment. Instead, the test is whether the entity has an unconditional right to receive consideration and only the passage of time is required to receive the consideration.

If the entity has satisfied (or partially satisfied a performance obligation) and has an unconditional right to consideration before it invoices the customer, it will recognize a receivable (unbilled receivable) rather than a contract asset. However, if the entity has satisfied a performance obligation but its right to consideration is conditional on something other than the passage of time – e.g. the entity's satisfaction of another performance obligation in the contract – the entity recognizes a contract asset.

Example 14.3.10

Record a receivable when the right to invoice the customer exists

On June 30, Year 1, ABC Corp. enters into a two-year contract with Customer to provide cleaning services. ABC charges Customer an hourly rate of $25. ABC has an unconditional right to payment as each hour is incurred; however, under the terms of the contract it bills Customer quarterly in arrears.

ABC concludes that the contract includes a single performance obligation satisfied over time. It applies the 'as invoiced' practical expedient to recognize revenue based on the hours incurred times the contractual rate because it has the right to payment in an amount that corresponds directly with the value of ABC's performance completed to date.

Each month as services are provided, ABC records revenue based on the number of hours times the contractual rate of $25 per hour and a corresponding receivable.

While ABC cannot bill Customer until the end of the quarter, as ABC performs it has an unconditional right to that amount that is conditional only on the passage of time (e.g. until the end of the quarter).

14.4 Refund liabilities

14.4.10 Overview

In some cases, an entity will have an unconditional right to consideration, even though it may be required to refund some or all of that consideration in the future – e.g. when a right-of-return exists. The possible obligation to refund consideration in the future does not affect the entity's present right to receive the gross amount of consideration. Therefore, the entity recognizes the gross amount of the consideration as a receivable and a separate refund liability (see section 5.4.20) unless there is a right to offset under Subtopic 210-20. See section 3.4 of KPMG Handbook, Financial statement presentation, for further discussion of balance sheet offsetting. [ASU 2014-09.BC326]

Excerpt from ASC 606-10

• • > Refund Liabilities

32-10 An entity shall recognize a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (that is, amounts not included in **transaction price**). The refund liability (and corresponding change in the transaction price and, therefore, the **contract liability**) shall be updated at the end of each reporting period for changes in circumstances. To account for a refund liability related to a sale with a right of return, an entity shall apply the guidance in paragraphs 606-10-55-22 through 55-29.

• • > Example 40—Receivable Recognized for the Entity's Performance

55-291 An entity enters into a contract with a customer on January 1, 20X9, to transfer products to the customer for $150 per product. If the customer purchases more than 1 million products in a calendar year, the contract indicates that the price per unit is retrospectively reduced to $125 per product.

55-292 Consideration is due when control of the products transfer to the customer. Therefore, the entity has an unconditional right to consideration (that is, a receivable) for $150 per product until the retrospective price reduction applies (that is, after 1 million products are shipped).

55-293 In determining the transaction price, the entity concludes at contract inception that the customer will meet the 1 million products threshold and therefore estimates that the transaction price is $125 per product. Consequently, upon the first shipment to the customer of 100 products the entity recognizes the following.

Receivable	$15,000[(a)]	
Revenue		$12,500[(b)]
Refund liability		$ 2,500

(a) $150 per product × 100 products

(b) $125 transaction price per product × 100 products

55-294 The refund liability (see paragraph 606-10-32-10) represents a refund of $25 per product, which is expected to be provided to the customer for the volume-based rebate (that is, the difference between the $150 price stated in the contract that the entity has an unconditional right to receive and the $125 estimated transaction price).

Question 14.4.10

Is a refund liability a contract liability?

Interpretive response: Generally, no. However, an entity should consider the specific facts and circumstances of the arrangement when determining if a refund liability should be characterized as a contract liability. [ASU 2016-20.BC37]

A contract liability is an obligation to transfer goods or services to a customer for which the entity has received consideration, or for which the amount of consideration is due from the customer. We believe a refund liability usually does not meet the definition of a contract liability because it typically does not represent an obligation to transfer goods or services in the future. [606-10 Glossary, 606-10-45-2]

An entity records a refund liability when it expects to refund some or all of the consideration received (or receivable) from the customer – e.g. when a right of return exists or a volume rebate on prior purchases is expected to be provided. In those cases, the refund liability is not a contract liability. The refund liability is similar to a receivable in that it is presented separately from the net contract asset or liability. [606-10-32-10]

However, if an entity concludes that a potential obligation to refund a customer does represent an obligation to transfer goods or services in the future, it would be a contract liability, and would be subject to the disclosure requirements for contract liabilities. For example, if an entity receives a refundable upfront fee prior to transferring goods or services in the contract, it would record a contract liability instead of a refund liability because it is obligated to transfer goods or services to the customer. In that case, the liability would be included as part of the net contract asset or liability for that particular contract.

Question 14.4.20

May refund liabilities be offset against receivables on the balance sheet?

Interpretive response: It depends. Topic 606 does not provide offsetting guidance. Therefore, an entity should offset refund liabilities against receivables only when guidance outside Topic 606 permits or requires offsetting – e.g. the balance sheet offsetting guidance in Subtopic 210-20. Subtopic 210-20 provides criteria that must be met to present a refund liability as an offset to accounts receivable. See section 3.4 of KPMG Handbook, Financial statement presentation, for further discussion of balance sheet offsetting. [TRG 10-14.7]

The criteria to offset balances require each party to owe the other determinable amounts and the entity to have an enforceable right and the intent to set off the amounts at the reporting date. Entities also evaluate their payment terms, refund policies and the expected timing of cash receipt and payment to determine whether the criteria are met. [210-20-45-1]

14.5 Contract liabilities

14.5.10 Overview

A contract liability (sometimes referred to in practice as deferred revenue) exists when an entity either:

— has received consideration (i.e. advance payment) before satisfying a performance obligation or in excess of amounts allocated to a previously satisfied performance obligation; or

— has an unconditional right to payment under a non-cancellable contract before it transfers the related goods or services to the customer; for example, a one-year contract for maintenance in a service arrangement that is non-cancellable and billable before the one-year period begins.

Example 38 in Topic 606 illustrates how an entity accounts for a contract liability and receivable in a cancellable and non-cancellable contract. Example 14.5.10 illustrates how determining the contract term affects the presentation of a prepayment liability for a cancellable contract.

Excerpt from ASC 606-10

• • > Example 38—Contract Liability and Receivable

• • • > Case A—Cancellable Contract

55-284 On January 1, 20X9, an entity enters into a cancellable contract to transfer a product to a customer on March 31, 20X9. The contract requires the customer to pay consideration of $1,000 in advance on January 31, 20X9. The customer pays the consideration on March 1, 20X9. The entity transfers the product on March 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:

a. The entity receives cash of $1,000 on March 1, 20X9 (cash is received in advance of performance).

Cash	$1,000	
Contract liability		$1,000

b. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	$1,000	
Revenue		$1,000

• • • > Case B—Noncancellable Contract

55-285 The same facts as in Case A apply to Case B except that the contract becomes noncancellable on January 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:

a. January 31, 20X9 is the date at which the entity recognizes a receivable because it has an unconditional right to consideration.

Receivable	$1,000	
Contract liability		$1,000

b. The entity receives the cash on March 1, 20X9.

Cash	$1,000	
Receivable		$1,000

c. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	$1,000	
Revenue		$1,000

55-286 If the entity issued the invoice before January 31, 20X9, the entity would not recognize the receivable and the contract liability in the statement of financial position because the entity does not yet have a right to consideration that is unconditional (the contract is cancellable before January 31, 20X9).

Example 14.5.10

Presentation of prepayment liability for cancellable contracts

On June 30, Year 1, Software Host enters into a contract with Customer to provide Customer with access to its hosted application for three years on a software-as-a-service (SaaS) basis. It concludes that its performance obligation to provide SaaS is satisfied over time because Customer receives and consumes benefits from the hosted application, as Software Host provides that access.

Software Host charges $180,000 a year for access to its hosted application, required to be prepaid at the start of each contractual year. The contract includes a provision that allows Customer to terminate the contract without penalty at the end of any designated month in exchange for a pro rata refund of its prepayment. Software Host concludes that a contract does not exist for periods beyond the then-current month.

The prepayment liability is presented as a deposit liability and not a contract liability. Because the contract term does not exist beyond the then-current month, there is no obligation to transfer a future month of hosting until Customer chooses to renew the contract for the subsequent month by not exercising its right to terminate. The deposit liability is presented separately from contract liabilities in the balance sheet.

14.6 Contract cost assets

The capitalization of contract costs to obtain or fulfill a contract is discussed in chapter 12.

Question 14.6.10

Are contract cost assets combined with the related contract asset or contract liability?

Interpretive response: No. An asset arising under Subtopic 340-40 from the capitalization of costs of obtaining or fulfilling a contract is presented separately from the related contract asset or contract liability. The contract asset or liability is accounted for and presented in accordance with Topic 606 and its nature is different from that of a contract cost asset which is accounted for under Subtopic 340-40.

Capitalized contract costs are amortized on a systematic basis that is consistent with the transfer of related goods and services to the customer. A contract asset or a contract liability, on the other hand, is dependent on the entity's performance and payment terms in the contract. An entity presents either a net contract asset or a net contract liability, depending on the relationship between the entity's performance and the timing of the customer's payment.

Question 14.6.20

How are contract cost assets presented on a classified balance sheet?

Interpretive response: We believe contract cost assets should be presented in a manner similar to intangible assets or property, plant and equipment. This means that contract cost assets under Subtopic 340-40 generally would not be bifurcated between current and noncurrent assets and will generally be classified as noncurrent unless the original amortization period is one year or less (see section 12.4).

However, we have observed diversity in practice for the balance sheet presentation of contract cost assets. Some entities have bifurcated the asset between current and noncurrent based on the period of amortization.

14.7 Income statement presentation

General income statement presentation guidance is included in Topic 220 and in the SEC's Regulation S-X. Topic 606 also provides income statement presentation guidance, which can be found in the application of different aspects of the revenue guidance.

Revenue transactions in the scope of Topic 606 are those in which the goods or services an entity provides under an arrangement are outputs of its ordinary activities. Sources of income that are not outputs of an entity's ordinary activities are generally presented as other income. For further discussion, see section 2.2 and Question 14.7.10 as well as section 4.5 of KPMG Handbook, Financial statement presentation. [606-10-15-3]

Principal vs. agent

When another party is involved in providing goods or services to a customer, an entity applies the principal versus agent guidance in Topic 606 to determine whether revenues are presented gross or net of those third-party costs (see chapter 9). This analysis considers whether an entity's promise to the customer is to provide the specified good or service itself or to arrange for it to be provided to the customer by another party(ies).

Step 3: Determine the transaction price

Step 3 of the revenue model includes guidance relevant to income statement presentation. See section 5.2.20 (Step 3 of Topic 606) for guidance on the presentation of payments from a customer that are collected on behalf of third parties (e.g. sales taxes collected by the entity) and section 5.7 for guidance on classifying payments made to customers. [606-10-32-2A, 606-10-32-25 – 32-27]

Consideration from a vendor

An entity considers the guidance in Subtopic 705-20 to determine whether consideration received from a vendor is presented as a reduction of costs or as revenue for transferring a distinct good or service.

In addition to the guidance here and the Questions in this section, income statement presentation is discussed in other sections of this Handbook, as summarized in the table.

Reference	Topic
Section 2.2	Scope: Identification of an entity's ordinary activities and sales to customers and noncustomers
Question 2.2.20	Patent infringement settlement
Example 2.2.10	Identifying ordinary activities
Example 2.2.12	Retailer credit card arrangements
Question 2.2.25 and Example 2.2.15	Byproduct sales
Example 2.2.40	Funding arrangements with noncustomers
Section 2.3	Scope exceptions
Question 4.2.160	Shipping and handling costs
Section 4.5.30	Distinguishing warranties from variable consideration
Section 5.2.20	Items not included in transaction price: Amounts collected on behalf of third parties and customer credit risk

Reference	Topic
Question 5.2.05	Taxes or fees that qualify for the policy election to be presented net
Example 5.2.05	Taxes collected from customer – gross reporting
Question 5.2.10	Customer reimbursement of out-of-pocket costs
Example 5.2.10	Reimbursements and pass-through costs
Question 5.3.100	Liquidated damages
Question 5.4.20	Right to return a defective item
Section 5.5.50	Significant financing component
Section 5.7.20	Consideration payable to a customer
Question 5.7.20	Are payments to customers in the form of equity-based instruments, instead of cash, considered 'consideration payable to a customer'?
Question 5.7.30	Payments made by a manufacturer to a retailer for advertising
Question 5.7.40	Slotting fees
Example 5.7.47	Fees paid to provide zero or low-interest financing to a customer
Example 5.7.48	Commission paid to a third party
Question 5.7.50	Nonrefundable upfront payments to a customer or potential customer
Section 7.5.60	Forward or call options
Section 7.5.70	Put options
Chapter 9	Principal vs. agent: when another party is involved in providing goods or services to a customer
Question 12.6.10	Amortization of contract costs
Chapter 13	Loss contracts
Question 15.9.10	Amortization and impairment of capitalized contract costs

Question 14.7.10

Can income outside the scope of Topic 606 be presented as revenue on the income statement?

Interpretive response: Yes. Income outside the scope of Topic 606 may be presented as revenue on the income statement if it meets the definition of revenue. The ASC master glossary defines revenue as inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. [ASC Master Glossary]

For example, a financial institution earns revenue from transactions in the scope of Topic 606 (e.g. deposit fees, credit card interchange, brokerage commissions) and from transactions outside the scope of Topic 606 (e.g. interest income, servicing income, dividends income). All of these sources of income are presented as revenue when they represent the ongoing major and central operations of the financial institution. For discussion of Topic 606 scope exceptions, see section 2.3.

However, if revenue under Topic 606 is not separately presented in the income statement, the amount is disclosed separately from other sources of revenue. For a discussion of these disclosure requirements, see section 15.3.10.

Question 14.7.20

Can interest income recognized from a significant financing component be presented as revenue in the income statement?

Interpretive response: It depends. If an entity regularly enters into financing transactions, it is not precluded from presenting interest as a type of revenue when the interest represents income from the entity's ordinary activities. [ASU 2014-09.BC246 – BC247]

If interest income from a significant financing component in a Topic 606 contract meets the ASC master glossary definition of revenue (see Question 14.7.10), it may be presented as revenue in the income statement. However, the interest income component must be presented separately from revenue from contracts with customers. [606-10-32-20]

For example, an entity may have standard contracts with customers that provide implicit financing – e.g. Telco provides a two-year financing option for a phone purchase, or Retailer allows customers to pay for furniture purchases over two years. The entity would present interest income as revenue separately from the sale of the product or service being financed if the financing is determined to be a significant financing component and providing financing to customers is an ongoing and major element of how the entity attempts to fulfill its basic function in the economy and earn a return.

Conversely, consider the following scenario.

— Car Dealership does not have a financing subsidiary and does not regularly provide financing on the sale of vehicles.
— A construction company (Customer) places an order for an entire fleet of trucks.
— Car Dealership agrees to provide financing by allowing Customer to pay for the vehicles over five years following transfer of control of the trucks.

Car Dealership would not present interest income as revenue because the financing is not part of its ongoing or central operations; it does not normally provide financing, does not plan to on a go-forward basis, and is only doing so because of the size of the order.

For a discussion of identifying and accounting for significant financing components, see section 5.5.

Question 14.7.30

Should an entity present components of revenue from a single performance obligation as separate line items in the income statement?

Interpretive response: Generally, we do not expect revenue from a single performance obligation to be disaggregated and presented as separate line items on the face of the income statement. Doing so may result in a presentation that either obscures information or is misleading because the unit of account is a single performance obligation.

However, it may occur that a portion of the performance obligation gives rise to different economic factors and separate presentation with clear disclosure may be appropriate. For a discussion of when disaggregation of a single performance obligation for disclosure purposes may be appropriate, see Question 15.4.60. We believe the discussion in Question 15.4.60 is also relevant to determining when disaggregation may be appropriate for presentation purposes.

SEC rules require the separate presentation of tangible product sales and service revenue, and these rules were not revised as a result of Topic 606. Because these rules were not developed with Topic 606 accounting in mind, there may be questions about the appropriate presentation of revenues under these SEC rules depending on the nature of the promise and the accounting under Topic 606. [S-X Rule 5-03(b)]

When an entity combines products and services into a single performance obligation, the performance obligation could be viewed as a single integration service, a single significantly modified product, or a combination of both products and services.

The SEC staff encourages registrants to consult if they have fact patterns in which they believe that applying the SEC rules and Topic 606 would result in the inconsistent presentation of revenues. [Regs Comm 03/2018]

Question 14.7.40

How is a writedown of a contract asset presented in the income statement?

Interpretive response: It depends. A writedown of a contract asset may be required in a variety of circumstances. The income statement presentation depends on whether the adjustment is the result of the customer's credit risk or a change in the estimated transaction price of the contract.

Contract assets are subject to impairment testing under Topic 310 or Topic 326 when adopted.

— If a contract asset is impaired because of the customer's creditworthiness, the entity presents the loss as bad debt expense.

— If a contract asset is written down because of a change in the transaction price, the adjustment is recorded following the guidance in Topic 606 and presented as a reduction of revenue (see section 6.8).

This determination may not be straightforward in all cases, and depends on the facts and circumstances. This includes evaluating whether the writedown relates to uncertainty in variable consideration or is the result of a contract modification, and assessing the nature of any continuing relationship with the customer.

In some cases, the entity's past business practices may indicate that the adjustment is a price concession. Question 3.4.10 addresses factors an entity considers in determining whether a potential transaction price adjustment is the result of an implied price concession or a collectibility issue; and Question 5.3.40 provides further discussion about price concessions.

15. Disclosure

Detailed contents

Item has been moved in this edition: ●

15.11 Interim disclosures

15.11.10 Overview

Question

15.11.10 Does a publicly traded entity disclose both quarter-to-date and year-to-date information for the disclosures required in its interim financial statements?

15.12 Reduced disclosure requirements for other entities

15.1 How the standard works

The objective of the disclosure requirements in Topic 606 and Subtopic 340-40 is to provide financial statement users with sufficient information to understand the nature, amount, timing and uncertainty of revenue, certain costs and cash flows arising from contracts with customers.

The following chart provides an overview of many of the disclosure requirements.

General disclosure (see section 15.3)	Remaining transaction price (see section 15.7)
Disaggregation of revenue (see section 15.4)	Significant judgments (see section 15.8)
Contract balances (see section 15.5)	Costs to obtain or fulfill a contract (see section 15.9)
Performance obligations (see section 15.6)	Practical expedients and policy elections (see section 15.10)

There are two sets of disclosure requirements.

Public entities	Applicable to: — public business entities; — not-for-profit entities that are conduit bond obligors; and — employee benefit plans that file or furnish their financial statements with the SEC. See section 15.11 for interim disclosure requirements.
Reduced disclosures for other entities	— Applicable to all other entities (nonpublic entities – see Question 15.2.10). See section 15.12 for a summary of reduced disclosure requirements.

All other entities may elect the reduced disclosure requirements, but also may choose to comply with any of the disclosure requirements applicable to public entities. The reduced disclosure requirements are derived from Topic 606's disclosure objective; therefore, some of the guidance below on the disclosure requirements applicable to public entities may be helpful in applying the reduced disclosure requirements for all other entities.

15.2 Disclosure objective

Excerpt from ASC 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).

50-2 An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.

50-3 Amounts disclosed are for each reporting period for which a statement of comprehensive income (statement of activities) is presented and as of each reporting period for which a statement of financial position is presented. An entity need not disclose information in accordance with the guidance in this Topic if it has provided the information in accordance with another Topic.

15.2.10 Overview

The disclosure requirements in Topic 606 are objective-based, meaning that an entity needs to comply with the required disclosures in a manner that satisfies the disclosure objective. Objective-based disclosures require an entity to exercise considerable judgment.

The disclosure objective in Topic 606 is for an entity to provide financial statement users with sufficient information to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To help entities achieve this objective, Topic 606 requires certain quantitative and qualitative disclosures about the following:

— contracts with customers;
— the significant judgments, and changes in the judgments, made in applying the guidance in Topic 606 and Subtopic 340-40 to those contracts; and
— any assets recognized from the costs to obtain or fulfill a contract with a customer. [606-10-50-1]

There are also disclosure requirements under Subtopic 340-40 regarding costs to fulfill contracts with customers.

Question 15.2.10

Does Topic 606 define a nonpublic entity for the purposes of reduced disclosure requirements?

Interpretive response: Not directly. For purposes of the reduced disclosure requirements, a nonpublic entity is an entity other than a public business entity, a not-for-profit entity that is a conduit bond obligor or an employee benefit plan that files or furnishes its financial statements to the SEC (see 'Reduced disclosure requirements for other entities' in section 15.12).

The FASB decided that the disclosure requirements should be reduced for nonpublic entities because the costs of providing some disclosures outweigh the benefits. The FASB also noted that the users of nonpublic entity financial statements often have access to supplemental revenue information directly from management that is tailored to their needs. [ASU 2014-09.BC506]

The FASB used the term 'nonpublic entity' informally in these instances. It did not formally define that term in Topic 606 and instead focused on a definition of a public business entity defined in the Master Glossary to the Codification.

The FASB defines a public business entity as an entity that meets any of the following criteria.

- It is required by the 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).
- 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.
- It is required to file or furnish financial statements with a foreign or domestic regulatory agency when preparing to sell or issue securities that are not subject to contractual restrictions on transfer.
- 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.
- 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 US 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 satisfy this criterion. [606-10 Glossary]

The FASB's definition of a public business entity is broader than the SEC's definition of an issuer. An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC – e.g. a non-issuer equity method investee whose financial statements are included in the filing by the investor pursuant to Rule 3.09 of Regulation S-X. In that case, the entity is a public business entity only for financial statements that are filed or furnished with the SEC and would be required to provide the more extensive revenue disclosures applicable to public business entities only in those statements.

Question 15.2.15●

Is a non-issuer broker-dealer a PBE?

Interpretive response: Yes. The FASB's definition of a public business entity (PBE) is broader than the SEC's definition of an issuer. A non-issuer broker-dealer meets the FASB's definition of a PBE because it is required by the Securities Exchange Act of 1934 to furnish financial statements under SEC Rule 17a-5.

Therefore, a calendar year non-issuer broker-dealer is required to make PBE disclosures that are more extensive than those made by nonpublic entities. [606-10 Glossary, 606-10-65-1(a)]

Question 15.2.20

Are there any industry-specific disclosure requirements?

Interpretive response: No. The disclosure requirements in Topic 606 apply to all revenue contracts within Topic 606's scope, regardless of the transaction or industry. However, the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements may vary by transaction or industry. The FASB observed that specifying an overall disclosure objective avoids the need for detailed and prescriptive disclosure guidance to accommodate the many varied types of contracts with customers that are within the scope of Topic 606. [ASU 2014-09.BC330]

Question 15.2.30

Under what circumstances may a specific disclosure that is otherwise required under Topic 606 be excluded?

Interpretive response: While the disclosure requirements specified in Topic 606 are mandatory, the manner in which an entity satisfies the requirements may vary significantly. The level of detail an entity includes to comply with each of the specific disclosure requirements could differ depending on the entity's specific facts and circumstances. Moreover, an entity may aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics. [606-10-50-2]

The disclosure requirements should not be viewed as a checklist of minimum disclosures because some disclosures may be relevant for some entities or industries but may be irrelevant or insignificant for others. The FASB also observed that it is important for an entity to consider the disclosure requirements together with the disclosure objective and materiality. An entity does not need to disclose information that is immaterial. An entity needs to apply judgment, giving consideration to relevant quantitative and qualitative information, when determining which disclosures are immaterial considering its specific facts and circumstances. [ASU 2014-09.BC331]

15.3 General disclosure requirements

Excerpt from ASC 606-10

> Contracts with Customers

50-4 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 Topics:

a. **Revenue** recognized from **contracts** with **customers**, which the entity shall disclose separately from its other sources of revenue
b. <u>Any impairment losses recognized (in accordance with Topic 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 from other contracts.</u>

Pending Content

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* ¦ Transition Guidance: 326-10-65-1

50-4 … b. Credit losses recorded (in accordance with Subtopic 326-20 on financial instruments measured at amortized cost) on any receivables or **contract assets** arising from an entity's contracts with customers, which the entity shall disclose separately from credit losses from other contracts.

15.3.10 Overview

The general disclosure requirements establish the starting point for the Topic 606 disclosures, which is to separately disclose revenue from contracts with customers. There are additional disclosure requirements for contracts with customers related to disaggregation of revenue (see section 15.4), contract balances (section 15.5), performance obligations (section 15.6) and transaction price allocated to the remaining performance obligations (section 15.7). These basic disclosure requirements seem straightforward – disclose the amount of revenue from contracts with customers separately from other sources of revenue.

Similar to the revenue disclosure requirements, entities separately disclose credit losses relating to receivables and contract assets within the scope of Topic 606 from credit losses relating to other assets. Although these requirements seem straightforward, judgment may be required when only a portion of a contract or a subset of revenue transactions is in the scope of Topic 606.

Example 15.3.10
Separate disclosure of revenue from contracts with customers from other sources of revenue

Bank had the following sources of revenue during the period.

Revenue from contracts with customers	$10,000[1]
Interest income	5,000
Dividend income	2,000
Lease income	4,000
Revenue	**$21,000**

Note:

1. Bank is required to provide the disaggregation of revenue disclosure in the footnotes (see section 15.4).

15.4 Disaggregation of revenue

Excerpt from ASC 606-10

• > Disaggregation of Revenue

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.

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.

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.

• > Disclosure of Disaggregated Revenue

55-89 Paragraph 606-10-50-5 requires an entity 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. Consequently, the extent to which an entity's revenue is disaggregated for the purposes of this disclosure depends on the facts and circumstances that pertain to the entity's contracts with customers. Some entities may need to use more than one type of category to meet the objective in paragraph 606-10-50-5 for disaggregating revenue. Other entities may meet the objective by using only one type of category to disaggregate revenue.

55-90 When selecting the type of category (or categories) to use to disaggregate revenue, an entity should consider how information about the entity's revenue has been presented for other purposes, including all of the following:

a. Disclosures presented outside the financial statements (for example, in earnings releases, annual reports, or investor presentations)
b. Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments
c. Other information that is similar to the types of information identified in (a) and (b) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.

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).

15.4.10 Overview

Topic 606 does not permit an entity to just disclose the aggregate amount of revenue from contracts with customers, but rather requires a disaggregation into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. The purpose of this disclosure is to provide information to help financial statement users understand the composition of revenue from contract with customers. [606-10-50-5]

Although Topic 606 provides examples of categories that may be used to achieve the disaggregation objective, an entity's revenue disaggregation disclosure is based on specific facts and circumstances of each entity and requires significant judgment. An entity considers how it presents its revenue for other internal and external purposes. This would include but is not limited to information provided to analysts, disclosed on earnings calls or within MD&A and information used by management or others to evaluate performance and allocate resources. [606-10-55-90]

The following are examples of the disaggregation categories included in Topic 606. [606-10-55-91]

Example categories	
Type of good or service	Type of contract
Geography	Contract duration
Market or type of customer	Sales channels
Timing of transfer of good or service	

Question 15.4.10

Must a minimum number of revenue categories be disclosed?

Interpretive response: No. Although Topic 606 provides some examples of disaggregation categories, it does not prescribe a minimum number of categories, and the examples should not be viewed as a checklist or an exhaustive list. The number of categories required to meet the disclosure objective depends on the nature and location of the entity's business(es) and the nature of its contracts. [ASU 2014-09.BC337]

Question 15.4.20

Are there any specific factors to be used as the basis for disaggregating revenue from contracts with customers?

Interpretive response: No. Topic 606 does not prescribe any specific factors to be used as the basis for disaggregating revenue from contracts with customers. An entity should consider Topic 606's disclosure objective when identifying categories that are meaningful for its business. The most useful disaggregation of revenue depends on various entity- or industry-specific factors. Focusing on the disclosure objective should result in disaggregation that is neither too aggregated nor too detailed. [ASU 2014-09.BC336]

The most appropriate categories depend on facts and circumstances and are not restricted to the information that the chief operating decision maker uses to assess the entity's performance and allocate its resources. For example, the entity could also consider how revenue is disaggregated in other communications for the purposes of evaluating financial performance (e.g. earnings releases, annual reports including MD&A, investor presentations and other information on the entity's website) or making resource allocation decisions. [606-10-55-90]

Question 15.4.30

Can an entity assume that its segment disclosures meet the disaggregation requirements?

Interpretive response: No. The objective of providing segment information is different from the objective for the disaggregation disclosure in Topic 606. Therefore, segment disclosure may not always provide users of financial statements with enough information to help them understand the composition of revenue recognized in the period. [ASU 2014-09.BC340]

Specifically, an entity may be required to disclose certain revenue streams below the segment level to satisfy the disclosure objective in Topic 606. For example, an entity's chief operating decision maker might regularly review a single report that combines the financial information about economically dissimilar businesses – i.e. these businesses form one operating segment.

However, if segment management makes performance or resource allocation decisions within the segment based on information that is further disaggregated or the dissimilarity of those revenue streams is not otherwise apparent, then those economically dissimilar businesses could include revenue that would meet the requirements for disaggregation disclosure under Topic 606. [606-10-55-90]

Nevertheless, if management concludes that the disaggregation level is the same for both Topic 606 and segment revenue, and the revenue disclosures are based on the recognition and measurement guidance in Topic 606, then the segment disclosure does not need to be repeated in the revenue footnote. This would also apply to entity-wide disclosures required by Topic 280. [606-10-50-3, ASU 2014-09.BC340]

Question 15.4.40

Are the entity-wide disclosures required by Topic 280 sufficient when disclosing revenue by geography under Topic 606?

Interpretive response: Not necessarily. Topic 280 on segment reporting requires a public entity to report revenues from external customers attributed to the entity's country of domicile and to all foreign countries in total. If revenues from an individual foreign country are material, those revenues are disclosed separately. [280-10-50-41(a)]

The objective of the disaggregated revenue disclosure is to depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Therefore, the geographic revenue information disclosed to satisfy the entity-wide disclosure requirement in Topic 280 may not be sufficient to meet the objective and requirements under Topic 606. [606-10-50-5, ASU 2014-09.BC340]

For example, an entity may currently disclose its foreign revenues in total under Topic 280 because no individual foreign country revenues are material. Assume that the European Union (EU) imposes regulations (or is considering significant regulations) that affect the uncertainty of revenue and cash flows for the entity's business within that region. In that case, the revenue from the EU could represent revenue that would meet the requirements for disaggregation disclosure under Topic 606 based on qualitative assessment even though no individual country within the EU is determined to be material under Topic 280.

Question 15.4.50

How does an entity disclose differences between the disaggregated revenue disclosure and its segment disclosure?

Interpretive response: It depends. An entity discloses the relationship between the disaggregated revenue and the entity's segment disclosure. Example 41 in Topic 606 (reproduced below) illustrates such a reconciliation in a tabular format. However, a tabular presentation is not required and an entity may opt to use a narrative format to disclose the relationship between the disaggregated revenue and the entity's segment disclosure. Some entities may describe this relationship in the revenue footnote, while others may include it in the segment footnote. This disclosure enables users of the financial statements to understand not only the composition of revenue but also how revenue relates to other information provided in the segment disclosure. [606-10-50-6, ASU 2014-09.BC338]

Excerpt from ASC 606-10

• • > Example 41 – Disaggregation of Revenue — Quantitative Disclosure

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).

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**	**Transport-ation**	**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

Question 15.4.60

May an entity disaggregate revenue that results from the transfer of a single performance obligation into two separate categories?

Interpretive response: Generally, a performance obligation is not disaggregated into separate categories, but there may be situations where it is appropriate.

Paragraph 606-10-50-5 requires disaggregation of revenue "into categories that depict how the nature, amount, timing, and uncertainty of revenue are affected by economic factors" to provide information to help financial statement users understand the composition of revenue from contracts with customers. Paragraph 606-10-50-2 provides that "An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by … the inclusion of a large amount of insignificant detail …"

A single performance obligation would generally not be disaggregated into multiple categories of revenue because it may result in a presentation that obscures information that may be important to users of the financial statements.

However, certain situations may exist that give rise to different economic factors for a portion of a performance obligation – e.g. a contractual restriction that requires an entity to spend an objectively identifiable portion of revenue for a specified purpose. If the amount of revenue subject to that restriction is meaningful (e.g. it is presented in press releases or investor presentations outside of the financial statements), it may be appropriate to disaggregate the performance obligation into two separate categories, as long as the disaggregation and its purpose is clearly and appropriately disclosed.

The following are examples of contractual clauses that may give rise to different economic factors within a performance obligation, making disaggregation appropriate:

- a contractual clause requiring an entity to spend a specified portion of revenue from a single performance obligation on qualifying costs;
- a contractual clause that designates a portion of revenue from a single performance obligation as a reimbursement for third-party costs incurred.

In both of these situations, the economic factor that distinguishes the specified portion of revenue from the remaining revenue for the performance obligation is that there are contractual restrictions or requirements associated with the specified portion.

15.5 Contract balances

Excerpt from ASC 606-10

• > Contract Balances

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

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.

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).

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 and 606-10-50-12A. However, if an entity elects not to provide the disclosures in paragraphs 606-10-50-8 through 50-10 and 606-10-50-12A, 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.

15.5.10 Overview

Topic 606 requires an entity to disclose information about contract assets and contract liabilities, and changes to contract balances, which may be presented in a tabular or narrative format. These disclosures are intended to provide information on how the timing of satisfaction of performance obligations and payment terms effect the contract balances, when contract assets are typically transferred to accounts receivable and when contract liabilities are recognized as revenue. [606-10-50-8 – 50-10]

For further discussion of contract assets and contract liabilities, see chapter 14.

The following diagram depicts the required disclosures regarding contract balances.

Contract balances

- Opening and closing balances of contract assets, contract liabilities and receivables
- Revenue recognized in current period that was included in the opening contract liability balance
- Explanation of how the timing of satisfaction of performance obligations and payment terms effect the contract balances
- Explanation of the significant changes in contract balances (including qualitative and quantitative information)

Question 15.5.10

Are the contract balances disclosures required to be presented through a tabular reconciliation?

Interpretive response: Not necessarily. Topic 606 does not require a tabular reconciliation of the aggregate contract balances, but instead permits narrative disclosures using quantitative and qualitative information. Regardless of which format it uses, an entity discloses the opening and closing balances of contract assets, contract liabilities and receivables from contracts with customers if they are not otherwise separately presented or disclosed. Although not required, an entity may consider disclosing where such balances are included in the balance sheet. [ASU 2014-09.BC346]

The contract balance disclosures also include a quantitative and qualitative explanation of the significant changes in contract asset and liability balances during the reporting period. An entity may find that a tabular presentation is the best way to make the required contract balance disclosures. [606-10-50-10]

Example 15.5.10

Disclosure of contract balances and changes in contract balances from contracts with customers using a tabular reconciliation

ABC Corp. generates revenue from building and delivering satellite communications equipment under long-term contracts with government agencies and other non-government customers. ABC does not operate or control the assets once delivered.

ABC adopts Topic 606 in Year 2 under the cumulative-effect method and has the following balances from contracts with customers at the end of Year 2.

	Year 2	Year 1
Receivables, included in trade and other receivables	$16,000	$15,000
Contract assets, included in other assets	$10,310	$10,000
Contract liabilities, included in other liabilities	$ (8,700)	$ (8,000)

Under contracts with government agencies, the government controls all of the work in process, as satellite communications equipment are being built. Revenue is recognized over time based on the cost-to-cost method. Payment terms for contracts with government agencies are usually based on equal instalments over the duration of the contract. If ABC has recognized revenue, but not issued a bill, it recognizes a contract asset. The contract asset is reclassified to a receivable when the right to consideration becomes unconditional.

Under non-government contracts, customers do not take control of the satellite communications equipment until it is completed. Revenue is recognized on formal acceptance by the customer. On signing of the contract, customers are usually required to make an advance payment of 20% of the contract value that is refundable if the contract is cancelled. The rest of the consideration is payable on acceptance.

The following table presents the significant changes in the contract asset and contract liability balances during Year 2.

	Contract assets increase (decrease)	Contract liabilities (increase) decrease
Reclassification of the beginning contract liabilities to revenue, as the result of performance obligations satisfied	$ -	$ 4,290
Cash received in advance and not recognized as revenue	-	(4,160)
Reclassification of the beginning contract assets to receivables, as the result of rights to consideration becoming unconditional	(1,590)	-
Contract assets recognized, net of reclassification to receivables	1,400	-

	Contract assets increase (decrease)	Contract liabilities (increase) decrease
Cumulative catch-up adjustment arising from changes in estimates of transaction price	-	(400)
Cumulative catch-up adjustment arising from changes in the measurement of progress	200	-
Cumulative catch-up adjustment arising from contract modifications	-	(100)
Effect of business combination	400	(330)
Impairment of contract assets	(100)	-
Net change	**$ 310**	**$ (700)**

The contract assets primarily relate to ABC's rights to consideration for work completed but not billed at the reporting date on government contracts. The contract assets are transferred to the receivables when the rights become unconditional. The contract liabilities primarily relate to the advance consideration received from customers for non-government contracts, for which transfer of control occurs, and therefore revenue is recognized on completion of satellite communications equipment.

15.6 Performance obligations

Excerpt from ASC 606-10

• > Performance Obligations

50-12 An entity shall disclose information about its **performance obligations** in **contracts** with **customers**, including a description of all of the following:

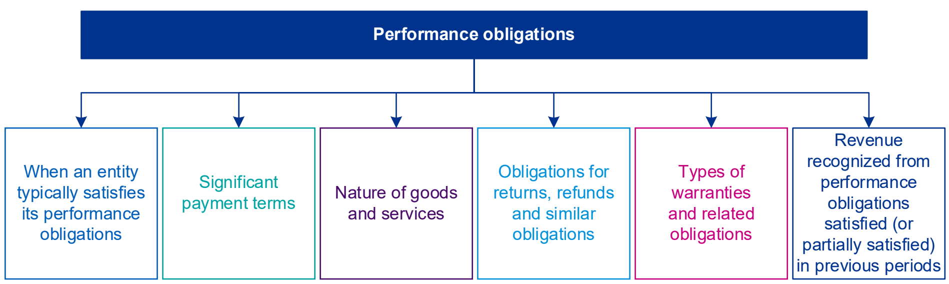
a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement
b. The significant payment terms (for example, when 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.

50-12A An entity shall disclose **revenue** recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).

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 and 606-10-50-12A. However, if an entity elects not to provide the disclosures in paragraphs 606-10-50-8 through 50-10 and 606-10-50-12A, 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.

15.6.10 Overview

Topic 606 requires the following qualitative and quantitative disclosures about an entity's performance obligations. [606-10-50-12 – 50-12A]



The qualitative disclosures are intended to provide descriptive information about an entity's performance obligations to help users of financial statements understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. These disclosure requirements are designed to elicit entity-specific disclosures based on relevant facts and circumstances, as opposed to boilerplate disclosures. [606-10-50-12]

In addition to these qualitative disclosures, an entity discloses the amount of revenue recognized in the current period that relates to performance obligations satisfied (or partially satisfied) in previous periods. This disclosure is triggered when, for example, an entity changes an estimate of the transaction price, including any changes to its assessment of whether an estimate of variable consideration is constrained. This disclosure provides useful information about the current-period operating results. The FASB noted that consistent with general materiality requirements, an entity is not required to provide this disclosure if the amounts are immaterial. An entity will need to apply judgment in making this assessment considering its specific facts and circumstances, including quantitative and qualitative information. [606-10-50-12A, ASU 2014-09.BC347]

The following example illustrates how to determine the amount to disclose when the estimated transaction price changes in the current period.

Example 15.6.10

Change in estimate of transaction price and its effect on revenue and disclosures

Manufacturer enters into a contract containing a single performance obligation that is satisfied over time. The contract price includes $5,000 fixed consideration plus up to $1,000 variable consideration based on manufacturing targets.

At the end of Year 1, the contract is 35% complete and Manufacturer estimates that the total variable consideration is $200. At the end of Year 2, the contract is 90% complete and Manufacturer estimates that the total variable consideration is $1,000. Manufacturer recognizes revenue as follows.

	Fixed consideration	Variable consideration	Total
At end of Year 1 (35% complete)			
Estimated transaction price	$5,000	$200	**$5,200**
Revenue recognized in Year 1 (35%)	$1,750	$70	**$1,820**
At end of Year 2 (90% complete)			
Estimated transaction price	$5,000	$1,000	**$6,000**
Cumulative revenue to end of Year 2 (90% complete)	$4,500	$900	**$5,400**
Less revenue recognized in Year 1	$1,750	$70	**$1,820**
Revenue recognized in Year 2	$2,750	$830	**$3,580**

In its financial statements for Year 2, Manufacturer discloses $280 as the amount of revenue recognized in Year 2 as a result of the change in the transaction price. Because the transaction price (variable consideration) has increased by $800 ($1,000 – $200) and the contract was 35% complete at the end of Year 1, the amount to be disclosed is $280 ($800 × 35%).

Manufacturer recognizes revenue of $3,580 in Year 2, of which $280 relates to performance obligations satisfied in the prior period – the cumulative catch-up adjustment resulting from the change in transaction price for variable consideration that was constrained in the prior period.

Manufacturer should separately track the effects of changes in the transaction price.

Entities should provide an explanation of changes in transaction price if significant.

Question 15.6.10

Does the requirement to disclose revenue from performance obligations satisfied (or partially satisfied) in a prior period apply to sales- and usage-based royalties?

Interpretive response: Sometimes. An entity discloses the amount of revenue recognized in the current period that relates to performance obligations satisfied (or partially satisfied) in previous periods. A sales- or usage-based royalty that relates to functional IP that was transferred to a customer in a previous period would meet the requirement for disclosure. [606-10-50-12A]

Although not required by Topic 606, when revenue is recognized related to a completed or partially completed performance obligation, the entity may consider whether it would be useful to disclose when the performance obligation was satisfied. With licenses of functional IP, it may be more common for the performance obligation to be satisfied or partially satisfied years in advance of the royalty revenue. For example, the license of a drug compound may have sales-based royalties based on subsequent marketing and sales of the drug that occur over a 20-year period after the license is transferred.

15.7 Transaction price allocated to the remaining performance obligations

Excerpt from ASC 606-10

• > Transaction Price Allocated to the Remaining Performance Obligations

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.

50-14 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.

50-14A An entity need not disclose the information in paragraph 606-10-50-13 for variable consideration for which either of the following conditions is met:

a. The variable consideration is a sales-based or usage-based royalty promised in exchange for a license of intellectual property accounted for in accordance with paragraphs 606-10-55-65 through 55-65B.
b. The variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b), for which the criteria in paragraph 606-10-32-40 have been met.

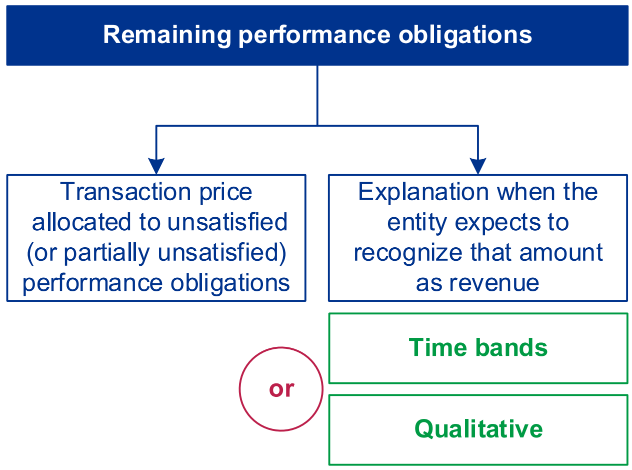
50-14B The optional exemptions in paragraphs 606-10-50-14(b) and 606-10-50-14A shall not be applied to fixed consideration.

50-15 An entity shall disclose which optional exemptions in paragraphs 606-10-50-14 through 50-14A it is applying. In addition, an entity applying the optional exemptions in paragraphs 606-10-50-14 through 50-14A shall disclose the nature of the performance obligation, the remaining duration (see paragraph 606-10-25-3), and a description of the variable consideration (for example, the nature of the variability and how that variability will be resolved) that has been excluded from the information disclosed in accordance with paragraph 606-10-50-13. This information shall include sufficient detail to enable users of financial statements to understand the remaining performance obligations that the entity excluded from the information disclosed in accordance with paragraph 606-10-50-13. In addition, an entity shall explain 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 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).

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.

15.7.10 Overview

Topic 606 requires an entity to disclose the aggregate amount of the transaction price allocated to the remaining performance obligations, which is often called the ‘remaining performance obligations’ disclosure. [606-10-50-13]



The remaining performance obligations disclosure is meant to provide financial statement users with additional information about the following:

— the amount and expected timing of revenue to be recognized from the remaining performance obligations in existing contracts;

— trends relating to the amount and expected timing of revenue to be recognized from the remaining performance obligations in existing contracts;

— risks associated with expected future revenue (e.g. some observe that revenue is more uncertain if an entity does not expect to satisfy a performance obligation until a much later date); and

— the effect of changes in judgments or circumstances on an entity's revenue. [ASU 2014-09.BC350]

This type of disclosure is very often referred to by users of financial statements as a sort of 'backlog' disclosure (see a comparison with Topic 606 below). It is most useful for long-term contracts because those contracts typically have the most significant amounts of unrecognized revenue.

When disclosing the aggregate amount of the transaction price allocated to unsatisfied (or partially satisfied) performance obligations, an entity also discloses when it expects to recognize this aggregate amount as revenue, which it may do in one of two ways. It may present the information either on a qualitative basis or on a quantitative basis using the time bands that are most appropriate for the duration of the remaining performance obligations. Example 42 in Topic 606 (reproduced below) contains two scenarios (Contract B and Contract C) illustrating how to present the remaining performance obligations on a quantitative basis using time bands. [606-10-50-13]

Excerpt from ASC 606-10

• • > Example 42 — Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations

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

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.

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, the entity could elect to apply the optional exemption in paragraph 606-10-50-14(b). If the entity elects not to disclose the transaction price allocated to the remaining performance obligations for Contract A, the entity would disclose that it has applied the optional exemption in paragraph 606-10-50-14(b). The entity also would disclose the nature of the performance obligation, the remaining duration, and a description of the variable consideration that has been excluded from the disclosure of remaining performance obligations in accordance with paragraph 606-10-50-15.

• • • > Contract B

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.

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 × 12 months.

(b) $2,400 = $400 × 6 months.

• • • > Contract C

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.

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.

	20X8	20X9	Total
Revenue expected to be recognized on this contract as of December 31, 20X7	$1,575[(a)]	$788[(b)]	$2,363

(a) Transaction price = $3,150 ($100 × 24 months + $750 variable consideration) recognized evenly over 24 months at $1,575 per year.

(b) $1,575 ÷ 2 = $788 (that is, for 6 months of the year).

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.

55-305A The entity does not meet the criteria to apply the optional exemption in paragraph 606-10-50-14A because the monthly consideration is fixed and the variable consideration does not meet the condition in paragraph 606-10-50-14A(b).

Example 43 in Topic 606 (reproduced below) illustrates a qualitative disclosure when an entity is uncertain about the timing of revenue recognition and does not use time bands to disclose the transaction price allocated to the remaining performance obligation.

Excerpt from ASC 606-10

• • > Example 43 — Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations—Qualitative Disclosure

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.

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.

Question 15.7.10

Are time bands the preferable approach to disclosing when an entity expects to recognize revenue?

Interpretive response: It depends. The determination of whether to use a quantitative disclosure in the form of time bands or a qualitative disclosure will depend on specific facts and circumstances. The method that best achieves the overall disclosure objective should be used. The objective is to provide sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows.

Time bands are likely the best way to achieve this objective when there is less uncertainty about the timing of revenue recognition. For example, an entity with a mature business, an established customer base and sufficient historical evidence to estimate the pattern of revenue recognition would likely find it appropriate to disclose revenue in time bands.

Judgment and estimation will generally be required to provide this disclosure and that fact alone should not determine whether time bands are used. However, as the uncertainty of timing increases, it may be appropriate to provide mostly qualitative disclosures or supplement time band disclosures with qualitative information about the uncertainty.

Question 15.7.20

Is the constrained or unconstrained transaction price used when disclosing the transaction price allocated to remaining performance obligations?

Interpretive response: Constrained. The transaction price used in the remaining performance obligations disclosure is the constrained amount. An entity also explains qualitatively whether any consideration is not included in the transaction price (e.g. constrained variable consideration), and therefore is not included in the remaining performance obligations disclosure.

Example 15.7.10

Disclosure of the transaction price allocated to the remaining performance obligations when variable consideration is constrained

Construction Company enters into a contract to construct a commercial building for 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. Construction Company accounts for the promised bundle of goods and services as a single performance obligation satisfied over time.

At contract inception, Construction Company 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 Construction Company's influence, including weather and regulatory approvals. In addition, Construction Company has limited experience with similar types of contracts.

Construction Company 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, Construction Company has satisfied 40% of its performance obligation on the basis of costs incurred to date. Construction Company reassesses the variable consideration and concludes that the amount is still constrained.

In this example, Construction Company discloses:

- the fixed consideration of $600,000 allocated to performance obligations unsatisfied as of the end of reporting period and when it expects this amount to be recognized as revenue, using either time bands or qualitative information;
- that the transaction price does not include a bonus of $200,000 and a description of how the constraint will be resolved.

In addition, Construction Company should ensure consistency between its accounting conclusions and disclosures. It would be inconsistent for Construction Company to disclose that $600,000 will be recognized the following year because the $200,000 bonus is fully constrained based on the expectation that the 24-month completion date is unlikely to occur. Therefore, if completion is expected after 24 months, the entire remaining $600,000 would not be expected to be recognized in the following year.

Question 15.7.30

Should the transaction price in the remaining performance obligations disclosure include contract renewals?

Interpretive response: It depends. The disclosure is required to reflect the transaction price allocated to remaining performance obligations from a legally enforceable contract – i.e. the legally enforceable contract term as determined in Step 1. A renewal is only reflected in the remaining performance obligations disclosure when it is a material right that has been allocated transaction price from the original contract. In contrast, additional consideration arising from the exercise of a renewal right is excluded from the disclosure.

Topic 606 requires certain renewal and cancellation rights to be accounted for in the same way because the customer is making the same economic decision. For example, a one-year service contract with an option to renew for an additional year at the end of the initial term is economically the same as a two-year service contract that allows the customer to cancel the contract at the end of the first year without penalty and avoid payment for the second year. In both of these examples, the legally enforceable contract term is one year.

The remaining performance obligations disclosure does not include the transaction price related to renewal periods (or cancellable periods that are akin to a renewal) that do not give the customer a material right. In contrast, if the renewal period in a one-year contract conveys a material right to the customer, the transaction price from the one-year contract that is allocated to that material right is included in the remaining performance obligations disclosure. However, any additional transaction price that could arise from the renewal, including additional consideration due to the customer exercising its material right, is not included in the remaining performance obligations disclosure. Similarly, if a provision in a two-year contract that permits a customer to cancel after the first year conveys a material right to the customer, the transaction price allocated to the material right is included in the remaining performance obligations disclosure.

The transaction price related to the optional goods or services within the expected renewal periods is used to allocate transaction price to the material right when the alternative approach is used (see section 8.5). Even though the consideration in the renewal period is used to account for the material right under the alternative approach, the answer to this question under the alternative approach is the same as noted above – i.e. the transaction price that arises from the optional goods or services in the renewal period is not included in the transaction price disclosure.

Example 15.7.15

Transaction price disclosure for a cancellable contract

ABC Corp. enters into a two-year contract with Customer to provide cleaning services on an as-needed basis for a flat fee of $200 per month. $200 is the stand-alone selling price for this service at contract inception. While the stated contract term is two years, it is cancellable at the end of each month by either party without penalty.

ABC determines that the initial contract term is for only one month and that the contract term will always be one month under this arrangement. This is because each subsequent month represents a wholly unperformed contract – each party has the unilateral, enforceable right to terminate the contract at the end of the then-current month without compensating the other party. A new contract is deemed to exist each month once each party forgoes its cancellation right for that period.

ABC determines that the remaining performance obligation disclosures only apply for the remaining days within the 30-day noncancellable period. Because the performance obligation is part of a contract with an original expected duration of one year or less, ABC can also elect an optional exemption from the disclosure (see section 15.7.20). [606-10-50-13, 606-10-50-14(a)]

Example 15.7.16

Transaction price disclosure when a contract contains a material right

ABC Corp. enters into a contract with Customer to provide equipment for $100,000 and one year of maintenance for $30,000 – both prices equal their stand-alone selling prices. The contract provides Customer the option to purchase additional equipment in the following year at a 20% discount.

ABC concludes the following.

- The equipment and maintenance are separate performance obligations.
- The option to purchase equipment at a discount provides a material right to Customer that Customer would not receive without entering into the contract because the discount is significant to what ABC charges similar customers.

ABC estimates the stand-alone selling price of the material right to be $20,000, which is the stand-alone selling price of the equipment multiplied by the 20% discount Customer would receive from exercising the option. In this example, Customer would not receive any discount without exercising the option and the likelihood of Customer not exercising the option is highly unlikely (i.e. no breakage).

ABC then allocates the transaction price of $130,000 on a relative stand-alone selling price basis as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation
Equipment	$100,000	67%	$ 87,100
Maintenance	30,000	20%	26,000
Material right	20,000	13%	16,900
Total	**$150,000**	**100%**	**$130,000**

As of the end of the reporting period, ABC has transferred the equipment and provided six months of its maintenance service obligation. ABC determined that a time-elapsed measure of progress was appropriate for its stand-ready maintenance obligation.

In its remaining performance obligation disclosure, ABC discloses $29,900 of transaction price:

- $13,000 related to the remaining maintenance obligation; plus
- $16,900 allocated to Customer's material right that is unsatisfied at the end of the reporting period.

ABC also discloses when it expects this amount to be recognized as revenue – e.g. within the next annual reporting period as remaining maintenance services are provided and before Customer's option expires at the end of the period.

Example 15.7.17

Transaction price disclosure when an entity uses the alternative approach to allocate transaction price to a material right

The following facts are from Example 8.5.10.

ABC Corp. enters into a contract with Customer to transfer two units of Product P for $2,000 ($1,000 per unit, which is the stand-alone selling price) with an option to purchase up to two more units of Product P at $500 per unit (i.e. a 50% discount). ABC concludes that each unit of Product P is distinct and satisfied at a point in time.

ABC concludes that the option for up to two additional units of Product P is a material right because the discount is incremental to discounts provided to other customers in this class of customers, and does not exist independently from the current contract.

ABC uses the alternative approach to allocate the transaction price to the options (see section 8.5 and Example 8.5.10). ABC expects there is a high likelihood Customer will exercise each option and does not expect breakage. Therefore, ABC includes all of the options in the expected number of goods it expects to provide.

As a result, ABC allocates the expected transaction price to the units expected to be transferred – i.e. includes the optional purchases in the allocation.

Expected transaction price	$3,000	$2,000 (price of original 2 units purchased) + $500 (price of third unit) + $500 (price of fourth unit)
Number of units expected to be transferred	4	2 original units purchased + option for 1 unit + option for 1 unit
Price allocated to each unit	$750	$3,000 / 4 units

In effect, $1,500 of the total consideration in the original contract of $2,000 is allocated to the purchase of the original two units and the remaining $500 is allocated to the two options.

At the end of the reporting period, ABC has only transferred the two original units and discloses $500 in its remaining transaction price disclosure related to the material right. ABC includes only the transaction price under the legally enforceable contract (i.e. the original contract) in its disclosure and does not include the optional purchase price of $1,000.

Example 15.7.18

Transaction price disclosure when there is a minimum purchase requirement

ABC Corp. enters into a two-year supply agreement that requires Customer to purchase a minimum of 20,000 units per year at $15 per unit. Customer has the option of purchasing units above the minimum at $15 per unit.

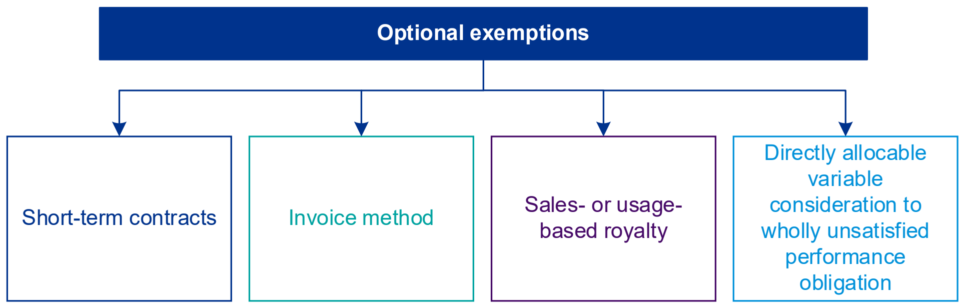
Customer submits purchase orders for a specific number of units on an as-needed basis and makes purchasing decisions for units above the minimum requirement when it submits purchase orders above the minimum. Based on historical sales with Customer, ABC expects to sell 40,000 units per year to Customer.

As of ABC's reporting date, Customer has submitted purchase orders for and received 4,000 units during the first three months of the two-year contract. ABC determines that the transaction price disclosure for remaining performance obligations is $240,000. This amount represents the remaining minimum committed purchases of 16,000 units (20,000 units less 4,000 units purchased) multiplied by the per unit transaction price of $15.

Although ABC expects to sell quantities in excess of the remaining 16,000 committed units, it does not include those uncommitted quantities in its remaining transaction price disclosure. This is because the optional purchases above the contractual minimums are not part of the legally enforceable contract with Customer.

15.7.20 Optional exemptions

There are four optional exemptions to the remaining performance obligations disclosure requirements. The FASB created these exemptions because there are some instances in which an entity need not estimate variable consideration under the recognition and measurement rules of Topic 606. Without these exemptions, an entity that need not estimate variable consideration under the recognition and measurement requirements would, nevertheless, have to estimate it for disclosure purposes. [606-10-50-14, 50-14A, 50-14B]



Short-term contract exemption

If the remaining performance obligations are part of a contract that has an original expected duration of one year or less, the entity may elect not to provide the remaining performance obligations disclosures. An entity that elects this exemption need not disclose any of the transaction price allocated to the remaining performance obligations, including any fixed and variable component of the transaction price. [606-10-50-14(a)]

Example 15.7.20
The short-term contract exemption

On December 29, Contract Manufacturer received and accepted a non-cancellable purchase order to provide customized goods. The contract meets the criteria for over-time revenue recognition. Contract Manufacturer expects to receive fixed consideration of $10,000 and to deliver the goods on January 12.

Consequently, Contract Manufacturer discloses the remaining transaction price at December 31 unless it elects the short-term contract exemption.

If Contract Manufacturer elects not to disclose this information at December 31, it discloses the following instead:

- that the optional exemption under paragraph 606-10-50-14(a) is being applied;
- the nature of the performance obligation: customized manufacturing performed over time; and
- the remaining duration: to be completed within the next quarter.

As-invoiced exemption

If revenue from a performance obligation is recognized over time using the as-invoiced practical expedient (see section 7.4.50), the entity may elect not to provide the remaining performance obligations disclosures for that performance obligation. [606-10-50-14(b)]

This as-invoiced practical expedient applies when the amount of consideration the entity has a right to invoice corresponds directly with the value to the customer of the entity's performance completed to date – e.g. a service contract in which the entity bills a fixed hourly amount. An entity that elects this exemption need not disclose the variable consideration in the transaction price allocated to the performance obligation; however, it still needs to disclose any allocated fixed consideration (e.g. any contractual minimums). [606-10-50-14(b), 50-14B]

Example 15.7.30
The invoice method optional exemption

On January 1, Year 1, ABC Corp. enters into a non-cancellable contract to provide cleaning services over the next two years. For services provided, Customer pays an hourly rate of $25.

Because ABC bills a fixed amount for each hour of service provided, it has a right to invoice Customer in the amount that corresponds directly with the value of its performance completed to date and to apply the as-invoiced practical expedient. Consequently, ABC may elect to apply the as-invoiced method exemption – and not disclose the amount of transaction price allocated to the remaining performance obligation.

If ABC entity elects not to disclose this information at December 31, Year 1, it discloses the following instead:

— that the optional exemption under paragraph 606-10-50-14(b) is being applied;

— the nature of the performance obligation: cleaning services performed over time, at least once per month;

— the remaining duration: a remaining term of one year; and

— a description of the variable consideration: revenue will be recognized as services are provided based on a number of hours and an hourly rate of $25.

Sales- or usage-based royalty exemption

If revenue from a performance obligation is a sales- or usage-based royalty promised in exchange for a license of IP, the entity may elect to exclude the variable consideration (i.e. the future royalty payments) from the remaining performance obligations disclosures. For this exemption to apply, the royalty must meet the requirements to apply the royalty exception (see section 10.11), which requires an entity to recognize a royalty fee as revenue at the later of when the sale or usage occurs and the related performance obligation to which the royalty relates is satisfied. [606-10-50-14A(a)]

An entity that elects this exemption need not disclose the variable consideration that is a sales- or usage-based royalty; however, it still needs to disclose any allocated fixed consideration. For example, it would disclose a guaranteed minimum amount of consideration included in a sales- or usage-based royalty, as that guaranteed minimum is considered fixed consideration. [606-10-50-14A(a), 50-14B, ASU 2016-20.BC24]

Example 15.7.40
The sales-based royalties optional exemption

On June 30, Year 1, Franchisor enters into a 10-year franchise agreement with Franchisee. The contract requires an initial franchise fee of $40,000 and ongoing royalties equal to 5% of Franchisee's sales. Franchisor could elect to apply the royalties optional exemption – and not disclose the variable consideration allocated to its performance obligation.

If Franchisor elects not to disclose the estimated future royalties at December 31, Year 1, it discloses the following:

— that the optional exemption under paragraph 606-10-50-14A(a) is being applied;

— the nature of the performance obligation: a right to symbolic IP recognized over time;

— the remaining duration: a remaining term of 9.5 years;

— a description of the variable consideration: the 5% royalty that will be recognized as sales occur; and

— the portion of the initial franchise fee (fixed consideration) that has not yet been recognized as revenue: e.g. $38,000 if Franchisor concluded that a time-elapsed measure of progress was appropriate.

Directly allocable variable consideration to wholly unsatisfied performance obligations exemption

If variable consideration is allocated entirely to a wholly unsatisfied performance obligation, the entity may elect to exclude the variable consideration from the remaining performance obligations disclosures for that performance obligation. [606-10-50-14A(b)]

This exemption also applies to variable consideration that is allocated entirely to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation under the series guidance. The term 'series guidance' refers to the guidance in paragraph 606-10-25-14(b) that requires the promised transfer of a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer to be accounted for as a single performance obligation (see section 4.4). [606-10-50-14A(b)]

The direct allocation exemption, if elected, applies only to the variable consideration that has been specifically and entirely allocated to the wholly unsatisfied performance obligation (or to the wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation) under the variable consideration allocation guidance. To apply this allocation guidance:

— the terms of the variable consideration must relate specifically to the entity's efforts to satisfy the performance obligation (or to transfer the distinct good or service that forms part of a single performance obligation); and

— the allocation of the variable consideration to the performance obligation (or to the promise to transfer a distinct good or service) must be consistent with the allocation objective. [606-10-32-40]

See sections 6.6 and 6.7 for discussion about when variable consideration can be directly allocated to a performance obligation or a distinct good or service within a series.

An entity that elects this disclosure exemption need not disclose the variable consideration in the transaction price allocated to the unsatisfied performance obligation; however, it still needs to disclose any allocated fixed consideration. It may be challenging, though, for some entities to provide a meaningful disclosure if an arrangement has a mix of fixed and variable consideration. [606-10-50-14A(b), 50-14B]

Example 15.7.50

Directly allocable variable consideration to wholly unsatisfied performance obligations exemption

Manufacturer enters into a non-cancellable contract to build an aircraft carrier for a customer. The contract includes a single performance obligation satisfied over time. Consideration is variable based on time and materials; however, the contract has a provision for contractual minimums. When the contract is initially executed and assuming Manufacturer has not begun to satisfy the performance obligation, Manufacturer could elect to apply the directly allocable variable consideration to wholly unsatisfied performance obligation exemption – and not disclose the variable consideration allocated entirely to the performance obligation that it is wholly unsatisfied.

If Manufacturer elects the optional exemption, it discloses which optional exemption it has elected to apply and information about the nature of performance obligations, the remaining duration and the characteristics of the variable consideration excluded from the disclosure. Manufacturer also discloses the contractual minimums, as those are considered fixed consideration.

Once Manufacturer commences work on the aircraft carrier, the exemption no longer applies because the performance obligation is no longer wholly unsatisfied. At this point, disclosure of the transaction price allocated to partially unsatisfied performance obligations, including an estimate of variable consideration, is required.

Example 15.7.60

Directly allocable variable consideration to wholly unsatisfied promise within a series exemption

Asset Manager enters into a contract with Customer to provide asset management services for five years. Asset Manager receives a 0.5% quarterly management fee based on Customer's assets under management at the end of each quarterly reporting period.

Asset Manager accounts for asset management services as a single performance obligation under the series guidance in paragraph 606-10-25-14(b). At the end of each quarter, the uncertainty related to assets under management is resolved and Asset Manager allocates the quarterly management fee to the distinct services provided during that quarter.

Asset Manager could elect to apply the directly allocable variable consideration to wholly unsatisfied performance obligations exemption. The exemption is available because, at each reporting date, the remaining variable consideration will be allocated entirely to a wholly unsatisfied promise that forms part of a single performance obligation recognized under the series guidance (see section 6.7).

If Asset Manager elects the optional exemption, it does not disclose the amount of the variable consideration, but it must disclose which optional exemption it is applying, the nature of its performance obligation, the remaining contract term, and when and how variability would be resolved.

Example 15.7.70

Variable consideration not directly allocable to a wholly unsatisfied promise within a series exemption

Assume the same facts as Example 15.7.60 except that the quarterly measurement period for the variable management fee does not line up with Asset Manager's quarterly reporting period. For example, the contract starts on December 1 such that the first quarter of the contract runs from December 1 to February 28 for a calendar-year reporting entity. At Asset Manager's reporting date of December 31, there is variable consideration that would not be directly allocable to a wholly unsatisfied promise.

In this example, the optional exemption does not apply for the management fee allocable to January 1 – February 28 and those estimated fees would be required to be disclosed. Management fees allocable to future quarters would still be eligible for the optional exemption.

Assume this contract also includes an annual performance-based incentive fee that contains investment return rate hurdles. This fee is not directly allocable to a wholly unsatisfied promise at December 31 and the optional exemption does not apply. However, if Asset Manager concludes that the variable consideration constraint should apply to the annual performance fee, it would apply the disclosure guidance on constrained transaction price in Question 15.7.20. That would result in no required disclosure for the fee, but for a different reason.

An entity should consider the nature of its arrangements when determining whether to apply an optional exemption. It may be challenging for an entity to provide meaningful disclosures if some arrangements within a similar line of business do not qualify for an exemption, or if there are arrangements with a mix of fixed and variable consideration, or a combination of both. It would not be appropriate to exclude transaction price disclosures where optional exemptions do not apply simply because the election of a permitted optional exemption makes those required disclosures less complete. In certain cases, an entity may consider not applying an optional exemption to avoid having confusing disclosures.

Question 15.7.40

What information does an entity disclose if it applies one of the optional exemptions?

Interpretive response: Although the optional exemptions allow an entity to forgo disclosing certain quantitative information, it needs to disclose the following additional information if it elects one or more of the optional exemptions:

- which optional exemption(s) it has elected;
- the nature of the performance obligation;
- the remaining duration of the contract;
- a description of the variable consideration – e.g. the nature of the variability and how that variability will be resolved;
- whether any consideration is not included in the transaction price – e.g. whether the amount of variable consideration is constrained.

These qualitative disclosures need to be detailed enough to enable users of financial statements to understand the remaining performance obligations. [606-10-50-15]

To comply with these disclosure requirements, an entity could disclose, for example, the portion of its current-period revenue that is variable consideration and meets the optional exemptions criteria or disclose the remaining contract duration for each significant customer. This information would provide the users of financial statements with some context about the remaining performance obligations that have not been disclosed without requiring an entity to estimate future variable consideration. [ASU 2016-20.BC28]

See Examples 15.7.20, 15.7.30, 15.7.40, 15.7.50, 15.7.60.

Question 15.7.50

Are minimum guarantees required to be included in the remaining transaction price disclosure when an optional exemption is applied?

Interpretive response: Sometimes. An entity that elects the short-term contract exemption is not required to disclose fixed or variable consideration. However, an entity that elects any of the other three optional exemptions (i.e. as-invoiced method, sales- or usage-based royalty, or direct allocation exemption) needs to disclose fixed consideration related to those contracts to which the optional exemption applies. Minimum guarantees represent fixed consideration and would be required to be disclosed. [606-10-50-14B, ASU 2016-20.BC24]

Question 15.7.60

Can the optional exemptions be applied on a contract-by-contract basis?

Interpretive response: It depends. An entity can elect to apply any one or more of the available optional exemptions. For example, an entity could elect to apply the as-invoiced method optional exemption and not the directly allocable variable consideration to wholly unsatisfied performance obligations exemption. This could result in disclosures for certain populations of contracts and not for others depending on which contracts meet the conditions for the optional exemptions. However, if an entity elects an optional exemption, it should apply that exemption to all contracts that meet the conditions to be eligible for that optional exemption.

Question 15.7.70

If an entity concludes it qualifies for one optional exemption, does it need to evaluate whether the other optional exemptions apply?

Interpretive response: It depends. As explained in Question 15.7.60, an entity can elect to apply any one or more of the available optional exemptions but it should apply that exemption to all contracts that meet the conditions to be eligible for that optional exemption.

Depending on the nature of an entity's contracts and the optional exemptions it elects, the entity may need to evaluate whether more than one optional exemption applies to its contracts.

For example, an entity may decide to provide transaction price disclosures for short-term contracts (not apply the short term contract optional exemption) because it believes the disclosures are reliable and provide decision-useful information to investors. However, because of the challenges associated with estimating variable consideration for longer term contracts, the entity could elect the other three optional exemptions when they apply. In this case an entity would not disclose variable consideration for a short-term contract that meets one of the other optional exemptions even though it did not elect the short-term contract optional exemption.

Alternatively, an entity may decide to elect all of the optional exemptions. The short-term contract exemption applies to all consideration. However, fixed consideration is required to be disclosed for contracts applying the other three optional exemptions (i.e. as-invoiced method, sales- or usage-based royalty, or direct allocation exemption). Therefore, an entity will determine whether the short-term contract exemption applies even if it already concluded one of the three other optional exemptions applies to a contract. The entity would then be able to determine whether disclosure of fixed consideration is required.

Examples

The following are examples that were included in chapter 6 to illustrate the application of the direct allocation of variable consideration guidance to a variety of arrangements. The table below summarizes these examples and includes an evaluation of whether an optional exemption can be applied. In some cases, the example transaction qualifies for more than one optional exemption. See Question 15.7.70 for discussion of considerations an entity makes in these cases. See section 6.7 for details of the examples included in the summary below.

Examples	Does an optional exemption apply?
Example 6.7.10 **Transaction-based fees allocated to the period they were earned**	Transaction Processor has a one-year contract with a customer that includes an upfront fixed fee and a per transaction fee. Transaction Processor concludes that variable amounts per transaction meet the variable consideration allocation exception and those amounts should be allocated to the distinct service period (each day) in which the transaction is processed. Transaction Processor could elect to apply the short-term contract exemption or the direct allocation exemption. Under either exemption, the variable fees would not be required to be disclosed. [606-10-50-14(a), 50-14A(b)] If Transaction Processor elects the short-term contract exemption, it does not disclose the fixed consideration. However, if it elects the direct allocation exemption but not the short-term contract exemption, Transaction Processor will disclose the remaining fixed fee. [606-10-50-14B]
Example 6.7.20 **Tiered pricing**	Transaction Processor has a one-year contract with a customer that includes an upfront fixed fee and a per transaction fee that is tiered based on quarterly transaction volume. Transaction Processor concludes that the variable allocation exception criteria are met and allocates the fees to the contractual quarter in which the transaction is processed. If the contractual quarters are coterminous with the entity's quarterly reporting periods, the direct allocation exemption

Examples	Does an optional exemption apply?
	would apply because any future variable amounts are allocated entirely to wholly unsatisfied service periods. However, if the contractual quarters are not coterminous with the reporting period the direct allocation exemption would only apply to contractual quarters that have not begun. For example, if the reporting period ended after the first month of a contractual quarter, Transaction Processor would have to disclose the fees attributable to the remaining two months of the contractual quarter because the fees are not allocated entirely to a wholly unsatisfied service period (i.e. they are allocated to a quarter that is 1/3 complete). The fees allocated to quarters that have not yet begun would still be subject to the exemption. Transaction Processor could elect to apply the short-term contract exemption or the direct allocation exemption. Under either exemption, the variable fees (other than those noted in the previous paragraph when contractual quarters are not coterminous with the reporting period) would not be required to be disclosed. [606-10-50-14(a), 50-14A(b)] If Transaction Processor elects the short-term contract exemption, it does not disclose the fixed consideration. However, if it elects the direct allocation exemption but not the short-term contract exemption, Transaction Processor will disclose the remaining fixed fee. [606-10-50-14B]
Example 6.7.30 **Changing prices – allocation objective is met**	Outsourcer has a three-year contract with Customer that includes an upfront fixed fee and variable fees that change throughout the contract. In this example, the tiered pricing is commensurate with market trends and the entity's cost of fulfilling the service. Outsourcer concludes that the variable consideration allocation exception is met and the amounts are allocated entirely to the periods in which they are earned. Outsourcer could elect to apply the direct allocation exemption. [606-10-50-14A(b)] If Outsourcer elects the exemption, the variable fees will not be disclosed. However, Outsourcer will disclose the portion of the fixed fee that has not yet been recognized as revenue (likely using time bands for the three-year period). [606-10-50-14B]
Example 6.7.40 **Changing prices – allocation objective is not met**	Outsourcer has a three-year contract with Customer that includes an upfront fixed fee and variable fees that change throughout the contract. In this example, the tiered pricing is structured in a way that offers a significant inducement in Year 1 and recovers the shortfall in Years 2 and 3. Outsourcer concludes that the variable consideration does not meet the variable consideration allocation exception in order to allocate the fees entirely to the periods in which they are earned. Outsourcer cannot elect any of the optional exemptions. It is required to comply with the disclosure requirements of the transaction price allocated to remaining performance obligations, which includes disclosure of the remaining

Examples	Does an optional exemption apply?
	fixed consideration and estimated variable consideration. [606-10-50-13]
Example 6.7.50 **Per user pricing – allocation objective is met**	Health Care has a three-year contract to provide healthcare managed services and charges Customer an escalating amount per member per month in addition to a fixed monthly fee. In this example, the escalating pricing is commensurate with the market value for those services. Health Care concludes that it meets the variable allocation consideration exception and allocates the fees entirely to the periods in which they are earned. Health Care may elect to apply the direct allocation exemption. [606-10-50-14A(b)] However, Health Care will still need to disclose the fixed monthly fee that has not yet been recognized as revenue (likely using the time bands). [606-10-50-14B]
Example 6.7.60 **Per user pricing – allocation objective is not met**	Health Care has a three-year contract to provide health care managed services and charges a fee per member per month in addition to a fixed monthly fee. In this example, Health Care charges a higher fee per member per month in the first year to recoup the significant set-up cost, which is not a separate promise in the contract. Health Care concludes it does not meet the variable consideration allocation exception to be allocated entirely to the periods in which the fees are earned. Health Care cannot elect any of the optional exemptions. It is required to comply with the disclosure requirements of the transaction price allocated to remaining performance obligations, which includes disclosure of the remaining fixed monthly fees and estimated variable consideration. [606-10-50-13]
Example 6.7.70 **Upfront professional services and SaaS**	Software Host provides upfront professional services and SaaS for three years and receives a usage-based fee. The professional services and SaaS are accounted for as separate performance obligations. Software Host determined that a reasonable amount of variable consideration was not allocated to the professional services and the variable consideration allocation exception was not met. Software Host allocated 10% of the variable consideration to the initial professional services and 90% to the SaaS. As a result, once Software Host commences providing the professional services, the direct allocation exemption is not met because the amounts are not allocated entirely to a wholly unsatisfied performance obligation or distinct service period. That is, the estimated fee is allocated to the professional services that have been performed and the SaaS. [606-10-50-13]
Example 6.7.80	The same facts as in Example 6.7.70, except that the usage-based fees are tiered based on volumes. The tiered/volume pricing resets each annual period.

Examples	Does an optional exemption apply?
Upfront professional services and SaaS – tiered pricing	Software Host determined that a reasonable amount of variable consideration was not allocated to the professional services and the variable consideration allocation exception was not met. Software Host allocated 10% of the variable consideration to the initial professional services and 90% to the SaaS. As a result, once Software Host commences the professional services, the direct allocation exemption is not met because the amounts are not allocated entirely to a wholly unsatisfied performance obligation or distinct service period. That is, the estimated fee is allocated to both the professional services that have been performed and the SaaS. [606-10-50-13]
Example 6.7.90 **Variable consideration allocated entirely to one performance obligation**	Software Host provides upfront professional services and SaaS for three years and receives a fixed fee for the professional services and a usage-based fee for SaaS. The professional services and SaaS are accounted for as separate performance obligations. Software Host concludes that the fixed fee represents the stand-alone selling price for the professional services. It also concludes that allocating the variable amounts entirely to the SaaS would meet the variable consideration allocation exception. Software Host may also conclude that it can apply the as-invoiced practical expedient related to the SaaS. Consequently, Software Host may elect to apply the as-invoiced method exemption or the direct allocation exemption. Under either exemption, the variable fees would not be required to be disclosed. [606-10-50-14(b), 50-14A(b)] However, Software Host will disclose the fixed fee allocated to the professional services that has not yet been recognized as revenue. [606-10-50-14B]
Example 6.7.100 **Fixed consideration allocated to multiple performance obligations and variable consideration allocated entirely to one performance obligation**	The same facts as in Example 6.7.90, except that the fixed fees are more than the stand-alone selling price of the professional services. Software Host is still able to conclude that allocating the variable amounts entirely to the SaaS would meet the variable consideration allocation exception. Software Host could elect to apply the direct allocation exemption. If elected, the variable fees would not be required to be disclosed. [606-10-50-14A(b)] However, Software Host will still disclose the fixed fee allocated to the SaaS and professional services that have not yet been recognized as revenue. [606-10-50-14B]
Example 6.7.110 **Multiple variable payments in one contract allocated to the period they were earned**	Hotel Manager provides management services for two years and receives three types of variable fees: management fee based on 2% of rental revenue, daily reimbursement of labor costs and an annual incentive based on gross profit. Hotel Manager concludes that allocating the 2% fee and the labor reimbursements entirely to each day/month during the

Examples	Does an optional exemption apply?
	contract period would meet the variable consideration allocation exception. Therefore, Hotel Manager could elect the direct allocation exemption for the rental fees and labor reimbursement. If the optional exemption is elected, the rental fees and labor reimbursement would not be disclosed. [606-10-50-14A(b)] Hotel Manager also concludes that the variable annual incentive can be allocated entirely to the annual period to which it relates, but it does not meet the variable consideration allocation exception within the annual period. Hotel Manager could elect the direct allocation exemption, but the exemption would only apply to the portion of the annual incentive fee for annual periods where performance has not occurred. [606-10-50-14A(b)] Therefore, in Year 1 the estimated annual incentive fee would be required to be disclosed once Hotel Manager performs, but the Year 2 annual incentive would not be required to be disclosed until the Year 2 measurement period began if the optional exemption was elected.
Example 6.7.120 **Variable consideration allocated in a series of distinct quantities**	Transaction Processor concludes that the contract consists of a single performance obligation of a series and that the nature of the promise is to process 12 transactions (one per month). The variable amounts (5% of the total dollar amount processed in each transaction) relate specifically to each transaction processed. Each transaction is priced the same throughout the contract period and the changes in the dollar amount reflect the additional value to the customer for processing larger or smaller transactions. Transaction Processor could elect to apply the short-term contract exemption, the as-invoiced method exemption or the direct allocation exemption. [606-10-50-14(a), 50-14(b), 50-14A(b)] In this example, the election of any of these optional exemptions results in the same outcome: no required disclosure of the remaining transaction price.

15.8 Significant judgments when applying Topic 606

Excerpt from ASC 606-10

> Significant Judgments in the Application of the Guidance in This Topic

50-17 An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in this Topic 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:

a. The timing of satisfaction of **performance obligations** (see paragraphs 606-10-50-18 through 50-19)

b. The **transaction price** and the amounts allocated to performance obligations (see paragraph 606-10-50-20).

• > Determining the Timing of Satisfaction of Performance Obligations

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.

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

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.

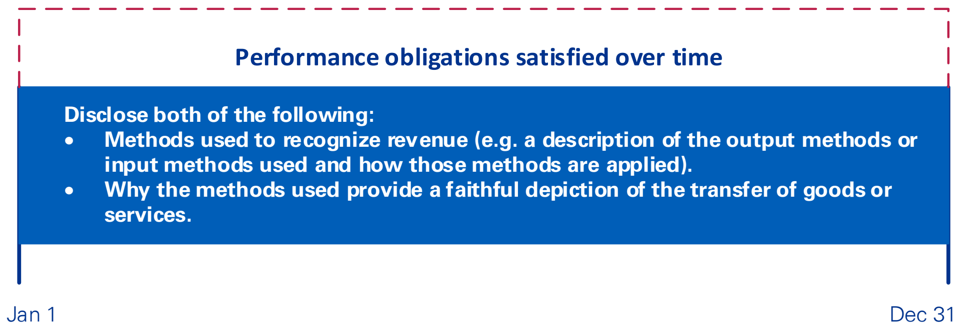
50-21 An entity except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements 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.

15.8.10 Overview

Because applying the principles in Topic 606 requires considerable judgment, financial statement users need an explanation of an entity's critical judgments to fully understand the nature, amount, timing and uncertainty of the entity's reporting of its revenue. For this reason, an entity discloses the judgments and changes in judgments it has made in applying Topic 606 that affect the amount and timing of revenue recognition. The disclosure requirements place particular emphasis on those judgments used to determine the timing of the satisfaction of performance obligations, the transaction price and amounts allocated to performance obligations.

Significant judgments when evaluating the performance obligations satisfied over time



Example 15.8.10
Performance obligation satisfied over time

Construction Company enters into a contract to construct a commercial building for 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. Construction Company accounts for the promised bundle of goods and services as a single performance obligation satisfied over time.

At the inception of the contract, Construction Company expects the following.

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

Construction Company 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, Construction Company has satisfied 40% of its performance obligation on the basis of costs incurred to date ($320,000) relative to total revised estimate of expected costs ($800,000). Construction Company reassesses the variable consideration and concludes that the amount is still constrained.

Consequently, the cumulative revenue and costs recognized for the first year are as follows.

Revenue	$400,000
Costs	(320,000)
Gross profit	**$ 80,000**

Construction Company has chosen the 'cost incurred' method for measuring satisfaction of its performance obligation. Accordingly, it discloses that it uses the 'cost incurred' method and describes how it applies this method. It further states why this method provides a faithful depiction of the transfer of the goods or services to Customer. It also discloses reasons variable consideration ($200,000 bonus) is constrained and excluded from the transaction price.

Excerpt from ASC 606-10

• • > Example 18 — Measuring Progress When Making Goods or Services Available

55-184 An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay $100 per month.

55-185 The entity determines that its promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes. This is because the extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The entity concludes that the customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available. Consequently, the entity's performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a).

55-186 The entity also determines that the customer benefits from the entity's service of making the health clubs available evenly throughout the year. (That is, the customer benefits from having the health clubs available, regardless of whether the customer uses it or not.) Consequently, the entity concludes that the best measure of progress toward complete satisfaction of the performance obligation over time is a time-based measure, and it recognizes revenue on a straight-line basis throughout the year at $100 per month.

Example 15.8.20
Significant judgments for performance obligations satisfied over time

Assume the facts from Example 18 in Topic 606 (reproduced above). The entity discloses that it recognizes revenue on a straight-line basis because it has determined the promise to be a stand-ready obligation and the customer benefits from having the health clubs available throughout the year, regardless of whether the customer uses the services or not.

Significant judgments when evaluating the performance obligations satisfied at a point in time

Example 15.8.30
Performance obligation satisfied at a point in time

Retailer ships goods to the customer FOB shipping point. Although title transfers to the customer at the point of shipment, Retailer insures the goods against risk of loss during transit. This type of an arrangement is often referred to as 'synthetic FOB destination'.

Significant judgment is necessary to determine the point in time control of goods transfers to the customer in this type of arrangement (see Question 7.5.40). Because transfer of the risks and rewards of the asset is only one of the indicators for determining when the customer obtains control of the goods, Retailer may determine based on an evaluation of the facts that control of the goods transfers when the goods are shipped – not when goods are received by the customer. Other indicators such as legal title, physical possession, right to payment and customer acceptance also need to be evaluated.

Retailer satisfies its disclosure requirement by stating why it believes a customer obtains control of promised goods when they are shipped or received by the customer, including the control indicators Retailer considers in its evaluation.

If Retailer elects as an accounting policy to treat shipping as a fulfillment activity rather than a separate performance obligation it also discloses that fact (see section 15.10).

Significant judgments when determining the transaction price

Determining the transaction price	
Disclose the methods, inputs and assumptions used when:	
Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of time value of money and measuring noncash consideration	Assessing whether an estimate of variable consideration is constrained

Excerpt from ASC 606-10

• • > Example 25 — Management Fees Subject to the Constraint

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.

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).

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.

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.

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.

Example 15.8.40
Significant judgments in determining transaction price

Assume the facts from Example 25 in Topic 606 (reproduced above). The entity discloses that the management fees and performance fees are constrained. It discloses the judgments noted in paragraphs 606-10-55-223 – 55-224 that it made to conclude the transaction price should be constrained.

In addition to the disclosures about determining transaction price, the entity discloses the judgments and assumptions from paragraph 606-10-55-225 used to conclude that the management fee is allocated to the distinct services provided during the quarter.

Significant judgments when allocating the transaction price to performance obligations

Allocating the transaction price to performance obligations

Disclose the methods, inputs and assumptions used when:

- **Allocating the transaction price, including estimating stand-alone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)**
- **Measuring obligations for returns, refunds and other similar obligations**

Excerpt from ASC 606-10

• • > Example 57 — Franchise Rights

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 fixed fee of $1 million, as well as a sales-based royalty of 5 percent of the customer's sales for the term of the license. The fixed consideration for the equipment is $150,000 payable when the equipment is delivered.

• • • > Identifying Performance Obligations

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 each distinct. This is because the customer can benefit from each good or service (that is, the license and the equipment) on its own or together with other resources that are readily available (see paragraph 606-10-25-19(a)). The customer can benefit from the license together with the equipment that is delivered before the opening of the franchise, and the equipment can be used in the franchise or sold for an amount other than scrap value. The entity also determines that the promises to grant the franchise license and to transfer the equipment are separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b). The entity concludes that the license and the equipment are not inputs to a combined item (that is, they are not fulfilling what is, in effect, a single promise to the customer). In reaching this conclusion, the entity considers that it is not providing a significant service of integrating the license and the equipment into a combined item (that is, the licensed intellectual property is not a component of, and does not significantly modify, the equipment). Additionally, the license and the equipment are not highly interdependent or highly interrelated because the entity would be able to fulfill each promise (that is, to license the franchise or to transfer the equipment) independently of the other. Consequently, the entity has two performance obligations:

a. The franchise license
b. The equipment.

• • • > Allocating the Transaction Price

55-378 The entity determines that the transaction price includes fixed consideration of $1,150,000 and variable consideration (5 percent of the customer's sales from the franchise store). The standalone selling price of the equipment is $150,000 and the entity regularly licenses franchises in exchange for 5 percent of customer sales and a similar upfront fee.

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 allocating the sales-based royalty (as well as the additional $1 million in fixed consideration) to the franchise license would be consistent with an allocation based on the entity's relative standalone selling prices in similar contracts. Consequently, the entity concludes that the variable consideration (that is, the sales-based royalty) should be allocated entirely to the performance obligation to grant the franchise license.

Example 15.8.50

Significant judgments in allocating transaction price to performance obligations

Assume the facts from Example 57 in Topic 606 (reproduced above). The entity's judgment to allocate the sales-based royalty and the $1 million fixed fee entirely to the franchise license affects the timing of revenue recognition. If significant to the entity, this fact should be disclosed along with the assumptions used to reach this judgment – e.g. stand-alone selling price of equipment, consistency with stand-alone selling price for franchise licenses in similar contracts.

Disclosure about judgments related to allocating transaction price is also required for an arrangement that includes sales- or usage-based royalties subject to a guaranteed minimum (see section 10.11). As shown in Examples 10.11.70, 10.11.90 and 10.11.100, there are several approaches that an entity could consider. It would be appropriate to disclose the judgments the entity makes when determining the best approach to allocate the minimum guarantee and recognize revenue.

15.9 Costs to obtain or fulfill a contract

Excerpt from ASC 340-40

> Assets Recognized from the Costs to Obtain or Fulfill a Contract with a Customer

50-1 Consistent with the overall disclosure objective in paragraph 606-10-50-1 and the guidance in paragraphs 606-10-50-2 through 50-3, an entity shall provide the following disclosures of assets recognized from the costs to obtain or fulfill a **contract** with a **customer** in accordance with paragraphs 340-40-25-1 or 340-40-25-5.

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.

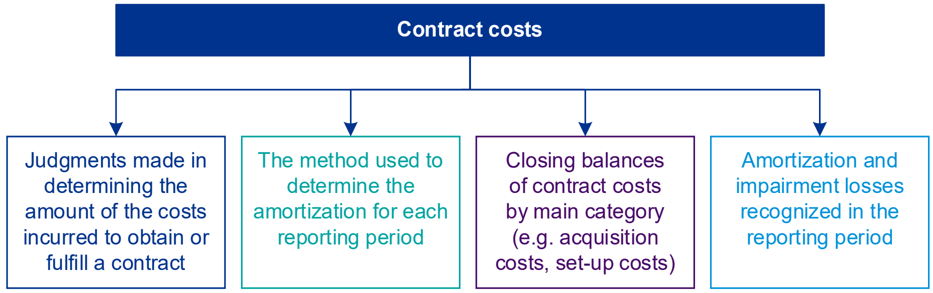
50-3 An entity shall disclose all of the following:

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.

50-4 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, may elect not to provide the disclosures in paragraphs 340-40-50-2 through 50-3.

15.9.10 Overview

An entity discloses the closing balance of assets that are recognized from the costs incurred to obtain or fulfill contracts with customers, separating them by their main category – e.g. acquisition costs, pre-contract costs, set-up costs and other fulfillment costs. It further discloses the amount of amortization and any impairment losses recognized in the reporting period from these assets. It also describes the judgments it made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer and the method used to determine the amortization for each reporting period. [340-40-50-1 – 50-3]



Question 15.9.10

Are the amortization of contract costs and impairment losses presented as separate line items in the income statement?

Interpretive response: Usually not. Topic 606 simply requires that these amounts be disclosed; it does not specify whether an entity presents these amounts as separate line items in the income statement or whether it may aggregate them with other items – e.g. other expenses.

To determine the appropriate presentation, an entity should apply the general principles for the presentation of financial statements (see chapter 4 of KPMG Handbook, Financial Statement Presentation). However, if it does not disclose these amounts on the face of the income statement by presenting them as separate line items, it needs to disclose these amounts in the footnotes.

See Question 12.6.10 for a discussion of income statement classification of amortization.

15.10 Disclosure of practical expedients and accounting policies elected

Excerpt from ASC 606-10

> Meeting the Objective

10-4 This guidance specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or **performance obligations**) within that portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

• > Promises in Contracts with Customers

25-18B If shipping and handling activities are performed after a customer obtains control of the good, then the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good. The entity shall apply this accounting policy election consistently to similar types of transactions. An entity that makes this election would not evaluate whether shipping and handling activities are promised services to its customers. If revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities shall be accrued. An entity that applies this accounting policy election shall comply with the accounting policy disclosure requirements in paragraphs 235-10-50-1 through 50-6.

> Determining the Transaction Price

32-2A An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process shall be excluded from the scope of the election. An entity that makes this election shall exclude from the transaction price all taxes in the scope of the election and shall comply with the applicable accounting policy guidance, including the disclosure requirements in paragraphs 235-10-50-1 through 50-6.

• > The Existence of a Significant Financing Component in the Contract

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.

> Practical Expedients

50-22 If an entity elects to use the practical expedient in either paragraph 606-10-32-18 (about the existence of a significant financing component) or paragraph 340-40-25-4 (about the incremental costs of obtaining a contract), the entity shall disclose that fact.

50-23 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 paragraph 606-10-50-22.

• • > Output Methods

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 the right to invoice.

Excerpt from ASC 340-40

• > Incremental Costs of Obtaining a Contract

25-4 As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

Excerpt from ASC 605-35

> Provisions for Losses on Contracts

25-47 If a group of contracts are combined based on the guidance in paragraphs 606-10-25-9, they shall be treated as a unit in determining the necessity for a provision for a loss. If contracts are not combined, the loss is determined at the contract level (see paragraph 605-35-25-45). As an accounting policy election, **performance obligations** identified in accordance with paragraphs 606-10-25-14 through 25-22 may be considered separately in determining the need for a provision for a loss. That is, an entity can elect to determine provisions for losses at either the contract level (including contracts that are combined in accordance with the guidance in paragraph 606-10-25-9) or the performance obligation level. An entity shall apply this accounting policy election in the same manner for similar types of contracts.

15.10.10 Overview

Topic 606 provides certain practical expedients and accounting policy elections that are summarized in the chart and discussed in detail in the respective chapters.

Optional practical expedients

Significant financing component	Cost of obtaining a contract	Portfolio approach	Invoice method
Not adjusting the transaction price for significant financing component for period less than one year (see section 5.5.30)	Expensing the cost of obtaining a contract when amortization period is less than one year (see section 12.4)	Applying Topic 606 to portfolio of contracts (see section 2.5)	Recognizing revenue in the amount to which the entity has a right to invoice (see section 7.4.50)

Accounting policy elections		
Shipping and handling	**Sales taxes**	**Loss contract unit of account**
Accounting for shipping and handling after control transfers as activities to fulfill the promise to transfer the good (see section 4.2.60)	Presenting revenue net of sales and other similar taxes (see section 5.2.20)	Determination of loss at the performance obligation level (see section 13.4.20)

The following disclosures are relevant for each of the items in the chart.

Significant financing component	Disclose election of the practical expedient. [606-10-50-22]
Cost of obtaining a contract	Disclose election of the practical expedient. [606-10-50-22]
Portfolio approach	No specific disclosures, but consider whether any significant judgments need to be disclosed (see section 15.8).
Invoice method	No specific disclosures, but consider whether any significant judgments need to be disclosed (see section 15.8).
Optional exemptions to remaining transaction price disclosure	Disclose any election not to disclose the remaining transaction price for eligible arrangements (see section 15.7.20). [606-10-50-15]
Immaterial promises	No specific disclosures, but consider whether any significant judgments need to be disclosed (see section 15.8).
Shipping and handling	Disclose accounting policy (and apply consistently). [606-10-25-18B, 235-10-50-1 – 50-6]
Sales taxes	Disclose accounting policy (and apply consistently). [606-10-32-2A, 235-10-50-1 – 50-6]
Loss contract unit of account	No specific disclosure requirement related to an entity's election to determine a loss provision under Subtopic 605-35 at the performance obligation level versus the contract level.

Subtopic 952-606 provides franchisors that are not public business entities with a practical expedient and an accounting policy election regarding pre-opening activities provided to a franchisee. A nonpublic company franchisor must be in the scope of Topic 952 to take advantage of this expedient and policy election. See Question 10.5.55.

Practical expedient and policy election	Disclosures
Practical expedient to account for pre-opening activities as distinct performance obligation(s) from franchise license	Disclose election of the practical expedient. [952-606-50-1]
Policy election to account for multiple pre-opening activities as a single performance obligation	Disclose accounting policy (and apply consistently). [952-606-50-2, 235-10-50-1 – 50-6]

15.11 Interim disclosures

Excerpt from ASC 270-10

• > Disclosure of Summarized Interim Financial Data by Publicly Traded Companies

50-1 Many **publicly traded companies** report summarized financial information at periodic interim dates in considerably less detail than that provided in annual financial statements. While this information provides more timely information than would result if complete financial statements were issued at the end of each interim period, the timeliness of presentation may be partially offset by a reduction in detail in the information provided. As a result, certain guides as to minimum disclosure are desirable. (It should be recognized that the minimum disclosures of summarized interim financial data required of publicly traded companies do not constitute a fair presentation of financial position and results of operations in conformity with generally accepted accounting principles [GAAP].) If publicly traded companies report summarized financial information at interim dates (including reports on fourth quarters), the following data should be reported, as a minimum:

...

50-1A Consistent with paragraph 270-10-50-1, 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, shall disclose all of the following information about **revenue** from **contracts** with **customers** consistent with the guidance in Topic 606:

a. A disaggregation of revenue for the period, see paragraphs 606-10-50-5 through 50-6 and paragraphs 606-10-55-89 through 55-91.
b. The opening and closing balances of receivables, **contract assets**, and **contract liabilities** from contracts with customers (if not otherwise separately presented or disclosed), see paragraph 606-10-50-8(a).
c. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period, see paragraph 606-10-50-8(b).

d. Revenue recognized in the reporting period from **performance obligations** satisfied (or partially satisfied) in previous periods (for example, changes in **transaction price**), see paragraph 606-10-50-12A).
e. Information about the entity's remaining performance obligations as of the end of the reporting period, see paragraphs 606-10-50-13 through 50-15.

15.11.10 Overview

Public business entities, not-for-profit entities that are conduit bond obligors, and employee benefit plans that file or furnish financial statements with or to the SEC must provide the following disclosures in their interim financial statements, if they are material.

Interim disclosure requirements

Disaggregation of revenue	Contract balances		Performance obligations	
Disaggregation of revenue for the period	Opening and closing balances of contract assets, contract liabilities and receivables	Revenue recognized in current period that was included in the opening contract liability balance	Revenue from performance obligations satisfied (or partially satisfied) in previous periods	Information about the entity's remaining performance obligations

Information on how to comply with these interim disclosure requirements is in each of the above sections of this chapter.

Question 15.11.10

Does a publicly traded entity disclose both quarter-to-date and year-to-date information for the disclosures required in its interim financial statements?

Interpretive response: Yes. The FASB amended Topic 270 to require certain quantitative disclosures about revenue in an entity's interim financial statements. If publicly traded entities report summarized financial information at interim dates (including reports on fourth quarters), the required disclosures should be made for those interim periods. Therefore if quarter-to-date and year-to-date financial information is provided, the quantitative required disclosures should be made for each of the periods presented. [270-10-50-1 – 50-1A]

15.12 Reduced disclosure requirements for other entities

Entities other than public business entities, not-for-profit entities that are conduit bond obligors, or employee benefit plans that furnish their financial statements with the SEC can elect not to provide certain disclosures that are required for public business entities.

The following table summarizes the reduced disclosure requirements for these entities.

Required	Optional
Disaggregation of revenue (section 15.4)	
— At minimum, revenue disaggregated in accordance with the timing of transfer of goods or services. — Qualitative information about how economic factors (e.g. type of customer, geographical location of customers and type of contract) and significant changes in those economic factors affect the nature, amount, timing and uncertainty of revenue and cash flows.	— Disaggregation of revenue into categories that depicts how revenue and cash flows are affected by economic factors. — Sufficient information to understand relationship between disaggregated revenue and the segment disclosure.
Contract balances (section 15.5)	
The opening and closing balances of contract assets, contract liabilities and receivables from contracts with customers if they are not otherwise separately presented or disclosed in the balance sheet.	— Explanation of the significant changes in the contract balances, including qualitative and quantitative information. — Explanation of how the timing of satisfaction of performance obligations and payment terms effect the contract balances. — Revenue recognized in current period that was included in the opening contract liability balance.
Performance obligations (section 15.6)	
— When performance obligations are typically satisfied. — Significant payment terms. — The nature of goods and services. — Obligations for returns, refunds and similar obligations. — Type of warranties and related obligations.	Revenue recognized from performance obligations satisfied (or partially satisfied) in previous periods (e.g. changes in transaction price).
Transaction price allocated to remaining performance obligations (section 15.7)	
None	The amount of the transaction price allocated to remaining performance obligations, including the explanation of when those amounts are expected to be recognized as revenue.

<table>
<tr><th>Required</th><th>Optional</th></tr>
<tr><td colspan="2">Significant judgments when applying the guidance (section 15.8)</td></tr>
<tr><td>
— The judgments and changes in judgments that significantly affect the determination of the amount and timing of revenue.
— The judgments and changes in judgments used in determining the timing of the satisfaction of performance obligations, the transaction price and the amounts allocated to performance obligations.
— The methods, inputs and assumptions used to recognize revenue – e.g. a description of the output or input methods and how those methods are applied.
— Information about the methods, inputs and assumptions used when assessing whether an estimate of variable consideration is constrained.
</td><td>
— An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.
— The significant judgments made in evaluating when a customer obtains control of promised goods or services.
— Information about the methods, inputs and assumptions used when:
  – 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;
  – allocating the transaction price, including estimating stand-alone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable); and
  – measuring obligations for returns, refunds and other similar obligations.
</td></tr>
<tr><td colspan="2">Costs to obtain or fulfill a contract (section 15.9)</td></tr>
<tr><td>None</td><td>
— The closing balance of assets that are recognized from the costs incurred to obtain or fulfill a contract with a customer, separating them by their main category (e.g. acquisition costs, pre-contract costs, set-up costs and other fulfillment costs).
— The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer.
— The method used to determine the amortization for each reporting period.
— The amount of amortization and any impairment losses recognized in the reporting period.
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</table>

Required	Optional
Practical expedients and accounting policies elected (section 15.10)	
When accounting policy elections related to shipping and handling or sales taxes are made, accounting policy disclosures required by 235-10-50-1 – 50-6 are made.	The use of practical expedients not to adjust the transaction price for a significant financing component (paragraph 606-10-32-18) and not to capitalize costs incurred to obtain a contract (paragraph 340-40-25-4).
Interim disclosure (section 15.11)	
None	See section 15.11 on interim disclosure.

17. Subtopic 610-20: Derecognition of nonfinancial assets

Detailed contents

17.1 How the standard works

Subtopic 610-20 provides a single model for recognizing a gain or loss on the transfer of nonfinancial assets and in-substance nonfinancial assets to noncustomers.

The FASB made two decisions that drive the accounting for the derecognition of nonfinancial assets.

— There is little economic difference between the sale of a nonfinancial asset to a customer and to a noncustomer. Therefore, an entity applies the principles in Topic 606 to determine the gain or loss in a transaction with a noncustomer.

— The derecognition of legal entities that hold only nonfinancial assets, or a combination of nonfinancial and in-substance nonfinancial assets, can be in the scope of Subtopic 610-20. In those transactions, an entity needs to evaluate whether it loses control (or does not acquire control of the counterparty) of the legal entity that holds the assets under Subtopic 810-10 (consolidation) before recognizing a gain or loss.

Because Subtopic 610-20 uses the principles in Topic 606 and Subtopic 810-10 to determine the gain or loss, it focuses on 1) scope and 2) incremental guidance on recognizing the gain or loss.

Scope

The scope of Subtopic 610-20 applies to transfers of nonfinancial assets and in-substance nonfinancial assets unless other guidance takes precedence. The following table summarizes transactions that are in scope and when they are subject to other guidance.

In-scope items include…		
Nonfinancial assets (see Question 17.2.30).	Transfer of an interest in a subsidiary, including partial sales (see Questions 17.2.80 and 17.2.90).	In-substance nonfinancial assets (see Question 17.2.100).
…unless the…		
— counterparty is a customer and the transaction is in the scope of Topic 606 (see section 2.2.20 and Question 17.2.130); — asset or subsidiary is (or is a part of) a business (see Question 17.2.140); — asset is transferred in a sale-leaseback transaction (see KPMG Handbook, Leases, and Question 17.2.150); or — transaction is in the scope of other guidance (see Question 17.2.170).		

Incremental guidance on recording the gain or loss

The following table summarizes key incremental guidance in Subtopic 610-20.

Topic	Key consideration
Topic 606 vs 810	An entity first considers whether it loses a controlling financial interest (or never obtains a controlling financial interest) in the entity that holds the transferred assets under Topic 810. If it does, next it applies the principles of Topic 606 to determine the gain/loss recognition. See Question 17.3.10.
Unit of account	A distinct nonfinancial asset is the unit of account even if the form of the transaction is the transfer of interests in a legal entity. See Question 17.3.40.
Retained NCI (partial sales)	A retained noncontrolling interest (NCI) is measured at fair value and factored into the gain or loss on derecognition, which results in a 100% gain/loss on derecognition in a partial sale. See section 17.3.40.

See KPMG publication, Revenue: Real estate, for in-depth discussion on real estate sales in the scope of Subtopic 610-20.

17.2 Scope of Subtopic 610-20

Excerpt from ASC 610-20

> Entities

15-1 The guidance in this Subtopic applies to all entities.

> Transactions

15-2 Except as described in paragraph 610-20-15-4, the guidance in this Subtopic applies to gains or losses recognized upon the derecognition of nonfinancial assets and **in substance nonfinancial assets**. Nonfinancial assets within the scope of this Subtopic include **intangible assets**, land, buildings, or materials and supplies and may have a zero carrying value. In substance nonfinancial assets are described in paragraphs 610-20-15-5 through 15-8.

15-3 The guidance in this Subtopic applies to a transfer of an ownership interest (or a **variable interest**) in a consolidated **subsidiary** (that is not a **business** or **nonprofit activity**) only if all of the assets in the subsidiary are nonfinancial assets and/or in substance nonfinancial assets.

15-4 The guidance in this Subtopic does not apply to the following:

a. A transfer of a nonfinancial asset or an in substance nonfinancial asset in a **contract** with a **customer**, see Topic 606 on **revenue** from contracts with customers
b. A transfer of a subsidiary or group of assets that constitutes a **business** or **nonprofit activity**, see Section 810-10-40 on consolidation
c. Sale and leaseback transactions within the scope of Subtopic 842-40 on leases
d. A conveyance of oil and gas mineral rights within the scope of Subtopic 932-360 on extractive activities—oil and gas
e. A transaction that is entirely accounted for in accordance with Topic 860 on transfers and servicing (for example, a transfer of investments accounted for under Topic 320 on investments—debt securities, Topic 321 on investments-equity securities, Topic 323 on investments—equity method and **joint ventures**, Topic 325 on investments—other, Topic 815 on derivatives and hedging, and Topic 825 on financial instruments)
f. A transfer of nonfinancial assets that is part of the consideration in a business combination within the scope of Topic 805 on business combinations, see paragraph 805-30-30-8
g. A nonmonetary transaction within the scope of Topic 845 on nonmonetary transactions
h. A lease contract within the scope of Topic 842 on leases
i. An exchange of takeoff and landing slots within the scope of Subtopic 908-350 on airlines—intangibles
j. A contribution of **cash** and other assets, including a promise to give, within the scope of Subtopic 720-25 on other expenses—contributions made or within the scope of Subtopic 958-605 on not-for-profit entities—revenue recognition
k. A transfer of an investment in a venture that is accounted for by proportionately consolidating the assets, liabilities, revenues, and expenses

of the venture as described in paragraph 810-10-45-14

l. A transfer of nonfinancial assets or in substance nonfinancial assets solely between entities or persons under common control, such as between a **parent** and its subsidiaries or between two subsidiaries of the same parent.

17.2.10 Overview

Subtopic 610-20 provides a single model for recognizing a gain or loss on the transfer of nonfinancial assets and in-substance nonfinancial assets to noncustomers. The Subtopic applies regardless of the industry in which an entity operates. [610-20-15-1, 15-2]

Subtopic 610-20 also applies to a transfer of an ownership interest in a consolidated subsidiary (that is not a business or NFP activity) if, and only if, all of the assets in the subsidiary are nonfinancial assets or a combination of nonfinancial and in-substance nonfinancial assets. [610-20-15-3]

In many transactions, the scope of Subtopic 610-20 is clear (e.g. a transfer of only nonfinancial assets). However, when a mix of financial and nonfinancial assets are transferred (whether inside or outside a subsidiary), it can require multiple layers of analysis. In those cases, the ordering of the analysis is important to determine if the transaction is in the scope of Subtopic 610-20 and the decision tree in Question 17.2.20 may be helpful.

Question 17.2.10
What is in the scope of Subtopic 610-20?

Interpretive response: The scope of Subtopic 610-20 generally applies to transfers of nonfinancial assets unless other guidance takes precedence. The following table summarizes the transactions that are in-scope and when they are subject to other guidance. [610-20-15-2 – 15-4]

In-scope items include…		
Nonfinancial assets (see Question 17.2.30)	Transfer of an interest in a subsidiary, including partial sales (see Questions 17.2.80 and 17.2.90).	In-substance nonfinancial assets (see Question 17.2.100).

…unless the…

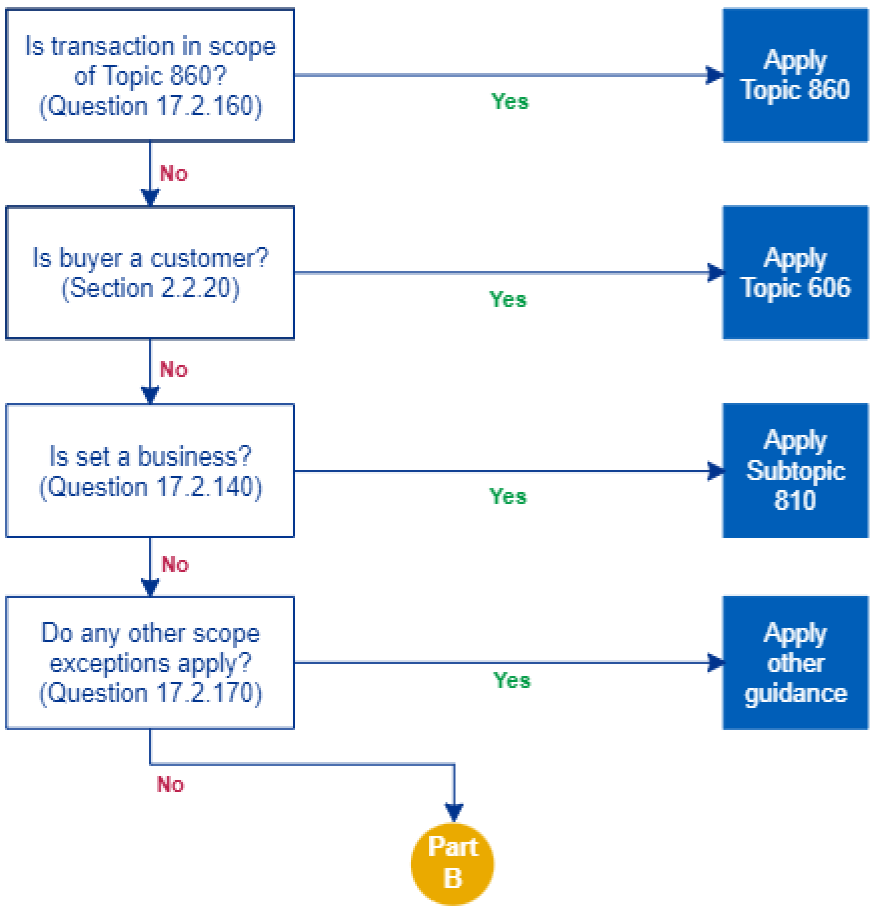
- counterparty is a customer and in the scope of Topic 606 (see section 2.2.20 and Question 17.2.130);
- asset or subsidiary is (or is a part of) a business (see Question 17.2.140);
- asset is transferred in a sale-leaseback transaction (see KPMG Handbook, Leases, and Question 17.2.150); or
- transaction is in the scope of other guidance (see Question 17.2.170).

Question 17.2.20

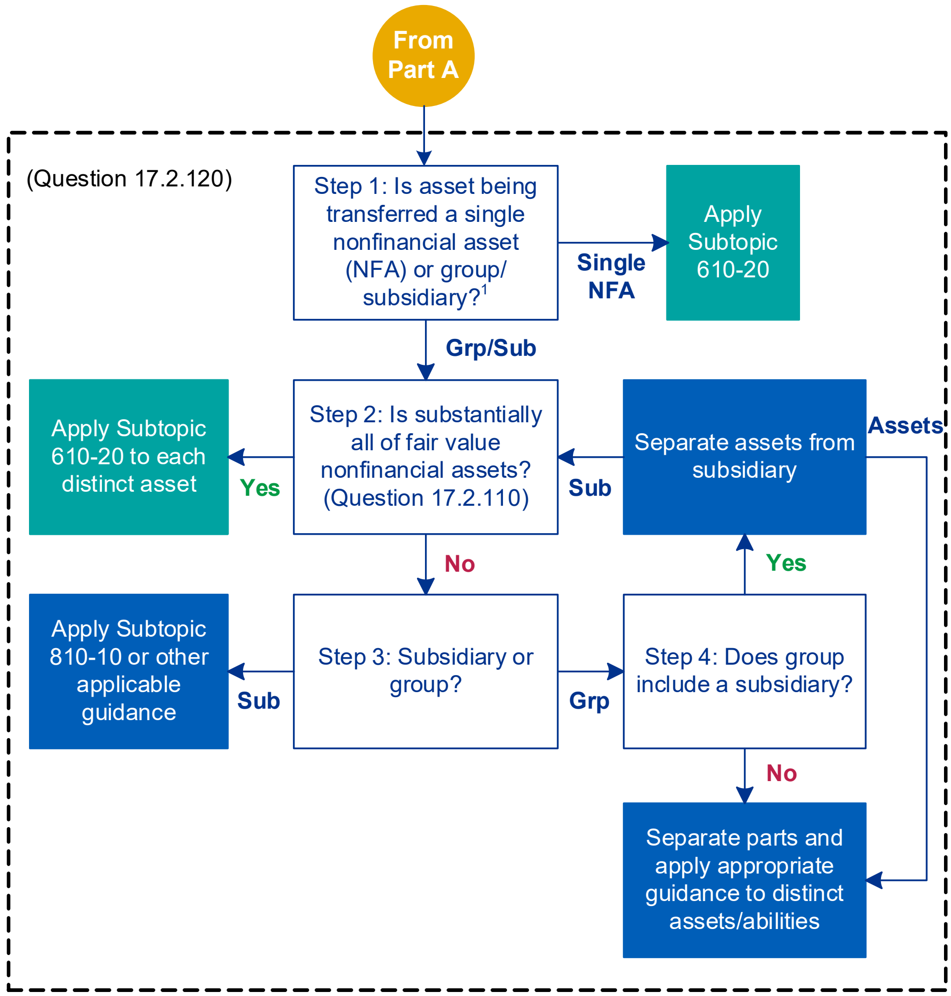
In what sequence is the scope of Subtopic 610-20 evaluated?

Interpretive response: The following decision tree summarizes the sequence of analysis required to evaluate the scope of Subtopic 610-20 for the whole or any part of the transaction. This decision tree may be more useful in more complicated transactions (mix of financial and nonfinancial assets) where the scope is not clear. [610-20-15-10]

Part A



Part B



Note 1: If the transfer includes other contractual arrangements that are not the assets of the seller that will be derecognized (e.g. guarantees), those contracts are separated and accounted for under the applicable guidance. See section 17.2.60 for additional guidance.

17.2.20 Nonfinancial assets

Question 17.2.30

What is a nonfinancial asset for purposes of Subtopic 610-20?

Interpretive response: Subtopic 610-20 applies to the derecognition of nonfinancial assets in transactions with noncustomers. However, Subtopic 610-20 does not apply to nonfinancial assets transferred that meet the definition of a business. [610-20-15-4(b)]

Nonfinancial assets include land, buildings, intangible assets, and materials and supplies. Nonfinancial assets may be either recognized or unrecognized (i.e. a zero carrying amount). [610-20-15-2]

An asset that meets the definition of a financial asset (e.g. cash, receivables, equity method investment) is not a nonfinancial asset. However, a financial asset could be an in-substance nonfinancial asset (see section 17.2.40).

Question 17.2.40

Are transfers of nonfinancial assets for nonmonetary consideration in the scope of Subtopic 610-20?

Interpretive response: Yes. Nonfinancial assets and in-substance nonfinancial assets exchanged for nonmonetary consideration are in the scope of Subtopic 610-20. This includes transactions where the entity transfers a nonfinancial asset for an NCI in the counterparty. [ASU 2017-05.BC50]

Transfers of nonfinancial assets in the scope of Subtopic 610-20 in exchange for noncash consideration are explicitly scoped out of Topic 845 (nonmonetary transactions). At the same time, Subtopic 610-20 explicitly scopes out transactions in the scope of Topic 845. While this may appear to be a circular reference, the effect is that Topic 845 only applies to transfers of nonfinancial assets that are not exchanges (e.g. nonreciprocal transfers with owners) or when Subtopic 610-20 would otherwise not apply (e.g. when there is explicit guidance in Topic 845 that applies to the transaction such as exchanges of inventory with the same counterparty). [610-20-15-4(g), 845-10-15-4(k), 845-10-55-2, ASU 2017-05.BC50]

Paragraph 845-10-55-2 clarifies the ordering of guidance for exchange transactions and that Topic 845 only applies when Subtopic 610-20 otherwise would not. Therefore, we believe the application of Topic 845 to transfers of nonfinancial assets in exchange for noncash consideration will be rare (other than for exchanges of inventory with the same counterparty). [610-20-15-4(g), 845-10-15-4(k)]

Question 17.2.50

Is the license of rights to a nonfinancial asset in the scope of Subtopic 610-20?

Interpretive response: When an entity's ordinary activities do not involve licensing IP, the contract is not in the scope of Topic 606. However, Subtopic 610-20 applies only to gains and losses on the derecognition of nonfinancial assets. As a result, an IP licensing transaction with a noncustomer is not directly in the scope of Subtopic 610-20 because the entity is not derecognizing the IP.

In the absence of other guidance, we believe an entity should apply the licensing guidance in Topic 606 by analogy to determine the recognition and measurement of consideration in transactions that are not an output of the entity's ordinary activities.

See Question 10.2.20 for further discussion on selling a license to a noncustomer, and chapter 10 for licensing IP in Topic 606.

Question 17.2.60

Are services in the scope of Subtopic 610-20?

Interpretive response: No. Subtopic 610-20 applies only to gains and losses on the derecognition of nonfinancial assets, and therefore services provided to a noncustomer are not in scope.

In the absence of other guidance, we believe it is generally acceptable to apply the guidance in Topic 606 by analogy to determine the recognition and measurement of services provided that are not an output of the entity's ordinary activities (e.g. when not in the scope of Topic 606).

Question 17.2.70

Is the transfer of a crypto asset that is accounted for as an intangible asset in the scope of Subtopic 610-20?

Background: The accounting for crypto assets is an emerging area. The AICPA Practice Aid, Accounting for and Auditing of Digital Assets, states that an entity should account for crypto assets as an indefinite-lived intangible asset under Topic 350 unless it applies industry-specific guidance such as Topic 946 (investment companies) or Topic 940 (broker dealers). [AICPA Digital Assets Q1]

'Crypto assets' are specific digital assets (e.g. bitcoin, ether) that: [AICPA Digital Assets Q1]

- function as a medium of exchange; and
- have all of the following characteristics:
  - are not issued by a jurisdictional authority (e.g. a sovereign government);
  - do not give rise to a contract between the holder and another party; and
  - are not considered a security under the Securities Act of 1933 or the Securities Exchange Act of 1934.

Interpretive response: Consistent with the AICPA practice aid, when the transferring entity accounts for a crypto asset as an indefinite-lived intangible asset, we believe that a subsequent transfer of that intangible asset to a noncustomer is in the scope of Subtopic 610-20 unless another scope exception applies. This is consistent with the sale of other intangible assets (see Question 17.2.30). [AICPA Digital Assets Q9]

When applying Subtopic 610-20 to crypto asset sales and evaluating the transfer of control and ownership, it is important to consider the relevant legal environment, especially in situations that are more complicated than a simple sale – e.g. a transaction that involves ongoing custodial services by the seller. For crypto assets, this evaluation may require special attention to legal issues, which is complicated by the fact that case law is only beginning to develop.

Future developments**

Accounting for and disclosure of crypto assets

On December 13, 2023, the FASB issued an Accounting Standards Update, Accounting for and disclosure of crypto assets. The ASU provides guidance on fair value measurement, presentation and disclosures for crypto assets in its scope. It requires entities to subsequently measure in-scope crypto assets at fair value, with changes in fair value recognized in net income each reporting period.

The guidance is effective for all entities for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. Early adoption is permitted.

For additional discussion of the ASU, see KPMG Defining Issues, FASB issues final ASU on crypto asset accounting.

17.2.30 Transfer of an interest in a subsidiary

Question 17.2.80

When is the transfer of an interest in a consolidated subsidiary in the scope of Subtopic 610-20?

Interpretive response: Subtopic 610-20 applies to the transfer of an interest in a consolidated subsidiary if the subsidiary:

— is not a business (or part of a business being transferred); and
— the subsidiary has only nonfinancial assets or a combination of nonfinancial and in-substance nonfinancial assets. [610-20-15-3]

The types of transactions in scope include the transfer of ownership interests in those subsidiaries, either in part (partial sales see Question 17.2.90) or in whole (100% ownership).

Subtopic 610-20 also applies to other scenarios where an entity loses control of a subsidiary in scope. For example, an entity may lose control over a subsidiary following expiration or termination of a contractual agreement, a dilution event, a government action, a default of a subsidiary’s nonrecourse debt or the contribution of those assets to a joint venture or another noncontrolled investee. [610-20-05-2]

Question 17.2.90

When are partial sales of a subsidiary in the scope of Subtopic 610-20?

Interpretive response: As described in Question 17.2.80, Subtopic 610-20 applies to partial transfers of ownership interests in a subsidiary.

Partial sales of nonfinancial assets can occur in several other ways that are also in scope; the following examples would be considered a partial sale in the scope of Subtopic 610-20.

— **Transaction 1.** A seller and a third-party investor form a venture. The seller contributes machinery to the newly formed venture and the third-party investor contributes cash, property or services. The seller has a controlling financial interest in the venture post-sale and no interest in the third party and the third party has an NCI in the venture.

— **Transaction 2.** Assume the same facts as Transaction 1 except the seller retains only an NCI in the venture post-sale. The venture may be a joint venture.

— **Transaction 3.** A seller contributes machinery to a newly formed, wholly owned venture. Sometime later, it sells an NCI in the venture to a third-party investor for cash, property or services. The consideration may come directly from the investor to the seller, or may be contributed by the investor to the venture. The seller retains a controlling financial interest in the venture post-sale and no interest in the third party.

— **Transaction 4.** Assume the same facts as Transaction 3 except the seller retains only an NCI in the venture post-sale. The venture may be a joint venture.

— **Transaction 5.** A seller transfers machinery to an existing equity method investee in exchange for cash or noncash consideration.

All of these transactions are similar in nature and are accounted for under Subtopic 610-20. However, the seller has different considerations relative to derecognition and measurement depending on whether it retains a controlling interest or an NCI (see section 17.3). [610-20-15-3, 323-10-35-7(c), 970-323-30-3, ASU 2017-05.BC43–BC51]

17.2.40 In-substance nonfinancial assets

Excerpt from ASC 610-20

> In Substance Nonfinancial Assets

15-5 An **in substance nonfinancial asset** is a financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets that are promised to a counterparty in a contract is concentrated in nonfinancial assets, then all of the financial assets promised to the counterparty in the contract are in substance nonfinancial assets. For purposes of this evaluation, when a contract includes the transfer of ownership interests in one or more consolidated **subsidiaries** that is not a business, an entity shall evaluate the underlying assets in those subsidiaries.

15-6 When a contract includes the transfer of ownership interests in one or more consolidated subsidiaries that is not a business, and substantially all of the fair value of the assets promised to a counterparty in the contract is not concentrated in nonfinancial assets, an entity shall evaluate whether substantially all of the fair value of the assets promised to the counterparty in an individual subsidiary within the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets in an individual subsidiary is concentrated in nonfinancial assets, then the financial assets in that subsidiary are in substance nonfinancial assets. (See Case C of Example 1 in paragraphs 610-20-55-9 through 55-10.)

15-7 When determining whether substantially all of the fair value of the assets promised to a counterparty in a contract (or an individual consolidated subsidiary within a contract) is concentrated in nonfinancial assets, **cash** or **cash equivalents** promised to the counterparty shall be excluded. Also, any liabilities assumed or relieved by the counterparty shall not affect the determination of whether substantially all of the fair value of the assets transferred is concentrated in nonfinancial assets.

15-8 If all of the assets promised to a counterparty in an individual consolidated subsidiary within a contract are not nonfinancial assets and/or in substance nonfinancial assets, an entity shall apply the guidance in paragraph 810-10-40-3A(c) or 810-10-45-21A(b)(2) to determine the guidance applicable to that subsidiary.

• > Example 1 - Scope

• • > Case B – Nonfinancial Assets and Financial Assets

55-6 Entity X enters into a contract to transfer machinery and financial assets, both of which have significant fair value. Entity X concludes that the assets promised in the contract are not a business within the scope of Topic 810 and are not an output of the entity's ordinary activities within the scope of Topic 606. Entity X also concludes that substantially all of the fair value of the assets promised in the contract is not concentrated in nonfinancial assets. Therefore, the financial assets promised in the contract are not in substance nonfinancial assets.

55-7 In accordance with the guidance in paragraph 610-20-15-9, Entity X should derecognize only the machinery in accordance with this Subtopic. Entity X should apply the guidance in paragraph 606-10-15-4 to separate and measure the financial assets.

55-8 If Entity X transfers the machinery and financial assets by transferring ownership interests in a consolidated subsidiary, it would still conclude that the financial assets are not in substance nonfinancial assets. As described in paragraph 610-20-15-8, if all of the assets promised to the counterparty in an individual consolidated **subsidiary** within a contract are not nonfinancial assets and/or in substance nonfinancial assets, those assets should not be derecognized in accordance with this Subtopic. Instead, Entity X should apply the guidance in paragraph 810-10-40(c) or 810-10-45-21A(b)(2) to determine the guidance applicable to that subsidiary.

• • > Case C—One Subsidiary That Holds Nonfinancial Assets and One Subsidiary That Holds Financial Assets

55-9 Entity A enters into a contract to transfer ownership interests in two consolidated subsidiaries to a single counterparty. Subsidiary 1 consists entirely of nonfinancial assets, and Subsidiary 2 consists entirely of financial assets. Assume that the assets in Subsidiary 1 and Subsidiary 2 have an equal amount of fair value. Entity A concludes that the transaction is not the transfer of a business within the scope of Topic 810 and that the subsidiaries are not outputs of the entity's ordinary activities within the scope of Topic 606.

55-10 Entity A first considers whether substantially all of the fair value of the assets promised to the counterparty in the contract is concentrated in nonfinancial assets. Because the contract includes the transfer of ownership interests in one or more consolidated subsidiaries, Entity A evaluates the underlying assets in those subsidiaries. Entity A concludes that because both the financial assets and nonfinancial assets have an equal amount of fair value, substantially all of the fair value of the assets promised to the counterparty in the contract is not concentrated in nonfinancial assets. Entity A next considers whether substantially all of the fair value of the assets within Subsidiary 1 or Subsidiary 2 is concentrated in nonfinancial assets. Because the assets transferred within Subsidiary 1 are entirely nonfinancial assets, Entity A concludes that those assets are within the scope of this Subtopic. Entity A also concludes that the financial assets in Subsidiary 2 are not in substance nonfinancial assets and, therefore, are not within the scope of this Subtopic. Entity A should apply the guidance in paragraph 606-10-15-4 to separate and measure the financial assets in Subsidiary 2 from the nonfinancial assets in Subsidiary 1 that are derecognized within the scope of this Subtopic.

The scope of Subtopic 610-20 includes in-substance nonfinancial assets. To determine whether a contract includes an in-substance nonfinancial asset, the entity performs a 'concentration test' to determine if substantially all of the fair value is concentrated in nonfinancial assets. [610-20-15-5, 15-6]

The FASB acknowledged that transactions may involve the transfer of both nonfinancial assets and financial assets (e.g. cash and receivables), and decided that if substantially all of the transfer is concentrated in nonfinancial assets then all of the assets should be in the scope of Subtopic 610-20. This was done primarily to avoid complexities of accounting for transfers of assets in legal entities, especially partial sales, under different accounting models. Therefore, when the substance of the transaction is the sale of nonfinancial assets, the Board decided the entire contract should be in the scope of Subtopic 610-20. [ASU 2017-05.BC12]

Question 17.2.100
What is an in-substance nonfinancial asset?

Interpretive response: An in-substance nonfinancial asset is a financial asset that is included in a group of assets or a subsidiary: [610-20-15-5

- that holds both financial and nonfinancial assets; and
- for which substantially all of the fair value of the collective assets in the group or subsidiary is concentrated in nonfinancial assets.

When evaluating the concentration of the assets, an entity excludes any liabilities assumed or relieved by the counterparty as well as cash and cash equivalents. This is referred to as the 'concentration test'. The concentration test is not applied if the transaction would otherwise meet a scope exception (e.g. the assets or subsidiary being disposed of are a business). [610-20-15-7]

Question 17.2.110 discusses the meaning of 'substantially all', and Question 17.2.120 discusses the concentration test.

Question 17.2.110
What is meant by 'substantially all'?

Interpretive response: To assess whether a transaction involves an in-substance nonfinancial asset, an entity evaluates whether substantially all of the fair value of the collective assets transferred in the group or subsidiary is concentrated in nonfinancial assets. This is the concentration test (see Question 17.2.120). [610-20-15-6]

The FASB decided to use the term 'substantially all' in its definition because it is commonly used throughout US GAAP. However, it did not specify a quantitative threshold for what substantially all means in this context.

In other US GAAP, substantially all is generally interpreted to mean approximately 90% or greater. In evaluating the scope of Subtopic 610-20, substantially all is not necessarily meant to be a bright-line quantitative threshold. We believe qualitative factors may also be considered when there is uncertainty about whether the substantially all threshold is met. Such uncertainty can exist, for example, when the ratio is slightly below 90% or the valuation of assets is based on unobservable (Level 3) fair value measurement inputs subject to significant measurement uncertainty.

The purpose of a qualitative assessment is to evaluate whether the substance of the transaction is a transfer of nonfinancial assets. We believe relevant factors to consider include (but are not limited to) whether the financial assets in the transaction are simply a product of the asset's operations or lack commercial substance.

- **Simply a product of the asset's operations** – e.g. the only financial assets are rent receivables related to a property. If so, it may be appropriate to conclude that substantially all of the fair value of the assets is concentrated in nonfinancial assets even if their fair value is slightly below 90% of the fair value of the set.

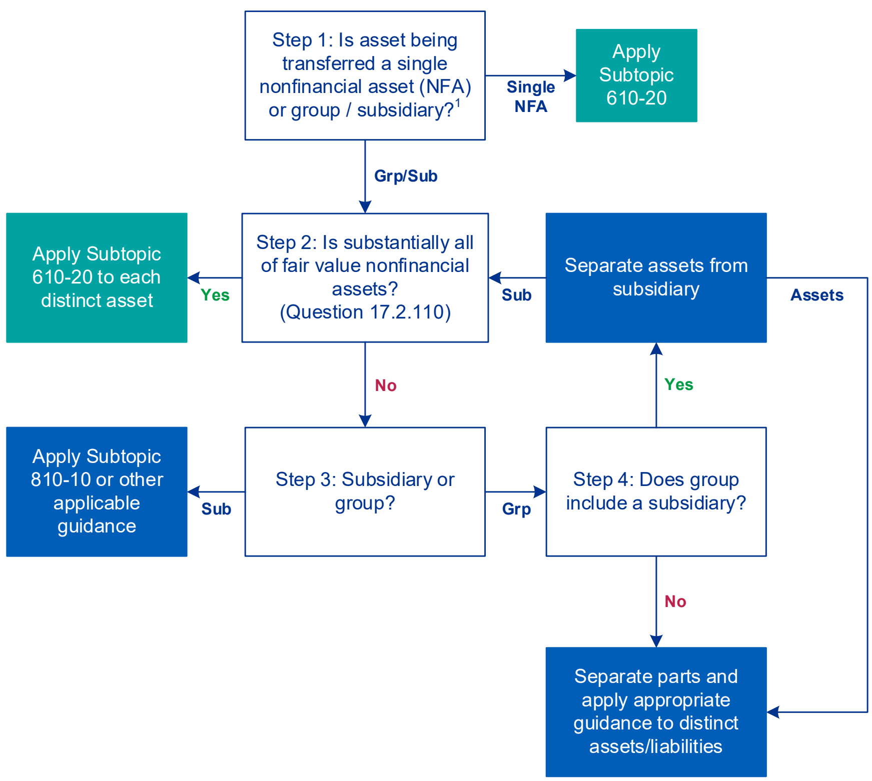
— **Lack commercial substance.** If so, a quantitative assessment that includes those assets would not be appropriate. For example, if the seller arbitrarily included financial assets in the transaction that otherwise would not have been part of the set to avoid applying Subtopic 610-20, those financial assets should be excluded from the quantitative analysis. These situations can be highly judgmental and depend on the specific facts and circumstances.

Question 17.2.120

In what order does an entity apply the concentration test?

Interpretive response: The definition of an in-substance nonfinancial asset includes an analysis of both groups of assets and subsidiaries and can, in more complicated transactions, require multiple layers of analysis. Therefore, the ordering of the analysis is important to determine whether a transaction includes in-substance nonfinancial assets and therefore is in the scope of Subtopic 610-20.

The following decision tree highlights this process for the concentration test.



Note 1: If the transfer includes other contractual arrangements that are not the assets of the seller that will be derecognized (e.g. guarantees), those contracts are separated and

accounted for under the applicable guidance. See section 17.2.60 for additional guidance.

The following elaborates on the key steps in applying the above decision tree, which evaluates nonfinancial assets, groups and subsidiaries that are not otherwise in the scope of other guidance (e.g. Subtopic 810-10 for transfers of businesses).

Step 1: Does the transaction include only a single nonfinancial asset or a group of assets or a subsidiary?

If the transaction only involves a single nonfinancial asset (and not a group of assets or a subsidiary), further analysis is not needed because the transfer of that asset is in the scope of Subtopic 610-20.

If the transaction involves a group of assets or a subsidiary then further analysis is needed.

Step 2: Is substantially all the fair value nonfinancial assets?

When evaluating a group of assets or a subsidiary, Subtopic 610-20 first requires an entity to evaluate the concentration of all the assets promised to the counterparty in the transaction (see Question 17.2.110). This evaluation applies regardless of legal form – i.e. regardless of whether the assets (recognized or unrecognized) are inside or outside of a legal entity. [610-20-15-5 – 15-6]

If substantially all of the fair value of *all* the applicable assets in the concentration test promised to the counterparty in the transaction is concentrated in nonfinancial assets, the entire transaction is in the scope of Subtopic 610-20. If not, further analysis is needed.

Step 3: Are the assets transferred a single subsidiary or a group?

When the transaction is a group, further analysis is required in the next step. A group for this purpose means:

— multiple assets to be transferred outside a legal entity;
— transfers of multiple subsidiaries; or
— a combination of the two (i.e. assets and subsidiaries).

When a single subsidiary is transferred with multiple assets, only the concentration test in Step 2 is required because the subsidiary and the entire transaction have the same set of assets. Therefore, when the Step 2 concentration test is not met, the subsidiary is in the scope of Subtopic 810-10, unless other guidance applies.

Step 4: Does the group include a subsidiary?

When the transaction is a group, the assessment depends on whether the group includes a subsidiary. If the group does not include a subsidiary, the transaction is partially in the scope of Subtopic 610-20 and partially in the scope of other guidance and the assets are accounted for separately (see section 17.2.60).

If the group includes a subsidiary, the concentration test is performed for each subsidiary; depending on the outcome of that test, the subsidiary may be in the scope of other guidance.

The following table summarizes potential outcomes if the group does or does not include a subsidiary:

No subsidiary	At least one subsidiary
— Apply Subtopic 610-20 to the nonfinancial assets. — Apply other applicable GAAP to the other assets.	Apply the concentration test to each subsidiary on an individual basis, and **then…** — Apply Subtopic 610-20 to those individual subsidiaries that meet the concentration test. [610-20-15-7] — Apply Subtopic 810-10 to subsidiaries that do not meet the concentration test, unless other GAAP applies (e.g. Topic 860). [610-20-15-8] — Apply Subtopic 610-20 to the nonfinancial assets outside of the subsidiary. [610-20-15-6] — Apply other applicable GAAP to the other assets outside of the subsidiary. [610-20-15-9]

Example 17.2.10
Multiple assets outside of legal entities

ABC Corp. enters into a contract with DEF Corp. to transfer two IP assets related to two drug compounds, plus an equity method investment in an entity that only holds IP related to a single drug compound, for $2 million. The group of assets does not meet the definition of a business and DEF is not a customer because the assets are not an output of ABC's ordinary activities.

Scenario 1: Group includes an in-substance nonfinancial asset

The two IP assets are nonfinancial assets and the equity investment is a financial asset. ABC performs the concentration test over the group of assets to determine if the equity method investment is an in-substance nonfinancial asset. The fair value of the two IP assets is $1.9 million and the fair value of the equity method investment is $100,000 – a total fair value of $2 million for the group of assets.

The IP makes up approximately 95% of the fair value of the group of assets and therefore substantially all of the fair value is concentrated in nonfinancial assets. As a result, ABC concludes that the equity method investment is an in-substance nonfinancial asset and is accounted for in the scope of Subtopic 610-20 (see Question 17.2.110). Therefore, the entire transaction is in the scope of Subtopic 610-20.

Scenario 2: Group does not have an in-substance nonfinancial asset

Assume the same facts as Scenario 1, except that the fair value of the IP is $1.2 million and the fair value of the equity method investment is $800,000.

The IP makes up approximately 60% of the fair value of the group of assets and therefore substantially all of the fair value is *not* concentrated in nonfinancial assets. As a result, ABC concludes that the equity method investment is not an in-substance nonfinancial asset and is not in the scope of Subtopic 610-20 (see Question 17.2.110).

Therefore, the two IP assets are in the scope of Subtopic 610-20 and the equity method investment is in the scope of Topic 860. Question 17.2.180 discusses separating and measuring parts of the contract that will be accounted for separately.

Example 17.2.20
Assets inside and outside a legal entity

ABC Corp. has entered into a contract to transfer 100% ownership in a consolidated subsidiary, Sub A, and an equity method investment (a financial asset) in a real estate property to DEF Corp.

Sub A has two assets – a building (nonfinancial asset) and a receivable (financial asset) – and debt secured by the property. When considered together, Sub A and the equity method investment do not meet the definition of a business, and DEF is not a customer because the assets and Sub A are not an output of ABC's ordinary activities.

The assets and liability have the following fair values.

Asset/Liability	Fair value
Building	$970,000
Receivable	30,000
Debt	600,000
Equity method investment	100,000

Following the steps in Question 17.2.120, ABC performs the following analysis to determine the appropriate accounting for the transfer.

— **Step 1.** Multiple assets are being transferred and therefore ABC proceeds to Step 2.

— **Step 2.** ABC applies the concentration test to *all* of the assets in the transfer (i.e. excluding the debt). The total fair value of the assets is $1.1 million with approximately 88% of the fair value concentrated in nonfinancial assets: $970,000 / $1,100,000.

  ABC determines that substantially all of the assets are *not* concentrated in nonfinancial assets at the group level, both quantitively and qualitatively because there are multiple types of financial assets that have commercial substance and are not *all* just a byproduct of the operations (i.e. the equity method investment is not a product of ABC's operations). Therefore, ABC proceeds to Step 3.

— **Step 3.** A combination of an asset (equity method investment) and a subsidiary (Sub A) is being transferred and therefore ABC proceeds to Step 4.

— **Step 4.** ABC applies the concentration test to all of the assets in Sub A (i.e. building and receivable, but excluding the debt). The total fair value of Sub A's assets is $1 million with approximately 97% of the fair value concentrated in nonfinancial assets: $970,000 / $1,000,000.

ABC determines that substantially all of the assets are concentrated in nonfinancial assets at the subsidiary level. As a result, the receivables are in-substance nonfinancial assets.

As a result, ABC concludes that:

— the sale of both of the assets in Sub A (receivable and building) is in the scope of Subtopic 610-20; and
— the sale of the equity method investment is accounted for under Topic 860.

Question 17.2.180 discusses separating and measuring parts of the contract that will be accounted for separately.

Example 17.2.30
Transfer of more than one subsidiary

ABC Corp. enters into a contract with DEF Corp. to transfer 100% of the ownership in two consolidated subsidiaries (Sub A and Sub B). When considered together, the transferred subsidiaries do not meet the definition of a business.

Sub A's only asset is a parcel of land (a nonfinancial asset). Sub B's only asset is an equity method investment in a real estate entity (a financial asset). The fair values of Sub A and Sub B are equal, meaning that half of the total fair value of the assets being transferred relates to a nonfinancial asset and the other half relates to a financial asset.

Following the steps in Question 17.2.120, ABC performs the following analysis to determine the appropriate accounting for the transfer.

— **Step 1.** Multiple assets are being transferred and therefore ABC proceeds to Step 2.

— **Step 2.** ABC analyzes the entire group of assets transferred (Sub A and Sub B together) to determine if the equity method investment is an in-substance nonfinancial asset. Sub B's equity method investment represents half of the fair value of the assets being transferred to DEF.

Because substantially all of the fair value of the group of assets is *not* concentrated in nonfinancial assets, ABC proceeds to Step 3.

— **Step 3.** Two subsidiaries (Sub A and Sub B) are being transferred and therefore ABC proceeds to Step 4.

— **Step 4.** ABC evaluates Sub A and Sub B individually:
  – Sub A's only asset is a nonfinancial asset, and therefore ABC applies Subtopic 610-20 to the sale of that asset.
  – Sub B's only asset is a financial asset, and therefore ABC applies Topic 860 to the sale of Sub B instead of Subtopic 610-20.

17.2.50 Scope exceptions

Question 17.2.130
Are contracts with customers in the scope of Subtopic 610-20?

Interpretive response: No. The transfer of a nonfinancial asset to a customer is not in the scope of Subtopic 610-20. Instead those transactions are in the scope of Topic 606. A customer is a counterparty that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities. See further discussion about the definition of a customer in section 2.2.20. [610-20 Glossary, 610-20-15-4(a)]

The principles in Topic 606 are applied to a transfer of a nonfinancial asset with either a customer or noncustomer (see section 17.3). However, the amounts recognized from contracts with noncustomers in the scope of Subtopic 610-20 generally are recognized as a gain/loss in other income (see Question 17.4.10).

Question 17.2.140
Are transfers of businesses in the scope of Subtopic 610-20?

Interpretive response: No. Subtopic 610-20 does not apply when an entity transfers or disposes of a business regardless of legal form (e.g. inside or outside of a legal entity). Such transactions are in the scope of Subtopic 810-10. [610-20-15-4(b)]

The definition of a business in Topic 805 is used for purposes of this evaluation. See also section 2 of KPMG Handbook, Business combinations. [610-20 Glossary]

Question 17.2.150
Are sale-leaseback transactions in the scope of Subtopic 610-20?

Interpretive response: No. Sale-leaseback transactions are in the scope of Subtopic 842-40 even though the asset being sold and leased back is a nonfinancial asset. See chapter 9 of KPMG Handbook, Leases, for further discussion. [610-20-15-4(c)]

Question 17.2.160

Is the transfer of an equity method investment in the scope of Subtopic 610-20?

Interpretive response: Generally, no. Subtopic 610-20 does not apply to transfers of financial assets, including transfers of investments accounted for under the equity method. Topic 860 (transfers and servicing) applies to the transfer of those investments regardless of whether the investee's underlying assets are nonfinancial assets. That is, an entity should not 'look through' the equity method investment to the underlying assets to make this determination. [610-20-15-4(e), 610-20-15-4(c), ASU 2017-05.BC30–BC31]

However, if an equity method investment meets the definition of an in-substance nonfinancial asset, it is in the scope of Subtopic 610-20. This could occur when substantially all of the fair value of the underlying assets in the subsidiary or group of assets being transferred with the equity method investment is concentrated in nonfinancial assets; see section 17.2.40 for guidance on making this determination.

Question 17.2.170

What other scope exceptions could apply?

Interpretive response: As discussed in Question 17.2.10, when other GAAP takes precedence, the transfer of a nonfinancial asset is outside the scope of Subtopic 610-20.

In addition to the scope exceptions listed in Question 17.2.10, Subtopic 610-20 does not apply to the following transactions: [610-20-15-4]

- conveyances of oil and gas mineral rights;
- transfers entirely in the scope of Topic 860 (e.g. sale comprising only financial assets);
- transfers of nonfinancial assets that are part of the consideration in a business combination in the scope of Topic 805;
- transfers in the scope of Topic 845 – e.g. nonreciprocal transfers with owners or inventory exchanges; see Question 17.2.40;
- lease contracts;
- exchanges of takeoff and landing slot intangibles for airlines;
- contributions of nonfinancial assets (including a promise to give) as it relates to other expenses or revenue of an NFP entity;
- investment transfers in a venture that is proportionately consolidated; and

— transfers of nonfinancial assets between entities under common control – e.g. between a parent and subsidiary, or between subsidiaries with the same parent.

17.2.60 Transactions partially in scope

Excerpt from ASC 610-20

> Contracts Partially within the Scope of Other Topics

15-9 If the promises to a counterparty in a contract are not all nonfinancial assets or all nonfinancial assets and in substance nonfinancial assets, a contract may be partially within the scope of this Subtopic and partially within the scope of other Topics. For example, in addition to transferring nonfinancial assets and in substance nonfinancial assets that are within the scope of this Subtopic, an entity may issue a guarantee to the counterparty that is within the scope of Topic 460 on guarantees. An entity shall apply the guidance in paragraph 606-10-15-4 to determine how to separate and measure one or more parts of a contract that are within the scope of other Topics. (See also Case A of Example 1 in paragraphs 610-20-55-2 through 55-5 and Case C of Example 1 in paragraphs 610-20-55-9 through 55-10.)

• > Example 1 – Scope

• • > Case A – Nonfinancial Assets, In Substance Nonfinancial Assets, and a Guarantee

55-2 Seller enters into a **contract** to transfer real estate, the related operating leases, and accounts receivable to Buyer. Seller guarantees Buyer that the cash flows of the property will be sufficient to meet all of the operating needs of the property for two years after the sale. In the event that the cash flows are not sufficient, Seller is required to make a payment in the amount of the shortfall.

55-3 Seller concludes that the assets promised in the contract are not a **business** within the scope of Topic 810 on consolidation and are not an output of Seller's ordinary activities within the scope of Topic 606 on **revenue** from contracts with **customers**. In addition, assume that Seller concludes that substantially all of the fair value of the assets promised in the contract is concentrated in nonfinancial assets (that is, substantially all of the fair value is concentrated in the real estate and in-place lease intangible assets). Therefore, the accounts receivable promised in the contract are in **substance nonfinancial assets**. In accordance with the guidance in this Subtopic, all of the assets in the contract, including the accounts receivable, are within the scope of this Subtopic.

55-4 Seller concludes that the guarantee, which is a liability of Seller, is within the scope of Topic 460 on guarantees. Therefore, Seller would apply the guidance in paragraph 606-10-15-4 to separate and measure the guarantee as described in paragraph 610-20-15-9.

55-5 Seller's conclusions would be the same if it transferred the real estate, leases, and receivables by transferring ownership interests in a consolidated **subsidiary**. That is, Seller would still conclude that all of the assets in the subsidiary are nonfinancial assets and in substance nonfinancial assets within the scope of this Subtopic and that the guarantee is within the scope of Topic 460.

When a contract includes one or more parts that are not nonfinancial assets or in-substance nonfinancial assets, the contract may be partially in the scope of Subtopic 610-20 and partially in the scope of other guidance. Entities will apply the separation and measurement guidance in Topic 606 to account for the respective parts. [610-20-15-9]

Question 17.2.180

Can a contract be partially in the scope of Subtopic 610-20 and partially in the scope of another Topic?

Interpretive response: Yes. For example, an entity may transfer a nonfinancial asset and issue a guarantee in the scope of Topic 460 (guarantees). Similar to contracts with customers, an entity applies the guidance in paragraph 606-10-15-4 to determine how to separate and measure one or more parts of the contract that are in the scope of other Topics (see section 2.4). [610-20-15-9]

Example 1, Case A in Subtopic 610-20 (reproduced above) illustrates a contract that is partially in its scope.

Example 17.2.40

Partial scope transaction

ABC Corp. sells a piece of machinery with a carrying amount of $1,500,000 to DEF Corp. for $2,000,000 in cash. ABC guarantees that the cash flows from the output of the machinery will be sufficient to meet the machinery's operating needs for the first three years after the sale date. The fair value of the guarantee at the sale date is $50,000 and there is no other variable consideration.

Because the guarantee is in the scope of Topic 460 and it provides separation and measurement guidance, the guarantee is separated from the machinery sale and measured at fair value. Therefore, ABC allocates $50,000 of the $2,000,000 contract consideration to the guarantee, and allocates $1,950,000 to the sale of the property, which is the transaction price in the scope of Subtopic 610-20.

17.3 Determining the gain or loss

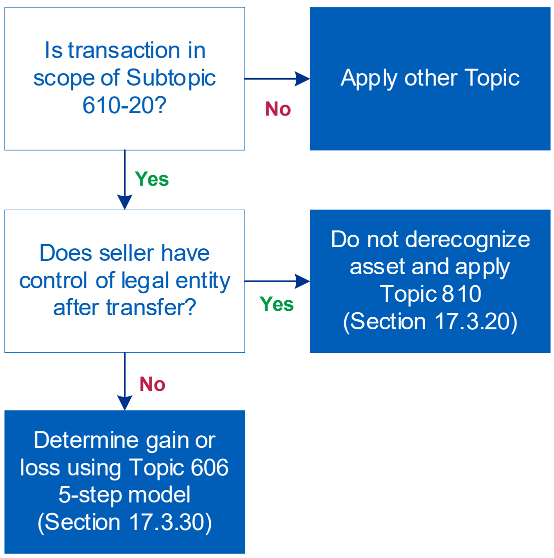
This section refers to nonfinancial assets and in-substance nonfinancial assets in the scope of Subtopic 610-20 collectively as NFAs.

17.3.10 Overview

The FASB decided that there is little economic difference between the sale of NFAs to a customer and to a noncustomer. Therefore, Subtopic 610-20 requires an entity to apply the principles in Topic 606 to determine the gain or loss.

However, because transfers of legal entities that hold NFAs are in the scope of Subtopic 610-20, entities also need to consider the consolidation guidance in Subtopic 810-10. This is because if an entity is required to consolidate a legal entity under Topic 810 then the NFA cannot be derecognized. [610-20-25-3]

The following decision tree highlights the ordering of this analysis. [ASU 2017-05.BC4, BC55]



Subtopic 610-20 provides guidance on determining the gain or loss. An entity still needs to consider the applicable impairment guidance for NFAs, which could result in an impairment loss being recorded before the sale. See KPMG Handbook, Impairment of nonfinancial assets.

17.3.20 Applying Topic 810

Excerpt from ASC 610-20

25-1 To recognize a gain or loss from the transfer of nonfinancial assets or **in substance nonfinancial assets** within the scope of this Subtopic, an entity shall apply the guidance in Topic 810 on consolidation and in Topic 606 on **revenue** from **contracts** with **customers** as described in paragraphs 610-20-25-2 through 25-7.

• > Determining Whether an Entity Has a Controlling Financial Interest

25-2 An entity shall first evaluate whether it has (or continues to have) a controlling financial interest in the **legal entity** that holds the nonfinancial assets and/or **in substance nonfinancial assets** by applying the guidance in Topic 810 on consolidation. For example, if a **parent** transfers ownership interests in a consolidated **subsidiary**, the parent shall evaluate whether it continues to have a controlling financial interest in that subsidiary. Similarly, when an entity transfers assets directly to a counterparty (or a legal entity formed by the counterparty), the entity shall evaluate whether it has a controlling financial interest in the counterparty (or the legal entity formed by the counterparty).

25-3 If an entity determines it has (or continues to have) a controlling financial interest in the legal entity that holds the nonfinancial assets or in substance nonfinancial assets, it shall not derecognize those assets and shall apply the guidance in paragraphs 810-10-45-21A through 45-24.

25-4 Any nonfinancial assets or in substance nonfinancial assets transferred that are held in a legal entity in which the entity does not have (or ceases to have) a controlling financial interest shall be further evaluated in accordance with the guidance in paragraphs 610-20-25-5 through 25-7.

If the NFA is transferred in a legal entity, the entity first considers whether it has (or continues to have) a controlling financial interest that would require it to consolidate (or continue to consolidate) the legal entity under Topic 810. Similarly, when an asset is transferred directly to a counterparty, the entity considers whether it would be required to consolidate the counterparty. [610-20-25-2]

Question 17.3.10

Is the transfer of a legal entity evaluated under both Subtopics 810-10 and 610-20?

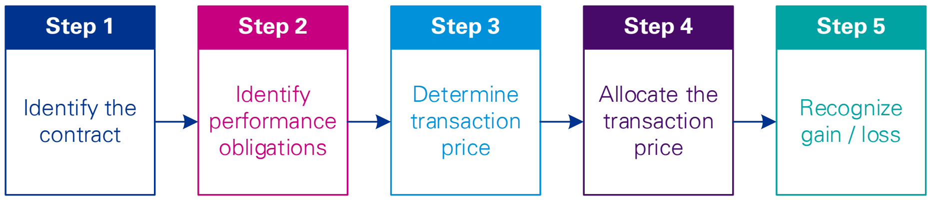
Interpretive response: Yes. When an entity is transferring an interest in a legal entity in the scope of Subtopic 610-20 (see Question 17.2.80) , it first evaluates whether it has lost its controlling financial interest in the legal entity under Subtopic 810-10. Similarly, an entity transferring an NFA outside of a legal entity to a counterparty needs to evaluate whether it has a controlling financial interest in the counterparty as a result of the transaction. Practically, this analysis is most relevant in partial sale transactions (see section 17.3.40 and Question 17.2.90). [610-20-25-2]

Subtopic 610-20 applies to both variable interest entities and voting interest entities. [610-20-25-1 – 25-3, 810-10-45-21A – 45-24]

If the entity does not lose its controlling financial interest in the legal entity under Subtopic 810-10, the entity does not derecognize the nonfinancial assets and the transfer of ownership interest is an equity transaction in the scope of paragraphs 810-10-45-21A to 45-24; see section 7.5.30 of KPMG Handbook, Consolidation. [610-20-25-3]

If the entity no longer has a controlling financial interest in the legal entity that holds the assets, the entity must still evaluate the provisions of Subtopic 610-20 to determine whether it is appropriate to derecognize the nonfinancial asset and the amount of gain or loss to recognize. [610-20-25-4]

17.3.30 Applying Topic 606



Excerpts from ASC 610-20

> Applying Revenue Recognition Guidance

25-5 After applying the guidance in paragraphs 610-20-25-2 through 25-4, an entity shall next evaluate a **contract** in accordance with the guidance in paragraphs 606-10-25-1 through 25-8. If a **contract** does not meet all of the criteria in paragraph 606-10-25-1, an entity shall not derecognize the nonfinancial assets or **in substance nonfinancial assets** transferred, and it shall apply the guidance in paragraph 350-10-40-3 to any **intangible assets** and the guidance in paragraph 360-10-40-3C to any property, plant, and equipment. An entity shall follow the guidance in paragraphs 606-10-25-6 through 25-8 to determine if and when a contract subsequently meets all of the criteria in paragraph 606-10-25-1.

25-6 Once a contract meets all of the criteria in paragraph 606-10-25-1, an entity shall identify each distinct nonfinancial asset and distinct in substance nonfinancial asset promised to a counterparty in accordance with the guidance in paragraphs 606-10-25-19 through 25-22. An entity shall derecognize each distinct asset when it transfers control of the asset in accordance with paragraph 606-10-25-30. In some cases, control of each asset may transfer at the same time such that an entity may not need to separate and allocate consideration to each distinct nonfinancial asset and in substance nonfinancial asset. That may be the case, for example, when a parent transfers ownership interests in a consolidated subsidiary that holds nonfinancial assets (or nonfinancial assets and in substance nonfinancial assets) and ceases to have a controlling financial interest in the subsidiary in accordance with Topic 810. However, control of each asset may not transfer at the same time if the parent has control of some of the assets in accordance with paragraph 606-10-25-30 (for example, through repurchase agreements).

25-7 For purposes of evaluating the indicators of the transfer of control in paragraph 606-10-25-30, if an entity has (or continues to have) a **noncontrolling interest** in the **legal entity** that holds the nonfinancial assets or in substance nonfinancial assets as a result of the transaction, the entity shall evaluate the point in time at which the legal entity holding the assets obtains (or has) control (for example, by evaluating whether the legal entity can direct the use of, and obtain substantially all of the benefits from, each distinct nonfinancial asset or in substance nonfinancial asset within it). (See Case A of Example 2 in paragraphs 610-20-55-11 through 55-14.) If the entity does not have a noncontrolling interest in the legal entity that holds the nonfinancial assets or in substance nonfinancial assets as a result of the transaction, it shall evaluate the point in time at which a counterparty (or counterparties, collectively) obtains control of the assets in the legal entity (for example, by evaluating whether a counterparty [or counterparties, collectively] can direct the use of, and obtain substantially all of the benefits from, each distinct nonfinancial asset or in substance nonfinancial asset within the legal entity).

• > Example 2—Transfer of Control

• • > Case A—Control Transfers under Topics 810 and 606

55-11 Entity A owns 100 percent of Entity B, a consolidated subsidiary. Entity B holds title to land with a carrying amount of $5 million. Entity A concludes that the land is not an output of its ordinary activities within the scope of Topic 606 and that Entity B does not meet the definition of a business within the scope of Topic 810.

55-12 Entity A enters into a contract to transfer 60 percent of Entity B to Entity X for $6 million cash due at contract inception. For ease of illustration, assume that at contract inception the fair value of the 40 percent interest retained by Entity A is $4 million. Because all of the assets (the land) promised to Entity X in the contract are nonfinancial assets, Entity A concludes that it should derecognize the land in accordance with this Subtopic.

55-13 As described in paragraphs 610-20-25-2 through 25-7, Entity A first considers the guidance in Topic 810 and concludes that it no longer has a controlling financial interest in Entity B or in Entity X (the buyer). Entity A then determines that the contract meets the criteria in paragraph 606-10-25-1 and that control of the land has been transferred in accordance with the guidance in paragraph 606-10-25-30. Because Entity A continues to have a noncontrolling interest in Entity B, it evaluates the point in time at which Entity B, its former subsidiary, has control of the distinct nonfinancial asset as described in paragraph 610-20-25-7. Entity A concludes that it has transferred control of the distinct nonfinancial asset because Entity B controls the distinct nonfinancial asset. When evaluating the indicators of control in paragraph 606-10-25-30, Entity A concludes the following:

a. It has the present right to payment.
b. Entity B has legal title to the land.
c. It does not have physical possession of the asset because it cannot restrict or prevent other entities from accessing the land.
d. Entity B has the significant risks and rewards of ownership.
e. There is no acceptance clause (assumption).

55-14 Entity A derecognizes the land and calculates the gain or loss as the difference between the amount of consideration measured in accordance with the guidance in paragraphs 610-20-32-2 and 610-20-32-6 and the carrying amount of the land. The amount of the consideration is $10 million, which includes $6 million in cash plus $4 million for the fair value of the noncontrolling interest in Entity B. Entity A recognizes a gain of $5 million ($10 million consideration – $5 million carrying amount of the assets) and presents the gain in the income statement in accordance with the guidance in paragraph 360-10-45-5. In accordance with the guidance in paragraph 610-20-32-4, Entity A records the noncontrolling interest in Entity B at $4 million and subsequently accounts for that interest in accordance with other Topics.

After concluding that it no longer has a controlling financial interest in the legal entity that holds the NFAs, the entity applies the guidance in Topic 606 to determine when to derecognize the NFA and the amount of the gain or loss. While the five-step model in Topic 606 is generally used for this analysis, Subtopic 610-20 provides incremental guidance and examples on applying the model to transactions in its scope. [610-20-25-5 – 25-7]

The rest of this section focuses on the incremental considerations applicable to all Subtopic 610-20 transactions. See section 17.3.40 for incremental guidance on partial sales.

Step 1: Identify the contract

Question 17.3.20
How does an entity determine that a contract exists?

Interpretive response: Subtopic 610-20 requires an entity to apply the guidance in Topic 606 to determine if the agreement meets the contract existence criteria (see section 3.2). If the agreement meets the contract existence criteria, the entity must still determine if transfer of control of the asset to the counterparty has occurred. [610-20-25-5]

Question 17.3.30
How is a transaction that does not meet the contract existence criteria accounted for?

Interpretive response: If the transaction does not meet the contract existence criteria, the entity does not derecognize the NFAs. An entity does not derecognize the NFAs until either the contract existence criteria are met or the criteria in the alternative model are met (see section 3.6). [610-20-25-5]

An entity continues to account for intangible assets following Section 350-10-40 and any property, plant or equipment following Section 360-10-40. These sections require the entity to:

— report the NFA in its financial statements;

— recognize amortization for intangible assets with a finite life and depreciation for property, plant and equipment as a period cost; and

— apply the relevant impairment guidance – Section 350-30-35 for intangible assets and Section 360-10-35 for property, plant and equipment. See KPMG Handbook, Impairment of nonfinancial assets.

If the property, plant or equipment or disposal group is classified as held-for-sale and the transaction does not meet the contract existence criteria, the entity ceases recognizing depreciation, presents the asset as held-for-sale, and measures the asset at the lower of its carrying amount or fair value less cost to sell. See chapter 4 of KPMG Handbook, Discontinued operations and held-for-sale disposal groups for further discussion on accounting for assets classified as held-for-sale.

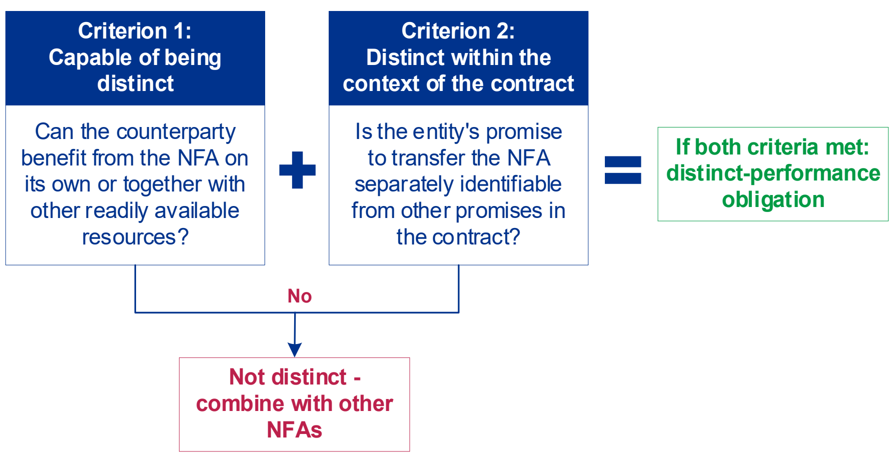
Step 2: Identify performance obligations

Question 17.3.40

What is the unit of account under Subtopic 610-20?

Interpretive response: A distinct NFA is the unit of account used to analyze when an NFA should be derecognized and the amount of the gain or loss. Subtopic 610-20 requires the seller to identify each distinct NFA using the criteria in Step 2 of the revenue recognition model in Topic 606. [610-20-25-6, 32-2]

Chapter 4 includes more in-depth discussion, but in summary, an NFA is distinct if both of the following criteria are met.



An entity uses this unit of account even when the NFAs are transferred together in a legal entity. However, the FASB observed that in many cases, control of NFAs in a subsidiary will transfer at the same time and practically an entity does not need to separately identify the distinct NFA when a subsidiary has multiple NFAs. Nevertheless, an entity should carefully evaluate the arrangement to ensure there are no provisions indicating that NFAs in a single subsidiary will transfer at different times. [ASU 2017-05.BC42]

Step 3: Determine the transaction price

Excerpt from ASC 610-20

32-2 When an entity meets the criteria to derecognize a distinct nonfinancial asset or a distinct **in substance nonfinancial asset**, it shall recognize a gain or loss for the difference between the amount of consideration measured and allocated to that distinct asset in accordance with paragraphs 610-20-32-3 through 32-6 and the carrying amount of the distinct asset. The amount of consideration promised in a **contract** that is included in the calculation of a gain or loss includes both the **transaction price** and the carrying amount of liabilities assumed or relieved by a counterparty.

32-3 To determine the transaction price, an entity shall apply the following paragraphs in Topic 606 on **revenue** from contracts with **customers**:

a. Paragraphs 606-10-32-2 through 32-27 on determining the transaction price, including all of the following:
   1. Estimating variable consideration
   2. Constraining estimates of variable consideration
   3. The existence of a significant financing component
   4. Noncash consideration
   5. Consideration payable to a customer.
b. Paragraphs 606-10-32-42 through 32-45 on accounting for changes in the transaction price.

32-4 If an entity transfers control of a distinct nonfinancial asset or distinct in substance nonfinancial asset in exchange for a **noncontrolling interest**, the entity shall consider the noncontrolling interest received from the counterparty as noncash consideration and shall measure it in accordance with the guidance in paragraphs 606-10-32-21 through 32-24. Similarly, if a **parent** transfers control of a distinct nonfinancial asset or in substance nonfinancial asset by transferring ownership interests in a consolidated **subsidiary** but retains a noncontrolling interest in its former subsidiary, the entity shall consider the noncontrolling interest retained as noncash consideration and shall measure it in accordance with the guidance in paragraphs 606-10-32-21 through 32-24. (See Case A of Example 2 in paragraphs 610-20-55-11 through 55-14.)

32-5 If a counterparty promises to assume or relieve a liability of an entity in exchange for a transfer of nonfinancial assets or in substance nonfinancial assets within the scope of this Subtopic, the transferring entity shall include the carrying amount of the liability in the consideration used to calculate the gain or loss. Although a liability assumed or relieved by a counterparty shall be included in the consideration used to calculate a gain or loss, an entity shall not derecognize the liability until it has been extinguished in accordance with the guidance in paragraph 405-20-40-1 (see paragraph 610-20-45-3 on how to present the liability if it is extinguished before or after the entity transfers control of the nonfinancial assets or in substance nonfinancial assets). If an entity transfers control of the nonfinancial assets or in substance nonfinancial assets before a liability is extinguished, it shall apply the guidance on constraining estimates of variable consideration in paragraph 606-10-32-11 to determine the carrying amount of the liability to be included in the gain or loss calculation.

32-6 An entity shall allocate the consideration calculated in accordance with the guidance in paragraphs 610-20-32-2 through 32-5 to each distinct nonfinancial asset or in substance nonfinancial asset by applying the guidance in paragraphs 606-10-32-28 through 32-41.

• > Example 3—Sale of a Nonfinancial Asset for Variable Consideration

55-17 An entity sells (that is, does not out license) the rights to in-process research and development that it recently acquired in a business combination and measured at fair value of $50 million in accordance with Topic 805 on business combinations. The entity concludes that the transferred in-process research and development is not a business. The buyer of the in-process research and development agrees to pay a nonrefundable amount of $5 million at inception plus 2 percent of sales of any products derived from the in-process research and development over the next 20 years. The entity concludes that the sale of in-process research and development is not a good or service that is an output of the entity's ordinary activities.

55-18 Topic 350 on goodwill and other intangibles requires the entity to apply the guidance in this Subtopic to determine the amount and timing of income to be recognized. Therefore, the entity applies the derecognition guidance in this Subtopic as follows:

a. The entity concludes that it does not have a controlling financial interest in the buyer.
b. The entity concludes that the contract meets the criteria in paragraph 606-10-25-1.
c. The entity also concludes that on the basis of the guidance in paragraph 606-10-25-30, it has transferred control of the in-process research and development asset to the buyer. This is because the buyer can use the in-process research and development's records, patents, and supporting documentation to develop potential products and the entity has relinquished all substantive rights to the in-process research and development asset.
d. In estimating the consideration received, the entity applies the guidance in Topic 606 on determining the **transaction price**, including estimating and constraining variable consideration. The entity estimates that the amount of consideration that it will receive from the sales-based royalty is $100 million over the 20-year royalty period. However, the entity cannot assert that it is probable that recognizing all of the estimated variable consideration in other income would not result in a significant reversal of that consideration. The entity reaches this conclusion on the basis of its assessment of factors in paragraph 606-10-32-12. In particular, the entity is aware that the variable consideration is highly susceptible to the actions and judgments of third parties, because it is based on the buyer completing the in-process research and development asset, obtaining regulatory approval for the output of the in-process research and development asset, and marketing and selling the output. For the same reasons, the entity also concludes that it could not include any amount, even a minimum amount, in the estimate of the consideration. Consequently, the entity concludes that the estimate

of the consideration to be used in the calculation of the gain or loss upon the derecognition of the in-process research and development asset is limited to the $5 million fixed upfront payment.

55-19 At inception of the contract, the entity recognizes a net loss of $45 million ($5 million of consideration, less the in-process research and development asset of $50 million). The entity reassesses the transaction price at each reporting period to determine whether it is probable that a significant reversal would not occur from recognizing the estimate as other income and, if so, recognizes that amount as other income in accordance with paragraphs 606-10-32-14 and 606-10-32-42 through 32-45.

Question 17.3.50

How is the gain or loss on derecognition of an NFA calculated?

Interpretive response: The gain or loss on derecognition of an NFA is calculated based on the difference between the consideration allocated to the distinct asset and the carrying amount of the distinct NFA. [610-20-32-2]

Question 17.3.40 discusses the determination of distinct assets, Question 17.3.60 discusses the measurement of the consideration and Question 17.3.90 discusses allocation of the transaction price.

Question 17.3.60

How is the amount of consideration used to calculate the gain or loss determined?

Interpretive response: The amount of consideration included in the calculation of the gain or loss is generally calculated consistent with determining the transaction price under Topic 606. [610-20-32-2]

Consistent with Topic 606, an entity considers the following when determining the transaction price: [610-20-32-3]

— estimating variable consideration (see section 5.3.30);
— constraining estimates of variable consideration (see section 5.3.40);
— the existence of a significant financing component (see section 5.5);
— noncash consideration (see section 5.6); and
— consideration payable to a customer (see section 5.7).

Subtopic 610-20 also provides incremental guidance that consideration includes the carrying amount of 'liabilities assumed' or relieved by the counterparty (see Question 17.3.70) and the fair value of any NCI in an entity retained or received in the transaction (see Question 17.3.150). [606-10-32-3, 610-20-32-4 – 32-5]

The royalty exception discussed in section 10.11 does not apply to sales or transfers of NFAs, including IP, because that exception applies only to legal form licenses and not legal sales of IP (see section 10.2.10).

Question 17.2.50 discusses licensing transactions that are not with a customer.

Question 17.3.70

How is the amount of a liability assumed or relieved by the counterparty as part of the consideration received determined?

Interpretive response: If the counterparty assumes or relieves a liability as part of the transaction, the entity includes the carrying amount of that liability in the calculation of the gain or loss. However, Subtopic 610-20 does not dictate when the entity should derecognize the liability. The liability would only be derecognized when it meets the criteria to extinguish a liability in Topic 405. [610-20-32-5]

When an entity does not meet the criteria to extinguish a liability at the same time control of the NFA is transferred, the entity will need to estimate the carrying amount of the liability when or if it is ultimately extinguished as a result of the transfer. In addition, the entity needs to apply the constraint on variable consideration and evaluate whether it is probable that no significant reversal will occur when the liability is ultimately extinguished. Section 5.3.30 discusses variable consideration, and section 5.3.40 discusses constraints on variable consideration. [610-20-32-5, 45-3, 405-20-40-1, 606-10-32-11]

Question 17.3.80

Is the receipt of an NCI in the counterparty noncash consideration?

Interpretive response: Yes, noncash consideration includes receipt of a new or incremental NCI in the counterparty. As discussed in Question 17.3.60, the consideration received in calculating the gain or loss includes the fair value of noncash consideration. If an entity cannot make a reasonable estimate of fair value, it refers to the estimated selling price of the promised goods or services. [606-10-32-22]

Noncash consideration is reflected in the transaction price based on the fair value measured at contract inception – i.e. when the agreement meets the contract existence criteria. Therefore, if control of an NFA is transferred after contract inception, the noncash consideration would be measured at a date different from when the gain or loss is recognized. [606-10-32-21]

When the fair value of noncash consideration after contract inception varies due to the form of the consideration (e.g. variations in price per share of the NCI), the transaction price is not adjusted and therefore the variable consideration constraint does not apply. Instead, an entity applies the US GAAP relevant to the form of the noncash consideration to determine whether and how any changes in fair value that occurred after contract inception are to be recognized on receipt of the noncash consideration. [ASU 2016-12.BC40]

In contrast, when the fair value of noncash consideration varies for reasons other than the form of the consideration (e.g. the number of shares received from the counterparty), the change is reflected in the transaction price and is subject to the guidance on constraining variable consideration. Because changes in noncash consideration for reasons other than form are part of the transaction price, these changes are included in the transaction price. The determination of whether a change in fair value is caused by the form of the noncash consideration or other reasons, and the determination of how to allocate the fair value changes between those that affect the transaction price and those that do not, may be challenging in some situations. [606-10-32-23]

Question 17.3.140 discusses evaluating control and measuring the gain or loss in partial sale transactions. Section 5.6 discusses noncash consideration.

Step 4: Allocate the transaction price

Question 17.3.90

How is the transaction price allocated when the transaction contains multiple distinct NFAs?

Interpretive response: The entity allocates the transaction price (including amounts related to the liability assumed or relieved by the seller) to each distinct NFA following Step 4 of the revenue recognition model. See chapter 6. [610-20-25-5]

Generally, that results in an allocation to each distinct NFA on a relative stand-alone selling price basis. Because of the nature of transactions that are in the scope of Subtopic 610-20, it is not likely that an observable stand-alone selling price has been established for the NFA. Therefore, the entity may have to estimate the stand-alone selling price (see section 6.3.20).

Step 5: Recognize the gain/loss

Question 17.3.100

When is the NFA derecognized and a gain or loss recorded?

Interpretive response: An entity derecognizes the NFA and records the gain or loss on the transfer at the point in time the counterparty obtains control of the NFA under the guidance in Topic 606. The entity evaluates when the counterparty controls the NFA when it has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the NFA. Section 7.2 discusses how to evaluate the transfer of control at a point in time. [610-20-25-6 – 25-7]

Under Topic 606, an entity determines at contract inception whether it satisfies the performance obligation over time or at a point in time. However, Subtopic 610-20 indicates that entities only need to evaluate the point-in-time guidance in Topic 606. We believe this is because the nature of the assets suggests control would be satisfied at a point in time. [606-10-25-30, 610-20-25-1, 25-5 – 25-7]

Question 17.3.110

Does an entity evaluate control under Topic 606 differently when it transfers its interest in a consolidated subsidiary?

Background: As noted in section 17.3.20, an entity first evaluates whether it has lost its controlling financial interest in the legal entity under Subtopic 810-10. If a controlling financial interest is lost under Subtopic 810-10, the entity applies the principles in Topic 606 to evaluate whether the counterparty has obtained control of the NFA.

Interpretive response: Generally, no. The evaluation under Topic 606 is done the same way for assets held in the legal entity as assets that are not. The entity evaluates when the counterparty has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the NFA. However, depending on the nature of the transaction the entity may identify the counterparty that obtains control differently. Consider the following scenarios. [610-20-25-7]

— Entity transfers a 100% interest in the subsidiary to a single counterparty. In this scenario, the entity would evaluate whether the counterparty that obtains the interest in the subsidiary controls the NFA.

— Entity transfers a 100% interest in the subsidiary to multiple counterparties. In this scenario (e.g. Investor 1 purchases 50% and Investor 2 purchases 50% in the same transaction), the entity evaluates whether the counterparties together collectively control the assets (i.e. parties share control of the assets).

We believe evaluating whether the counterparties collectively control the assets can be done by evaluating whether the former subsidiary controls the assets under Topic 606. This is similar to evaluating a partial sale when the entity no longer has a controlling financial interest in the legal entity that holds the assets (see Question 17.3.140). [610-20-25-7]

When the entity retains an NCI in the former subsidiary (i.e. the legal entity that holds an NFA), the entity views the former subsidiary as the counterparty in the transaction. Therefore, the entity evaluates whether that former subsidiary can direct the use of, and obtain substantially all of the benefits from, each distinct asset. Question 17.3.140 further discusses evaluating when control transfers in a partial sale. [610-20-25-7]

Example 17.3.10 further illustrates how an entity would identify the counterparty in various transactions other than partial sales.

Example 17.3.10

Transferring financial interest scenarios

Scenario 1: Direct transfer of NFA

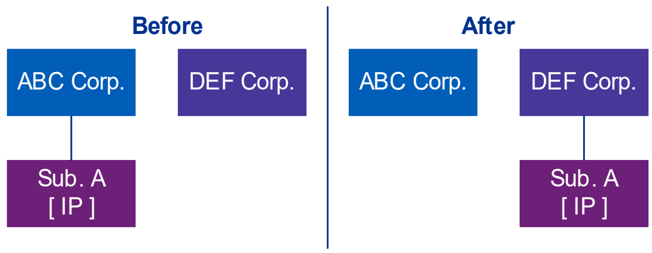
ABC Corp. enters into a contract to transfer IP (a nonfinancial asset) to DEF Corp. for $100 and the contract existence criteria are met.

After the transfer, ABC does not have a controlling or noncontrolling financial interest in the IP. ABC derecognizes the IP and recognizes the gain or loss at the point in time DEF obtains control of the IP.

Scenario 2: Transfer of a subsidiary that owns an NFA

ABC Corp. owns 100% of consolidated Sub A, which comprises a single IP asset (nonfinancial). ABC enters into a contract to transfer its entire interest in Sub A to DEF Corp. for $100. The contract existence criteria are met.

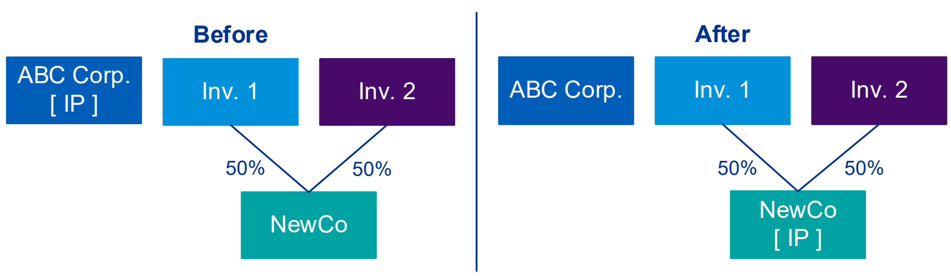
After the transfer, ABC no longer has a controlling or noncontrolling financial interest in Sub A. ABC derecognizes the IP and recognizes the gain or loss at the point in time DEF obtains control of the IP.



Scenario 3: NFA transfer to third party subsidiary

ABC enters into a contract to transfer IP (a nonfinancial asset) to NewCo for $100. NewCo was formed and is owned equally by Investor 1 and Investor 2. The contract existence criteria are met.

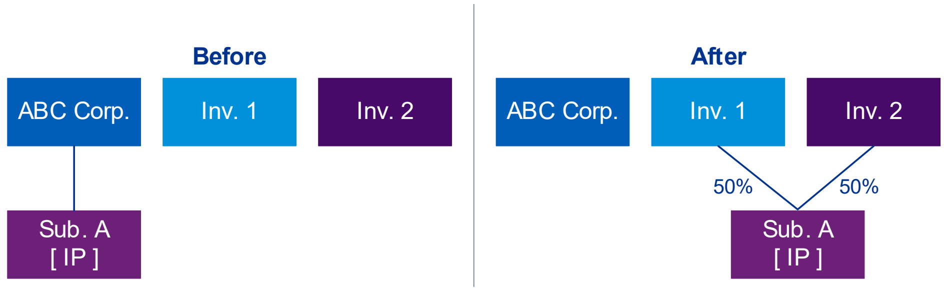
After the transfer, ABC does not have a controlling or noncontrolling financial interest in NewCo. ABC derecognizes the IP and recognizes the gain or loss at the point in time NewCo obtains control of the IP.



Scenario 4: Subsidiary with NFA transfer to third party

ABC owns 100% of consolidated Sub A, which comprises a single IP (nonfinancial) asset. ABC enters into a single transaction whereby it transfers 50% of Sub A to Investor 1 and 50% to Investor 2 for $100 ($50 each). The contract existence criteria are met.

After the transfer, ABC no longer has a controlling or noncontrolling financial interest in Sub A. ABC derecognizes the IP and recognizes the gain or loss at the point in time Investor 1 and Investor 2 collectively obtain control of the IP.



Question 17.3.120

Does a repurchase feature affect whether control of an NFA has transferred?

Interpretive response: Yes. Subtopic 610-20 requires an entity to evaluate whether it has transferred control of a distinct NFA under Topic 606. Topic 606 provides guidance on accounting for an entity's obligation to repurchase an asset at the counterparty's request (a put option), an entity's right to repurchase an asset (a call option) and an entity's obligation to repurchase an asset (a forward) that can affect whether control has transferred. Therefore, the guidance on repurchase features applies equally to transactions in the scope of Subtopic 610-20. Section 7.5.50 discusses the accounting for repurchase features. [606-10-55-66, 55-67]

In addition, consistent with Example 2, Case B in Subtopic 610-20 (reproduced below), we believe the repurchase feature guidance applies to repurchases of an NFA directly or indirectly by repurchasing a controlling financial interest in the legal entity holding the assets.

Excerpt from ASC 610-20

• > Example 2—Transfer of Control

• • > Case B—Control Transfers under Topic 810 but Not under Topic 606

55-15 Assume the same facts as in Case A, except that Entity A has the right but not the obligation to repurchase the 60 percent ownership interest in Entity B that it transferred to Entity X (that is, Entity A has a call option). The call option gives Entity A the right to repurchase the 60 percent ownership interest in 2 years for $7 million.

55-16 Entity A concludes that although the call option represents a **variable interest** in Entity B, it does not have a controlling financial interest in Entity B in accordance with the guidance in Topic 810. However, when evaluating whether control of the land has been transferred in accordance with the guidance in paragraph 606-10-25-30, Entity A considers the guidance on repurchase features in paragraphs 606-10-25-30(c) and 606-10-55-68 and concludes that it does not transfer control of the land. In addition, because the exercise price on the call option is an amount that is greater than the original selling price, the transaction is considered a financing agreement in accordance with the guidance in paragraph 606-10-55-68(b). Entity A does not derecognize the land and records a financial liability of $6 million in accordance with the guidance in paragraph 606-10-55-70. Entity A does not recognize an investment for its retained 40 percent ownership interest until it derecognizes the land.

17.3.40 Partial sales

Excerpts from ASC 610-20

• > Example 2—Transfer of Control

• • > Case A—Control Transfers under Topics 810 and 606

55-11 Entity A owns 100 percent of Entity B, a consolidated subsidiary. Entity B holds title to land with a carrying amount of $5 million. Entity A concludes that the land is not an output of its ordinary activities within the scope of Topic 606 and that Entity B does not meet the definition of a business within the scope of Topic 810.

55-12 Entity A enters into a contract to transfer 60 percent of Entity B to Entity X for $6 million cash due at contract inception. For ease of illustration, assume that at contract inception the fair value of the 40 percent interest retained by Entity A is $4 million. Because all of the assets (the land) promised to Entity X in the contract are nonfinancial assets, Entity A concludes that it should derecognize the land in accordance with this Subtopic.

55-13 As described in paragraphs 610-20-25-2 through 25-7, Entity A first considers the guidance in Topic 810 and concludes that it no longer has a controlling financial interest in Entity B or in Entity X (the buyer). Entity A then determines that the contract meets the criteria in paragraph 606-10-25-1 and that control of the land has been transferred in accordance with the guidance in paragraph 606-10-25-30. Because Entity A continues to have a noncontrolling interest in Entity B, it evaluates the point in time at which Entity B, its former subsidiary, has control of the distinct nonfinancial asset as described in paragraph 610-20-25-7. Entity A concludes that it has transferred control of the distinct nonfinancial asset because Entity B controls the distinct nonfinancial asset. When evaluating the indicators of control in paragraph 606-10-25-30, Entity A concludes the following:

a. It has the present right to payment.
b. Entity B has legal title to the land.
c. It does not have physical possession of the asset because it cannot restrict or prevent other entities from accessing the land.
d. Entity B has the significant risks and rewards of ownership.
e. There is no acceptance clause (assumption).

55-14 Entity A derecognizes the land and calculates the gain or loss as the difference between the amount of consideration measured in accordance with the guidance in paragraphs 610-20-32-2 and 610-20-32-6 and the carrying amount of the land. The amount of the consideration is $10 million, which includes $6 million in cash plus $4 million for the fair value of the noncontrolling interest in Entity B. Entity A recognizes a gain of $5 million ($10 million consideration – $5 million carrying amount of the assets) and presents the gain in the income statement in accordance with the guidance in paragraph 360-10-45-5. In accordance with the guidance in paragraph 610-20-32-4, Entity A records the noncontrolling interest in Entity B at $4 million and subsequently accounts for that interest in accordance with other Topics.

Partial sale transactions are in the scope of Subtopic 610-20 (see Question 17.2.90). Typically, a partial sale transaction is when an entity retains or receives a noncontrolling financial interest in the legal entity that holds the NFA as a result of the transaction. As discussed in Question 17.2.90, partial sales can be structured in many different ways.

Similar to the sale of a 100% interest in an NFA or legal entity, the entity first considers the guidance in Subtopic 810-10. If the entity does not have or retain a controlling financial interest in the legal entity that holds the asset, it applies the guidance in Topic 606 to determine the gain or loss. Subtopic 610-20 provides incremental guidance to clarify how to apply the Topic 606 model to partial sales. The rest of this section focuses on that incremental guidance.

Question 17.3.130

What is the unit of account in a partial sale?

Interpretive response: The distinct NFA is the unit of account in a partial sale transaction. Therefore, after an entity loses control of the legal entity under Subtopic 810-10, an entity evaluates when the counterparty obtains control of the NFA even in scenarios in which it is transferring ownership interests in a legal entity. [ASU 2017-05.BC53]

Consider the following transactions described in Question 17.2.90.

— **Transaction 2.** A seller and a third-party investor form a venture. The seller contributes machinery to the newly formed venture and the third-party investor contributes cash, property or services. The seller retains only an NCI in the venture post-sale. The venture may be a joint venture.

— **Transaction 4.** A seller contributes machinery to a newly formed, wholly owned venture. Sometime later, it sells a partial ownership interest in the venture to a third-party investor for cash, property or services. The consideration may come directly from the investor to the seller, or may be contributed by the investor to the venture. The seller retains only an NCI in the venture post-sale. The venture may be a joint venture.

— **Transaction 5.** A seller transfers machinery to an existing equity method investee in exchange for cash or noncash consideration.

Although the form of these transactions may be different, the FASB observed that the substance of the transactions is the same, and therefore they should be accounted for in a similar manner. Even if the seller is transferring an ownership interest in an entity (Transaction 4), it evaluates whether the venture (the legal entity that holds the NFA) controls the underlying distinct NFA. [ASU 2017-05.BC48]

Question 17.3.140 further discusses evaluating the transfer of control.

Question 17.3.140

How does an entity evaluate whether the counterparty has obtained control when it retains an NCI in a former subsidiary?

Background: As discussed in Question 17.3.110, the entity first evaluates whether it has a controlling financial interest in the entity that holds the assets under Subtopic 810-10. If the entity does not retain or acquire a controlling financial interest, it then applies Topic 606 to determine when to derecognize the NFAs. [610-20-25-7]

As discussed in Question 17.3.130, the unit of account in a partial sale is the distinct NFA regardless of the form of the transaction.

Interpretive response: When the entity retains an NCI in the former subsidiary (i.e. the legal entity that holds an NFA), the entity views the former subsidiary as the counterparty in the transaction. Therefore, the entity evaluates whether that former subsidiary obtains (or has) control of each distinct NFA. [ASU 2017-05.BC59]

Viewing the former subsidiary as the counterparty results in the same control evaluation under Topic 606 regardless of the form of the transaction – e.g. Transaction 2 and Transaction 4 in Question 17.3.130 both view the unit of account as the distinct NFA and the legal entity as the 'customer'. Additionally, without this distinction, the 'obtain substantially all the benefits' threshold within the definition of control, may have been interpreted as requiring the other investor to obtain an ownership interest in the former subsidiary greater than 90% to obtain control. Therefore, to avoid this high derecognition threshold, the FASB decided the NFA should be derecognized when the former subsidiary obtains (or has) control of the NFA rather than when the other investor does. [ASU 2017-05.BC61]

Because in most cases the subsidiary owns and controls the assets before the entity sells the ownership interest in the subsidiary to a third party, we believe most partial ownership transfers will result in gain recognition when the seller relinquishes its controlling financial interest in the subsidiary under Subtopic 810-10. This is because the subsidiary typically has the ability to direct the assets it wholly owns and obtain all of the benefits of its wholly owned assets.

However, if the entity retains rights to individual assets held by the former subsidiary that constrain the subsidiary's ability to control the assets, control may not transfer until those rights expire. For example, if the parent retains a right (or has an obligation) to repurchase certain assets directly or purchase a controlling financial interest in the former subsidiary, the repurchase feature prevents derecognition because control of the assets does not transfer to the former subsidiary under the repurchase feature guidance. Question 17.3.120 discusses repurchase features. [606-10-55-68, 610-20-55-16]

Question 17.3.150

How is the retained NCI in a partial sale measured?

Background: When an entity transfers control of NFAs, it derecognizes them and recognizes gains or losses equal to the differences between the allocated amount of consideration received and the carrying amount of each asset (see Question 17.3.50). [610-20-32-2]

Interpretive response: The entity treats the retained NCI as noncash consideration, and generally measures it at fair value. Therefore, the amount of the consideration received to calculate the gain or loss includes the fair value of the retained or received NCI. By including the fair value of the NCI in the transaction price, the entity recognizes a 100% gain on these transactions when control of the assets transfers. [606-10-32-21]

Because the NCI is accounted for as noncash consideration, its measurement date is contract inception, which could differ from the date the transaction closes, the assets are derecognized and/or the entity records the investment. Question 17.3.80 further discusses noncash consideration.

Example 17.3.20

Evaluating control under Topic 606 in a partial sale

ABC Corp. owns 100% of consolidated Sub X. Sub X owns a single intangible asset (IP) and is not a business. The IP was developed internally and its carrying amount is zero.

ABC enters into a contract with Investor to transfer an 80% controlling financial ownership interest in Sub X for $80 upon consummation of the transaction. Investor is not a customer because the assets are not an output of ABC's ordinary activities. The fair value of the retained NCI is $20; for simplicity, this example assumes no control premium.

Because ABC no longer has a controlling financial interest in Sub X, it then evaluates whether control has transferred under Topic 606. To do this ABC evaluates whether Sub X has control of the IP.

ABC concludes that Sub X has control because:

— Sub X has the ability to direct the use of the asset; the voting interests in Sub X affect the governance of Sub X, but Sub X itself has the ability to direct the asset; and

— Sub X obtains 100% of the benefits of the asset because it has the only economic interest in the asset; the owners of Sub X have an interest in the asset, but Sub X itself obtains the benefits of the asset.

Further, when considering the factors in paragraph 606-10-25-30:

- ABC has a present right to payment;
- Sub X has title and legal ownership of the IP;
- the asset is intangible so there is no physical possession;
- Sub X has the risks and rewards of ownership of the asset; and
- there are no acceptance provisions.

Therefore, ABC derecognizes the IP and records the following journal entry; see Question 17.3.150 on measuring the gain or loss and retained NCI.

	Debit	*Credit*
Cash	80	
Equity method investment in Sub X	20	
Gain		100
To record gain on transfer of IP.		

Question 17.3.160

Is the gain or loss on the transfer of an NFA to an existing equity method investee eliminated?

Interpretive response: No. The FASB decided that transactions with an existing equity method investee are similar to partial sales transactions. To be consistent with recognizing a 100% gain when retaining an NCI, it made an exception to the equity method guidance such that no elimination is required. [323-10-35-7, ASU 2017-05.BC67]

The FASB acknowledged that this is inconsistent with the accounting for transactions with equity method investees that are in the scope of Topic 606 (e.g. sale of inventory to the investee that is a customer) in which case the entity is required to eliminate a portion of the gain. [ASU 2017-05.BC67]

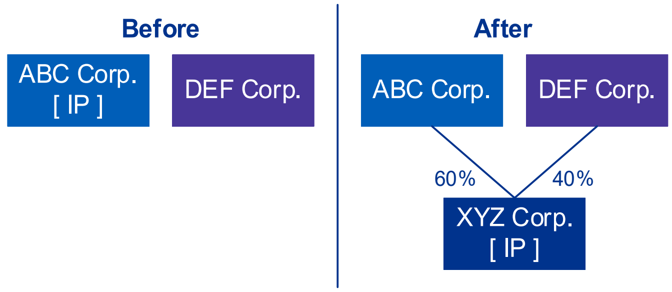
Partial sale examples

The following examples illustrate how an entity records partial sale transactions in various scenarios.

Example 17.3.30

Retained controlling financial interest

ABC Corp. and DEF Corp. form a venture, XYZ. ABC contributes IP with a carrying amount of $100 and receives $120 in cash from DEF and a 60% interest in XYZ. ABC has a controlling financial interest in XYZ post-transaction.



Because ABC has a controlling financial interest in XYZ post-transaction, the IP is not derecognized and ABC accounts for the sale of the NCI to DEF as an equity transaction under Subtopic 810-10.

ABC records the following journal entry.

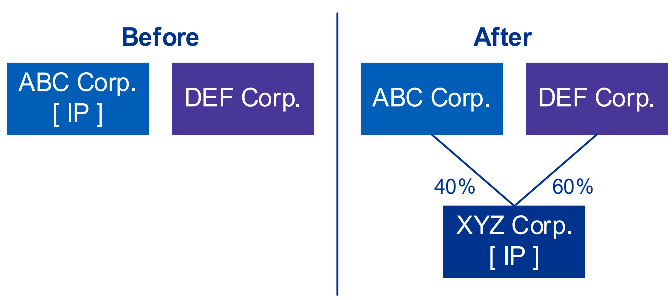
	Debit	Credit
Cash	120	
NCI[1]		40
Additional paid-in capital		80
To reflect cash received from DEF in exchange for 40% interest in XYZ.		

Note:

1. $100 carrying amount × 40% NCI in XYZ.

Example 17.3.40
Contribution of a nonfinancial asset to a venture

ABC Corp. and DEF Corp. form a venture, XYZ. ABC contributes IP with a carrying amount of $100 and a fair value of $300. ABC receives $180 in cash from DEF and a 40% noncontrolling interest in XYZ. ABC does not have any right or obligation to purchase shares of XYZ or the IP directly.



ABC accounts for its investment in XYZ under the equity method post-transaction. XYZ controls the IP post-transaction because it can direct the use and obtain substantially all the benefits of the IP.

ABC derecognizes the IP because post-transaction it has only an NCI in XYZ and XYZ controls the IP. ABC also recognizes a gain for the difference between the total consideration received and the carrying amount of the IP. The total consideration received includes $180 in cash plus $120 equal to the fair value of the 40% NCI in XYZ.

ABC records the following journal entry.

	Debit	*Credit*
Cash	180	
Equity method investment in XYZ[1]	120	
IP		100
Gain		200
To derecognize IP and recognize full gain.		

Note:

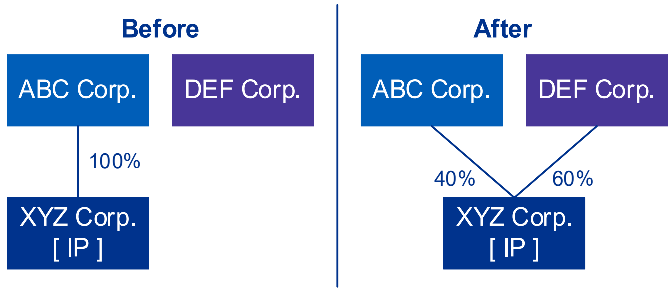
1. $300 fair value × 40% investment in XYZ (accounted for as equity method investment).

Example 17.3.50

Transfer of partial ownership interest in a subsidiary

In Year 1, ABC Corp. forms a wholly owned venture, XYZ. ABC contributes IP with a carrying amount of $100. Because ABC owns 100% of the newly formed venture and has control of the property, the IP is not derecognized.

In Year 2, ABC enters into a contract to transfer a 60% ownership interest in XYZ for $180 cash to DEF Corp. At the time of the transaction, XYZ has a fair value of $300. ABC does not have any right or obligation to repurchase the shares of XYZ or the IP directly.



ABC accounts for its investment in XYZ under the equity method post-transaction. XYZ controls the IP post-transaction because it can direct the use and obtain substantially all the benefits of the IP.

ABC derecognizes the IP because post-transaction it has only an NCI in XYZ and XYZ controls the IP. ABC also recognizes a gain for the difference between the total consideration received and the carrying amount of the IP. The total consideration received includes $180 in cash plus $120, equal to the fair value of the 40% NCI in XYZ.

ABC records the following journal entry.

	Debit	*Credit*
Cash	180	
Equity method investment in XYZ[1]	120	
IP		100
Gain		200
To derecognize IP and recognize full gain.		

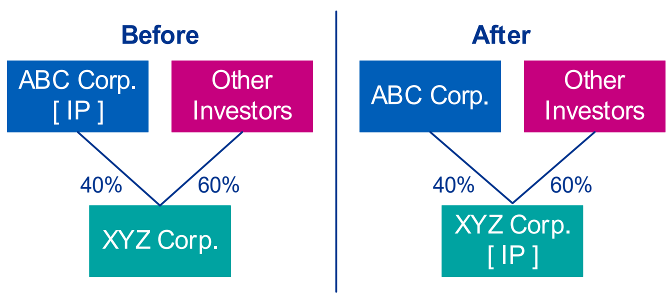
Note:

1. $300 fair value × 40% investment in XYZ (accounted for as equity method investment).

Example 17.3.60
Sale to an existing equity method investee

ABC Corp. owns 40% of XYZ Corp. and accounts for its investment under the equity method.

ABC enters into a contract to transfer IP to XYZ with a carrying amount of $100 and a fair value of $300. The other investors in XYZ contribute $180 in cash to the venture to fund their portion of the purchase. ABC receives $180 in cash from XYZ and retains a 40% share in its underlying net assets. XYZ controls the IP post-transaction.



ABC continues to account for its investment in XYZ under the equity method post-transaction. ABC derecognizes the IP because post-transaction it has only an NCI in XYZ and XYZ controls the IP. ABC also recognizes a gain for the difference between the total consideration received and the carrying amount of the IP. The total consideration received includes $180 in cash plus $120, equal to the increase in the value of ABC's share of XYZ's underlying net assets.

ABC records the following journal entry.

	Debit	*Credit*
Cash	180	
Equity method investment in XYZ[1]	120	
IP		100
Gain		200
To derecognize IP and recognize full gain.		

Note:

1. $300 fair value × 40% investment in XYZ (accounted for as equity method investment).

Note: ABC would recognize the same gain if it had received $300 in cash instead of $180 in cash and $120 increase to its share of XYZ's underlying net assets.

17.4 Presentation requirements of Subtopic 610-20

Excerpts from ASC 610-20

45-1 See paragraph 360-10-45-5 for guidance on presentation of a gain or loss recognized on the sale of a long-lived asset (**disposal group**).

45-2 When either party to a **contract** has performed, an entity shall apply the guidance in paragraphs 606-10-45-1 through 45-5 to present the relationship between the entity's performance and the counterparty's payment.

45-3 If an entity meets the criteria in paragraph 405-20-40-1 to derecognize a liability assumed (or relieved) by a counterparty before transferring control of a distinct nonfinancial asset, the liability shall be derecognized but no gain or loss shall be recognized. Instead, the entity shall record a **contract liability**, which represents consideration received before transferring control of the asset. If an entity transfers control of a distinct nonfinancial asset before meeting the criteria to derecognize a liability assumed by a counterparty, the entity shall recognize a **contract asset** to the extent the carrying amount of the liability is included in the calculation of the gain or loss.

50-1 See paragraphs 360-10-50-3 through 50-3A for guidance on disclosure of a gain or loss recognized upon the derecognition of a long-lived asset (**disposal group**).

Excerpts from ASC 360-10

• > Presentation of Disposal Gains or Losses in Continuing Operations

45-5 A gain or loss recognized on the sale of a long-lived asset (disposal group) that is not a discontinued operation shall be included in income from continuing operations before income taxes in the income statement of a business entity. If a subtotal such as income from operations is presented, it shall include the amounts of those gains or losses.

• > Long-Lived Assets Classified as Held for Sale or Disposed Of

50-3 For any period in which a long-lived asset (**disposal group**) either has been disposed of or is classified as held for sale (see paragraph 360-10-45-9), an entity shall disclose all of the following in the notes to financial statements:

a. A description of the facts and circumstances leading to the disposal or the expected disposal.
b. The expected manner and timing of that disposal.
c. The gain or loss recognized in accordance with paragraphs 360-10-35-37 through 35-45 and 360-10-40-5.
d. If not separately presented on the face of the statement where net income is reported (or in the statement of activities for a not-for-profit entity), the caption in the statement where net income is reported (or in the statement of activities for a not-for-profit entity) that includes that gain or loss.
e. If not separately presented on the face of the statement of financial position, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group classified as held for sale. Any loss recognized on the disposal group classified as held for sale in accordance with paragraphs 360-10-35-37 through 35-45 and 360-10-40-5 shall not be allocated to the major classes of assets and liabilities of the disposal group.
f. If applicable, the segment in which the long-lived asset (disposal group) is reported under Topic 280 on segment reporting.

50-3A In addition to the disclosures in paragraph 360-10-50-3, if a long-lived asset (disposal group) includes an individually significant **component of an entity** that either has been disposed of or is classified as held for sale (see paragraph 360-10-45-9) and does not qualify for presentation and disclosure as a discontinued operation (see Subtopic 205-20 on discontinued operations), a **public business entity** and 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 shall disclose the information in (a). All other entities shall disclose the information in (b).

a. For a public business entity and 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, both of the following:
    1. The pretax profit or loss (or change in net assets for a not-for-profit entity) of the individually significant component of an entity for the period in which it is disposed of or is classified as held for sale and for all prior periods that are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity) calculated in accordance with paragraphs 205-20-45-6 through 45-9
    2. If the individually significant component of an entity includes a noncontrolling interest, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent for the period in which it is disposed of or is classified as held for sale and for all prior periods that are presented in the statement where net income

is reported (or statement of activities for a not-for-profit entity).

b. For all other entities, both of the following:
   1. The pretax profit or loss (or change in net assets for a not-for-profit entity) of the individually significant component of an entity for the period in which it is disposed of or is classified as held for sale calculated in accordance with paragraphs 205-20-45-6 through 45-9
   2. If the individually significant component of an entity includes a noncontrolling interest, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent for the period in which it is disposed of or is classified as held for sale.

Question 17.4.10

How is the gain or loss presented in the income statement?

Interpretive response: Subtopic 610-20 refers to the guidance in Topic 360 for presenting the gain or loss on the sale of long-lived assets. Under that guidance, the gain or loss that is not part of a discontinued operation is presented in income (loss) from continuing operations. If the entity presents a subtotal such as income (loss) from operations, the gain or loss is included in that subtotal. [610-20-45-1, 360-10-45-5]

Subtopic 610-20 does not provide guidance on presenting the gain or loss on sales of assets that are in its scope but are not long-lived assets. However, we believe entities generally should present the gain or loss consistent with the Topic 360 guidance applicable to long-lived assets.

In our experience, some entities include gains on disposals of long-lived assets on the same income statement line as impairment and disposal losses. Others include gains in an other income/expense or similar income statement line.

The SEC staff has stated that a registrant should report gains and losses that result from the disposition of long-lived assets as a component of other general expenses (i.e. in income from continuing operations) under Regulation S-X, with any material items stated separately. Further, the SEC staff has distinguished between other general expenses and selling, general, and administrative expenses, although both line items are included in operating income. [S-X Rule 5-03(b)(6), 605-10-S99-1]

An entity is required to disclose where the gain or loss is reported in the notes to the financial statements if it is not separately stated on the face of the income statement as described in paragraphs 360-10-50-3 and 50-3A. [610-20-50-1]

Question 17.4.20

Does the guidance on contract assets and liabilities in a Subtopic 610-20 transaction need to be considered?

Interpretive response: Yes. Consistent with Topic 606, an entity presents its net position in a contract with a customer and recognizes a contract asset or liability in certain situations. Chapter 14 discusses contract assets, liabilities and receivables. [610-20-45-2]

For example, if an entity receives consideration after the contract existence criteria are met but before it transfers control of a nonfinancial asset using the guidance in Topic 606, it recognizes a contract liability. In contrast, if an entity derecognizes a nonfinancial asset and recognizes a gain before the customer pays or before payment is due (e.g. when there is unresolved variable consideration), it recognizes a contract asset. This is also the case if the consideration already received or to be received relates to the extinguishment of a liability to be assumed or relieved by the counterparty. [610-20-45-2 – 45-3, 606-10-45-1 – 45-5, ASU 2017-05.BC57]

When an entity retains a controlling financial interest in an entity that is under the guidance in Subtopic 810-10 (e.g. the entity only sells a noncontrolling interest in a subsidiary that holds an NFA), the transaction is accounted for as an equity transaction; see section 7.5.30 of KPMG Handbook, Consolidation. That is, the entity does not recognize a contract liability as the offset for the cash received because in those scenarios there is no further obligation to transfer a nonfinancial asset. [ASU 2017-05.BC57]

Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. The following symbols are used throughout this Handbook to indicate the types of revisions made in this edition for sections, Questions, Examples and other items:

** new item

significant updates or revisions to the item

● item moved

9. **Principal vs. agent**

Question

9.3.35 Can an entity be the principal in a transaction when it only retains a fixed percentage commission for reselling a supplier's good? **

16. **Effective date and transition #**

Removed from this edition

17. **Subtopic 610-20: Derecognition of nonfinancial assets**

Future developments

Accounting for and disclosure of crypto assets **

Moved guidance

The following table summarizes Questions and an Example that were created from previous content. None of these items were significantly updated.

Questions/Example	Old location	New location
At what level is the significance of a financing component determined?	Section 5.5.40 (narrative)	5.5.75
Is the allocation of consideration limited to non-contingent amounts?	Section 6.4.10 (comparison to legacy US GAAP)	6.4.05
How does an entity apply the over-time criteria for contract manufacturing arrangements to produce goods to a customer's specifications?	Section 7.3.10 (comparison to legacy US GAAP)	7.3.35
How are customer loyalty programs that provide a customer with a material right accounted for under Topic 606?	Section 8.6.10 (comparison to legacy US GAAP)	8.6.01
License renewal	Section 10.10.10 (comparison to legacy US GAAP)	10.10.10
Can the royalty exception apply to a portion of a royalty?	Section 10.11.20 (narrative)	10.11.05
Is a non-issuer broker-dealer a PBE?	16.2.10	15.2.15

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- Transfers and servicing of financial assets

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