



BLUEPRINT: A BDO SERIES

# Revenue Recognition Under ASC 606

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## INTRODUCTION

In May 2014, the Financial Accounting Standards Board (FASB) issued new revenue recognition guidance in ASU 2014-09, *Revenue from Contracts with Customers* (ASC 606). ASC 606 sets out a single and comprehensive framework for revenue recognition and addresses virtually all industries, including those that previously followed industry-specific guidance, such as the real estate, construction, and software industries. The objective of ASC 606 is to establish the principles that an entity should apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from its contracts with customers. ASC 606 includes an overall disclosure objective along with comprehensive disclosure requirements, which are principles-based (rather than a checklist). An entity is required to make several judgments and estimates in applying the requirements of ASC 606.

The revenue recognition project was one of several joint projects between the FASB and the International Accounting Standards Board (IASB) aimed at converging U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS). The U.S. and international standard setters had observed inconsistencies and weaknesses in each of their respective accounting standards. Under U.S. GAAP, concepts for revenue recognition had been supplemented with a broad range of industry-specific guidance, which had resulted in economically similar transactions being accounted for differently. In IFRS, there was significant diversity in practice because existing standards contained limited guidance for a range of significant topics, such as accounting for contracts with multiple elements. Both the FASB and the IASB also stated that the prior disclosure requirements were inadequate, as they often resulted in insufficient information for users of financial statements to understand the sources of revenue and the key judgments and estimates made in its recognition. The information disclosed was also often “boilerplate” and uninformative.

The Boards achieved their goal of reaching the same conclusions on all significant requirements for accounting for revenue from contracts with customers with the issuance of ASC 606 and IFRS 15 *Revenue from Contracts with Customers* in May 2014. After the issuance of the new accounting standards for revenue recognition, the FASB and IASB formed the Joint Transition Resource Group for Revenue Recognition (TRG) to inform the Boards about potential implementation issues and to assist stakeholders in understanding specific aspects of the new guidance. Because of TRG deliberations, the FASB and IASB updated ASC 606 and IFRS 15, respectively, several times. Additionally, since the implementation of ASC 606 by public business entities, the FASB is performing a post-implementation review of ASC 606, which has resulted in additional amendments to ASC 606. While ASC 606 was converged with IFRS 15 upon issuance, the subsequent amendments introduced differences in certain aspects of the two standards. The differences relate to the following areas:

- ▶ Revenue recognition for an arrangement that does not meet the criteria for a contract to exist under the revenue standards
- ▶ Promised goods or services that are immaterial within the context of a contract
- ▶ Determination of performance obligations by franchisors<sup>1</sup> that are not public business entities
- ▶ Shipping and handling activities
- ▶ Presentation of sales taxes
- ▶ Noncash consideration
- ▶ Consideration payable to a customer (equity instruments)
- ▶ In-substance sales of intellectual property (IP)

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<sup>1</sup> A franchisor is defined as “the party who grants business rights (the franchise) to the party (the franchisee) who will operate the franchised business.”

▶ Licensing:

- Determining the nature of an entity’s promise in granting a license of IP
- Contractual restrictions in a license and identification of performance obligations
- Renewals of licenses of IP

▶ Disclosures

While the two standards are no longer fully converged, the differences are still relatively minor. Additional information on revenue recognition for contracts with customers under IFRS 15 is available [here](#).

## ASC 606 IN A NUTSHELL – THE FIVE-STEP REVENUE RECOGNITION MODEL



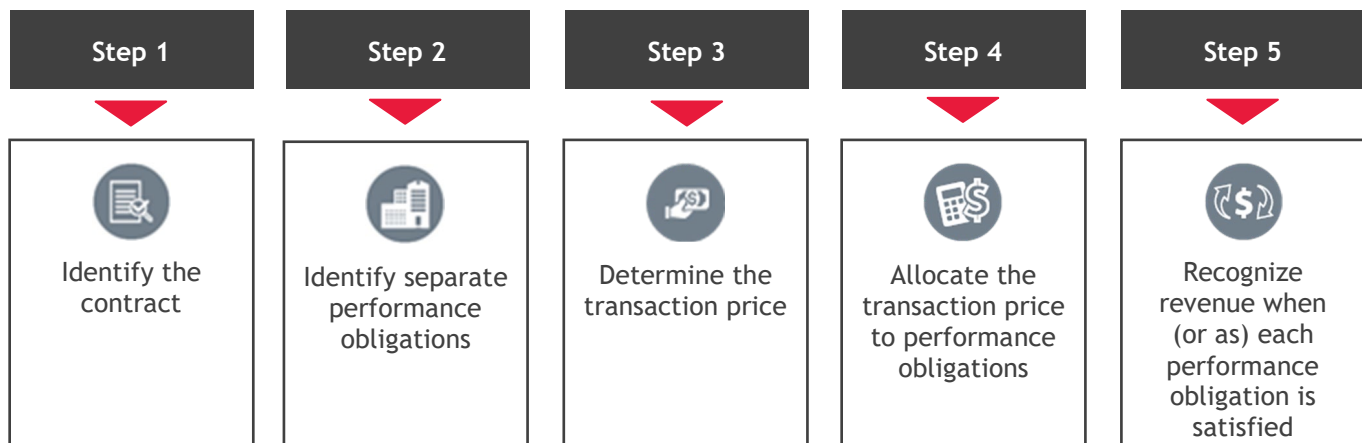
### FASB REFERENCES

ASC 606-10-05-1 through 05-4

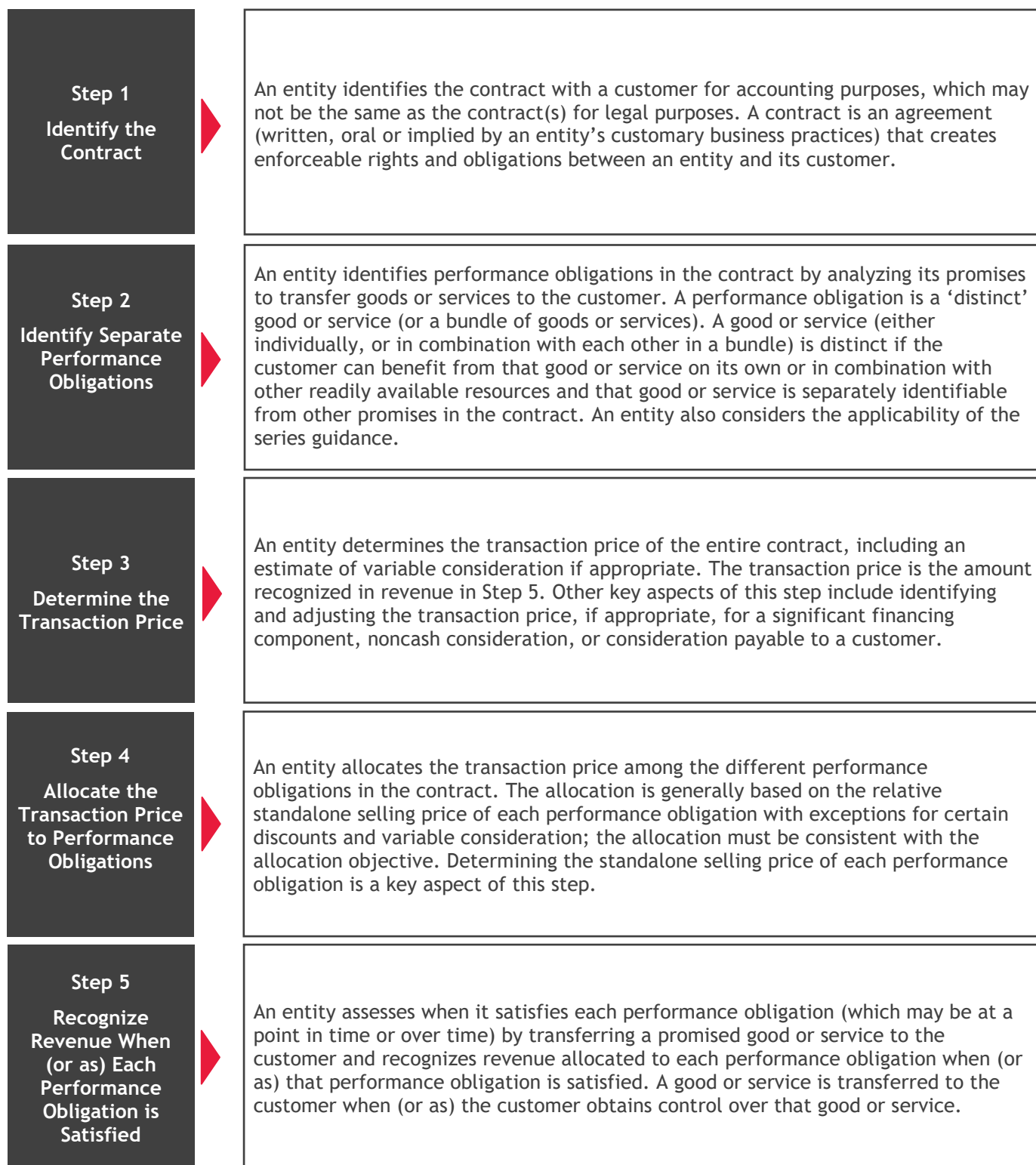
ASC 606 establishes a single, comprehensive framework to determine how much revenue to recognize, and when. The core principle is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. An entity recognizes revenue when or as control over the goods or services is transferred to the customer.

Recognition of revenue is linked to changes in an entity’s assets and liabilities; this can be in the form of cash inflows, increases in receivable balances, or decreases in liabilities that represent deferred revenue. All changes in those assets and liabilities are recognized in profit or loss, other than those relating to transactions with owners (for example, shareholders) in their capacity as such.

The core principle is applied in the following five steps (or the five-step revenue recognition model):



The following diagram provides a high-level summary of the five-step revenue recognition model, which is discussed in detail in the following chapters:



The five-step revenue recognition model is applied to individual contracts. However, as a practical expedient, an entity is permitted to apply the model to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects would not differ materially from applying it to individual contracts. For example, an entity may elect to apply this practical expedient when it may have many contracts affected by a particular issue and an estimate is more appropriately made for the population of contracts as a whole rather than for each contract individually. For example, for retail sales that give the customer a right of return, it may be more appropriate to estimate the aggregate returns for a group of similar retail sale transactions, rather than at the contract level (that is, rather than for each retail sale for which a right of return is granted).

### **BDO INSIGHTS – INDUSTRY-AGNOSTIC REVENUE RECOGNITION MODEL**

ASC 606 is a comprehensive and industry-agnostic revenue recognition model. The adoption of ASC 606 resulted in changes in revenue recognition policies for entities, but the amount and timing of revenue recognition did not materially change for many entities. Regardless, an entity must make sure that its internal controls over financial reporting comply with the requirements of ASC 606.

## **OTHER KEY CONCEPTS**

### **Principal Versus Agent Considerations**

ASC 606 provides guidance on principal versus agent assessments when a third party is involved in providing goods or services to a customer. An entity is a principal, and thus recognizes revenue on a gross basis, if it controls a good or service before transferring the good or service to the customer. An entity is an agent, and thus recognizes revenue on a net basis, if it arranges for a good or service to be provided by another entity. The standard contains indicators and examples to assist with the analysis.

ASC 606 clarifies the application of the principal versus agent guidance in the following areas:

- ▶ Unit of account at which the principal versus agent determination is made
- ▶ The control principle and principal versus agent indicators
- ▶ Applying the control principle to certain types of transactions

### **BDO INSIGHTS – PRINCIPAL VERSUS AGENT ANALYSIS IS BASED ON CONTROL**

The principal versus agent guidance is based on the concept of control. Control refers to an entity's ability to direct the use of and derive substantially all of the benefits from an asset. The control concept in ASC 606 includes the elements of power and benefits.

Risks and rewards are merely indicators of control, which are not solely conclusive of whether control has transferred.

Determining whether an entity controls a good or service before it is transferred to the customer requires the application of professional judgment, based on the facts and circumstances.

### **Contract Modifications**

ASC 606 includes a comprehensive model to account for modifications of contracts with customers. A contract modification is a change in the scope or price of a contract approved by parties to the contract. This might be referred to as a change order, variation, or an amendment. Accounting adjustments are only made for a contract modification when either new enforceable rights and obligations are created, or existing ones are changed.

Depending on the nature of modifications, a contract modification may be accounted for under any one of the following approaches:

- a) A separate (and additional) contract with no adjustments to revenue recognized from the existing contract,



- b) A termination of the existing contract and the creation of a new contract with prospective adjustments to revenue recognized from the existing contract,
- c) A continuation of the existing contract with cumulative catch-up adjustments to revenue recognized to date from the existing contract,
- d) A combination of the approaches described in b and c.

### Customer Options for Additional Goods or Services

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. ASC 606 provides guidance on accounting for a customer option to acquire additional goods or services based on whether it is a material right, a renewal option or neither.

### Licensing

ASC 606 contains special rules for recognizing revenue from licenses of IP. ASC 606 specifies that there are two types of licenses of IP with different patterns for revenue recognition based on the nature of the license:

- ▶ **Symbolic IP license** – It provides the customer with a right to access an entity’s IP throughout the license period, and its utility is derived from the entity’s past or ongoing activities (for example, use of a brand). Revenue from symbolic IP is recognized over time.
- ▶ **Functional IP license** – It provides the customer with a right to use an entity’s IP as it exists at a point in time at which the license is granted, and has significant standalone functionality (for example, a drug compound, technology, or software product). Revenue from functional IP is generally recognized at a point in time.

### Onerous Contracts (Loss Contracts)

ASC 606 does not provide specific guidance for onerous (loss) contracts with customers. However, certain guidance in the prior revenue recognition guidance<sup>2</sup> continues to be applicable to certain onerous contracts with customers even after the adoption of ASC 606. Given the lack of clear guidance, accounting for onerous contracts requires the application of professional judgment, based on the facts and circumstances.

### Contract Costs

ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*, was issued concurrently with ASC 606 and includes specific guidance on accounting for the incremental costs of obtaining and the costs incurred in fulfilling a contract with a customer within the scope of ASC 606. Certain contract costs are initially recognized as an asset (that is, deferred) and subsequently expensed on a systematic basis that is consistent with the pattern of transfer to the customer of the good or service to which those costs relate.

## PRESENTATION AND DISCLOSURES

### Presentation

ASC 606 includes guidance on presenting contract assets, contract liabilities and receivables in the balance sheet for contracts with customers. When either party to a contract has performed, an entity presents the contract in the balance sheet as either a contract asset or a contract liability, depending on the relationship between the entity’s performance and the customer’s payment. An entity presents any unconditional rights to consideration separately as a receivable.

### Disclosure Objective

ASC 606 includes an overall disclosure objective, which is for an entity to disclose information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from

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<sup>2</sup> ASC 605-20, *Revenue Recognition – Services* and ASC 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts*



contracts with customers. This objective is accompanied by comprehensive and principles-based disclosure requirements about an entity's:

- ▶ Contracts with customers
- ▶ Significant judgments, and changes in the judgments, made in applying ASC 606 to those contracts
- ▶ Assets recognized for costs of obtaining and fulfilling those contracts<sup>3</sup>

An entity is specifically required to consider both:

- ▶ The level of detail necessary to satisfy the disclosure objective
- ▶ Emphasis to be placed on each disclosure requirement

The purpose of the disclosure objective is to make sure that:

- ▶ Information that users will find useful is not obscured by a large amount of insignificant detail
- ▶ Items with sufficiently different characteristics are disaggregated and presented separately

### **BDO INSIGHTS – SEC STAFF CONSULTATIONS ON ASC 606**

The SEC staff continues to receive consultations on revenue recognition matters, including identification of performance obligations, principal versus agent considerations, identification of a customer and accounting for consideration payable to a customer. The SEC staff will respect well-reasoned judgments grounded in facts and the relevant accounting principles. Entities must also make sure that revenue recognition disclosures provide the appropriate context to investors.

## **ABOUT THE BLUEPRINT**

The Blueprint reflects the key aspects of the following accounting standards updates (referred to as ASC 606 in this Blueprint):

- ▶ ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*
- ▶ ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*
- ▶ ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*
- ▶ ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*
- ▶ ASU 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016, EITF Meeting (SEC Update)*
- ▶ ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*
- ▶ ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*
- ▶ ASU 2017-13, *Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017, EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments (SEC Update)*
- ▶ ASU 2017-14, *Income Statement—Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605) and Revenue from Contracts with Customers (Topic 606) (SEC Update)*
- ▶ ASU 2018-18, *Collaborative Arrangements (Topic 808): Clarifying the Interaction between Topic 808 and Topic 606*

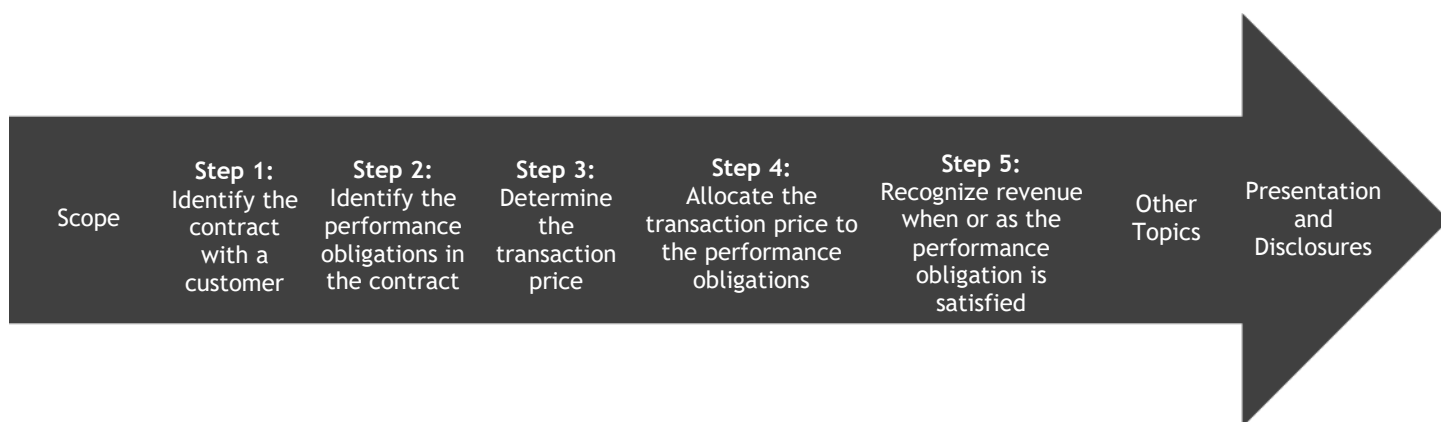
<sup>3</sup> The disclosure requirements for assets recognized for costs of obtaining contracts with customers and fulfilling those contracts is included in ASC 340-40.

- ▶ ASU 2019-08, *Compensation—Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Codification Improvements—Share-Based Consideration Payable to a Customer*
- ▶ ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*
- ▶ ASU 2021-02, *Franchisors—Revenue from Contracts with Customers (Subtopic 952-606): Practical Expedient*

This Blueprint includes detailed guidance and diagrams on analyzing and accounting for contracts with customers under ASC 606. While this Blueprint does not include all requirements of ASC 606, it summarizes key aspects of ASC 606 that are commonly considered in applying ASC 606. It also includes practical examples and interpretive guidance to assist entities and practitioners in their continued application of ASC 606. The diagrams are provided to assist readers in understanding various aspects of ASC 606. Revenue recognition for contracts with customers varies based on the specific facts and circumstances of each contract and, therefore, may differ from the examples and insights provided in the Blueprint.

The Blueprint has been divided into chapters that address key aspects of the revenue recognition standard. These chapters are generally organized in the order in which an entity would apply ASC 606 and the questions that an entity would need to answer as it proceeds through the evaluation. For example, the first two chapters discuss whether a contract exists and is within the scope of ASC 606, and if so, a reader moves to the next chapter, which addresses identification of the performance obligations in a contract with a customer, and so on. Other key aspects of ASC 606 related to specific issues in applying the five-step revenue recognition model have been grouped into one chapter entitled “Other Topics,” which includes principal versus agent considerations, contract modifications, customer options for additional goods and services, licensing, onerous contracts, and contract costs. Finally, there is a chapter discussing the presentation and disclosure requirements in ASC 606.

The diagram below depicts how the chapters are organized.



The Blueprint focuses on revenue recognition for contracts with customers under ASC 606 only. More information on revenue recognition for contracts with customers under International Financial Reporting Standards (IFRS) is available [here](#).

### Use of the Term “Public Entity” and “Nonpublic Entity”

ASC 606 includes certain modified requirements for an entity that does not meet the following definition of a public business entity. Throughout this Blueprint, the term “public entity” refers to an entity that meets that definition and the term “nonpublic entity” refers to an entity that does not meet that definition.



## FASB REFERENCES

### ASC 606-10-20

#### Public business entity

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

- ▶ 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, as amended, or rules or regulations promulgated under that 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 in preparation for the sale of or for purposes of issuing 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 U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.



### CAREFULLY EVALUATE THE DEFINITION OF “PUBLIC BUSINESS ENTITY”

The definition of “*public business entity*” is complex and encompasses more than just those entities whose stock are listed on an exchange.

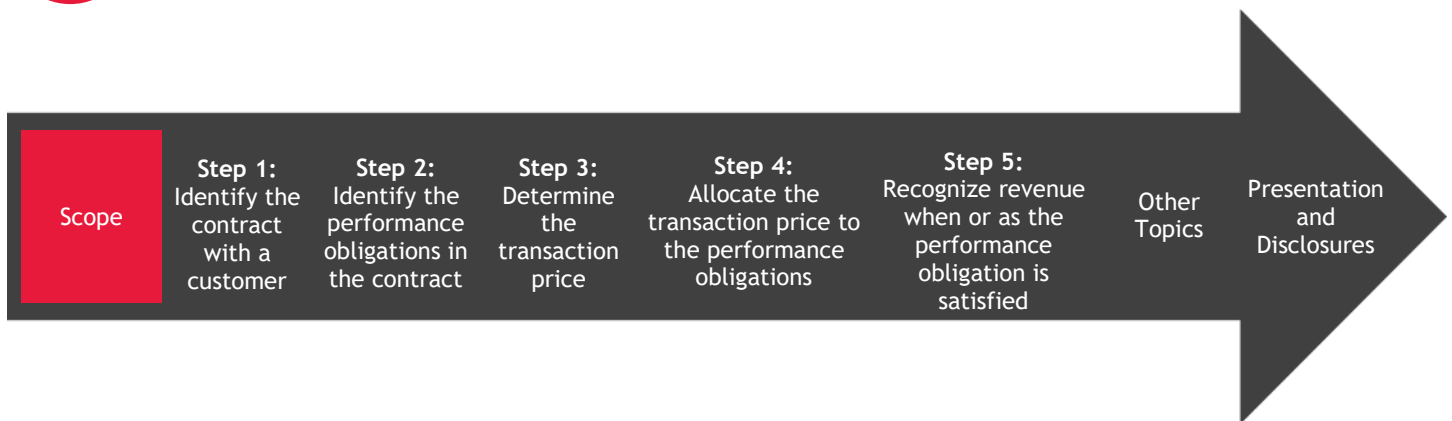
## Future Standard Setting



### FASB PROJECT – POST-IMPLEMENTATION REVIEW FOR ASC 606

The FASB is performing a post implementation review of ASC 606 to consider whether further amendments to ASC 606 are needed. However, as of the issuance date of this Blueprint, the FASB does not have an active standard-setting project on its agenda related to revenue recognition.

# CHAPTER 1 – SCOPE



## 1.1 OVERVIEW

ASC 606 applies to all entities and all contracts with customers to transfer goods or services arising from their ordinary activities, except for contracts or transactions that are excluded from its scope. The definitions of “contract” and “customer” establish the scope of ACS 606. ASC 606 includes guidance for a contract that is partially within the scope of ASC 606 and partially within the scope of other U.S. GAAP.

## 1.2 SCOPE AND SCOPE EXCEPTIONS



### FASB REFERENCES

ASC 606-10-15-2

The following contracts or transactions are excluded from the scope of ASC 606:

- ▶ Lease contracts within the scope of ASC 842, *Leases*<sup>4</sup>
- ▶ Contracts within the scope of ASC 944, *Insurance*
- ▶ Financial instruments and other contractual rights and obligations within the scope of ASC 320, *Investments – Debt Securities*, ASC 321, *Investments – Equity Securities*, ASC 323, *Investments – Equity Method and Joint Ventures*, ASC 325, *Investments – Other*, ASC 405, *Liabilities*, ASC 460, *Guarantees* (except certain warranties), ASC 470, *Debt*, ASC 815, *Derivatives and Hedging*, ASC 825, *Financial Instruments* and ASC 860, *Transfers and Servicing*
- ▶ Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers

The scope exceptions in ASC 606 require that if specific guidance in other standards is applicable to a transaction, an entity applies that guidance rather than the guidance in ASC 606. For example, guarantees (other than product warranties) within the scope of ASC 460 are not within the scope of ASC 606 because ASC 460 provides specific guidance for recognizing and measuring a guarantee liability. In other words, ASC 606 is applied as the residual standard when a transaction is not within the scope of other U.S. GAAP.

<sup>4</sup> See our Blueprint, [Accounting for Leases Under ASC 842](#), for guidance on ASC 842.

### 1.2.1 Nonmonetary Exchanges Between Entities in the Same Line of Business



#### FASB REFERENCES

ASC 606-10-15-2(e)

In industries with homogeneous products, it is common for entities in the same line of business to exchange products to facilitate sales to customers or potential customers who may not be a party to that exchange. This may be done, for example, to reduce transport costs, meet immediate inventory needs or otherwise facilitate a sale to the end customer.

ASC 606-10-15-2(e) includes an example of two oil companies agreeing to exchange oil (or inventory) to fulfill customer demand in different locations. In that example, because the oil being exchanged is an output of each oil company's ordinary activities, the counterparty to the exchange meets the definition of a customer (see Section 1.3 for discussion of the definition of a customer). Applying ASC 606 to the exchange would have resulted in double recognition of revenue for the same supplies of oil for each entity – once for the exchange of inventory between the two oil companies, and thereafter for the sale of the inventory to the end customer. To avoid such gross up of revenues and expenses, nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers are excluded from the scope of ASC 606. Such transactions may be within the scope of ASC 845, *Nonmonetary Transactions*. If so, the oil companies in this example would apply the guidance in ASC 845 to account for the exchange of oil between them and ASC 606 to recognize revenue for the sale of oil to the end customer.

#### **BDO INSIGHTS – “LINE OF BUSINESS”**

ASC 606 does not include any further guidance on interpreting “line of business” when assessing exchange transactions, therefore judgment may be needed. We believe the scope exception is quite strictly drawn.

For example, consider whether an entity involved in mining diamonds is in the same line of business as an entity mining rubies because they both operate in the same industry sub-sector (that is, mining of precious stones), or whether they are in different lines of business because they mine different gemstones. We believe the entities are not in the same line of business because rubies and diamonds are not acceptable substitutes for one another, unlike in the example of oil in Section 1.1.1.

However, even if the transaction is within the scope of ASC 606, it is necessary to understand the commercial substance of an exchange transaction before concluding whether the exchange generates revenue. Further, even if there is commercial substance to the exchange, each entity might be acting as an agent for the other in the ultimate sale to the other entity's end customer, meaning that they are providing agency services to each other. This conclusion would impact the measurement of revenue, which would then be based on the provision of the agency services, not the gross value of the exchanged goods or services.

Reaching a conclusion about whether two entities are in the same line of business, whether an exchange between the entities has commercial substance, and whether an entity is acting as an agent for the other entity, requires the application of professional judgment, based on the facts and circumstances.

The TRG clarified when certain transactions are subject to one of the scope exceptions during its deliberations. Following is a summary of those discussions:



## TRG DISCUSSIONS – ARRANGEMENTS BETWEEN FINANCIAL INSTITUTIONS AND CREDIT CARDHOLDERS

At the July 2015 meeting, the TRG discussed whether certain arrangements between financial institutions and credit cardholders are within the scope of ASC 606. Although some income streams, such as interest charges on late payments, are not within the scope of ASC 606, questions had been raised regarding periodic or annual fees that are not dependent on the amount of credit available or the use of the credit card or ancillary services, such as access to airport lounges and reward programs.

The FASB staff concluded that entities should continue to account for services exchanged for credit card fees under ASC 310 (now superseded by ASC 326, *Financial Instruments – Credit Losses*) rather than ASC 606. Additionally, if the credit card arrangement is within the scope of ASC 310 (now superseded by ASC 326), then the associated reward program would be as well. However, the FASB staff stated that ASC 310 (now superseded by ASC 326) would not apply if the issuance of a card is incidental to the arrangement.



## TRG DISCUSSIONS – INCOME FROM SERVICING AND SUB-SERVICING ACTIVITIES

At the April 2016 meeting, the TRG discussed whether income from servicing and sub-servicing activities (for example, servicing mortgage loans) are within the scope of ASC 606. The TRG stated that while ASC 860 includes detailed guidance on the initial recognition and subsequent measurement of servicing assets and liabilities, it does not include explicit guidance describing the revenue recognition of servicing fees.

However, the FASB staff concluded that the subsequent measurement guidance in ASC 860 provides sufficient implicit guidance on accounting for servicing cash flows and, therefore, the accounting for servicing and sub-servicing revenues is within the scope of ASC 860 rather than ASC 606.



## TRG DISCUSSIONS – DEPOSIT-RELATED FEES

At the April 2016 meeting, the TRG discussed whether deposit-related fees, such as monthly service fees, ATM usage fees and foreign exchange fees, are within the scope of ASC 405, which governs the accounting for the related deposit liability. The FASB staff concluded that ASC 405 only addresses the accounting for the deposit liability and does not contain an accounting framework for recognizing revenue from deposit-related transactions. Therefore, deposit-related fees are within the scope of ASC 606.



## TRG DISCUSSIONS – INCENTIVE-BASED CAPITAL ALLOCATIONS, SUCH AS CARRIED INTEREST

At the April 2016 meeting, the TRG discussed whether incentive-based performance fees through an allocation of capital (often referred to as a “carried interest”) are within the scope of ASC 606. Some entities, particularly asset managers, receive incentive-based performance fees by way of an allocation of capital from investment funds under management as compensation for services and performance in managing the funds.

Multiple TRG members, the FASB staff and Board members concluded that those fees are within the scope of ASC 606 because they are compensation for services provided and, hence, form a revenue transaction.

However, some TRG members held an alternate view that a carried interest could be considered an equity arrangement outside the scope of ASC 606 because it is, in form, an ownership interest in an entity. Under that alternate view, an entity receiving a carried interest would apply the consolidation model in ASC 810, equity method of accounting in ASC 323, or other U.S. GAAP to determine the appropriate accounting treatment for the ownership interest held in another entity.

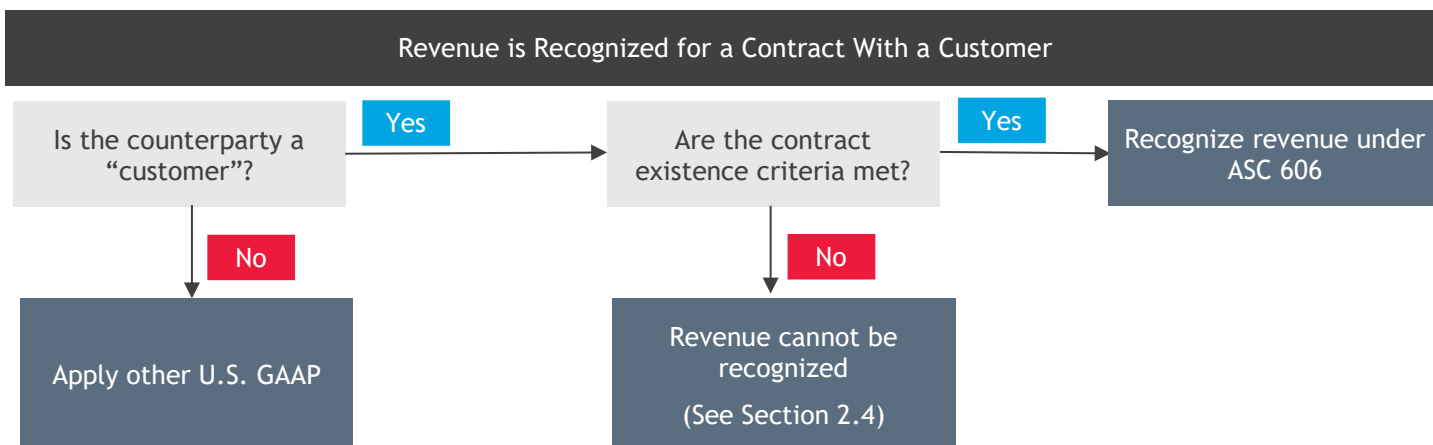
At that meeting, the SEC staff observer indicated that the SEC staff would accept treatment of carried interest as a revenue transaction within the scope of ASC 606. However, the SEC staff also stated that there may also be a basis for applying an ownership model. If an entity were to apply an ownership model, then the SEC staff would expect full application of the ownership model, including an analysis of the consolidation model under ASC 810, the equity method of accounting under ASC 323, or other relevant guidance. See our [BDO Knows: Variable Interest Entities](#) for guidance on applying ASC 810.

### BDO INSIGHTS – ACCOUNTING FOR CARRIED INTERESTS

We believe determining whether to account for a carried interest as a revenue transaction or an equity arrangement is an accounting policy election that must be consistently applied, and fully disclosed. Accounting for carried interests requires the application of professional judgment, based on the facts and circumstances.

#### 1.2.2 Scope of ASC 606

The definitions of contract and customer establish the scope of ASC 606 – this is illustrated in the following diagram. The definition of a customer is discussed in Section 1.3 and the definition of a contract (the contract existence criteria) is discussed in Section 2.2.





## 1.3 DEFINITION OF A CUSTOMER



### FASB REFERENCES

ASC 606-10-20, ASC 606-10-15-2A and 15-3

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.”

### 1.3.1 Ordinary Activities

ASC 606 does not define the term “ordinary activities,” which was derived from the definitions of revenue in the FASB’s conceptual framework. The definition of revenue in Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, (Concepts Statement 6) refers to the notion of an entity’s “ongoing major or central operations.”

In December 2021, the FASB replaced the definition of revenue in Concepts Statement 6 with a new definition in Statement of Financial Accounting Concepts No. 8, which removed the reference to the notion of an entity’s “ongoing major or central operations.” In making that change, the FASB concluded that delivering or producing goods and rendering services are primary factors in distinguishing revenue from gains, regardless of whether they are considered major or central to an entity. Despite that subsequent change in the conceptual definition of revenue since the issuance of ASC 606 in 2014, in practice, entities continue to consider the notion of “ongoing major or central operations” because that was the thought process behind the FASB using the term “ordinary activities” in defining the customer under ASC 606.

The definition of a customer was included in the standard to enable entities to distinguish contracts for which revenue is recognized under ASC 606 (that is, contracts with customers) from contracts that are not within the scope of ASC 606. Revenue from transactions within the scope of ASC 606 is derived from contracts with customers entered by an entity for the sale of goods or services arising from its ordinary activities.

Revenue from a transaction that does not arise from a contract with a customer is not within the scope of ASC 606. For example, receipts of dividends, sales of nonfinancial assets (such as excess properties), nonexchange transactions (including receipts of government assistance or donations) are not within the scope of ASC 606. Those transactions are recognized in accordance with other U.S. GAAP.

### **BDO INSIGHTS – DETERMINING WHETHER INCOME IS FROM “ORDINARY ACTIVITIES”**

Judgment may be required to determine whether an income generating activity is an ordinary activity under ASC 606 in certain circumstances. For example, an entity that starts selling new products or services would need to determine whether and at what point the new offering becomes its ordinary activity or part of its ongoing major or central operations. Reaching a conclusion about whether an income generating activity is an ordinary activity requires the application of professional judgment, based on the facts and circumstances.



## FASB PROJECT – ACCOUNTING FOR GOVERNMENT GRANTS

The FASB has a research project on accounting for government grants received. U.S. GAAP currently does not include specific guidance on recognition and measurement of government grants received by for-profit entities. Entities can analogize to the guidance in IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, ASC 450-30, *Gain Contingencies*, or ASC 958-605, *Not-for-Profit Entities – Revenue Recognition – Contributions*, on revenue recognition by not-for-profit entities to determine the accounting for government grants received.

ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*, includes guidance on recognition of gains or losses from derecognition of nonfinancial assets and in-substance nonfinancial assets transferred to counterparties that are not customers, which typically results in a net presentation of the gain or loss outside revenue.<sup>5</sup> ASC 610-20 generally requires applying the revenue recognition principles in ASC 606 to contracts within the scope of ASC 610-20.

### EXAMPLE 1-1: SALE TO A COUNTERPARTY THAT IS NOT A CUSTOMER

An entity generates revenue by manufacturing and selling containers. The entity enters a contract to transfer one of the machines from its manufacturing facility to a counterparty in exchange for \$10,000.

The entity considers whether the sale of machinery is within the scope of ASC 606. The entity observes that it does not ordinarily generate revenue by selling machinery. Rather, it employs the machinery (that is, a fixed asset) in its facility to manufacture containers for sale. The entity concludes that the sale of machinery is not an output of its ordinary activities. Therefore, the entity determines that the counterparty in the contract for the sale of machinery is not a customer, and accordingly ASC 606 is not applicable to the transaction. That is, the entity does not recognize or present the \$10,000 it receives as revenue from the sale of the machinery.

The entity considers the guidance in ASC 610-20 on transfer of nonfinancial assets to determine the appropriate accounting and presentation of the sale of machinery.

### 1.3.2 More Than One Customer in a Contract

A revenue transaction may have more than one customer such that an entity may be transferring goods or services that are an output of its ordinary activities to more than one party. For example, an entity that is acting as an agent may conclude that both the principal in the arrangement and the end customer are its customers for different aspects of the arrangement. See Section 7.2 for discussion of the principal versus agent analysis.



### PRINCIPAL VERSUS AGENT ANALYSIS – IDENTIFICATION OF THE CUSTOMER(S)

Careful analysis is required to identify an entity's customer(s) in revenue transactions that include more than two parties. Correct identification of customer(s) is important because it affects the identification of consideration payable to a customer, which, under certain conditions, is recognized as a reduction of revenue (see Section 4.6 for discussion on consideration payable to a customer).

<sup>5</sup> Based on a reference in ASC 610-20-45-1 to ASC 360-10-45-5 for presentation of a gain or loss recognized on the sale of a long-lived asset.

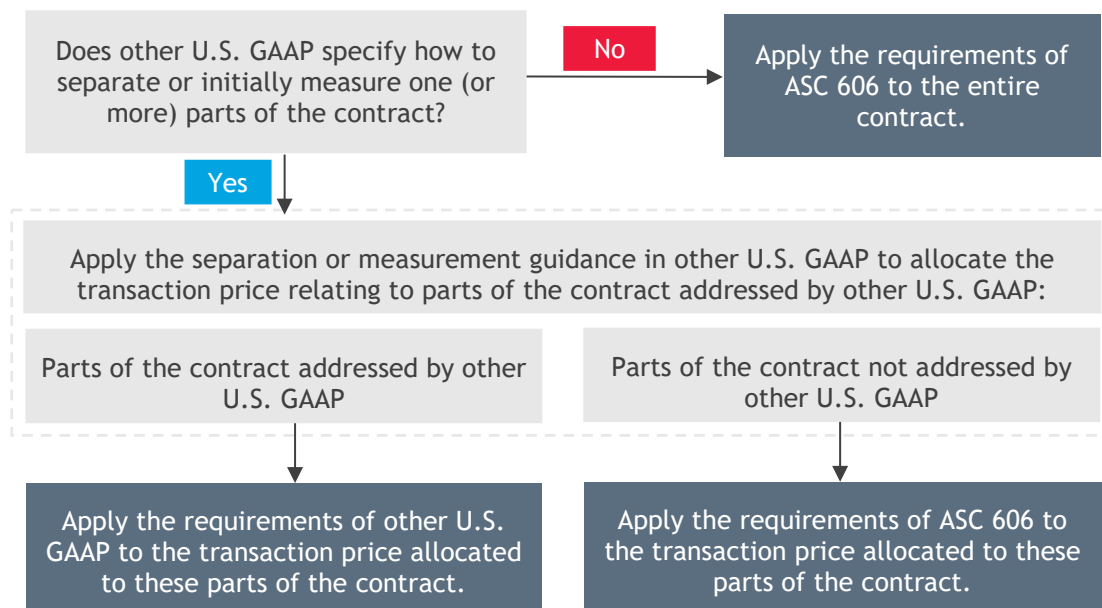
## 1.4 CONTRACTS PARTIALLY WITHIN THE SCOPE OF OTHER STANDARDS



### FASB REFERENCES

ASC 606-10-15-4

An entity applies the approach summarized in the following diagram to account for a contract that is partially within the scope of ASC 606 and partially within the scope of other U.S. GAAP:



If one or more other standards specify how to separate or measure the parts of a contract that they address, then an entity applies the separation and measurement guidance in those other standards to determine the portion of the transaction price that is excluded from ASC 606. If other standards do not address how to separate or measure the parts of the contract that they address, then the guidance in ASC 606 for separating and measuring parts of the contract (see Chapter 5 for related discussion) is used to determine how to allocate the transaction price between the element(s) subject to other standards and the element(s) subject to ASC 606.

#### EXAMPLE 1-2: CONTRACT PARTIALLY WITHIN THE SCOPE OF ASC 606 – LEASE OF EQUIPMENT WITH MAINTENANCE SERVICE

An entity leases a bulldozer, a truck, and a crane to a customer for three years. The entity also agrees to maintain each piece of equipment throughout the lease term. Assume that the leases meet the definition of a lease under ASC 842 and, therefore, the contract is within the scope of ASC 842.

In accordance with ASC 842-10-15-31, the entity separates the lease and non-lease components (maintenance services) in the contract and applies the requirements in ASC 842 to the lease components. While non-lease components are not within the scope of ASC 842, ASC 842 includes guidance on allocating the consideration in a

contract to each separate lease and non-lease component of the contract. The entity applies ASC 606 only to the consideration received from the customer that is allocated to the maintenance services<sup>6</sup>.

### 1.4.1 Contributions Received by Not-for-Profit Entities



#### FASB REFERENCES

ASC 606-10-20 and ASC 958-605-20

ASC 606 requires an entity to consider the guidance in ASC 958-605 when determining whether a transaction is a contribution within the scope of ASC 958-605 or a transaction within the scope of ASC 606. Contributions received from donors are not specifically outside the scope of ASC 606. However, in practice, those contributions are typically not within the scope of ASC 606 because ASC 606 defines revenue as “inflows or other enhancement of assets of an entity or the settlement of its liabilities (or a combination of both) from delivering or producing goods, rendering services or other activities that constitute the entity’s ongoing and major activities.” On the other hand, a contribution is defined in ASC 958-605 as “an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.” In other words, revenue is derived from a reciprocal transfer between parties in which the parties are expecting to exchange similar value, whereas a contribution is voluntary and nonreciprocal. Because of these differences in the nature of revenue and contributions, a contribution received by a not-for-profit (NFP) is outside the scope of ASC 606.

Nevertheless, an NFP may engage in activities that are considered exchanges or revenue transactions with customers and thus are within the scope of ASC 606. An NFP must evaluate its contracts to determine if they include both contributions and exchange transactions. A contribution component is outside the scope of ASC 606 and, consequently, contracts that have both components are required to be separated. For example, the following arrangements may be partially or wholly within the scope of ASC 606:

- ▶ Memberships
- ▶ Sale of products and services
- ▶ Sponsorships
- ▶ Tuition
- ▶ Licensing
- ▶ Subscription
- ▶ Royalty agreements
- ▶ Conferences and seminars
- ▶ Advertising
- ▶ Federal and state grants and contracts



#### TRG DISCUSSIONS – CONTRACTS PARTIALLY WITHIN THE SCOPE OF ASC 606 – PAYMENT RECEIVED BY AN NFP

In certain circumstances, a payment received by an NFP may represent both a contribution and a reciprocal transfer of goods or services. For example, a service organization may charge an annual membership fee that, in addition to providing funding to support the organization’s programs, grants the member the right to receive a monthly or quarterly magazine.

<sup>6</sup> See our Blueprint, [Accounting for Leases Under ASC 842](#), for guidance on ASC 842, including a practical expedient that allows lessors to combine lease and non-lease components and account for the combined component under ASC 606 or ASC 842 based on whether the lease or non-lease component is predominant.

At its March 2015 meeting, the TRG discussed whether contributions are within the scope of ASC 606. The TRG observed that because contributions represent nonreciprocal transfers, they do not represent the sale of goods or services and thus are not within the scope of ASC 606.

However, the FASB staff acknowledged that if an NFP transfers a good or service in a reciprocal transfer, that arrangement is accounted for under ASC 606. Therefore, the annual membership fee in this example represents a contract that is partially within the scope of ASC 606 and partially within the scope of ASC 958-605.

Additionally, because ASC 958-605-55 contains specific guidance for separating and initially measuring contribution and exchange portions of a payment, the NFP applies that guidance to allocate the payment received. Therefore, the NFP determines the fair value of the exchange portion of the transaction, with the residual reported as contributions.

## 1.5 INTERACTION WITH OTHER STANDARDS

Consequential amendments were made to the existing requirements of other standards for the recognition of gain or loss on the transfer of some non-financial assets that are not an output of an entity's ordinary activities (such as property, plant, and equipment and intangible assets) to be consistent with the requirements in ASC 606. See Section 1.3.1 for discussion on ASC 610-20.

Additionally, ASC 606 specifies the interaction with certain other standards as discussed below.

### 1.5.1 Deferred Costs From Contracts With Customers



#### FASB REFERENCES

ASC 606-10-15-5

For contracts with customers that are within the scope of ASC 606, an entity applies ASC 340-40, which provides guidance on accounting for the costs incurred to obtain or fulfill a contract with a customer if those costs are not within the scope of other U.S. GAAP (see Section 7.7).

### 1.5.2 Collaborative Arrangements



#### FASB REFERENCES

ASC 606-10-15-3 and ASC 808-10-15-5A through 15-5C

ASC 808-10-20

A collaborative arrangement is defined as “a contractual arrangement that involves a joint operating activity. These arrangements involve two (or more) parties that meet both of the following requirements:

- ▶ They are active participants in the activity.
- ▶ They are exposed to significant risks and rewards dependent on the commercial success of the activity.”

ASU 2018-18 amended ASC 606 and ASC 808, *Collaborative Arrangements*, to clarify the interaction between the two standards. Certain transactions between collaborative arrangement participants are within the scope of ASC 606 when the collaborative arrangement participant is a customer in the context of a unit of account. In those situations, all of ASC 606 guidance is applied, including recognition, measurement, presentation, and disclosure requirements.

ASC 808 includes guidance on unit of account (that is, whether an activity is a distinct good or service) that is aligned with the guidance in ASC 606. That guidance is used to determine whether the collaborative arrangement, or a part of the arrangement, is within the scope of ASC 606.

An entity is precluded from presenting income from a collaborative arrangement with revenue recognized under ASC 606 unless:

- ▶ The collaborative arrangement participant is a customer
- ▶ The transaction with a collaborative arrangement participant is directly related to sales to third parties<sup>7</sup>

### **BDO INSIGHTS – DETERMINING WHETHER A RESEARCH AND DEVELOPMENT ARRANGEMENT IS WITHIN THE SCOPE OF ASC 606**

For life sciences entities, research and development (R&D) arrangements are often complex, involve multiple deliverables and various types of consideration, and span several years. The analysis of whether a counterparty to an arrangement is a customer (as defined in ASC 606) is important when evaluating whether “reimbursements” or “funded R&D” can be accounted for as revenue from a contract with a customer. In answering this question, an entity determines whether the reimbursement relates to goods or services that are an output of the entity’s ordinary activities. If the entity’s ordinary activities are performing R&D, then it is likely that the relationship between the entity and the counterparty is an entity-customer relationship, and the consideration would be recognized as revenue under ASC 606. Reaching a conclusion about whether an R&D arrangement is within the scope of ASC 606 requires the application of professional judgment, based on the facts and circumstances



### **COLLABORATIVE ARRANGEMENT**

A collaborative arrangement within the scope of ASC 808 is also within the scope of ASC 606 if the counterparty is a customer as defined in ASC 606. In that scenario, an entity applies the guidance in both ASC 606 and ASC 808 to that transaction. Specifically, an entity would apply the following guidance:

- ▶ Recognition, measurement, presentation and disclosure requirements in ASC 606
- ▶ Disclosure requirements in ASC 808

## **1.6 PORTFOLIO APPROACH**



### **FASB REFERENCES**

ASC 606-10-10-4

ASC 606 specifies the accounting for an individual contract with a customer. Entities often have many similar contracts for which applying the standard on a contract-by-contract basis might be impractical. As a practical expedient, an entity may apply the guidance in ASC 606 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 the guidance to

<sup>7</sup> ASC 808-10-55-11 through 55-14 includes a related example.

the portfolio would not differ materially from applying the guidance to the individual contracts (or performance obligations) within that portfolio. See Chapter 3 for discussion on performance obligations.

When accounting for a portfolio of contracts with customers, an entity uses estimates and assumptions that reflect the size and composition of the portfolio. Entities often apply the portfolio approach when many contracts are affected by a particular issue (for example, when an estimate is more appropriately made for the population of contracts rather than for each contract individually). For example, for retail sales that give the customer a right of return, it may be more appropriate to estimate the aggregate returns for a group of similar retail sale transactions, rather than at the contract level (that is, rather than for each retail sale for which a right of return is granted).

### 1.6.1 Evaluation of Whether Portfolio Approach Results in a Materially Different Outcome



#### FASB REFERENCES

ASC 606-10-55

ASC 606 does not provide specific guidance on whether or when the application of the portfolio approach is appropriate or how to determine whether the effects of applying the portfolio approach would differ materially from applying ASC 606 on a contract-by-contract basis.

However, ASC 606 illustrates the portfolio approach in an example related to a right of return (see Section 4.3.8 for discussion on a sale with a right to return). That example includes a fact pattern in which an entity applies the portfolio approach to 100 contracts, each of which includes the sale of one product at the same price and with the same terms. Additionally, the Background Information and Basis for Conclusions (BC) 293 of ASU 2014-09 states that using the portfolio approach could simplify the application of the guidance on allocation of transaction price (in Step 4) for a group of similar contracts in certain circumstances. However, BC69 of ASU 2014-09 states that the FASB did not intend for an entity to quantitatively evaluate each outcome and, instead, an entity can use a reasonable approach to determine the portfolios that would be appropriate for its types of contracts.

#### BDO INSIGHTS – PORTFOLIO APPROACH

While the portfolio approach is a more practical and cost-effective approach to applying the standard, entities need appropriate processes and controls in place to apply it. Additionally, an entity needs to apply judgment in:

- ▶ Selecting the size and composition of the portfolio and determining whether the contracts within a portfolio have similar characteristics. Characteristics of a contract would include considerations for:
  - Type of customer
  - Goods or services (or performance obligations) transferred
  - Pricing
  - Any other pertinent terms
- ▶ Evaluating qualitatively the effects on the financial statements of applying ASC 606 on a portfolio basis rather than on a contract-by-contract basis.
- ▶ Reassessing the appropriateness of the level of portfolio or use of portfolio approach for subsequent changes in the characteristics of contracts.

Reaching a conclusion about when and how to appropriately use the portfolio approach requires the application of professional judgment, based on the facts and circumstances.





## CHAPTER 2 – STEP 1: IDENTIFY THE CONTRACT WITH A CUSTOMER

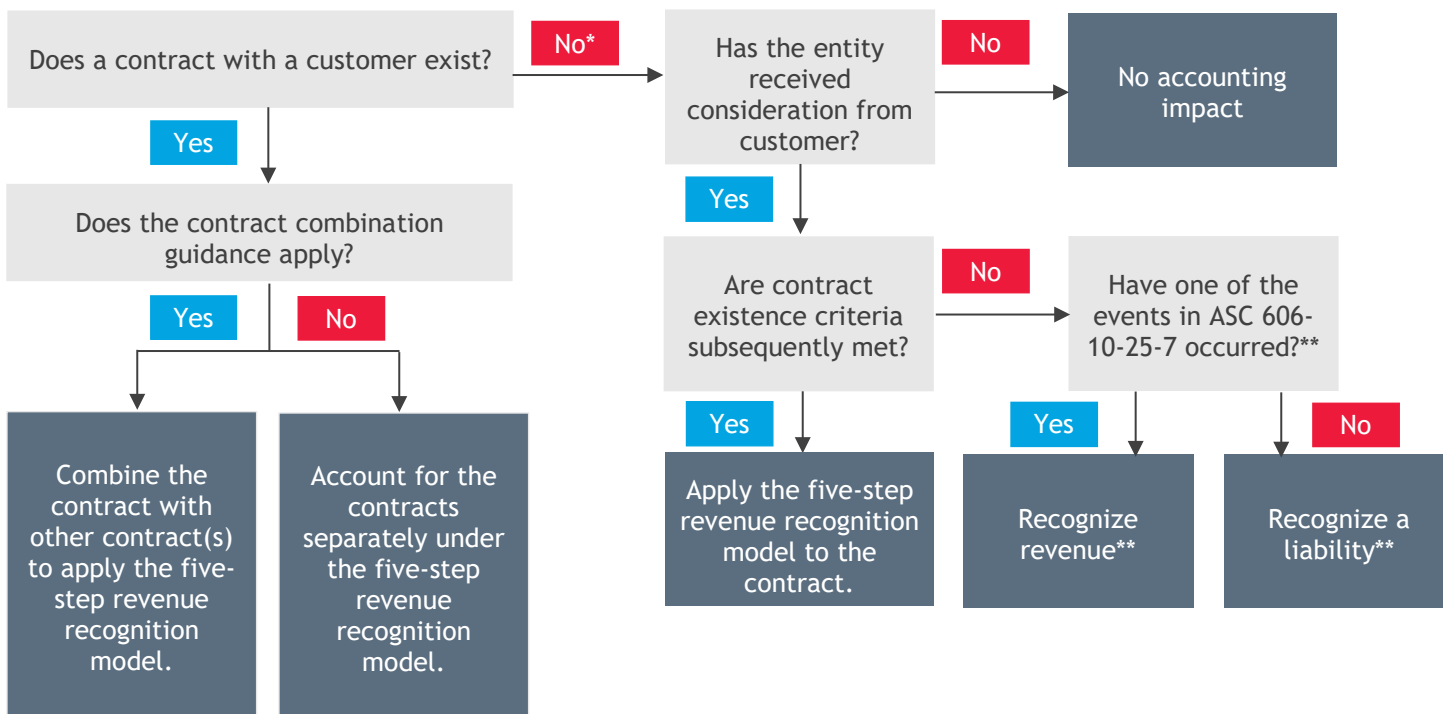


### 2.1 OVERVIEW

Once an entity determines that it is transferring goods or services arising from its ordinary activities to a customer in a transaction within the scope of ASC 606, the first step in applying the five-step revenue recognition model is to identify the contract(s) with a customer. A contract is defined as an agreement between two or more parties that creates enforceable rights and obligations. The standard includes five contract existence criteria, each of which must be met for a contract with a customer to exist. If the contract existence criteria are met, revenue from the contract is accounted for under the five-step revenue recognition model in ASC 606. If any one of the contract existence criteria are not met, ASC 606 includes guidance on reassessing whether the contract existence criteria are subsequently met and accounting for consideration received from a customer before the contract existence criteria are met.

ASC 606 also includes contract combination guidance to determine when an entity should combine two or more contracts and account for them as a single contract.

The following diagram provides an overview of Step 1:



\* Continuously reassess the arrangement to determine whether the contract existence criteria are subsequently met

\*\* See Section 2.4.2 for discussion on consideration received from customer before the contract existence criteria are met.

## 2.2 DEFINITION OF A CONTRACT



### FASB REFERENCES

ASC 606-10-20

A contract is defined as “an agreement between two or more parties that creates enforceable rights and obligations.”

### 2.2.1 Enforceable Rights and Obligations



### FASB REFERENCES

ASC 606-10-25-2

An agreement does not need to be written to create legally enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Determining whether a contractual right or obligation is enforceable is considered within the context of the relevant legal framework (or equivalent framework) to make sure that the parties’ rights and obligations are upheld. A contract with a customer for accounting under ASC 606 need not be the same as a contract for legal purposes.

The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. Additionally, business practices may vary within an entity, for example, depending on the class of customer or

the nature of the goods or services. Written, oral or implied contracts with customers could create enforceable rights and obligations depending on legal jurisdictions, industries, or customary business practices. An entity must consider those factors in determining whether and when an agreement with a customer creates enforceable rights and obligations.

In many cases, the contract that is accounted for separately under ASC 606 is the individual contract negotiated with the customer. However, the structure and scope of a contract can vary depending on how the parties to the contract record their agreement. For instance, there may be legal or commercial reasons for the parties to use more than one contract to document the sale of related goods or services or to use a single contract to document the sale of unrelated goods or services. See Section 2.6 for a discussion on when to combine contracts.

Although there must be legally enforceable rights and obligations between parties for a contract to exist under ASC 606, a promise within the contract is not necessarily required to be legally enforceable to be a performance obligation. A promise within the contract could arise from the customer having a valid expectation that the entity will transfer goods or services to the customer even though that promise is not enforceable. See Chapter 3 for discussion on identifying promises and performance obligations in a contract.

### 2.2.2 Contract Existence Criteria



#### FASB REFERENCES

ASC 606-10-25-1 and ASC 606-10-32-21

To determine whether enforceable rights and obligations exist in an arrangement with a customer, an entity evaluates the following five contract existence criteria. Contract inception is the date at which all five contract existence criteria are met. ASC 606 is applied to contracts with customers only when all five criteria are met.

#### Contract Existence Criteria

The contract has been approved and the parties are committed to perform their obligations.

Each party's rights regarding the goods or services to be transferred can be identified.

The payment terms for the goods or services to be transferred can be identified.

The contract has commercial substance.

Collectibility of substantially all of the considered is considered probable.

BC33 of ASU 2014-09 states that in establishing the contract existence criteria to complement the definition of a contract, the FASB reasoned that when any of those criteria are not met, it is questionable whether the contract establishes enforceable rights and obligations between an entity and its customer.

### 2.2.2.1 The Contract Has Been Approved and The Parties Are Committed to Perform Their Obligations



#### FASB REFERENCES

ASC 606-10-25-1(a)

For a contract to be enforceable, the parties to the contract must approve the contract and commit to performing their respective obligations under the contract. An entity considers all relevant facts and circumstances in assessing whether the parties intend to be bound by the terms and conditions of the contract. The form of the contract does not, in and of itself, determine whether the parties have approved the contract. Depending on customary business practices, in some cases the parties to an oral or implied contract may have agreed to fulfill their respective obligations while in other cases, a written contract may be required to determine that the parties to the contract have approved it.

#### **BDO INSIGHTS – WHETHER THE PARTIES ARE COMMITTED TO PERFORM THEIR OBLIGATIONS**

Determining whether an entity and its customer are committed to fulfilling their respective obligations may require judgment. For example, BC36 of ASU 2014-09 describes a contract that requires the customer to purchase a minimum quantity of goods from the entity each month, but the customer's past practice indicates that the customer is not committed to always purchasing the minimum quantity each month, and the entity does not enforce the requirement to purchase the minimum quantity. In that example, the first contract existence criterion, whether the contract has been approved and the parties are committed to performing their obligations, could still be satisfied if there is evidence that demonstrates that the customer and the entity are substantially committed to the contract. The FASB stated that requiring all rights and obligations to be fulfilled would have inappropriately resulted in no recognition of revenue for some contracts in which the parties are substantially committed to the contract.

Reaching a conclusion about whether the parties are committed to perform their obligations requires the application of professional judgment, based on the facts and circumstances.

### 2.2.2.2 Each Party's Rights Regarding the Goods or Services Transferred Can Be Identified



#### FASB REFERENCES

ASC 606-10-25-1(b)

For a contract to be enforceable, an entity must be able to identify each party's rights regarding the goods or services transferred. This criterion was included because an entity would not be able to assess the transfer of goods or services for revenue recognition under the five-step revenue recognition model if it could not identify each party's rights regarding those goods or services in Step 2.

**EXAMPLE 2-1: MASTER SUPPLY AGREEMENT**

An entity enters a master supply agreement (MSA) with a customer to supply a product according to the terms and conditions (for example, duration of the MSA, pricing information, payment terms, return rights) specified in the MSA. The MSA states that the customer will place a purchase order (PO) for the quantity of products needed throughout the term of the MSA, and that each PO will be subject to the terms and conditions of the MSA. The MSA itself does not obligate the entity to transfer a specific number of products to the customer or the customer to purchase and pay for a specific number of products. One month after the execution of the MSA, the customer submits a PO specifying the number of products it wishes to purchase.

The MSA and PO collectively create enforceable rights and obligations for the entity to transfer the products under the PO to the customer and the customer to purchase those products and pay according to the pricing information and payment terms in the MSA. Therefore, assuming the customer has the intent and ability to pay amounts due under the PO, the MSA and PO together meet the definition of a contract.

**EXAMPLE 2-2: MSA WITH MINIMUM VOLUME GUARANTEE**

An entity enters an MSA with a customer to supply a product according to the terms and conditions (for example, duration of the MSA, pricing information, payment terms, return rights) specified in the MSA. The MSA provides that the customer will place Pos for the quantity of products needed throughout the term of the MSA, and that each PO will be subject to the terms and conditions of the MSA. The MSA includes a minimum volume guarantee such that the entity guarantees the supply of the product, and the customer agrees to purchase a minimum volume of the product during the contract term. If the customer fails to purchase the minimum volume required, the entity has the right to charge a penalty equal to the price of the shortfall.

The MSA itself obligates the entity to transfer a specific number of products to the customer and the customer to purchase and pay for a specific number of products. Therefore, the MSA itself may create enforceable rights and obligations for the entity to transfer the minimum volume of the product to the customer and the customer to purchase the minimum volume of the product and pay for it according to the pricing information and payment terms in the MSA.

See Example 2-3 for a discussion of the effects of an entity's past practice in determining whether a contractually specified minimum volume is substantive.

**EXAMPLE 2-3: MSA WITH MINIMUM VOLUME GUARANTEE THAT HAS NOT BEEN ENFORCED IN THE PAST**

Assume the same facts in Example 2-2 except that the entity's past practice indicates that if the customer does not purchase the specified minimum volume in the MSA, the entity may not enforce such purchase.

Even though the MSA includes minimum volume guarantee, the past practice of not enforcing it may indicate that the entity and the customer are not committed to that minimum volume. In other words, the minimum guarantee may not be substantive in this fact pattern. As a result, the MSA may not create enforceable rights and obligations on its own, but rather the MSA when combined with a PO would collectively create enforceable rights and obligations for the parties to the contract.

### 2.2.2.3 The Payment Terms for the Goods or Services Transferred Can Be Identified



#### FASB REFERENCES

ASC 606-10-25-1(c)

For a contract to be enforceable, an entity must be able to identify the payment terms for the goods or services transferred. This criterion was included because an entity would not be able to determine the transaction price in Step 3 of the five-step revenue recognition model if it could not identify the payment terms in exchange for the promised goods or services.

In certain industries, for example the construction industry, it is common for parties to agree to unpriced change orders that specify the scope of work but not the consideration for that work. The amount of consideration may not be determined for a period of time. In BC39 of ASU 2014-09, the FASB clarified that it did not intend 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, an entity considers the guidance on contract modifications (see Section 7.3) to determine the appropriate accounting for such change orders. Under the contract modification guidance, if enforceable rights and obligations are created by the approval of the parties to the change in scope but not the price, then the change in price is considered variable consideration. See Section 4.3 for discussion on variable consideration.

### 2.2.2.4 The Contract Has Commercial Substance



#### FASB REFERENCES

ASC 606-10-25-1(d)

For a contract to be enforceable, it must have commercial substance. That is, the risk, timing or amount of the entity's future cash flows is expected to change because of the contract. This criterion was included because without commercial substance it is questionable whether an entity has entered a transaction that has economic consequences. Commercial substance is based on the guidance for nonmonetary exchange transactions in ASC 845.

This criterion was developed when the FASB was considering whether an entity should recognize revenue from contracts with customers that include nonmonetary exchanges. To prevent scenarios where entities might transfer goods or services back and forth to each other (often for little or no cash consideration) to artificially inflate their revenues, the FASB decided that an entity cannot recognize revenue from a nonmonetary exchange if the exchange has no commercial substance. That decision was extended to all contracts (not only nonmonetary exchanges) to prevent an entity from recognizing revenue for transactions that do not have commercial substance or economic consequences for the entity. This criterion prevents an entity from recognizing revenue for a contract with customer that serves no substantive business purpose for the entity.

### 2.2.2.5 Collectibility



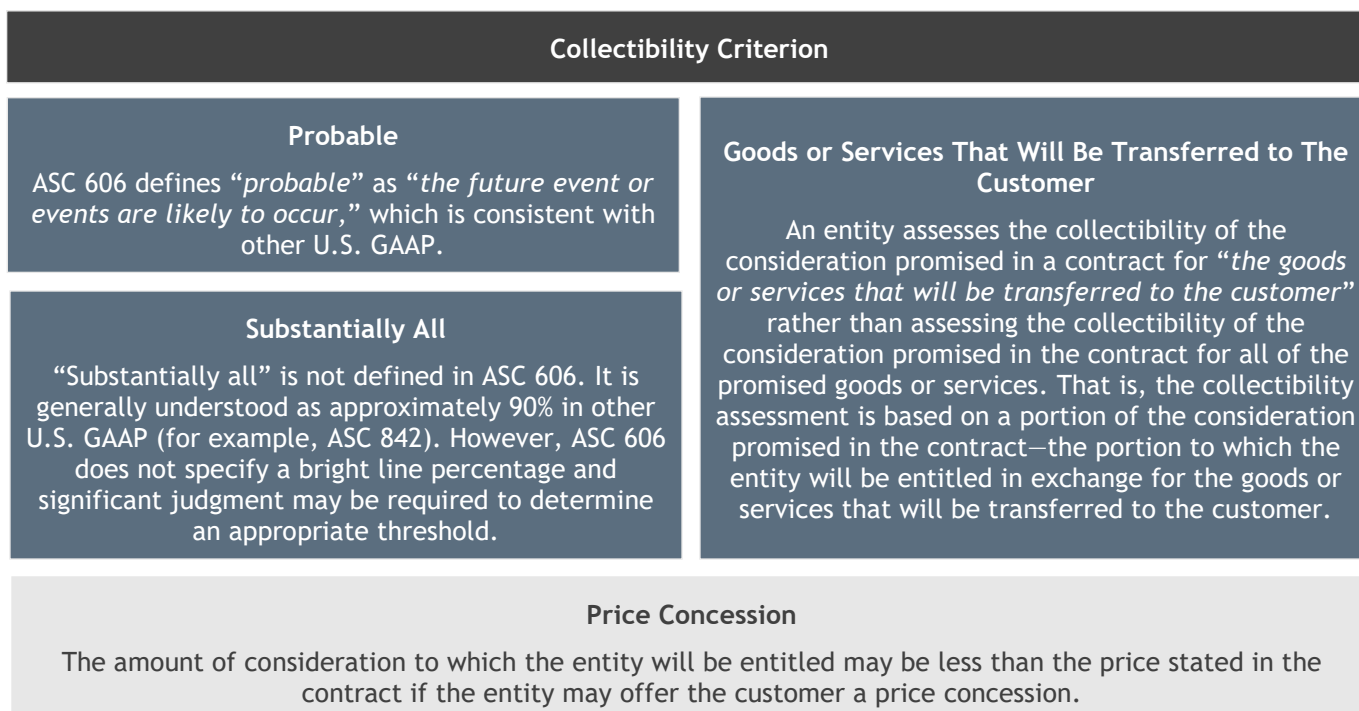
#### FASB REFERENCES

ASC 606-10-25-1(e) and ASC 606-10-55-3A

For a contract to be enforceable, it must be 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. “Probable” and “substantially all” are key thresholds in evaluating this criterion and are discussed further in the diagram below. The 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 intends to provide a price concession to the customer. See Section 4.3 for discussion on variable consideration.

The objective of this assessment is to determine whether the contract is valid and represents a substantive transaction between the entity and the customer, which is a necessary condition for the contract to be accounted for under the revenue recognition model in ASC 606.

The following diagram illustrates the key concepts inherent in assessing the collectibility criterion:



In assessing the collectibility criterion, the focus is often on the price included in the contract between an entity and its customer. However, it is possible that the amount of consideration that the entity ultimately expects to be entitled to will be less because the entity expects to offer a price concession (or discount) to the customer, regardless of whether the entity has communicated that to the customer. In that case, the assessment of the customer’s ability and intention to pay is made based on the lower amount. See Section 4.3 for discussion of variable consideration, including implicit price concessions.

BC12 of ASU 2016-12 states that if it is not probable that the customer will fulfill its obligations under the contract (that is, make payments as due), there is a question about whether the contract is valid and the revenue-generating transaction is substantive, regardless of whether a legal contract exists. However, BC44 of ASU 2014-09 clarifies that the FASB did not expect many arrangements to fail to meet the collectibility criterion because entities generally only



enter contracts after concluding it is probable that they will be fairly compensated for their performance. That is, in most instances, an entity would not enter a contract with a customer if there was significant credit risk from that customer without also having adequate economic protection to collect the consideration.

#### 2.2.2.5.1 Evaluating Whether Collectibility is Probable



#### FASB REFERENCES

ASC 606-10-55-3A through 55-3C and ASC 606-10-55-99 through 55-105

In evaluating whether collectibility is probable, an entity evaluates the customer's financial ability and intention to pay a consideration when due. The collectibility assessment is partly a forward-looking assessment. It requires an entity to use judgment and consider all facts and circumstances, including the entity's customary business practices and its knowledge of the customer.

Additionally, as part of the collectibility assessment, an entity considers its exposure to credit risk and its ability to mitigate that credit risk. In assessing collectibility, an entity determines whether the contractual terms and its customary business practices indicate that the entity's exposure to credit risk is less than the consideration promised in the contract because the entity can mitigate its credit risk. Examples of contractual terms or customary business practices that might mitigate the entity's credit risk include:

- ▶ **Advance payments:** An entity may mitigate all or a portion of its credit risk by requiring advance payments from its customer where a customer must pay all or a portion of the consideration promised in the contract before the entity transfers promised goods or services to the customer. The advance payments collected from the customer would not be subject to credit risk.
- ▶ **Ability to stop transferring goods or services to customers in default:** An entity may limit its exposure to credit risk if it has the right to stop transferring additional goods or services to a customer if the customer fails to pay consideration when it is due. If the customer fails to perform as promised (that is, pay consideration when due) and consequently, the entity stops transferring additional goods or services to the customer, the entity will not consider the likelihood of payment for the promised goods or services that will not be transferred under the contract.
  - For example, an entity may have the ability and intent (evidenced by its customary business practice) to discontinue transfer of services in the third month of a 12-month contract if the customer does not pay as promised for any of the first three months of services. In this example, the entity evaluates whether the customer has the intent and ability to pay substantially all of the consideration for the first three months of services only, because the entity can manage its credit risk for the subsequent nine months by discontinuing the transfer of additional services to the customer if the customer defaults on payment for the first three months of services.

An entity's ability to repossess an asset transferred to a customer is not considered when assessing the entity's ability to mitigate its exposure to credit risk 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. An entity's ability to repossess an asset transferred to a customer might, however, affect its assessment of when or whether control of the asset transfers to the customer in some arrangements. See Section 6.6 for discussion on repurchase rights.

#### 2.2.2.5.2 "Substantially All"

The "substantially all" threshold in the collectibility criterion clarifies that a contract may 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. ASC 606 does not quantify the "substantially all" threshold, which is generally understood as approximately 90% in other U.S. GAAP (for example, ASC 842). However, ASC 606 does not specify a bright line percentage.

**BDO INSIGHTS – “SUBSTANTIALLY ALL” THRESHOLD**

We believe that interpreting “substantially all” requires the application of professional judgment, based on the facts and circumstances because ASC 606 does not specify a bright line percentage. Additionally, we believe that the term must be interpreted consistently in each place it is used in U.S. GAAP.

**2.2.2.5.3 “Goods or Services That Will Be Transferred to the Customer”**

The phrase “goods or services that will be transferred to the customer” exists only for the purposes of evaluating the probability of whether an entity will collect substantially all of the consideration to which it will be entitled as part of identifying the contract with the customer in Step 1. An entity considers whether a valid contract with a customer exists for the purposes of applying the revenue recognition model in ASC 606 by considering the entity’s exposure to nonpayment for goods or services that the entity’s rights, obligations, and business practices suggest that the entity will transfer to the customer.

An entity cannot apply the notion of “goods or services that will be transferred to the customer” to the other aspects of ASC 606, such as identifying the performance obligations, determining the transaction price, allocating the transaction price to performance obligations, or recognizing revenue. That is, once a contract is determined to exist under ASC 606, the rest of the guidance in ASC 606 is applied to the contract.

**BDO INSIGHTS – COLLECTIBILITY ASSESSMENT IN STEP 1**

Under ASC 606, collectibility is assessed when determining whether a contract exists (in Step 1) rather than when determining how much revenue to recognize. The collectibility assessment acts as a gating question to determine whether the five-step revenue recognition model can be applied to a contract. Thus, the collectibility assessment under ASC 606 precludes revenue recognition when collectibility is not probable; it does not affect the measurement of revenue recognized. The collectibility assessment requires the application of professional judgement, based on the facts and circumstances.

**EXAMPLE 2-4 (ADAPTED FROM ASC 606-10-55-99 THROUGH 55-101): IMPLICIT PRICE CONCESSION – CONSIDERATION IS NOT THE STATED FIXED PRICE**

An entity sells a product to a customer in return for a contractually agreed amount of \$1 million. This is the entity’s first sale to a customer in a new geographic region and the region is experiencing significant economic difficulty. Therefore, the entity expects that it will not collect the full contract price. However, even though it may not collect the full amount, the entity believes that economic conditions in the region will improve in future and establishing a trading relationship with this customer could help it to open a new market with other potential customers in the region.

Based on the evaluation of economic difficulties in the region and the entity’s desire to continue the contract with the customer to generate future revenue growth in that region, the entity determines that it expects to provide a price concession to the customer and will accept an amount lower than \$1 million from the customer. Accordingly, the entity concludes that the contract price is not fixed at \$1 million but rather the consideration in the contract is variable. The entity estimates the variable consideration it expects to be entitled to is \$400,000 (see Section 4.3 for discussion on variable consideration).

The entity assesses the customer’s intention and ability to pay \$400,000 and concludes that despite the poor economic conditions, it is probable that it will collect \$400,000 from the customer. Therefore, the collectibility criterion is met.

Assuming that the other four contract existence criteria are met, the entity concludes that it has entered a contract with the customer for the sale of the product in return for a variable consideration of \$400,000, which will be accounted for under the five-step revenue recognition model in ASC 606.

**EXAMPLE 2-5 (ADAPTED FROM ASC 606-10-55-102 THROUGH 55-105): IMPLICIT PRICE CONCESSION AND REASSESSMENT OF CONTRACT EXISTENCE CRITERIA – MEDICAL SERVICES TO UNINSURED PATIENT**

A hospital provides certain medical services to an uninsured patient in the emergency room. The hospital has not previously provided services to that patient. Local law requires the hospital to provide medical services to all emergency room patients. Given the medical condition of the patient upon arrival, the hospital provided medical services immediately before determining whether the patient is committed to perform his or her obligations under the contract in exchange for the medical services provided (that is, pay his or her medical bill). Therefore, the contract existence criteria are not met, and the hospital will continue to assess its conclusion based on updated facts and circumstances. See Section 2.5 for discussion on the requirement to continuously reassess contract existence criteria.

After providing services, to assess the patient's ability and intention to pay for the services provided, the hospital reviews the information available about the patient and services provided. It determines that:

- ▶ Its standard rate for the services provided in the emergency room is \$10,000
- ▶ According to its internal policies and the patient's income level, the services provided are not charity care
- ▶ The patient does not qualify for governmental subsidies

Before reassessing whether the contract existence criteria have been met, the hospital considers that although the standard rate for its services is \$10,000 (which is the amount invoiced to the patient), the hospital expects to accept a lower amount. Accordingly, the hospital concludes that the transaction price is lower than \$10,000 and, therefore, the consideration is variable. Upon reviewing its historical cash collections from this customer class and other relevant information about the patient, the hospital estimates the variable consideration and determines that it expects to be entitled to \$1,000 (see Section 4.3 for discussion on variable consideration).

In reassessing whether the collectibility criterion has been met, the hospital assesses the patient's ability and intention to pay \$1,000. Based on its collection history from patients in this customer class, the hospital concludes it is probable that the hospital will collect \$1,000 (that is, the estimated variable consideration). Therefore, the collectibility criterion is met.

Assuming that the other four contract existence criteria are met, the hospital concludes that it has entered a contract with the patient for provision of emergency room services in return for a variable consideration of \$1,000, which will be accounted for under the five-step revenue recognition model.

**BDO INSIGHTS – IMPLICIT PRICE CONCESSION - VARIABLE CONSIDERATION VERSUS BAD DEBT EXPENSE**

Determining whether an entity will give an implicit price concession to the customer by accepting a price lower than the price stated in the contract is a matter of significant professional judgment, based on the facts and circumstances. Conceptually, an entity's decision to accept a lower price represents a concession, whereas a customer's default because of the customer's lack of ability and intent to pay reflects credit risk. Concessions are presented as a reduction of revenue whereas expectations about amounts to be collected (or defaults) due to credit risk are relevant in determining the impairment of receivables under ASC 326 and thus the measurement of bad debt expense.

An entity may have experience indicating that it will not collect all consideration from some customers in a portfolio of contracts. However, each of the contracts in the portfolio may individually meet the collectibility criterion in Step 1 because it is probable that the customers will pay substantially all of the amounts owed based on credit checks and other procedures performed by the entity. For example, an entity may have a large volume of homogenous revenue-generating customer contracts for which the entity's historical evidence indicates that a small portion of the amounts billed will become uncollectible. However, in applying the collectibility assessment criterion at the individual contract level, the entity may determine that it is probable that each of the customers will pay substantially all of the amounts owed under the relevant contracts. Questions arose in practice as to how an entity should apply Step 1 to contracts in

which the entity has historical experience that it will not collect consideration from some customers in a portfolio of contracts. The TRG discussed this scenario at its January 2015 meeting as illustrated in the following example:

#### EXAMPLE 2-6: ASSESSING COLLECTIBILITY FOR A PORTFOLIO OF CONTRACTS

An entity has a large volume of homogenous revenue generating customer contracts for which invoices are sent in arrears on a monthly basis. Before accepting a customer, the entity performs procedures designed to make sure that it is probable that the customer will pay the amounts owed. If these procedures result in the entity concluding that it is not probable the customer will pay the amounts owed, the entity does not accept them as a customer. Because these procedures are only designed to determine whether collection is probable (and thus not a certainty), the entity anticipates that some customers will not pay all amounts owed. While the entity collects the entire amount due from the vast majority of its customers, on average, the entity's historical evidence (which is representative of its expectations for the future) indicates that the entity will only collect 97% of the amounts billed.

The entity bills \$100 to its customers in a particular month and there are no other issues that would preclude recognition of revenue for that amount in the month it is billed. Assume that the performance obligation related to the billing is satisfied as of the billing date.

The TRG considered whether the entity recognizes (a) revenue of \$100 and a bad debt of \$3 or (b) revenue of \$97 because the historical evidence indicates that it will collect only 97% of the amount billed. The TRG concluded that the entity recognizes \$100 (not \$97) as revenue because each contract within the portfolio meets the collectibility criterion that collection of substantially all of the consideration due under that contract is probable. The entity applies the subsequent steps in the five-step revenue recognition model to the entire contract rather than the portion of the contract expected to be collected on a portfolio basis (that is, only 97%). The fact that only 97% of the amounts invoiced are expected to be collected is relevant in determining the impairment of receivables under ASC 326.

## 2.3 CONTRACT ENFORCEABILITY AND TERMINATION CLAUSES



### FASB REFERENCES

ASC 606-10-25-3

Sometimes the term or duration of a contract may be readily determinable. However, in other instances, determining the contract term may require judgment. For example, some contracts with customers may have a fixed duration but grant the customer renewal or termination rights, with or without an associated penalty payment. Other contracts may not have a fixed duration and can be terminated or modified by either party at any time, while other contracts may automatically renew periodically as specified in the contract. An entity applies ASC 606 to the term of the contract in which the parties to the contract have enforceable rights and obligations.

### 2.3.1 Wholly Unperformed Contract



### FASB REFERENCES

ASC 606-10-25-4

If each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party, then a contract does not exist under ASC 606. 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
- ▶ The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services

ASC 606 does not explicitly explain how termination penalties are considered in determining the contractual period in which the parties have present enforceable rights and obligations. At the January 2015 meeting, the TRG discussed how termination provisions affect the duration of a contract. See Section 2.3.2 for more discussion.

### 2.3.2 Effect of a Termination Penalty on Contract Term

A contract exists if each party to the contract has the unilateral enforceable right to terminate the contract only by paying a substantive termination penalty to the other party. A contract continues to exist during the specified contractual period regardless of each party's unilateral and enforceable right to terminate the contract at any time during the specified contractual period because enforceable rights and obligations exist throughout the contractual period, which is evidenced by the fact that compensation (a termination penalty) would be required to terminate the contract. In other words, on termination, the parties to the contract waive their enforceable rights and avoid their obligations by paying the termination penalty.

#### **BDO INSIGHTS – EFFECT OF TERMINATION PROVISIONS ON ENFORCEABLE RIGHTS AND OBLIGATIONS**

The revenue recognition model is applied to the period for which enforceable rights and obligations exist between an entity and its customer. An entity is required to carefully evaluate substantive termination provisions (termination rights, termination penalties or other payments) in a contract with a customer and customary business practices to determine whether the duration for which enforceable rights and obligations exist is shorter or longer than the contractually stated term.

#### **BDO INSIGHTS – ANALYZING TERMINATION PENALTIES**

ASC 606 does not define penalty or termination penalty. Additionally, ASC 606 does not contain bright lines for determining whether a termination penalty is substantive. In analyzing whether either party must “compensat[e] the other party” to exercise a termination right, an entity evaluates any amount payable upon termination that is unrelated to the payments due for the goods or services transferred up to the termination date. Therefore, the analysis is not restricted only to payments explicitly characterized as termination penalties. Rather, the substance of the payments made to compensate the other party to terminate a contract prior to the stated term is considered.

Additionally, the analysis of termination penalties is not restricted only to cash payments. For example, in certain R&D arrangements, requiring the customer to return an exclusive license to a drug compound upon early termination of the contract may represent a substantive termination penalty. Conversely, requiring the customer to return a nonexclusive software license upon early termination of the software license contract may not represent a substantive termination penalty.

Determining what constitutes a termination penalty and whether the termination penalty is substantive requires the application of professional judgment, based on the facts and circumstances.

#### **EXAMPLE 2-7: MONTHLY TERMINATION RIGHTS IN AN ANNUAL CONTRACT – TERMINATION RIGHTS ARE HELD BY BOTH PARTIES**

An entity enters a contract with a customer to provide cleaning services. The stated contract term is one year. The contract is cancelable at the end of each month by either party without penalty.

The enforceable rights and obligations for the parties to the contract do not extend beyond the then-current month because either party can terminate the contract without penalty at the end of each month. The entity accounts for the contract as a month-to-month contract.

The term of a contract in which each party has the unilateral enforceable right to terminate the contract without penalty does not extend beyond the then-current period. However, if only one party could terminate a contract without penalty, some enforceable rights and obligations may exist even if the term of the contract is limited to the then-current period. For example, if only the customer could terminate a contract without penalty, the entity is obliged to stand ready to perform at the discretion of the customer. The customer, in effect, can extend the contract by not exercising its termination rights, which might represent a material right. See Chapter 3 and Section 7.4 for discussion on customer options and material rights.

**EXAMPLE 2-8: MONTHLY RENEWAL RIGHTS IN AN EVERGREEN (MONTH-TO-MONTH) CONTRACT – RENEWAL RIGHT IS HELD BY THE CUSTOMER**

An entity enters a contract with a customer to provide cleaning services. The stated contract term is one month, and the contract automatically renews at the end of each month unless the customer elects not to renew.

When only the customer has a unilateral option to renew the contract for another month (by electing not to terminate the contract at the end of a month), enforceable rights and obligations exist only for the then-current month.

Additionally, the customer has an enforceable right to receive, and the entity is obligated to provide, cleaning services in the subsequent months if the customer chooses to renew the contract by not exercising its termination rights. The unilateral renewal rights held by the customer effectively provide the customer 11 renewal option(s) to extend the contract.

The entity evaluates whether the customer's renewal options are accounted for as material rights, which are separate performance obligations under Step 2. See Chapter 3 and Section 7.4 for discussion on performance obligations, customer options and material rights.

If the contract does not include a material right, then the entity disregards the customer's options (termination rights) and applies the five-step revenue recognition model to the first month only.

If the contract includes a material right, then the entity allocates a portion of the consideration received from the customer to the material right and defers recognizing it in revenue until the customer exercises the option or the option lapses.

The existence of a material right does not extend the contract term beyond the then-current month; that is, the contract term remains one month. However, the existence of a material right affects the amount and timing of revenue recognition for a contract because consideration allocated to the material right is deferred for a later recognition in revenue. See Section 7.4 for discussion on accounting for material rights, including the accounting policy election to account for a customer's exercise of a material right as the continuation of a contract or a contract modification.

**EXAMPLE 2-9: MONTHLY TERMINATION RIGHTS IN AN ANNUAL CONTRACT – TERMINATION RIGHT IS HELD BY THE CUSTOMER**

An entity enters a contract with a customer to provide cleaning services. The stated contract term is one year. The customer has a unilateral right to terminate the contract at the end of each month without penalty.

When only the customer has a unilateral option to terminate a period-to-period contract, enforceable rights and obligations exist only for the then-current month. Additionally, the customer has an enforceable right to receive, and the entity is obligated to provide, cleaning services in the subsequent months if the customer chooses to not

exercise its termination right. The unilateral termination right held by the customer effectively provides the customer 11 renewal option(s) to extend the contract by not exercising its termination rights. The entity evaluates whether the customer's options are accounted for as material rights, as discussed in Example 2-8.



## TRG DISCUSSIONS – CONTRACT ENFORCEABILITY AND TERMINATION CLAUSES

Although ASC 606 contains guidance on when a contract exists, questions were raised about how to assess whether a contract exists for accounting purposes (and, if so, the contract duration) if the contract between an entity and its customer contains termination clauses. The TRG considered the following examples in deliberating how such clauses must be considered by an entity and generally agreed with the following conclusions:

### Example A

An entity enters a contract with a customer to provide services until the contract is terminated. Each party can terminate the contract without compensating the other party for the termination (that is, there is no termination penalty).

The duration of the contract does not extend beyond the services already provided.

### Example B

An entity enters a contract with a customer to provide services for two years. Each party can terminate the contract at any time after 15 months from the start of the contract without compensating the other party for the termination.

The duration of the contract is 15 months.

### Example C

An entity enters a contract with a customer to provide services for two years. Either party can terminate the contract by compensating the other party.

The duration of the contract is the specified contractual period of two years.

### Example D

An entity enters a contract with a customer to provide services for 24 months. Either party can terminate the contract by compensating the other party. The entity has a past practice of allowing customers to terminate the contract at the end of 12 months without enforcing collection of the termination penalty.

In this case, whether the contractual period is 24 months or 12 months depends on whether the past practice is considered by law to restrict the parties' enforceable rights and obligations, which may vary by jurisdiction. The entity's past practice of allowing customers to terminate the contract at the end of month 12 without enforcing collection of the termination penalty affects the contract term only if that practice changes the parties' legally enforceable rights and obligations. If that past practice does not change the parties' legally enforceable rights and obligations, then the contract term is the stated period of 24 months.



**BDO INSIGHTS – SIGNIFICANCE OF THE CONTRACT TERM**

An entity needs to first determine the duration of the contract (or contract term) to apply certain aspects of the five-step revenue recognition model (for example, identifying performance obligations, determining the transaction price, and recognizing revenue upon satisfaction of a performance obligation). The contract term is also important when determining whether a practical expedient can be elected. For example, an entity can elect the practical expedient on significant financing components in Step 3 for a short contract term (one year or less).

Determining the contract term is generally not complex when a contract has a stated duration and neither party has the unilateral right to cancel the contract. Additionally, it may not be particularly relevant to revenue recognition if the only promises are goods that are delivered at a point in time. However, it can be more challenging to determine the contract term when either party has cancellation rights. Analyzing cancellation rights to determine the contract term may require the application of professional judgment, based on the facts and circumstances. In some cases, legal advice may be required to determine the duration for which enforceable rights and obligations exist.

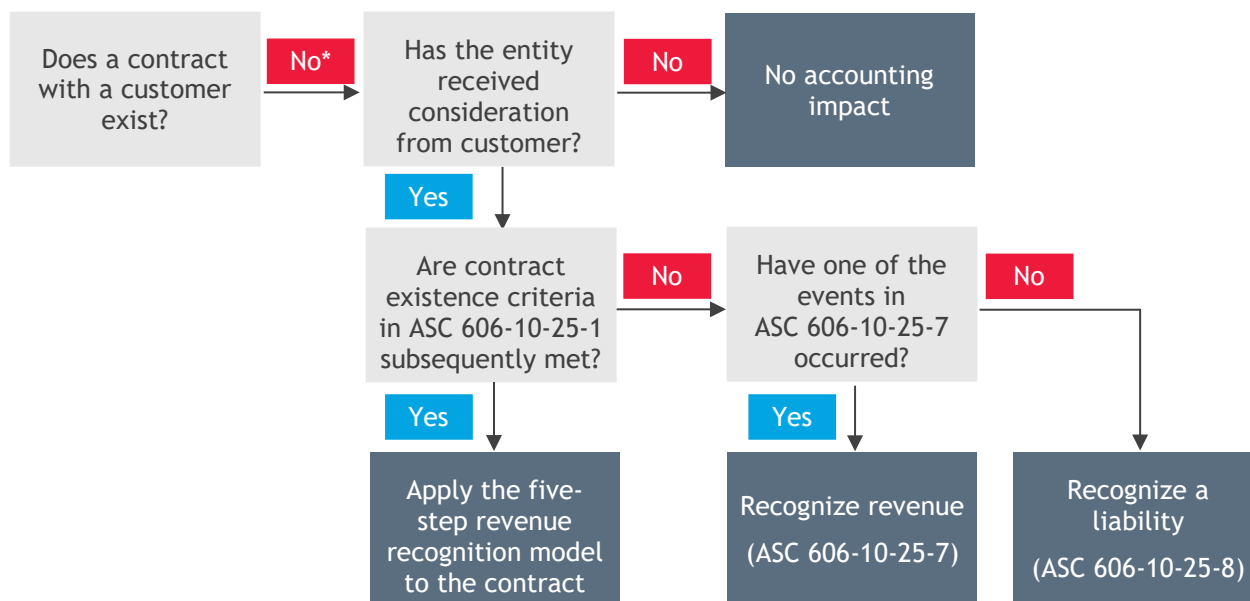
## 2.4 CONTRACT EXISTENCE CRITERIA ARE NOT MET



### FASB REFERENCES

ASC 606-10-25-6 through 25-8

The following diagram provides an overview of the accounting requirements when the contract existence criteria are not met:



\* Continuously reassess the contract to determine whether the contract existence criteria in ASC 606-10-25-1 are subsequently met

If any of the five contract existence criteria are not met, a contract does not exist for revenue recognition purposes regardless of whether a legal contract exists. ASC 606 includes the following guidance, which is applied when an arrangement with a customer does not meet the contract existence criteria:

- ▶ Continuous reassessment of whether the contract existence criteria are subsequently met
- ▶ Accounting for consideration received from customer before contract existence criteria are met

### 2.4.1 Continuous Reassessment of Contract Existence Criteria



### FASB REFERENCES

ASC 606-10-25-6

An entity continuously reassesses arrangements with customers that do not meet all of the five contract existence criteria to determine whether and when those criteria are subsequently met. An entity applies the five-step revenue recognition model when the contract existence criteria are met.

## 2.4.2 Consideration Received From Customer Before Contract Existence Criteria Are Met



### FASB REFERENCES

ASC 606-10-25-7 and 25-8

If the contract existence criteria are not met and an entity receives consideration from the customer, the amount received is recognized as revenue only when any one of the three following events (specified in ASC 606-10-25-7) has occurred:

- ▶ The entity has no remaining contractual obligations to transfer goods or services and all, or substantially all, of the consideration has been received and is nonrefundable
- ▶ The contract has been terminated and the consideration received is nonrefundable
- ▶ 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

An entity cannot recognize revenue until the contract is complete or cancelled or until a subsequent reassessment indicates that the contract meets all contract existence criteria. Any consideration received from the customer is recognized as a liability until either the criteria for a contract to exist are subsequently met, or one of the three events in ASC 606-10-25-7 occurs. Depending on the specifics of the contract, the liability recognized represents the entity's obligation to transfer goods or services or to refund the consideration received. In either case, the liability is measured as the amount received from the customer.

The guidance on accounting for consideration received from a customer when the contract existence criteria are not met avoids revenue recognition related to contracts that may not be valid and that do not represent genuine transactions; recognizing revenue for those contracts would not provide a faithful representation of an entity's business activities.



### NONREFUNDABLE PAYMENTS RECEIVED FROM A CUSTOMER BEFORE THE CONTRACT EXISTENCE CRITERIA ARE MET

Regardless of whether the consideration received from the customer is nonrefundable, an entity cannot recognize revenue based on cash collected from the customer unless either the contract existence criteria are subsequently met (in which case the entity follows Steps 2 through 5 for recognizing revenue) or one of the three events in ASC 606-10-25-7 has occurred.

## 2.5 REASSESSMENT OF CONTRACT EXISTENCE CRITERIA



### FASB REFERENCES

ASC 606-10-25-5 and ASC 606-10-55-106 through 55-109

If a contract with a customer meets the contract existence criteria at contract inception, an entity does not reassess those criteria unless there is an indication of a significant change in facts and circumstances. The standard includes an

example, which states that if a customer's ability to pay the consideration deteriorates significantly, an entity must 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.

When an entity determines that a previously identified contract no longer meets the contract existence criteria:

- ▶ No further revenue is recognized until either the entity can once again conclude that the contract existence criteria (including the collectibility criterion) are met or the revenue recognition requirements in ASC 606-10-25-7 are met (see Section 2.4.2 for discussion of the accounting for consideration received from customer when contract existence criteria are not met).
- ▶ Any revenue, receivable or contract asset recognized to date is not reversed. Instead, the receivable or contract asset is subject to the impairment guidance in ASC 326.

#### **EXAMPLE 2-10 (ADAPTED FROM ASC 606-10-55-106 THROUGH 55-109): REASSESSING THE CRITERIA FOR CONTRACT EXISTENCE**

An entity and a customer enter a multi-year contract for the transfer of certain goods or services. The contract meets the contract existence criteria at the inception of the multi-year contract and, therefore, the entity starts recognizing revenue from the contract according to the five-step revenue recognition model.

In the second year of the contract the customer's financial condition declines and its access to credit and available cash on hand are limited. The entity continues to recognize revenue in the second year and evaluates any receivables recognized for impairment.

At the beginning of the third year of the contract, the entity becomes aware that the customer has lost access to credit and its major customers, and thus the customer's ability to pay significantly deteriorates. The entity determines that it is unlikely that the customer will be able to make any further payments for goods or services being transferred.

Because of this significant change in facts and circumstances, the entity reevaluates the contract existence criteria and concludes that the contract existence criteria are no longer met because collectibility is no longer probable. Based on that conclusion, the entity does not recognize revenue for that customer in the third year.

The entity does not reverse any revenue or existing receivables recognized during the first and second years of the contract. The entity accounts for the impairment of any existing receivables under ASC 326.

#### **BDO INSIGHTS – REASSESSMENT OF CONTRACT EXISTENCE CRITERIA**

Determining whether there is a significant change in facts or circumstances requiring a reassessment of contract existence criteria requires the application of professional judgment, based on the facts and circumstances. The facts in Example 2-10 on reassessing the existence of a contract include a severe deterioration in the customer's financial condition to demonstrate that the standard does not intend to capture minor changes in facts and circumstances (that is, those that do not call into question the validity of the contract), which might reasonably fluctuate during a contract term, especially a long-term contract.

## 2.6 COMBINATION OF CONTRACTS



### FASB REFERENCES

ASC 606-10-25-9

Two or more contracts entered at or near the same time and with the same customer (or related parties of the customer, as defined in ASC 850, *Related Party Disclosures*) are accounted for as if they were a single contract, if one of the following criteria are met:

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

The amount of consideration in one contract depends on the price or performance of the other contract(s).

The goods or services that are promised in the contracts (or some of the goods or services) represent a single performance obligation.\*

\* See Chapter 3 for discussion on performance obligations.

The guidance requiring the combination of two or more contracts was provided because in some cases, the amount and timing of revenue might differ depending on whether an entity accounts for two or more contracts separately or as one contract. A necessary condition for two or more contracts to be combined is that they must be executed at or near the same time with the same customer (or the customer's related parties).

Multiple contracts negotiated at or near the same time with the same customer or its related parties with a single commercial objective or by pricing one contract based on the price or performance of other contract(s) create pricing interdependencies between the separate contracts. Those contracts are required to be combined so that the combined consideration is allocated to the performance obligations in the combined contract, resulting in revenue recognition that faithfully depicts the value of the performance obligations transferred to the customer.

Some or all the promised goods or services in separate contracts negotiated at or near the same time with the same customer or its related parties may comprise a single performance obligation. Those contracts are required to be combined to preclude an entity from effectively bypassing the guidance for identifying performance obligations based on how contracts are legally structured. Rather, the contracts are combined and revenue for the single performance obligation is recognized when or as it is satisfied. See Chapters 3-6 for discussion on Steps 2 through 5 on identifying performance obligations, determining the transaction price, allocating the transaction price, and recognizing revenue.

### **BDO INSIGHTS – COMBINING CONTRACTS REQUIRES JUDGMENT**

Determining whether multiple contracts entered with the same customer (or its related parties) at or near the same time must be combined requires the application of professional judgment, based on the facts and circumstances. An entity considers the facts and circumstances surrounding those contracts, the pricing and the nature of the goods or services being transferred to evaluate the substance of those contracts and determine whether they must be combined.

Additionally, the phrase “at or near the same time” is not defined under ASC 606. Entities may establish accounting policies to define that term (for example, as 90 days). However, the standard does not include a bright line. Therefore, determining whether any contracts executed shortly outside the defined time frame are within the scope of contract combination guidance requires the application of professional judgment, based on the facts and circumstances.

**BDO INSIGHTS – CONTRACT COMBINATION GUIDANCE - CUSTOMER'S RELATED PARTIES**

The standard requires an entity to consider whether the contract combination guidance is applicable to contracts that are entered with two or more separate parties who are related parties, because there may be interdependencies between or among those contracts. The amount and timing of revenue recognized might differ depending on whether those contracts are accounted for as separate contracts as opposed to a single contract. The term “*related parties*” has the same meaning as the definition in ASC 850, which encompasses a wide range of entities and individuals, and careful analysis may be required to ensure that all of these parties are considered.

Determining whether another entity is a related party of the customer and whether multiple contracts entered with the customer and the customer's related party must be combined requires the application of professional judgment, depending on the facts and circumstances.

**SEC STAFF GUIDANCE****[Remarks before the 2016 Baruch College Financial Reporting Conference](#)**

Wesley R. Bricker, Deputy Chief Accountant, Office of the Chief Accountant

May 5, 2016

***Contract Combination Guidance - Limited to a Customer and Its Related Parties***

*An SEC staff speech stated that the SEC's Office of the Chief Accountant was consulted on the contract combination guidance in ASC 606. The SEC staff objected to extending the contract combination guidance beyond contracts with the same customer or related parties of the same customer because ASC 606 explicitly limits which contracts may be combined. Therefore, an entity cannot combine contracts with different counterparties who are not related parties, even if they are negotiated as a package with the same commercial objective.*

**BDO INSIGHTS – CONTRACT COMBINATION GUIDANCE – DIFFERENT DEPARTMENTS OF AN ENTITY**

An entity may enter contracts with different departments or divisions of the customer entity. Regardless of whether the different departments function independently within the entity, those contracts fall within the scope of contract combination guidance and must be combined if the contract combination requirements are met.

Similarly, when evaluating contracts with different departments of a government body (federal, state, local, or foreign), different departments under the control of the same government body are generally considered part of a single entity. For example, separate contracts with different departments of the federal government may be combined if the contract combination requirements are met.

**BDO INSIGHTS – INTERACTION BETWEEN THE GUIDANCE ON CONTRACT COMBINATION AND CONSIDERATION PAYABLE TO CUSTOMER**

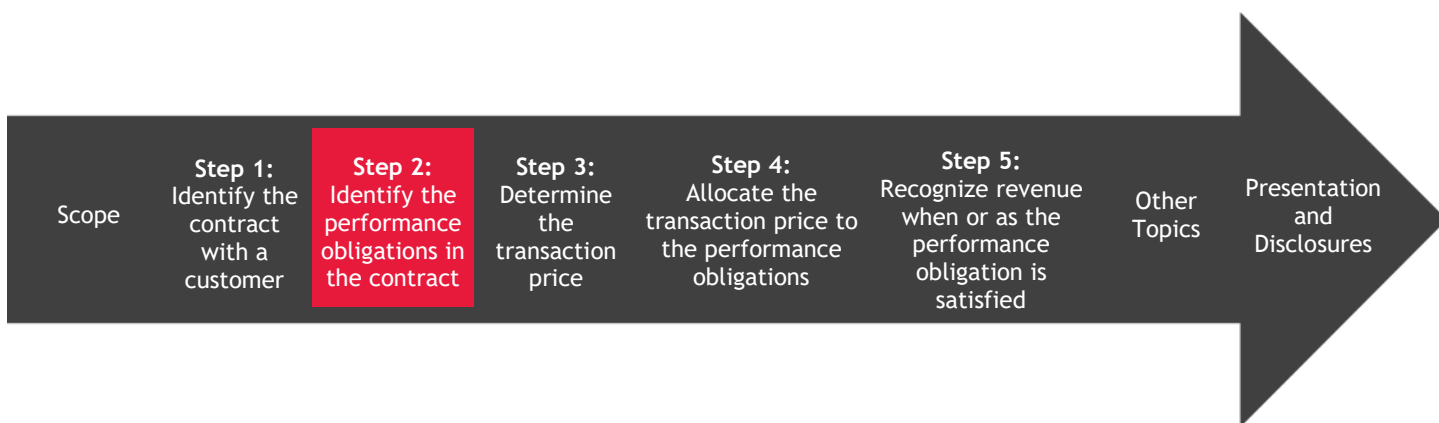
When evaluating multiple contracts with a customer or its related parties that require the entity to make cash or noncash payments to the customer or the customer's related parties, an entity must carefully consider the applicability of the guidance on consideration payable to the customer, along with the guidance on contract combination. Consideration payable to the customer is recognized as a reduction in revenue if certain conditions are met (see Section 4.6 for related discussion).

For example, consider a biotechnology entity that sells R&D services and a functional IP license to a customer in exchange for a fee. The biotechnology entity in-licenses certain technology from the customer's related party in exchange for a fee and uses that technology to provide the R&D services to the customer. If the two contracts were entered at or near the same time, the biotechnology entity must evaluate whether the two contracts must be combined, for example, because they have a single commercial objective or pricing interdependencies. If the contracts are combined, then the payments made by the biotechnology entity to the customer's related party for the in-license may be recognized as a reduction in revenue (rather than as an expense) under the guidance on consideration payable to customer.

Reaching a conclusion about whether to combine contracts and recognize payments to a customer or its related parties) as a reduction in revenue requires the application of professional judgment, based on the facts and circumstances.



## CHAPTER 3 – STEP 2: IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT



### 3.1 OVERVIEW



#### FASB REFERENCES

ASC 606-10-25-14

After identifying the contract for accounting purposes in Step 1, an entity must identify the promised goods and services within the contract and determine which of those goods and services are separate performance obligations.

A “performance obligation” is the unit of account for applying ASC 606 to recognize revenue from the transfer of promised goods and services to a customer. In Steps 3 through 5, the transaction price in a contract is allocated to each performance obligation in the contract, and the allocated transaction price is recognized in revenue when or as the performance obligation it relates to is satisfied. Correctly identifying the performance obligations in a contract is fundamental to the principle that the amount and timing of revenue recognized for the contract must faithfully depict an entity’s performance in transferring the promised goods or services to the customer.

At contract inception, an entity assesses the promised goods and services in a contract and identifies separate performance obligations. A performance obligation is a promise to transfer to a customer either:

- ▶ A good or service (or a bundle of goods or services) that is distinct
- ▶ A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer



**BDO INSIGHTS – A PERFORMANCE OBLIGATION IS THE UNIT OF ACCOUNT FOR REVENUE RECOGNITION**

Appropriate identification of the performance obligations in a contract is crucial because each performance obligation is a separate “unit of account” for determining when and how much revenue to recognize.

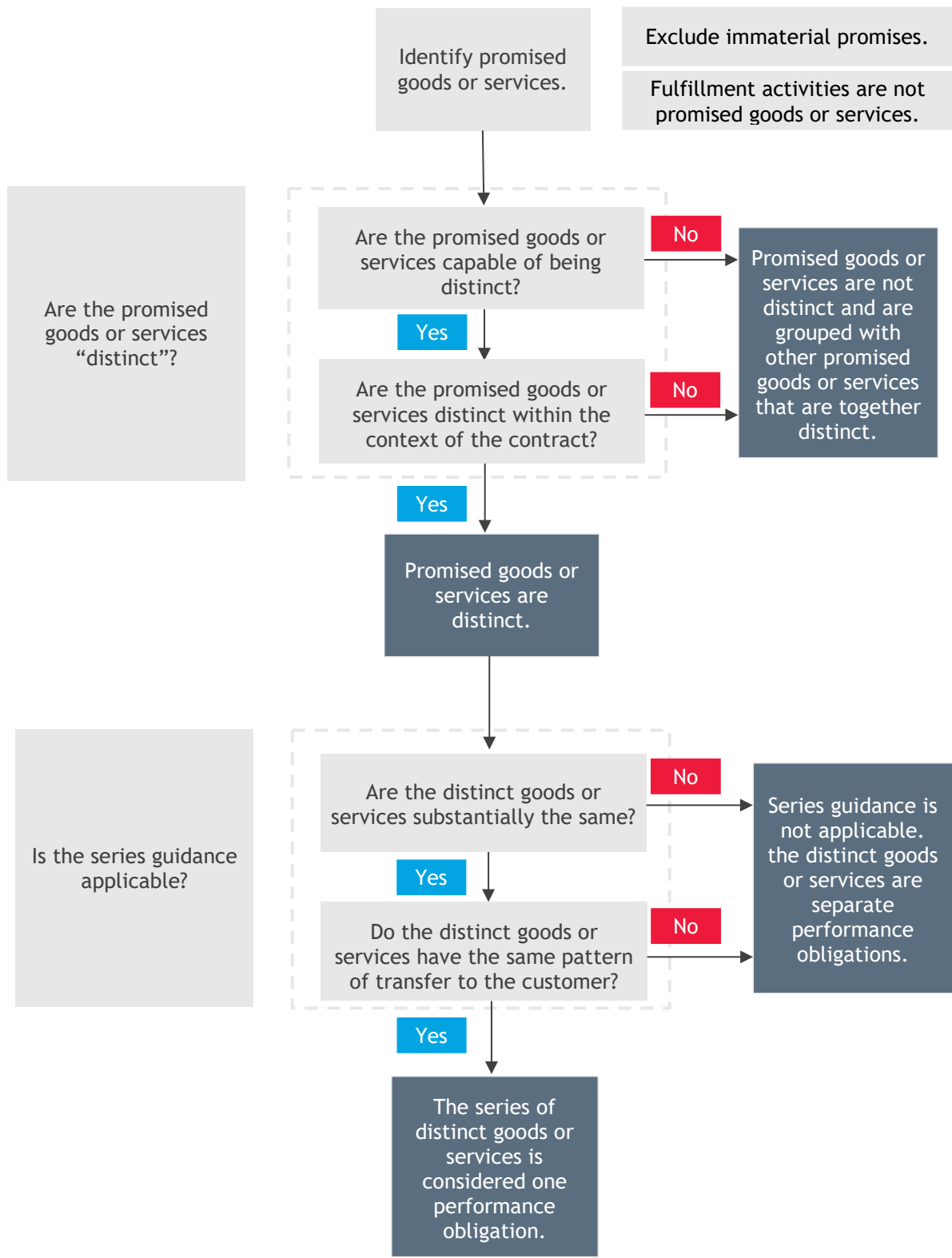
Additionally, the accounting for contract modifications (see Section 7.3) is based on, among other things, whether a promised good or service is distinct (and therefore a performance obligation) and whether a performance obligation in a contract has been satisfied before the modification date. Therefore, even if a contract includes multiple performance obligations that are satisfied concurrently and could practically be accounted for as a single performance obligation, an entity is required to correctly identify performance obligations in the original contract if that contract is modified.

**BDO INSIGHTS – REASSESSING PERFORMANCE OBLIGATIONS**

The performance obligations identified in a contract are not reassessed unless the contract is modified, and the modification is not accounted for separately from the existing contract. See Section 7.3 for discussion on accounting for contract modifications.

ASC 606 also includes specific guidance for determining whether a warranty is a performance obligation and a practical expedient for franchisors that are nonpublic entities (nonpublic franchisors) when identifying performance obligations.

The following diagram provides an overview of Step 2:



## 3.2 PROMISES IN CONTRACTS WITH CUSTOMERS



### FASB REFERENCES

ASC 606-10-25-16 through 25-18

To identify the performance obligations in a contract with a customer, an entity is first required to identify, at contract inception, all of the promised goods or services in that contract. Generally, all goods or services that an entity promises to transfer to a customer are identified explicitly in the contract. Examples of promised goods or services include the sale of goods, performing agreed-upon tasks, standing ready to provide goods or services (for example, unspecified software updates to software provided on when-and-if-available basis), arranging for another party to transfer goods or services, constructing an asset on behalf of a customer, and granting licenses.

### 3.2.1 Implied Promises in a Contract



### FASB REFERENCES

ASC 606-10-25-16

Promised goods and services in a contract are not limited to the goods or services that are explicitly stated in that contract. In some cases, promises to provide goods or services might be implied by the entity's customary business practices, published policies or specific statements if, at the time of entering the contract, the customer has a reasonable expectation that it will receive certain goods or services from the entity. If the customer has a reasonable expectation that it will receive certain goods or services not explicitly identified in the contract, it will likely view those promises as part of the negotiated exchange.



### IMPLIED PROMISES – CONSIDERING CUSTOMER'S EXPECTATIONS

In identifying the implied promises in a contract, it is important for an entity to consider the customer's expectations (rather than only the entity's perspective) regarding which goods or services the customer expects to receive and for which it has paid or will pay under the contract.

Analyzing customer's expectations and identifying implied promises requires the application of professional judgment, based on the facts and circumstances.

While a contract with a customer identified in Step 1 must be enforceable by law, implied promises in the contract do not need to be enforceable by law. If the customer has a valid expectation that the entity will transfer a good or service, then the customer would view that promise as a part of the negotiated exchange. In BC87 of ASU 2014-09, the FASB stated that absent this guidance, an entity might recognize all the consideration in a contract as revenue even though the entity continues to have remaining implied promises related to the contract with the customer.

### 3.2.2 Promises That Require the Involvement of a Third Party



#### FASB REFERENCES

ASC 606-10-25-18

Promised goods and services in a contract may include:

- ▶ Resale of rights to goods or services purchased by the entity to its customer. For example, a ticket reseller may purchase tickets from an airline and then sell the tickets (or the right to the flight service) to its customer.
- ▶ Providing a service of arranging for another party to transfer goods or services to a customer. For example, an entity may act as an agent of another party who will transfer goods or services to a customer.

In this type of arrangement, another party is involved in providing goods or services to the customer. Therefore, an entity needs to determine whether it is the principal or agent in that arrangement for revenue recognition purposes. See Section 7.2 for discussion on principal versus agent considerations.

### 3.2.3 Promises to a Customer's Customer



#### FASB REFERENCES

ASC 606-10-25-18(g)

Granting a right to goods or services to be provided in the future that a customer can transfer to its customer (for example, when an entity makes a promise to provide goods or services to its customer's customer) is a promised good or service in a contract. Those types of promises exist in distribution networks in various industries, for example, the automotive industry.

For example, when a manufacturer sells a motor vehicle to its customer, a motor vehicle dealer, the manufacturer may promise to provide additional goods or services, such as maintenance, to the dealer's customer. An entity is required to identify all of the promises, both explicit and implicit, that are made to the customer as part of the contract with that customer. Consequently, the manufacturer's promise to provide a good or service (such as maintenance) that the dealer can pass on to the dealer's customer would be a performance obligation for the manufacturer if that promise could be identified (explicitly or implicitly) in the manufacturer's contract with the dealer.

However, some promised goods or services that do not exist (explicitly or implicitly) at the time the parties agree to the contract but are added after contract inception do not represent performance obligations in the original contract but are instead new contracts entered with a different counterparty.

### 3.2.4 Customer Options to Purchase Additional Goods or Services – Material Right



#### FASB REFERENCES

ASC 606-10-25-18(j)

Granting an option to a customer to purchase additional goods or services could be a promised good or service in a contract when that option provides the customer with a material right. See Section 7.4 for discussion on customer options and material rights.

Additionally, see Section 7.4.1.1 for a summary of the TRG discussions on whether a variable quantity of a good or service constitutes a customer's purchase option(s) or variable consideration.

### 3.2.5 Exception for Immaterial Promises in a Contract



#### FASB REFERENCES

ASC 606-10-25-16A and 25-16B

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 (see Section 3.3 for discussion on identifying performance obligations). That is, an entity is exempt from accounting for performance obligations that an entity might consider perfunctory or inconsequential. Assessing whether a promised good or service is immaterial at the contract level requires judgment. BC12 of ASU 2016-10 states that in assessing immateriality, an entity considers both the quantitative and qualitative nature of the promised goods or services in the contract. An entity also considers the relative significance or importance of a promised good or service in the contract to the arrangement with the customer as a whole.

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 are accrued.

An entity cannot apply the exception for immaterial promises to a customer's option to acquire additional goods or services that provides the customer with a material right. See Section 7.4 for discussion on customer options and material rights.

### 3.2.6 Fulfillment Activities



#### FASB REFERENCES

ASC 606-10-25-17

Activities performed to fulfill a contract that do not transfer goods or services to the customer are not considered promised goods or services in a contract, even though those activities are required to successfully transfer the goods or services for which the customer has contracted. Fulfillment activities may exist in many contracts in which an entity undertakes separate activities that do not directly transfer goods or services to the customers. For example, a service provider may need to perform various administrative tasks (or set up activities) to set up a contract before providing services to the customer. The performance of the administrative tasks does not transfer a service to the customer as the tasks are performed and, therefore, those activities are not promised goods or services in the contract.

See Section 7.7 for discussion on accounting for costs incurred to fulfil a contract with a customer.

#### 3.2.6.1 Tooling and Set-Up Activities

Manufacturing entities often incur significant costs at the inception of contracts for tooling, equipment, and engineering start-up activities, often referred to as "pre-production activities." Manufacturers need to consider whether these pre-production activities are a promised good or service, or whether they are fulfillment activities, which requires judgment and consideration of the facts and circumstances. If a manufacturer has difficulty in determining whether a pre-production activity is a promised good or service in a contract, it evaluates whether control of that good or service is transferred to the customer (for example, whether the customer will own the results of the pre-production activity even if the contract is terminated). If so, this may indicate that the pre-production activity is a promised good or service.

**EXAMPLE 3-1: TOOLING AND SET-UP ACTIVITIES**

An entity manufactures parts for the automobile industry and has contracted with a customer to supply pistons. Each piston is determined to be a distinct performance obligation. To fulfill the contract, the entity must:

- ▶ Purchase an additional diamond-core cutting machine costing \$500,000 and tooling costing \$200,000
- ▶ Incur engineering costs of \$100,000 to configure the production line

The entity receives \$1,000,000 from the customer at contract inception to compensate for the pre-production activities.

The entity retains title to the equipment, tooling, and any IP (for example, patents) that result from the engineering activities. The entity is also responsible for maintaining and directing the use of the tooling and equipment.

The entity determines that the contract includes the promise to transfer pistons to the customer, and the pre-production activities do not result in control of additional goods or services being transferred to the customer. Therefore, the pre-production activities are not promised goods or services and cannot be a separate performance obligation within the contract.

The entity includes the upfront \$1,000,000 payment within the transaction price (see Chapter 4 for discussion on determining the transaction price) and initially records it as a contract liability (deferred revenue). A portion of the contract liability is derecognized and credited to revenue as control over each piston is transferred to the customer (presuming the contract consists of multiple performance obligations, that is, each piston is a separate performance obligation). See Chapter 6 for discussion on recognizing revenue when (or as) a performance obligation is satisfied.

**BDO INSIGHTS – PRE-PRODUCTION ACTIVITIES**

If pre-production activities do not represent a separate performance obligation and are related to a performance obligation for which revenue is recognized over time (instead of a point in time, as is the case in Example 3-1), the pre-production activities are not considered when measuring progress toward completion of that performance obligation because they do not result in control of a good or service being passed to the customer. In other words, the manufacturer does not recognize any revenue just by incurring any of the \$800,000 of pre-production activities. Instead, those costs are treated as costs to fulfill a contract. See Chapter 6 for discussion on recognizing revenue over time and measure of progress and Section 7.7 for discussion on accounting for the costs of contracts with customers.

In contrast, if the pre-production activities are determined to be a promised good or service, a portion of the transaction price is allocated to that good or service, as either a single performance obligation or as part of a combined performance obligation that includes the pre-production activities with other goods and services.

**BDO INSIGHTS – PRE-PRODUCTION ACTIVITIES FOR LONG-TERM SUPPLY CONTRACTS**

ASC 340-10, *Other Assets and Deferred Costs – Overall*, includes guidance on accounting for the costs of designing and developing “molds, dies, and other tools that will be used in producing” products under a long-term supply agreement. ASC 606 did not amend or supersede the guidance provided on pre-production costs in ASC 340-10. Therefore, manufacturers that conclude that their pre-production costs are within the scope of ASC 340-10 continue to follow that guidance after adopting ASC 606. Additionally, entities apply the guidance in ASC 340-40 to account for pre-production costs that are not within the scope of ASC 340-10. See Section 7.7 for discussion on accounting for the costs of contracts with customers.



## TRG DISCUSSIONS – PRE-PRODUCTION ACTIVITIES – ANALYZING CONTROL

In November 2015, the TRG discussed an implementation question about whether pre-production activities are a promised good or service or included in the measure of progress toward complete satisfaction of a performance obligation that is satisfied over time.

The TRG observed that entities may find it helpful to consider the core principle of ASC 606 *“that an entity shall recognize revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.”*

Furthermore, ASC 606 specifies that the good or service is transferred when (or as) the customer obtains control. The FASB staff provided an example to illustrate an entity’s assessment of whether control of a good or service is transferred to the customer when the entity is having difficulty determining whether pre-production activities are a promised good or service. An entity is performing engineering and development activities as part of developing a new product for a customer and the customer will own the IP (for example, patents) that results from those activities. The entity would likely conclude that it is transferring control of that IP to the customer and consequently, the engineering and development activities are promised goods or services in the contract.

The FASB staff used this straightforward example to illustrate a case in which it was clear that control transferred to the customer. However, sometimes an entity needs to apply judgment to determine whether control of a good or service transfers to the customer. ASC 606 includes criteria for determining whether an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation over time. The FASB staff thinks that one of those criteria that may be applicable to pre-production activities is whether the customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs. Sometimes an entity may not be able to readily identify whether this criterion is met. In those circumstances, an entity considers whether another entity would need to reperform the work that the entity has completed to date if that other entity were to fulfill the remaining performance obligation.

For example, consider a scenario in which an entity is performing engineering and development activities as part of developing a new product for a customer. If the entity 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) or if the entity must provide the customer with the design information completed to date in the case of a termination of the contract, then the entity likely would conclude that control of that service has transferred to the customer.

As another example, when a piece of equipment is transferred over time, an entity has determined that the customer has control over the asset because, for example, the entity has a right to payment for an asset with no alternative use. The entity might include labor costs in a cost-to-cost measure of progress for constructing the piece of equipment. The labor itself is not a separate promised good or service to the customer in the contract. However, each time the worker turns a wrench, the asset (the equipment) is changed, and the customer obtains control of that changed asset. Similarly, an entity might determine the pre-production cost should be included in the measure of progress, depending on the circumstances of the arrangement. However, if the arrangement involves significant costs for the entity near the start of the arrangement and the activities giving rise to those costs do not transfer a good or a service to the customer, then the entity considers the guidance on adjustments to the measure of progress when using a cost-based input method. Application of that guidance requires an entity to consider whether the costs for certain activities must be excluded from the measure of progress or whether the input method must be adjusted to recognize revenue only to the extent of that cost incurred.

See Chapter 6 for discussion on the notion of control, recognizing revenue over time or at a point in time, measure of progress and adjustments to the measure of progress when using a cost-to-cost method.

### 3.2.6.2 Shipping and Handling Activities



#### FASB REFERENCES

ASC 606-10-5-18A

An entity that promises to transfer goods to a customer may perform shipping and handling activities related to those goods. If the shipping and handling activities are performed before the customer obtains control of the goods, the shipping and handling activities are not promised services to the customer but rather activities to fulfill the entity's promise to transfer goods.

#### 3.2.6.2.1 Shipping and Handling Activities – Accounting Policy Election



#### FASB REFERENCES

ASC 606-10-5-18B

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 rather than as additional promised services.

If an entity opts for the accounting policy election:

- ▶ Shipping and handling activities are not identified as separate performance obligations and no revenue is allocated to them.
- ▶ If revenue for related goods is recognized before the shipping and handling activities occur, an entity must accrue the related costs of those shipping and handling activities.

If the accounting policy election is not made, then the entity evaluates shipping and handling activities as promised services and potential performance obligations.

The accounting policy election must be applied consistently to similar types of transactions.

## 3.3 DISTINCT GOODS OR SERVICES



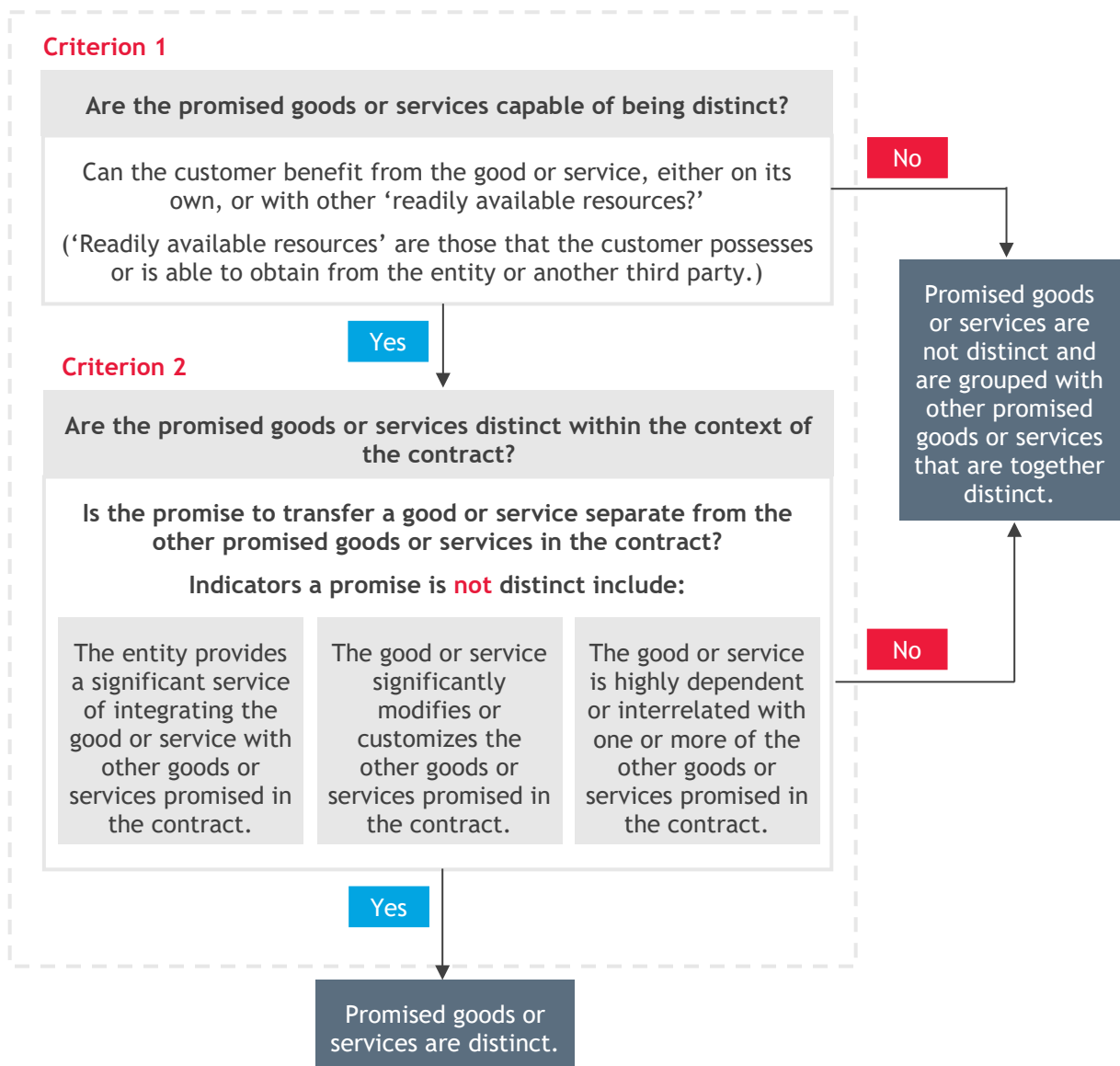
#### FASB REFERENCES

ASC 606-10-25-19 through 25-22

After identifying the promised goods or services in the contract, an entity determines which of those promised goods or services (or bundle of goods and services) are “*distinct*” and, hence, represent separate performance obligations. If a promised good or service is not distinct, the entity must combine that good or service with other promised goods or services until a bundle of goods or services that is distinct can be identified.

The following diagram illustrates the guidance on determining whether a promised good or service is distinct, and hence a separate performance obligation:





As illustrated in the diagram, for a good or service to be distinct, **both** of the following criteria must be met:

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

### 3.3.1 Criterion 1 – Good or Service Is Capable of Being Distinct



#### FASB REFERENCES

ASC 606-10-25-19(a) and ASC 606-10-25-20

A good or service is capable of being distinct if a customer can benefit from the good or service either on its own or with other resources that are readily available to the customer. A customer can benefit from a good or service if the good or service can be used, consumed, or sold (other than for scrap value), or held in any other way to generate economic benefits. While a customer may benefit from some goods or services on its own in other circumstances, it may only be able to obtain benefits from goods or services in conjunction with other readily available resources.

A readily available resource is either:

- ▶ A good or service that is sold separately (either by the entity or a third party)
- ▶ A resource that the customer has already obtained from the entity, including a good or service that the entity has already transferred to the customer under the contract or from other transactions or events

Whether the customer can benefit from a good or service either on its own or in conjunction with other readily available resources can be corroborated by various factors. For example, if an entity regularly sells a good or service separately, this indicates that a customer can benefit from that good or service either on its own or in conjunction with other readily available resources. If a good or service is not capable of being used on its own or with other resources, conceptually there would not be a market for an entity to provide that good or service on a standalone basis.

#### 3.3.1.1 Customer Can Benefit From the Goods or Services on Its Own



#### FASB REFERENCES

ASC 606-10-25-19(a), ASC 606-10-55-150A through 55-150F

The assessment of whether the “customer can benefit from the goods or services on its own” is based on the characteristics of the goods or services themselves rather than the way in which the customer contractually may use or obtain the goods or services. Therefore, an entity disregards any contractual limitations that might prevent the customer from obtaining readily available resources from a source other than the entity.

“Capable of being distinct” is the minimum characteristic that a promised good or service must possess to be considered for separate accounting in a contract with a customer. If this criterion is not met, then the promised good or service is not distinct, and an evaluation of the second criterion is not necessary. Rather, that promised good, or service is combined with other promised goods or services in the contract until a distinct bundle of goods or services is identified.

#### EXAMPLE 3-2 (ADAPTED FROM ASC 606-10-55-150A THROUGH 55-150D): GOODS AND SERVICES ARE CAPABLE OF BEING DISTINCT

Entity A contracts with a customer to sell machinery and installation services. Installation of the machinery is not complex and can be provided by Entity A or other entities. Entity A identifies two promised goods and services in the contract: (a) machinery and (b) installation services. Entity A observes that the customer can benefit from the machinery on its own, by using it or reselling it for an amount greater than scrap value, or with other readily available resources (that is, installation services available from other entities). Additionally, the customer can benefit from the installation service promised by Entity A with other resources that the customer will already have

obtained from the entity under the contract (that is, the machinery). Therefore, Entity A determines that the machinery and installation services are capable of being distinct.

### EXAMPLE 3-3 (ADAPTED FROM ASC 606-10-55-150A THROUGH 55-150F): GOODS AND SERVICES ARE CAPABLE OF BEING DISTINCT

Assume the same facts in Example 3-2 except the customer is contractually required to purchase the installation service from Entity A rather than other entities. Entity A's promises to transfer the machinery and installation services to the customer are capable of being distinct for the reasons stated in Example 3-2, despite the contractual limitations that prevent the customer from purchasing the installation service from other entities. This is because the assessment of whether a customer can benefit from a good or service (the machinery or installation service) on its own is based on the characteristics of the good or service itself (machinery or installation service) rather than any contractual limitations. The contractual requirement to use Entity A's installation service does not change the characteristics of the machinery or installation service, nor does it change Entity A's promise to the customer.

### 3.3.2 Criterion 2 – Promise to Transfer Good or Service Is Distinct Within the Context of the Contract



#### FASB REFERENCES

ASC 606-10-25-19(b) and ASC 606-10-25-21

An entity's promise to transfer a good or service is distinct within the context of the contract if that promise is separately identifiable from other promises in the contract. The objective of assessing whether an entity's promise to transfer a good or service is separately identifiable from other promised goods or services in the contract 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(s) to which the promised goods or services are inputs.

In certain cases, even though the individual goods or services promised as a bundle of goods or services might be capable of being distinct, accounting for those goods or services separately may not result in a faithful depiction of the entity's performance in that contract. For example, many construction- and production-type contracts involve transferring many goods and services that are capable of being distinct (for example, various building materials, labor, and project management services) to the customer. However, identifying all those individual goods and services as separate performance obligations would be impractical. More importantly, it would not faithfully represent the nature of the entity's promise to the customer. Therefore, when identifying whether promised goods or services in a contract are distinct, an entity considers both the characteristics of an individual good or service (that is, whether the good or service is capable of being distinct) and whether the promise to transfer the good or service is separately identifiable (that is, distinct within the context of the contract).

Determining whether an entity's promise to transfer a good or service is separately identifiable in a contract requires significant judgment and consideration of all facts and circumstances for each individual contract with a customer.

ASC 606 specifies three factors to assist an entity in making that judgment. Those factors, stated below, indicate that an entity's promise to transfer two or more goods or services to the customer are not separately identifiable:

- ▶ 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 represents the combined output(s) for which the customer has contracted.
- ▶ One or more of the goods or services significantly modify or customize or are significantly modified or customized by one or more of the other goods or services promised in the contract.
- ▶ The goods or services are highly interdependent or highly interrelated.

The “separately identifiable” principle is influenced by the notion of separable risks, which is whether the risk that an entity assumes to fulfill its obligation to transfer one of those promised goods or services to the customer is inseparable from the risk relating to the transfer of the other promised goods or services in the contract.

The FASB stated in BC29 of ASU 2016-10 that its intent is that an entity must evaluate whether a contract is to deliver:

- ▶ Multiple promised goods or services that are outputs themselves
- ▶ A combined item(s) that consists of the multiple promised goods or services that are inputs to a combined item(s)

For multiple promised goods or services to be considered inputs to a combined item(s), an entity’s promise to transfer the promised goods or services must result in a combined item(s) that is(are) greater than (or substantively different from) the sum of those promised goods and services.

Additionally, in BC32 of ASU 2016-10, the FASB clarified that the “separately identifiable” principle is intended to consider the level of integration, interrelation, or interdependence among promises to transfer goods or services. That is, the separately identifiable principle is intended to evaluate when an entity’s performance in transferring a bundle of goods or services in a contract is, in substance, fulfilling a single promise to a customer. Therefore, the entity evaluates whether two or more promised goods or services (for example, a delivered item and an undelivered item) each significantly affect the other (and, therefore, are highly interdependent or highly interrelated) in the contract. The entity cannot merely evaluate whether one item, by its nature, depends on the other (for example, an undelivered item that would never be obtained by a customer absent the presence of the delivered item in the contract or the customer having obtained that item in a different contract).

Entities must consider the three factors with the “separately identifiable” principle. The three factors are not an exhaustive list, and not all of them need to be met (or not met) to conclude that the entity’s promises to transfer goods or services are not (are) separately identifiable. Furthermore, sometimes the factors are less relevant to the evaluation of the “separately identifiable” principle and, therefore, entities must consider the principle, not only the three factors.

Additionally, the three factors are not mutually exclusive. On the contrary, because the factors are based on the same underlying principle of inseparable risks, it is possible that more than one of the factors might apply to a contract with a customer. However, each of the three factors was included in the standard because each one may be more or less applicable for particular contracts or industries.

### 3.3.2.1 Significant Integration Service



#### FASB REFERENCES

ASC 606-10-25-21(a), ASC 606-10-55-137 through 55-140

Two or more promises to transfer goods or services to a customer are not separately identifiable if an entity provides a significant service of integrating those goods or services with other goods or services promised in the contract into a bundle that represents 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(s) specified by the customer. A combined output may include more than one phase, element, or unit. Therefore, as stated in BC107 of ASU 2014-09, when an entity provides an integration service, the risk of transferring the individual goods or services is inseparable, because a substantial part of the entity’s promise is to incorporate the individual goods and services into the combined output.

The factor on significant integration service may be relevant in many construction contracts in which the contractor provides an integration (or contract management) service to manage and coordinate the various construction tasks.

**EXAMPLE 3-4 (ADAPTED FROM ASC 606-10-55-137 THROUGH 55-140): SIGNIFICANT INTEGRATION SERVICE IN CONSTRUCTION CONTRACT**

A contractor enters a contract with a customer to construct a building. The contractor is responsible for the overall management of the project and has promised multiple goods and services in the contract, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, equipment installation and finishing.

The contractor considers that each of those goods and services are regularly sold separately by it or its competitors. Additionally, the customer could generate economic benefit from the individual goods and services by using, consuming, selling, or holding those goods or services. Therefore, the contractor determines that the customer can benefit from each of the goods or services either on its own or with other readily available resources, and each good or service is capable of being distinct.

The contractor determines that the promises to transfer the goods and services are not separately identifiable because the contractor provides a significant service of integrating the goods and services (the inputs) into the building (the combined output) for which the customer has contracted.

Therefore, the individual goods and services in the contract are not distinct and the contractor accounts for all of the goods and services in the contract as a single performance obligation.

**3.3.2.2 Significant Modification or Customization****FASB REFERENCES**

ASC 606-10-25-21(b)

Two or more promises to transfer goods or services to a customer are not separately identifiable if one or more of the goods or services significantly modifies or customizes, or is significantly modified or customized by, another good or service promised in the contract.

In some industries, for example, the software industry, the notion of inseparable risks (that is, the concept that the risk that an entity assumes to fulfill its obligation to transfer one of the promised goods or services to the customer is inseparable from the risk relating to the transfer of the other promised goods or services in the contract) is more clearly illustrated by assessing whether one good or service significantly modifies or customizes another good or service. If a good or service significantly modifies or customizes another good or service in the contract, each good or service is being assembled (that is, as an input) to produce a combined output for which the customer has contracted.

See Examples 3-10 and 3-11 in this chapter.

**3.3.2.3 High Interdependency or Interrelation****FASB REFERENCES**

ASC 606-10-25-21(c), ASC 606-10-55-137 through 55-150J

Two or more promises to transfer goods or services to a customer are not separately identifiable if the goods or services are highly interdependent or highly interrelated. That is, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, two or more goods or services may be 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.

In some cases, whether an entity is providing an integration service or whether the goods or services are significantly modified or customized may be unclear. Nevertheless, the individual goods and services in the contract may still not be separately identifiable from the other goods or services promised in the contract because the goods or services are highly dependent on, or highly interrelated with, other promised goods or services in the contract in such a way that the customer could not choose to purchase one good or service without significantly affecting the other promised goods or services in the contract.

When considering whether the promises in a contract are highly interdependent or interrelated, it is important for an entity to consider whether one promise in a contract has a transformative effect on another promise rather than merely an additive effect. The fact that a good or service depends on a second good or service (that is, they have a functional relationship) does not necessarily mean the two promises are not distinct in the context of the contract.

For example, equipment and related consumables needed to operate the equipment are distinct even though the value of the consumables depends on access to the equipment, because the supply of consumables does not result in any changes to the equipment. Instead, the dependency between the promises must be bi-directional, that is, they must each impact the other – see Example 3-8 in this chapter. Additionally, Example 3-5 in this chapter illustrates two promises that each impact the other, resulting in a conclusion that they are not distinct in the context of the contract.

#### **BDO INSIGHTS – IDENTIFICATION OF DISTINCT GOODS OR SERVICES REQUIRES CAREFUL ANALYSIS**

The identification of distinct goods or services in a contract requires the application of professional judgment, based on the facts and circumstances. An entity may need to perform a detailed analysis of contractual terms and apply significant judgment to determine whether a promise in a contract is a distinct good or service (and, hence, constitutes a performance obligation) or must be combined (“bundled”) with other promises in the contract to create a single performance obligation. Subtle differences in contractual terms and conditions, unique facts and circumstances and customer expectations can affect this analysis.

#### **EXAMPLE 3-5 (ADAPTED FROM ASC 606-10-55-140A THROUGH 55-140C): SIGNIFICANT INTEGRATION SERVICE AND HIGH INTERDEPENDENCY AND INTERRELATION IN MANUFACTURING CONTRACT**

A manufacturer enters a contract with a customer to deliver multiple units of a highly complex, specialized device. The contract requires the manufacturer to establish a manufacturing process to produce the contracted units. The specifications are unique to the customer based on a custom design owned by the customer and were developed under the terms of a separate contract that is not part of the current negotiated exchange. The manufacturer is responsible for the overall contract management, which requires the performance and integration of various activities, including procurement of materials, identifying and managing subcontractors, and performing manufacturing, assembly, and testing.

The manufacturer considers that each unit of the device can function independently of the other units and, therefore, the customer can benefit from each device on its own. Therefore, the manufacturer determines that each unit of the device is capable of being distinct.

The manufacturer considers the nature of its promise in the contracts and observes that it has promised to establish and provide a service of producing the full complement of devices for which the customer has contracted. The manufacturer is responsible for overall contract management 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). Therefore, the manufacturer determines that the devices and the various promised goods and services inherent in manufacturing those devices are not separately identifiable.

The manufacturer provides a manufacturing process specific to its contract with a customer. In addition, the nature of the manufacturer’s performance and, particularly, the significant integration of various activities mean that a change in one of the manufacturer’s activities to produce the highly complex specialized devices has a significant effect on the other activities required to produce those devices, such that the entity’s activities are highly interdependent and highly interrelated.

Therefore, the manufacturer concludes that the goods and services in the contract are not distinct and accounts for all of the goods and services as a single performance obligation.



## TRG DISCUSSIONS – EFFECT OF CONTRACTUAL RESTRICTIONS ON IDENTIFYING PERFORMANCE OBLIGATIONS

Stakeholders raised questions about the effect of contractual restrictions on the identification of performance obligations. Therefore, the FASB added an example to illustrate that a contract for the sale of specialized equipment and the installation of the equipment could be distinct within the context of the overall contract even if the entity requires the customer to buy installation services when it buys equipment. Other relevant factors might include:

- ▶ The extent to which the equipment could operate without the installation
- ▶ Whether other entities would have been able to undertake the installation absent the contractual restriction
- ▶ The extent to which the installation services significantly modify or customize the equipment being installed
- ▶ Whether the customer could benefit economically from the machine if it did not receive the installation services

### EXAMPLE 3-6 (ADAPTED FROM ASC 606-10-55-150A THROUGH 55-150C): PROMISES ARE SEPARATELY IDENTIFIABLE – INSTALLATION

This example is a continuation of Example 3-2. The content from Example 3-2 has been reproduced here for improved readability.

Entity A contracts with a customer to sell machinery and installation services. Installation of the machinery is not complex and can be provided by Entity A or other entities. Entity A identifies two promised goods and services in the contract: (a) machinery and (b) installation service.

#### Capable of Being Distinct

Entity A observes that the customer can benefit from the machinery on its own, by using it or reselling it for an amount greater than scrap value, or with other readily available resources (that is, installation services available from other entities). Additionally, the customer can benefit from the installation service promised by Entity A with other resources that the customer will already have obtained from the entity under the contract (that is, the machinery). Therefore, Entity A determines that the machinery and installation services are capable of being distinct.

#### Distinct in the Context of the Contract

Entity A then determines whether its promises to transfer the machinery and to provide the installation services are each separately identifiable. Entity A considers the following to determine whether the machinery and the installation services are inputs to a combined item:

- ▶ Entity A is not providing a significant integration service. That is, Entity A has promised to deliver the machinery and then install it; Entity A would be able to fulfill its promise to transfer the equipment separately from its promise to subsequently install it. Entity A has not promised to combine the machinery and the installation services in a way that would transform them into a combined output.
- ▶ Entity A's installation services will not significantly customize or significantly modify the machinery.



- ▶ Although the customer can benefit from the installation services only after it has obtained control of the machinery, the installation services do not significantly affect the machinery because Entity A would be able to fulfill its promise to transfer the machinery independently of its promise to provide the installation services. In other words, there is no two-way interdependency between the machinery and installation services. Because the machinery and the installation services do not significantly affect each other, they are not highly interdependent or highly interrelated.

Based on this assessment, Entity A determines that the machinery and installation services are not inputs to a combined item and identifies two performance obligations (the machinery and installation services) in the contract. Note that each of the three factors contributes to, but is not individually determinative of, the conclusion that the equipment and the installation services are separately identifiable.

#### **EXAMPLE 3-7 (ADAPTED FROM ASC 606-10-55-150A THROUGH 55-150F): PROMISES ARE SEPARATELY IDENTIFIABLE – INSTALLATION**

Assume the same facts in Example 3-6 except the customer is contractually required to purchase the installation service from Entity A rather than from other entities.

##### **Capable of Being Distinct**

Entity's A promises to transfer the machinery and installation services to the customer are "capable of being distinct" for the reasons stated in Example 3-6, despite the contractual limitations that prevent the customer from purchasing the installation service from other entities. This is because the assessment of whether a customer can benefit from a good or service on its own is based on the characteristics of the good or service itself (the machinery or installation service in this example) rather than any contractual limitations. The contractual requirement to use Entity A's installation service does not change the characteristics of the machinery or installation service, nor does it change Entity A's promise to the customer.

##### **Distinct in the Context of the Contract**

Entity A's analysis of and conclusion on whether the machinery and installation services are separately identifiable is consistent with Example 3-6. That is, Entity A identifies two performance obligations (the machinery and installation services) in the contract.

#### **EXAMPLE 3-8 (ADAPTED FROM ASC 606-10-55-150G THROUGH 55-150J): SEPARATELY IDENTIFIABLE – EQUIPMENT AND CONSUMABLES**

An entity enters a contract with a customer to deliver a printer (which is off-the-shelf and operational without any significant customization or modification) and specialized ink cartridges that are required to operate the printer. The entity is contractually required to provide replacement cartridges on specified dates over the next three years. The cartridges are specific to the printer and produced only by the entity. The entity sells the cartridges separately to customers who have bought the printer from the entity or from other parties.

##### **Capable of Being Distinct**

The entity determines that the printer and the cartridges are each capable of being distinct because:

- ▶ The customer can benefit from the printer with the readily available cartridges. The cartridges are readily available because they are regularly sold separately by the entity (that is, through refill orders to customers who previously purchased the printer).
- ▶ The customer can benefit from the cartridges that will be delivered under the contract with the printer that will be delivered to the customer initially under the contract.



Therefore, the entity determines that the printer and the cartridges are each capable of being distinct.

#### **Distinct in the Context of the Contract**

The entity determines that its promises to transfer the printer and to provide cartridges over a three-year period are each separately identifiable because:

- ▶ The printer and the cartridges are not inputs to a combined item in the contract because the entity is not providing a significant integration service that transforms the printer and cartridges into a combined output.
- ▶ Neither the printer nor the cartridges are significantly customized or modified by the other.
- ▶ The printer and the cartridges are not highly interdependent or highly interrelated because they do not significantly affect each other.

Although the customer can benefit from the cartridges only after it has obtained control of the printer (that is, the cartridges would have no use without the printer) and the cartridges are required for the printer to function, the printer and the cartridges 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 printer even if the customer did not purchase any cartridges and would be able to fulfill its promise to provide the cartridges even if the customer acquired the printer separately.

Therefore, the entity identifies two performance obligations in the contract: the printer and the cartridges.

#### **3.3.2.4 Utility of Promised Good or Service – Customer’s Perspective**



#### **FASB REFERENCES**

ASC 606-10-55-140D through 55-150

In BC33 of ASU 2016-10, the FASB stated that when evaluating whether two or more promises in a contract are separately identifiable, consideration is given to the utility of the promised goods or services (that is, the ability of each good or service to provide benefit or value) to the customer. While an entity may be able to fulfill its promise to transfer each good or service in a contract independently of the other, each good or service may significantly affect the other’s utility to the customer.

The “capable of being distinct” criterion considers the utility of the promised good or service, but merely establishes the baseline level of economic substance a good or service must achieve. Utility also is relevant in evaluating whether two or more promises in a contract are separately identifiable because even if two or more goods or services are capable of being distinct because the customer can derive some economic benefit from each one, the customer’s ability to derive its intended benefit from the contract may depend on the entity transferring each of those goods or services.

For example, in Example 3-9 in this chapter on anti-virus software license with updates, the entity’s ability to transfer the initial license is not affected by its promise to transfer the updates or vice versa, but the provision (or not) of the updates will significantly affect the utility of the licensed IP to the customer such that the license and the updates are not separately identifiable. They are, in effect, inputs to the combined solution for which the customer contracted.

#### **EXAMPLE 3-9 (ADAPTED FROM ASC 606-10-55-140D THROUGH 55-140F): LICENSE TO ANTI-VIRUS SOFTWARE WITH WHEN-AND-IF AVAILABLE UPDATES**

A software entity grants a customer a three-year term license to an anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The software entity often provides updates that are critical to the continued utility of the anti-virus software. Without those updates, the

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

#### Capable of Being Distinct

The software entity determines that the anti-virus software and the updates are each 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).
- ▶ The customer can benefit from the updates with the software license transferred at the outset of the contract.

#### Distinct in the Context of the Contract

The software entity determines that its promises to transfer the anti-virus software and the unspecified updates, when-and-if available, are not separately identifiable. This is because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The unspecified updates will significantly modify the functionality of the anti-virus 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 anti-virus license and periodic unspecified updates fulfill a single promise to the customer in the contract – a promise to provide protection from computer viruses for three years. Therefore, the software entity accounts for the software license and the when-and-if available updates as a single performance obligation in the contract.

See Section 7.5 for additional discussion on licensing arrangements.



## SEC STAFF GUIDANCE

### Remarks before the 2019 AICPA Conference on Current SEC and PCAOB Developments

Susan M. Mercier, Professional Accounting Fellow, Office of the Chief Accountant

December 9, 2019

#### *License to Software with Updates – Single Performance Obligation*

*An SEC staff speech elaborated on a consultation in which the SEC staff did not object to the conclusion that a software license and updates represent a single, combined performance obligation. In the fact pattern consulted on, a software entity licenses its software that allows its customers, application (app) developers, to build and deploy, and therefore monetize, their own apps on various third-party platforms. The third-party platforms include phones and home entertainment systems, which often undergo software updates as well. The software entity's software and updates make sure that the app built by customers using the software is compatible with all platforms that it supports, both when the app is initially deployed on a platform and over time as that platform is updated. To maintain continued compatibility of the software with third-party platforms, the software entity partners with the third-party platforms to understand their timelines for internal updates so that the software entity can timely initiate corresponding updates to its software. Without those software updates, the customer's ability to benefit from the software would be significantly limited over the contract term.*

*The SEC staff did not object to the software entity's conclusion that the software license and updates represent a single performance obligation because, in the SEC staff's view, the promises to provide the software license and the updates are, in effect, inputs that fulfill a single promise to the customer, which is to continually be able to deploy and monetize content using third-party platforms of the customer's choice in a rapidly changing environment, and that the updates are integral to maintaining the utility of the software license. The SEC staff stated that in this fact pattern, the combined output (whether marketed as a "solution" or not) is greater than, or substantively different than, the individual promises (that is, the software license and the updates).*

### **BDO INSIGHTS – DETERMINING WHETHER A SOFTWARE LICENSE AND UPDATES ARE A SINGLE PERFORMANCE OBLIGATION**

In the fact pattern discussed above in the SEC staff speech and the example of an anti-virus software license (Example 3-9 in this chapter), the entity concluded that the software license and related updates are a single performance obligation. We believe it may be possible to reach the same conclusion in additional fact patterns, although we believe that will be rare.

Key factors we believe may be helpful in determining whether a software license and updates are a single performance obligation include:

- ▶ How frequent the updates are
- ▶ Whether the updates are driven by factors within the software entity's control
- ▶ How significantly the functionality of the software is impacted by the upgrades
- ▶ How often and how many customers elect not to adopt an upgrade and continue to derive the intended benefit from the software license

The factor on significant customization or modification may be relevant in a software development contract in which a software developer customizes a software product for a specific customer. ASC 606 includes two fact patterns to illustrate whether a significant customization service provided by a software developer in a contract with a customer is distinct from a software license – see adaptations below.

### **EXAMPLE 3-10 (ADAPTED FROM ASC 606-10-55-141 THROUGH 55-145): SOFTWARE DEVELOPMENT CONTRACT – SIGNIFICANT CUSTOMIZATION OR MODIFICATION IS NOT PROVIDED**

A software developer contracts with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support for a specified period. The software developer 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 IT). Other competitor entities routinely perform the installation service, which does not significantly modify the software. The software remains functional without the updates and the technical support.

#### **Capable of Being Distinct**

The software developer assesses the promised goods and services and concludes that the customer can benefit from each of the goods and services either on its own or with the other goods and services that are readily available (that is, the goods and services are capable of being distinct). This is because:

- ▶ 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 with the software license transferred at the outset of the contract.

### Distinct in the Context of the Contract

The software developer determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (that is, the goods and services are distinct in the context of the contract) because:

- ▶ 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 other providers.
- ▶ The software updates do not significantly affect the customer's ability to use and benefit from the software license because the software updates are not necessary for the software to maintain a high level of utility to the customer during the license period.
- ▶ None of the promised goods or services significantly modify or customize one another.
- ▶ The software developer is not providing a significant service of integrating the software and the services into a combined output.
- ▶ The software and the services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated because the software developer 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.

Based on the above analysis, the software developer concludes that there are four performance obligations in the contract:

- ▶ Software license
- ▶ Installation service
- ▶ Software updates
- ▶ Technical support

### EXAMPLE 3-11 (ADAPTED FROM ASC 606-10-55-146 THROUGH 55-150): SOFTWARE DEVELOPMENT CONTRACT — SIGNIFICANT CUSTOMIZATION IS PROVIDED

Consider the same fact pattern in Example 3-10, except that the contract requires the software developer, as part of the installation service, to substantially customize the software to add significant new functionality to enable the software to interface with other customized software applications used by the customer. Other competitor entities can provide the customized installation service.

#### Capable of Being Distinct

For the same reasons in Example 3-10, the software developer concludes that the software license, installation service, software updates, and technical support are each capable of being distinct.

#### Distinct in the Context of the Contract

The software developer then considers the following:

- ▶ The contractual terms 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 software developer is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) in accordance with the customer's specifications.
- ▶ The software is significantly modified and customized by the installation service.

Consequently, the software developer determines that the promise to transfer the software license is not separately identifiable from the customized installation service and they are not distinct in the context of the

contract. Therefore, the software license and the customized installation service are combined into a single performance obligation.

Based on the same analysis as in Example 3-10, the software developer concludes that the software updates and technical support are distinct from the other promises in the contract.

Therefore, the software developer concludes that there are three performance obligations in the contract:

- ▶ Software customization (comprised of the software license and the customized installation service)
- ▶ Software updates
- ▶ Technical support

### 3.3.3 Firmware



#### FASB REFERENCES

ASC 606-10-55-56(a)

Many consumer products include embedded software that is required for the product to function as intended. This type of software is often called firmware. A license that forms a component of a tangible good and is integral to the functionality of the good is not distinct from the good. In that case, the tangible good and license are accounted for as a single performance obligation. As a result, a firmware is typically combined with the related product and accounted for as a single performance obligation.

In a growing number of instances, an entity may also provide functionality related to a consumer product through a mobile application that is made available for free. An entity needs to determine whether:

- ▶ The application is integral to the functionality of the product and is thus combined with the product and firmware as a single bundled performance obligation
- ▶ The application represents incremental functionality that is a distinct performance obligation

Consider the following examples:

#### EXAMPLE 3-12: HARDWARE WITH EMBEDDED FIRMWARE AND MOBILE APPLICATION

A medical device entity sells a blood glucose monitor. When purchasing a monitor, a customer also receives a limited license to the firmware that is embedded on the monitor and without which it cannot determine blood glucose levels as promised. In addition, the entity makes available a mobile application that the customer can download for free onto a mobile device to use with the monitor.

The blood glucose monitor includes a user interface, which, when used properly, visually reports blood glucose levels of the user. The mobile application provides more functionality, including wirelessly syncing to the monitor to receive measurements, storing the measurements, and predicting when a user may experience high or low measures based on that history.

The medical device entity concludes that the embedded firmware is a component of the blood glucose monitor and is integral to its functionality. As such, the license is not capable of being distinct.

The medical device entity then considers whether the mobile application is capable of being distinct from the blood glucose monitor. The entity concludes that the blood glucose monitor is capable of being distinct because a user can obtain the promised benefit of determining blood glucose levels without downloading the mobile application. In addition, because the mobile application can be used in conjunction with other resources that a customer already owns, namely the blood glucose monitor, it is also capable of being distinct from the monitor.

The medical device entity then determines whether the mobile application is distinct in the context of the contract. The entity notes that while the mobile application is dependent upon the blood glucose monitor, the monitor is not dependent upon the mobile application. That is, the interdependency between the mobile application and the monitor is not bi-directional. In addition, neither the mobile application nor the monitor modifies or customizes the other, and the entity does not perform a significant service of integrating the monitor and mobile application into a combined output.

Therefore, the medical device entity concludes that the mobile application is distinct from the blood glucose monitor.

Note that the medical device entity must evaluate whether the mobile application is a functional IP license that is generally satisfied at a point in time. See Section 7.5 for discussion on IP licenses and related revenue recognition considerations.

#### EXAMPLE 3-13: HARDWARE WITH EMBEDDED FIRMWARE AND MOBILE APPLICATION

Assume the same fact pattern as in Example 3-13 except the blood glucose monitor does not include a user interface. Instead, it automatically delivers the measurements wirelessly to the mobile application. A user must utilize the mobile application to receive the blood glucose measurement taken by the monitor. The mobile application also provides tracking and charting of historical measurements, and predictive analysis based on that history.

Consistent with Example 3-13, the medical device entity concludes that the firmware is not distinct from the blood glucose monitor.

However, in this example, the medical device entity concludes that the mobile application is also not capable of being distinct. Specifically, the blood glucose monitor cannot function as intended by a user without the mobile application, because the mobile application is the only mechanism by which the user can obtain his or her blood glucose measurements. Therefore, the entity concludes that it has a single performance obligation consisting of the blood glucose monitor, the firmware, and the mobile application.

Note that the medical device entity must evaluate whether the mobile application is a functional IP license that is generally satisfied at a point in time. Presuming the application is a functional IP license that is always available on an application store for the customer to download, the application is generally considered to be delivered at the same time as the hardware and firmware. See Section 7.5 for discussion on IP licenses and related revenue recognition considerations.

### 3.3.4 Combining a Good or Service With Other Promised Goods or Services



#### FASB REFERENCES

ASC 606-10-25-22

If a good or service is not distinct, an entity must 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, this may result in an entity accounting for all the goods or services promised in a contract as a single performance obligation.

### 3.3.5 Application of Step 2 for Concurrently Satisfied Performance Obligations

ASC 606 does not specify the accounting for concurrently delivered distinct goods or services that have the same pattern of transfer. Based on the FASB's observation in BC116 of ASU 2014-09, an entity is not precluded from accounting for the goods or services in a contract that are delivered concurrently as if they were a single performance

obligation if the outcome is the same as accounting for the goods and services as individual performance obligations. See Chapter 6 for discussion on the pattern of transfer of a good or service.

### **BDO INSIGHTS – MODIFICATION OF A CONTRACT THAT INCLUDES CONCURRENTLY SATISFIED PERFORMANCE OBLIGATIONS**

Even if a contract includes multiple performance obligations that are satisfied concurrently and could practically be accounted for as a single performance obligation, an entity is required to correctly identify separate performance obligations in the original contract if that contract is modified. This is because accounting for a contract modification is based on, among other things, whether a promised good or service is distinct (and therefore a performance obligation) and whether a performance obligation in a contract has been satisfied before the modification date. Those considerations affect the amount and timing of revenue recognized at or after the modification date. See Section 7.3 for discussion on accounting for contract modifications.

Identifying performance obligations and accounting for contract modifications requires the application of professional judgment, based on the facts and circumstances.

## **3.4 SERIES OF DISTINCT GOODS OR SERVICES**



### **FASB REFERENCES**

ASC 606-10-25-14 through 25-15 and ASC 606-10-55-157B through 55-157E

A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer are considered one performance obligation in the contract for applying the five-step revenue recognition model. A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

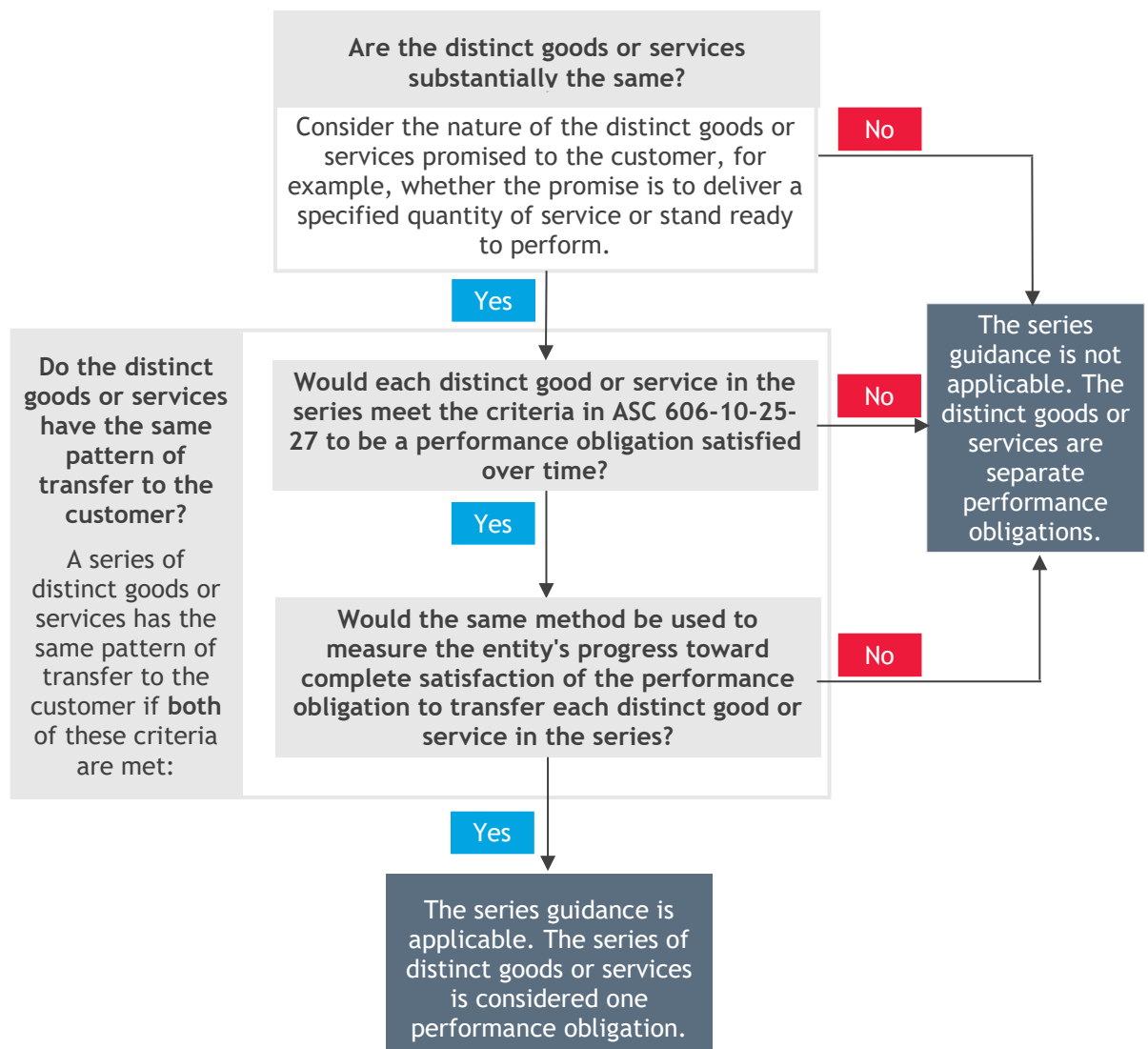
- ▶ Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in ASC 606-10-25-27 to be a performance obligation satisfied over time.
- ▶ The same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

See Chapter 6 for discussion on whether a performance obligation is satisfied over time and measurement of an entity's progress towards satisfying its performance obligation.

In determining whether the series guidance is applicable, an entity must first determine the nature of the goods or services promised to the customer before assessing whether the promised services are distinct and substantially the same. In some cases, this analysis may include determining whether the promise is the actual delivery of a specified quantity of service or the act of standing ready to perform.

The following diagram gives an overview of the guidance for determining whether the series guidance is applicable:





The series guidance was included as part of the definition of performance obligation to simplify the application of the five-step revenue recognition model and to promote consistency in the identification of performance obligations in circumstances in which the entity provides the same good or service repeatedly over a period of time. An entity may provide the same good or service repeatedly over a period of time, for example, in a repetitive service contract, such as a cleaning contract, transaction processing contract, or a contract to deliver electricity. If the series guidance were not included in the definition of performance obligation, an entity would be required to identify multiple distinct goods or services (or separate performance obligations), allocate the transaction price to each of the resulting performance obligations based on its standalone selling price (SSP), and recognize revenue when (or as) those performance obligations are satisfied. For example, an entity would be required to allocate the overall consideration to each incremental hour of cleaning in a cleaning contract. The series guidance was included to provide a cost-effective and more operable approach to apply the five-step revenue recognition model when an entity provides a series of distinct goods or services that are substantially the same.

When the contract includes a promise to transfer a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer, an entity identifies a single performance obligation and allocates the transaction price to that performance obligation. The entity then recognizes revenue by applying a single measure of progress to that performance obligation. See Chapter 6 for discussion on the pattern of transfer of a performance obligation (over time or point in time) and measure of progress when a performance obligation is satisfied over time.



In assessing whether multiple goods or services are treated as a series, it is not necessary that:

- ▶ The goods or services be transferred consecutively
- ▶ The accounting result from applying the series guidance be substantially the same as would result from accounting for each promised good or service as a separate performance obligation

**EXAMPLE 3-14 (ADAPTED FROM ASC 606-10-55-157B THROUGH 55-157E): SERIES OF DISTINCT GOODS OR SERVICES – SUBSTANTIALLY THE SAME**

A hotel manager contracts with a customer to manage a customer-owned property for 20 years. The hotel manager receives a monthly payment that is equal to 1% of the revenue from the customer-owned property.

The hotel manager evaluates the nature of its promise to the customer and determines that it has promised to provide a hotel management service. That service consists of 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 hotel manager concludes that each increment of the promised service (for example, each day of the hotel management service) is distinct because:

- ▶ The customer can benefit from each day of the hotel management service on its own (that is, each increment of service 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.

**Is each increment of service substantially the same?**

The hotel manager considers that although the underlying tasks or activities it performs to provide hotel management services may vary from day to day, the nature of its promise to its customer is the same each day, which is to provide hotel management services. Therefore, the hotel manager concludes that the hotel management services provided each day are substantially the same.

To determine whether the series guidance is applicable, the hotel manager would determine whether each distinct increment of service has the same pattern of transfer. See Chapter 6 for discussion on whether a performance obligation is satisfied over time and measurement of an entity's progress towards satisfying its performance obligation.

**EXAMPLE 3-15: R&D SERVICES – APPLICABILITY OF THE SERIES GUIDANCE**

A biotechnology entity enters a contract with a customer, Big Pharma, to provide R&D services to develop a new drug compound. The R&D services are to be provided in various phases covering the initial development, trials, and regulatory approvals. Each subsequent phase is dependent on the successful completion of the prior phase.

The biotechnology entity evaluates the nature of its promise to Big Pharma to determine whether the R&D activities performed each day represent a series of distinct increments of time or service. The entity observes that:

- ▶ The nature of its promise is to provide R&D services each day, which are comprised of various activities that may vary each day.
- ▶ Each day's research and related results are dependent on or interrelated with the prior day's research. Therefore, each day of R&D services builds on and is interrelated with the other days of services.

The biotechnology entity determines that while the underlying activities may differ from day to day, its promise is the same for each day, which is to provide R&D services. Additionally, the nature of its promise is cumulative such that each increment of time or R&D service builds on and is dependent on the preceding increments of time or R&D

service. Therefore, the entity determines that an increment of time or service is not distinct, and the series guidance is not applicable.



## TRG DISCUSSIONS – SERIES GUIDANCE – SUBSTANTIALLY THE SAME

### How should an entity evaluate whether the performance obligation consists of distinct goods or services that are substantially the same?

To be considered a series of goods or services, there must be two or more goods or services that are distinct, and each distinct good or service must also be considered substantially the same. The first step is to determine the nature of an entity's promise in providing the goods or services to the customer. In some cases, an entity would need to determine if the nature of the promise is the actual delivery of a specified quantity of service or the act of standing ready to perform. This evaluation will require significant judgment. See the related TRG discussions below in this section.

The TRG considered the FASB's intention that a series could consist of distinct time increments (an hour of cleaning) or the good or service delivered (each unit of electricity), depending on the nature of the promise. Therefore, an entity should consider the following in applying the series guidance:

#### Is each time increment distinct?

- ▶ If the nature of the entity's promise is the act of standing ready or providing a single service for a period of time (that is, because there is an unspecified quantity delivered), the evaluation would likely focus on whether each time increment, rather than the underlying activities, are distinct and substantially the same.
  - For example, in Example 3-14, nature of the hotel manager's promise is to provide a daily management service, and not a specified quantity of services, which could include management of the hotel employees, accounting services, training and procurement. While the underlying activities could significantly vary within a day and from day to day, that would not be relevant to the evaluation of the nature of the promise. In that example, the hotel management performance obligation is a series of distinct days of service.

#### Is each unit of output distinct?

- ▶ If the nature of the promise is the delivery of a specified quantity of a service, then the evaluation should consider whether each service is distinct and substantially the same.
  - ASC 606-10-55-160 illustrates an annual contract to provide monthly payroll processing services that are considered a series. In that contract, the nature of the promise is to deliver 12 distinct instances of the service, rather than a promise to stand ready to perform an undefined number of tasks.



## TRG DISCUSSIONS – SERIES GUIDANCE – STAND-READY OBLIGATIONS

### What is the nature of the promise to the customer in arrangements described as stand-ready obligations?

ASC 606-10-25-18 provides examples of promised goods or services, one of which is a 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. If the goods or services provided meet the criteria in ASC 606-10-25-27 to be performance obligations that are satisfied over time and have the same pattern of transfer (see Chapter 6 for discussion on assessing timing and

pattern of revenue recognition), then a stand-ready obligation will generally meet the definition of a series and be accounted for as a single performance obligation. However, determining whether the promise to the customer is a stand-ready obligation can require significant judgment.

In January 2015, the TRG addressed this question by considering certain types of promises (Types A-D) and discussing whether the nature of the good or service underlying the promises is the act of “standing ready,” or the actual delivery of the underlying goods or services that the entity stands ready to provide to the customer.

**Type A:** Obligations in which the delivery of the good, service or IP underlying the obligation is within the control of an entity, but the entity must still further develop its good, service or IP. For example, a software entity’s promise to transfer unspecified software upgrades at the entity’s discretion, or a pharmaceutical entity’s promise to provide when-and-if-available updates to previously licensed IP to a drug formula based on advances in R&D.

**Type B:** Obligations in which the delivery of the underlying good or service is outside the control of the entity and the customer. For example, an entity’s promise to remove snow from an airport’s runways in exchange for a fixed fee for the year.

**Type C:** Obligations in which the delivery of the underlying good or service is within the control of the customer. For example, an entity’s promise to provide periodic maintenance, when-and-if needed, on a customer’s equipment after a specified amount of usage by the customer.

**Type D:** Making a good or service available to the customer continuously, for example, a health club membership.

In arrangements, such as in Type B, C, or D, in which an entity provides uncertain goods or services (for example, while the entity knows it will provide maintenance services, it does not know the number of service calls it will make or the parts it will be required to fix), the entity provides a service to the customer in “standing ready” to perform.

Promises such as those in Type A (for example, to provide when-and-if available updates or upgrades in software or biotechnology IP licensing arrangements) may require additional analysis to determine the nature of the promise because the entity itself, rather than the customer or external events, might unilaterally control when updates or upgrades become available for transfer to the customer. However, the nature of the entity’s promise in Type A arrangements may be similar to those in Types B through D arrangements because an entity often will not be able to predetermine the timing, number, or specific functionality or features of major IP improvements that will be completed in the future and made available for transfer to a customer. For example, a biotechnology entity likely cannot unilaterally determine when its scientists will make an R&D advancement for a drug formula. Similarly, a software entity might have no major update or upgrade available for release during a contract period, especially if the contract period is relatively short (for example, one year). In those examples, an entity’s performance on a Type A arrangement, such as a when-and-if available upgrade right might, similar to those obligations in Types B through D arrangements, be dependent upon events or circumstances that are largely outside the entity’s control.

Additionally, similar to the obligations in Types B through D arrangements, a Type A promise to unspecified when-and-if available upgrades is also often about the customer obtaining assurance that it will have access to future improvements to the product it has obtained, thus, providing the customer with a guarantee against obsolescence or defects in that product. In the software license example, this guarantee provides a benefit to the customer by protecting the customer’s investment in the software (which may include, for example, an expensive implementation that would not be recovered economically if the customer had to implement a new software in the near future) or the customer’s related business interests (for example, a customer that embeds the software in its own products might want assurance that it will have access to upgrades of the software so that its products remain competitive in the marketplace). Absent the right to unspecified upgrades, the entity might charge the customer exorbitant fees in a separate negotiation for the next version of the software or might enter an exclusive arrangement with another customer that restricts the customer’s ability to obtain the upgrades.

In determining the nature of its promise to a customer in a Type A arrangement, an entity must carefully evaluate whether it has promised one or more specified upgrades to a customer even if the contract refers only to unspecified upgrades that will be transferred to the customer only when-and-if they become available. A promise to deliver a specified upgrade is accounted for in the same manner as any other specifically promised good or service. For example, a promise to deliver a specified upgrade to a software license is evaluated in the same manner as any other software license.

#### EXAMPLE 3-16: SOFTWARE-AS-A-SERVICE WITH USAGE-BASED PRICING

A technology entity enters a contract to provide a customer access to its software-as-a-service (SaaS) platform for two years. The customer will have the ability to process 100,000 transactions each year through the SaaS platform. The customer is required to make annual payments of \$120,000 each year. If needed, the customer is able to process transactions beyond the annual volume of 100,000 transactions but is charged for the incremental transactions at a higher rate. The entity does not expect the customer to exceed 100,000 transactions per year.

The technology entity evaluates the nature of its promise to determine whether it has an obligation to provide:

- ▶ A specified amount of services (that is, 100,000 transactions per year processed through SaaS) where each transaction is distinct and substantially the same
- ▶ A stand-ready obligation, comprised of distinct increments of time, to provide SaaS to process all transactions if and when required by the customer

The technology entity determines that it has a stand-ready obligation to provide SaaS for the entire contractual period, regardless of the amount of services specified in the contract or expected to be sold. In making that determination, the entity considers the following:

- ▶ The customer benefits from the right to access the SaaS platform and process transactions in the amount and at the time as needed. The entity stands ready to perform throughout the contract duration.
- ▶ The entity is unable to predetermine the timing and volume of transactions and its performance is dependent upon events or circumstances that are outside its control.
- ▶ The entity stands ready to process unlimited transactions. While transactions that exceed the annual volume are billed at a premium price, the customer does not have to separately contract for the right to transact those volumes. The entity's obligation to the customer does not diminish as transactions are processed. Selling a specified volume at a fixed price and overages on a variable basis is a pricing strategy rather than determinative of the entity's obligations to the customer.



#### TRG DISCUSSIONS – SERIES GUIDANCE – CONSECUTIVE DELIVERY OF GOODS OR SERVICES

##### To apply the series provision, must the goods be delivered, or services performed consecutively?

No. In March 2015, the TRG considered whether the series guidance applies when there is a gap or an overlap in the entity's delivery of goods or performance of services and generally agreed with the FASB staff that whether the goods or services are delivered or performed consecutively is not a determinative factor in assessing whether the series guidance is applicable. While an entity may consider the pattern of performance in determining the measure of progress towards satisfying a performance obligation, the consideration of whether the pattern of performance is consecutive or not is not explicitly required in the series guidance.

Both of the following fact patterns are accounted for as single performance obligations in accordance with the series guidance:

**Case A:** An entity contracts with a customer to provide a manufacturing service in which it will produce 10,000 units of a product every month for a two-year period. The entity will perform the service evenly over the two-year period with no breaks in production. The entity does not incur any significant upfront costs to develop the production process. The units produced are substantially the same and manufactured to the specifications of the customer.

Assume that the entity's manufacturing service of producing each unit is a distinct service. Additionally, the service is accounted for as a performance obligation satisfied over time (see Chapter 6) because:

- ▶ The units are manufactured specific to the customer (that is, the entity's performance does not create an asset with alternative use to the entity).
- ▶ If the contract is cancelled, the entity has an enforceable right to payment (cost plus a reasonable profit margin).

Therefore, the criteria to apply the series guidance have both been met.

**Case B:** Assume the same facts in Case A, except that the entity does not plan to perform evenly over the two-year service period. That is, the entity does not produce 10,000 units each month, continuously. Instead, the entity plans to perform the manufacturing service over the two-year period, but in achieving the production targets, the entity produces 20,000 units in some months and zero units in other months.

Despite the lag in manufacturing service, each unit comprises a series because ASC 606 does not require consecutive performance of a service.



## TRG DISCUSSIONS – SERIES GUIDANCE – ASSESSING ACCOUNTING OUTCOME

**To apply the series guidance (that is, to account for multiple distinct goods or services comprising a series as a single performance obligation), does the accounting result need to be the same as if the underlying distinct goods or services each were accounted for as separate performance obligations?**

No. The TRG discussed this issue in March 2015 and generally agreed that the series guidance does not include a requirement to assess whether the accounting outcome of applying the series guidance would be the same as the outcome of accounting for each distinct goods or services underlying the series as a separate performance obligation.

The TRG stated that requiring entities to compare revenue recognition patterns in a “with and without” type manner would be onerous and negate the FASB's intent in establishing the series guidance, which was to simplify the accounting and make it more operational. A requirement to prove whether application of the series guidance results in a difference in the revenue recognition result would be counter to that objective. Therefore, the application of the series guidance does not require an entity's revenue recognition to be substantially the same with or without the series provision.

## BDO INSIGHTS – SERIES GUIDANCE IS MANDATORY IF APPLICABLE

Although the series guidance simplifies the application of ASC 606 in many situations, it is not a practical expedient that entities have a choice of applying. Rather, it is mandatory if the criteria for its application are met. Therefore, entities need to carefully consider whether the series guidance is applicable, in particular, to repetitive service contracts or contracts involving the delivery of a quantity of similar items that are not all delivered at the same

time, but repeatedly over the contractual period. See Chapter 6 for discussion on the pattern of transfer of a performance obligation.

Determining whether the series guidance is applicable requires the application of professional judgment, based on the facts and circumstances.



### EFFECT OF THE SERIES GUIDANCE ON OTHER ASPECTS OF ASC 606

There are three primary areas in which the accounting treatment may vary when a promise is a single performance obligation comprised of a series of distinct goods or services, rather than a single performance obligation comprised of goods or services that are not distinct from each other:

- ▶ **Changes in transaction price** (see Section 4.8) – ASC 606 requirements are applied differently in some cases to a single performance obligation comprised of non-distinct goods or services compared to a single performance obligation resulting from applying the series guidance.
- ▶ **Allocation of variable consideration** (see Section 5.5) – The amount of the variable consideration that is recognized for each reporting period could be different, as the standard requires an entity to allocate variable consideration solely to one or more distinct goods or services even if those goods or services form a single performance obligation.
- ▶ **Contract modifications** (see Section 7.3) – If the remaining undelivered goods or services are distinct (even if part of a single performance obligation under the series guidance), the entity will account for the modified contract on a prospective basis, whereas if the remaining goods or services are not distinct from those already provided, there will be a cumulative effect adjustment resulting from the modification.

## 3.5 WARRANTIES



### FASB REFERENCES

ASC 606-10-55-30 through 55-35

An entity may provide a warranty in connection with the sale of a good or service in accordance with the contract, the law or the entity's customary business practices. The nature of a warranty can vary significantly across industries and contracts. ASC 606 differentiates between assurance- and service-type warranties:

#### Service-type Warranty

A warranty that provides the customer with a service in addition to the assurance that the product will function in accordance with agreed-upon specifications.

For example, a customer could purchase an extended warranty that requires the original equipment manufacturer to repair the equipment if it stops working after the standard warranty period expires.

#### Assurance-type Warranty

A warranty that provides a customer with the assurance that the product will function in accordance with agreed-upon specifications.

For example, an equipment manufacturer may sell an equipment with standard warranty to cover any manufacturing defects for five years after purchase of the equipment by the customer. These are accounted for in accordance with the guidance on product warranties in ASC 460.



If a customer can purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a service-type warranty accounted for as a separate performance obligation. That warranty represents a distinct service that the entity promises to provide to the customer in addition to the product that has the functionality described in the contract.

Even if a warranty is not sold separately, an entity evaluates whether the warranty, or a part of the warranty, provides the customer with a service in addition to an assurance that the product complies with agreed-upon specifications (that is, an assurance component). In assessing whether a warranty provides a customer with a service in addition to the assurance component, an entity considers factors such as:

#### Whether the Warranty Is Required by Law

A law requiring an entity to provide a warranty indicates that the warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.

#### Length of the Warranty Coverage Period

A longer coverage period indicates that it is more likely that the promised warranty is a performance obligation because an entity is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

#### Nature of the Tasks That the Entity Promises to Perform

If an entity must perform specified tasks to provide the assurance that a product will function in accordance 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.

If a warranty, or a part of the warranty, does not provide a customer with a service in addition to the assurance that a product complies with agreed-upon specifications, then an entity must account for that warranty in accordance with the guidance on product warranties in ASC 460-10 on guarantees. However, 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 represents a service-type warranty, which is a separate performance obligation from the product. Therefore, an entity must allocate the transaction price to the product and the service-type warranty (see Chapter 5 for discussion on allocation of transaction price). Further, if an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, then the entity must account for both warranties as a single performance obligation distinct from the related product.

A law that requires an entity to pay compensation if its products cause harm or damage does not create a performance obligation. For example, if a laptop manufacturer sells laptops in a jurisdiction in which the law holds the laptop manufacturer liable for any damages that might be caused by a consumer using a product for its intended purpose, the legal requirements do not create a performance obligation. Similarly, an entity's promise to indemnify the customer for liabilities or damages arising from claims of patent, copyright, trademark, or other infringement by the entity's products does not create a separate performance obligation. Rather, an entity accounts for such obligations in accordance with ASC 450-20, *Contingencies – Loss Contingencies*.

#### EXAMPLE 3-17: LIFETIME WARRANTY

A manufacturer manufactures high-end, designer computer carrying cases. Each computer case comes with a lifetime warranty on parts and labor. The warranty covers any type of damage to the case, no matter what the cause.

Each contract likely includes both an assurance and service warranty because:

- ▶ There is no local law requiring the manufacturer to provide lifetime warranty on the cases.

- ▶ The length of time covered by the warranty covers the life of the case.
- ▶ The warranty covers damage beyond manufacturing defects.

The manufacturer devises an accounting policy, controls, and processes to:

- ▶ Identify the implicit assurance warranty period, and the likely period over which customers will benefit from the service warranty.
- ▶ Determine the portion of the transaction price that is allocable to the service warranty.
- ▶ Recognize the amount of revenue allocated to the service warranty over the anticipated period that customers will benefit from the implied service warranty.

Revenue recognition for the service warranty begins at the end of the assurance warranty period, unless the manufacturer concludes that it cannot reasonably separate the assurance warranty and the service warranty, in which case revenue recognition commences when control of the computer case transfers to the customer. See Chapter 6 for discussion on recognizing revenue when (or as) a performance obligation is satisfied.



## TRG DISCUSSIONS – WARRANTIES

In March 2015, the TRG discussed a fact pattern that included a lifetime warranty similar to Example 3-17. In discussing the fact pattern, the FASB staff considered the following two aspects of the guidance on warranties:

- ▶ If an entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation.
- ▶ A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation.

The FASB staff stated that the two aspects of the guidance on warranties must not be applied by analogy to warranties that are not required by law and that such an analogy disregards the nature of the promise given to the customer, the three factors in ASC 606 for determining whether a warranty is a performance obligation, and the overall facts and circumstances of the arrangement.

The FASB staff stated that while not determinative in isolation, the length of the warranty is an important consideration under ASC 606. Overall, an entity must not focus its assessment on when the fault in the product arises. Rather, an entity must evaluate if the substance of the warranty reflects an additional service, considering the promises made, and using the three factors in ASC 606 to assess whether the warranty is a performance obligation.

An evaluation of whether a warranty provides a service in addition to the assurance that the product complies with agreed-upon specifications requires judgment and consideration of the facts and circumstances.

## BDO INSIGHTS – WARRANTIES

An entity determines the amount of transaction price to be allocated to a separately priced extended warranty contract using a standalone selling price methodology, rather than simply using the contractually stated price (see Section 7.6.1 for a related discussion). Additionally, regardless of whether a warranty is separately priced, an entity determines whether a portion of the warranty represents a service warranty that must be accounted for separately. Reaching a conclusion about whether an entity is providing a service warranty, and if so, measuring the standalone selling price of that service warranty may require the application of professional judgment, based on the facts and circumstances.

Additionally, entities accrue the costs related to assurance warranties under ASC 460.



### 3.6 PRACTICAL EXPEDIENT FOR NONPUBLIC FRANCHISORS



#### FASB REFERENCES

ASC 952-606-25-2 through 25-4

ASC 952-606-20

A franchisor is defined as “*the party who grants business rights (the franchise) to the party (the franchisee) who will operate the franchised business.*”

During the implementation of ASC 606, private entity stakeholders in the franchise industry raised concerns about the cost and complexity of identifying performance obligations related to pre-opening services provided in a franchise agreement and determining the amount and timing of revenue recognition for initial franchise fees. The initial franchise fee is an upfront payment typically paid in a lump sum to a franchisor in exchange for establishing a franchise relationship, with the provision of varying levels of pre-opening services to the franchisee.

Under the prior industry-specific guidance in ASC 952, *Franchisors*, the initial franchise fee was recognized when the franchisor delivered the promised pre-opening services, which was typically when the franchise location opened. Under the five-step revenue recognition model in ASC 606, the franchisor must determine whether the pre-opening activities represent distinct performance obligations and, if so, evaluate the standalone selling prices for those performance obligations to determine the timing and amount of revenue recognition.

The FASB issued ASU 2021-02 to provide nonpublic franchisors with a practical expedient to account for certain pre-opening services as distinct from the franchise licenses when identifying performance obligations under ASC 606. The practical expedient simplifies the evaluation of whether pre-opening activities are distinct from the related franchise right. Application of this guidance directly or by analogy is prohibited for all other entities.

As a practical expedient, a nonpublic franchisor may account for the following pre-opening services as distinct from the promise to grant the franchise license:

- ▶ Assistance in the selection of a site
- ▶ Assistance in obtaining and preparing the facilities for their intended use, including related financing, architectural, engineering and lease negotiation services
- ▶ Training of the franchisee’s personnel or the franchisee
- ▶ Preparation and distribution of manuals and similar material about operations, administration and record keeping
- ▶ Bookkeeping, IT, advisory services, including setting up the franchisee’s records and advising the franchisee about income, real estate, and other taxes or about regulations affecting the franchisee’s business
- ▶ Inspection, testing, and other quality control programs

A franchisor that elects to use the practical expedient may elect an accounting policy to account for the bundle of pre-opening services as a single performance obligation, instead of evaluating whether each of the pre-opening services is distinct.

If a franchisor elects not to apply the practical expedient or the pre-opening services in the arrangement do not qualify for the practical expedient, the franchisor applies the general guidance on identifying performance obligations (see discussion in Sections 3.2 through 3.5).

**BDO INSIGHTS – PRACTICAL EXPEDIENT FOR NONPUBLIC FRANCHISORS MUST BE APPLIED CONSISTENTLY**

If elected, the practical expedient for nonpublic franchisors must be applied consistently to contracts with similar characteristics and in similar circumstances.

Since the expedient is only intended to simplify the application of Step 2 of the model, franchisors must apply the general guidance in ASC 606 for the remaining aspects of accounting for revenue, including allocating the transaction price and recognizing revenue. Specifically, there is no relief from determining the standalone selling price of the pre-opening services that are considered distinct. This assessment requires the application of professional judgment, based on the facts and circumstances. A franchisor cannot assume that the standalone selling price of the pre-opening services is equal to the amount of the initial franchise fee.

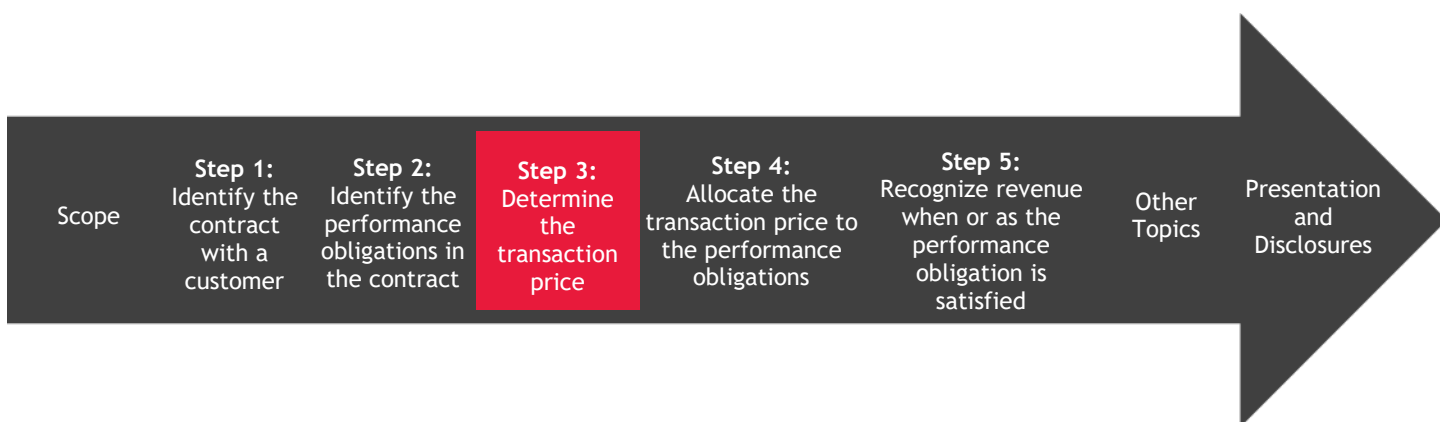
Additionally, although a franchisor can account for the distinct pre-opening services as a bundle, the determination of the standalone selling price for the bundle may not be easier than the determination for each of the services separately.

**BE CAREFUL BEFORE ELECTING AN EXPEDIENT FOR A NONPUBLIC ENTITY**

There is no transition relief if a nonpublic entity becomes a public business entity (as defined in U.S. GAAP). Therefore, the entity accounts for such a change in accordance with ASC 250, *Accounting Changes and Error Corrections*, and restates its financial statements without applying the nonpublic entity practical expedient, which can be complex and time consuming. An entity should carefully consider the likelihood of becoming a public business entity (including acquisition by an existing public business entity) before electing this alternative.



# CHAPTER 4 – STEP 3: DETERMINE THE TRANSACTION PRICE



## 4.1 OVERVIEW

After identifying the performance obligations in a contract in Step 2, an entity determines the transaction price for the contract. Determining the transaction price is a key step in the five-step revenue recognition model because the transaction price is the amount that an entity allocates to the performance obligations in a contract and ultimately recognizes as revenue when (or as) the performance obligations are satisfied.

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. Consequently, the objective in determining the transaction price is to ascertain the total amount of consideration to which the entity will be entitled from the contract. The transaction price is often the amount specified in the contract. However, determining the transaction price is more challenging if the contracts include variable consideration. ASC 606 requires an entity to estimate variable consideration initially at contract inception and to update that estimate at the end of each reporting period. The estimated amount of variable consideration is included in the transaction price only to the extent that it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty from the variable consideration is subsequently resolved. Additionally, in determining the transaction price for a contract, an entity is required to consider the contractual terms, the effect of customary business practices that may indicate that the entity will accept a lower amount than stated in the contract, noncash consideration, consideration payable to customer and any significant financing component.

The following diagram illustrates the key concepts in determining the transaction price in Step 3:



**BDO INSIGHTS – ESTIMATING VARIABLE CONSIDERATION**

ASC 606 requires entities to estimate variable consideration with limited exceptions. While estimating revenue reflects the principle in ASC 606 that the amount recognized in revenue closely depicts the transfer of control, it introduces uncertainty in the measurement of revenue. Estimating variable consideration requires the application of professional judgment, based on the facts and circumstances.

## 4.2 DETERMINING THE TRANSACTION PRICE

**FASB REFERENCES**

ASC 606-10-32-2 through 32-4

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. The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or consideration in a form other than cash. An entity considers the terms of the contract and its customary business practices to determine the transaction price.

The nature, timing, and amount of consideration promised by a customer affect the estimate of the transaction price and, therefore, an entity must consider the effects of all of the following in addition to the fixed consideration in the contract:

- ▶ Variable consideration
- ▶ Constraining estimates of variable consideration
- ▶ The existence of a significant financing component in the contract
- ▶ Noncash consideration, that is, an amount of consideration in a form other than cash
- ▶ Consideration payable to a customer by the entity

Although determining the transaction price requires several estimates about the future, the estimates are based on the goods and services to be transferred in accordance with the existing contract. Expectations about whether the contract will be cancelled, renewed, or modified are not considered when estimating the transaction price.

BC186 of ASU 2014-09 clarifies that the transaction price includes only amounts (including variable amounts) to which an entity has rights under the present contract. For example, the transaction price does not include an entity's estimates of consideration received from the future exercise of customer options for additional goods or services or from future change orders because until the customer exercises the option or agrees to the change order, the entity does not have a right to the related consideration.

In BC187 of ASU 2014-09, the FASB clarified that the amounts to which the entity has rights under the present contract can be paid by any party (that is, not only by the customer). For example, in the healthcare industry, an entity may determine the transaction price based on amounts to which it will be entitled to payment from the patient, insurance entities, or governmental organizations. This may also occur in other industries, for example, when an entity receives a payment from a manufacturer because the manufacturer issues coupons or rebates directly to the entity's customer or when an entity acts as an agent on behalf of another entity but collects the consideration from the end consumer (see Section 7.2 for discussion on principal versus agent assessment).

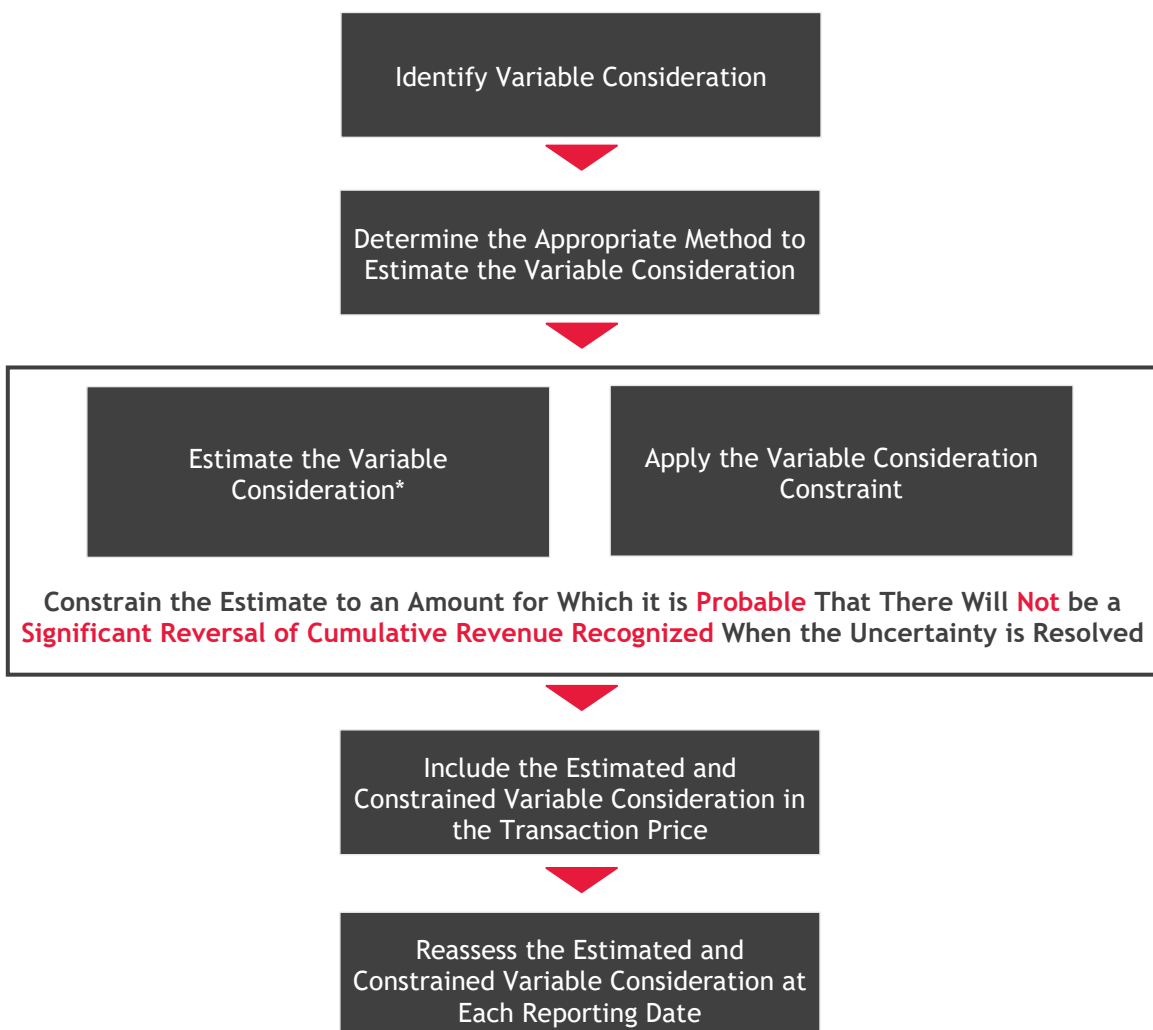
Amounts collected on behalf of another party (for example, some sales taxes) are not included in the transaction price.

### 4.2.1 Accounting Policy Election for Taxes

An entity may make an accounting policy election to exclude from the measurement of transaction price all taxes assessed by a taxing authority related to the specific transaction that are collected from the customer. Examples include sales, use, value added and some excise taxes. If an entity elects the policy, such tax amounts are presented net, that is, as reductions of the transaction price (or revenue) rather than as costs in the income statement. If an entity does not elect the policy, it must analyze each jurisdiction in which it operates to determine whether such amounts are included in or excluded from the transaction price.

## 4.3 VARIABLE CONSIDERATION

The following diagram provides an overview of the accounting considerations for variable consideration:



\*See Section 4.3.2 for the limited exceptions from estimating variable consideration.

### 4.3.1 Identifying Variable Consideration



#### FASB REFERENCES

ASC 606-10-32-5 through 32-7, ASC 606-10-55-194 and 55-195

Variable consideration can arise in any circumstance in which the amount of consideration to which the entity is entitled varies. An entity is required to estimate the amount of consideration to which it expects to be entitled in exchange for transferring the promised goods or services to a customer. Examples of common types of variable consideration that may exist in a contract with a customer include:

- ▶ Discounts
- ▶ Rebates
- ▶ Refunds
- ▶ Credits
- ▶ Price concessions
- ▶ Incentives
- ▶ Performance bonuses
- ▶ Penalties
- ▶ Other similar items
- ▶ Sales-or usage-based royalties

The consideration for a contract 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 is variable if a good is sold with a right of return or a fixed amount is promised as a performance bonus upon achievement of a specified milestone.

BC191 of ASU 2014-09 includes an example of a fixed-price service contract in which the customer pays upfront, and the terms of the contract provide the customer with a full refund of the amount paid if the customer is dissatisfied with the service at any time. In that example, the consideration is variable because the entity might be entitled to all of the consideration or none of the consideration if the customer exercises its right to a refund.

See Section 7.4.1.1 for a summary of the TRG discussions on whether a variable quantity of a good or service constitutes a customer's purchase option(s) or variable consideration.

#### 4.3.1.1 Implied Variable Consideration

Variability in consideration may be explicitly stated in a contract or implied based on an entity's customary business practices or other facts and circumstances surrounding the contract. That is, an entity must look beyond the contract between an entity and its customer to identify all forms of variable consideration. Variable consideration may be implied if either of the following conditions are met:

- ▶ **Customary Business Practices** – 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 contractually stated price. That is, the customer expects that the entity will offer a price concession. Based on the jurisdiction, industry or customer, this offer (or price concession) may be referred to as a discount, rebate, refund or credit.
  - In BC192 of ASU 2014-09, the FASB stated that in many cases, entities grant price concessions to enhance customer relationships or to encourage future sales to customers. For example, a manufacturing entity may grant a price concession to a retailer customer for goods that were previously sold to that retailer to enable the retailer to discount the goods and, therefore, more easily sell them to a third-party end consumer.
- ▶ **Other Facts and Circumstances** – Other facts and circumstances indicate that the entity's intention, when entering the contract with the customer, is to offer a price concession to the customer by accepting a lower amount of consideration than contractually stated.
  - BC193 of ASU 2014-09 includes an example in which an entity enters a contract with a new customer with a strategy to develop the customer relationship. In that case, although there may not be past evidence that the

entity will provide a price concession in future, there may be other factors that result in the entity concluding that it will accept a lower price than contractually stated.

#### EXAMPLE 4-1 (ADAPTED FROM ASC 606-10-55-194 AND 55-195): VARIABLE CONSIDERATION – PENALTY

A construction entity enters a contract with a customer to build an asset for \$2 million. The terms of the contract include a penalty of \$200,000 if the construction is not completed within four months of a date specified in the contract. The construction entity concludes that the consideration promised in the contract includes a fixed amount of \$1.8 million and a variable amount of \$200,000 arising from the penalty.

#### BDO INSIGHTS – PRICE CONCESSION VERSUS CREDIT RISK

Sometimes it may be difficult to determine whether an entity has offered a price concession or has chosen to accept the risk of the customer defaulting on the contractually agreed amount of consideration. In the development of ASC 606, the FASB stated that this judgment was already required in the prior revenue recognition guidance and decided not to include detailed requirements in ASC 606 for making the distinction between a price concession and an impairment of receivables.

When a customer does not pay the contractually stated amount, an entity must consider whether it is providing a price concession or has incurred bad debt expense. We believe if the entity continues to provide goods or services to the customer despite not collecting the contractually stated price related to prior performance, the entity may have offered a price concession. However, this determination requires the application of significant judgment, based on the facts and circumstances.

### 4.3.2 Estimating Variable Consideration



#### FASB REFERENCES

ASC 606-10-32-8 through 32-9, ASC 606-10-55-197 through 55-199

When the consideration promised in a contract with a customer includes a variable amount, an entity estimates the amount of variable consideration it expects to be entitled to in exchange for promised goods or services in the contract by using either of the following two methods:

- ▶ **The expected value** – The sum of probability-weighted amounts in a range of possible consideration amounts. It may be an appropriate estimate of the variable consideration if a contract includes a large number of possible outcomes or if an entity has many contracts with similar characteristics.
- ▶ **The most likely amount** – The single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). It may be an appropriate estimate of the variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).



#### SELECT A METHOD TO ESTIMATE VARIABLE CONSIDERATION

Selecting a method to estimate a variable consideration is not intended to be a free choice; rather, an entity must determine which method it expects to better predict the amount of consideration to which it will be entitled and apply that method consistently for similar types of contracts.

The expected value method (that is, the probability-weighted method) reflects all the uncertainties existing in the transaction price at the end of the reporting period and, therefore, best reflects the conditions that are present at the end of each reporting period. For instance, it reflects the possibility of receiving a greater amount of consideration as well as the risk of receiving a lesser amount. The expected value method could be used to predict the amount of consideration to which an entity will be entitled if the entity has many contracts with similar characteristics.

However, an expected value may not always faithfully predict the consideration to which an entity will be entitled. BC200 of ASU 2014-09 includes an example in which an entity is certain to receive one of the only two possible consideration amounts in a single contract. In those cases, the expected value would not be a possible outcome and, therefore, might not be relevant in predicting the amount of consideration to which the entity will be entitled. Rather, the most likely amount method identifies the individual amount of consideration in the range of possible consideration amounts that is more likely to occur than any other individual outcome.

Although an entity using the most likely amount method must consider all possible outcomes to identify the most likely one, in practice, the entity is not required to quantify the less probable outcomes. Similarly, in practice, estimating variable consideration under the expected value method (that is, probability-weighted method) does not require an entity to consider all possible outcomes using complex models and techniques even if an entity has extensive data and can identify many outcomes. In many cases, a limited number of discrete outcomes and probabilities can often provide a reasonable estimate of the distribution of possible outcomes for variable consideration in a contract.



#### INFORMATION CONSIDERED IN ESTIMATING A VARIABLE CONSIDERATION

An entity must consider all the information (historical, current, and forecast) that is reasonably available to the entity to identify a reasonable number of possible amounts of variable consideration. Typically, that information would be similar to the information that the entity's management used during the bid-and-proposal process and when it established prices for the promised goods or services.



#### CONSISTENT APPLICATION OF THE METHOD SELECTED TO ESTIMATE AN UNCERTAINTY

An entity applies one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity expects to be entitled.

However, this does not mean that an entity would need to use one method to measure each uncertainty in a single contract. Rather, an entity may use different methods for different uncertainties in a single contract.

#### EXAMPLE 4-2 (ADAPTED FROM ASC 606-10-55-197 THROUGH 55-199): VARIABLE CONSIDERATION – METHODS OF ESTIMATION

A construction entity enters a contract with a customer to build a customized asset. The contract includes the following terms related to pricing:

- ▶ The promised consideration is \$4 million.
- ▶ For each day after a specified date that the asset is incomplete, the promised consideration decreases by \$20,000.



- ▶ For each day before that specified date that the asset is complete, the promised consideration increases by \$20,000.
- ▶ Upon completion of the asset, if the asset receives a specified rating from a third-party inspector based on certain contractually defined metrics, the construction entity will be entitled to a bonus of \$300,000.

In determining the transaction price, the construction entity identifies two types of variable consideration in the contract:

- ▶ Variable consideration from the daily penalty or incentive for an amount of \$20,000
- ▶ Variable consideration from the bonus for an amount of \$300,000

The construction entity concludes the following regarding the appropriate method of estimating the two types of variable consideration in the contract:

- ▶ The expected value method is appropriate for estimating the variable consideration from the daily penalty or incentive (that is, \$4 million, plus or minus \$20,000 per day). The entity expects that method to better predict the amount of consideration to which it will be entitled because there is a range of possible outcomes dependent on how the variability is resolved.
- ▶ The most likely amount method is appropriate for estimating the variable consideration from the bonus because there are only two possible outcomes (\$300,000 or \$0). The entity expects the most likely amount method will better predict the amount of consideration to which it will be entitled because the outcome is binary, and a probability-weighted amount will not reflect either of the possible outcomes.

### **BDO INSIGHTS – LIMITED EXCEPTIONS FROM ESTIMATING VARIABLE CONSIDERATION**

While ASC 606 generally requires entities to estimate all variable consideration, there are a few exceptions:

- ▶ An entity does not estimate variable consideration if the variable consideration in the form of sales- or usage-based royalties in exchange for licenses of IP (in accordance with ASC 606-10-55-64 through 55-65B). This exception is explicitly limited to licenses of IP and cannot be applied to sales- or usage-based royalties in exchange for providing other goods or services, including SaaS. See Section 7.5.4 for related discussion.
- ▶ An entity does not estimate variable consideration if it applies the as-invoiced practical expedient to recognize revenue in accordance with ASC 606-10-55-18. See Section 6.4.2.1.1 for related discussion.
- ▶ An entity does not estimate variable consideration if the variable consideration allocation exception in ASC 606-10-32-40 applies (see Section 5.5) as follows:
  - A performance obligation will be satisfied in future and the variable consideration is allocated entirely to that performance obligation.
  - A series of distinct services is determined to be a series of distinct time increments and the variable consideration relates to the distinct services provided in the period in which it is earned.

Reaching a conclusion on whether any of the exceptions from estimating variable consideration is applicable requires the application of professional judgment, based on the facts and circumstances.

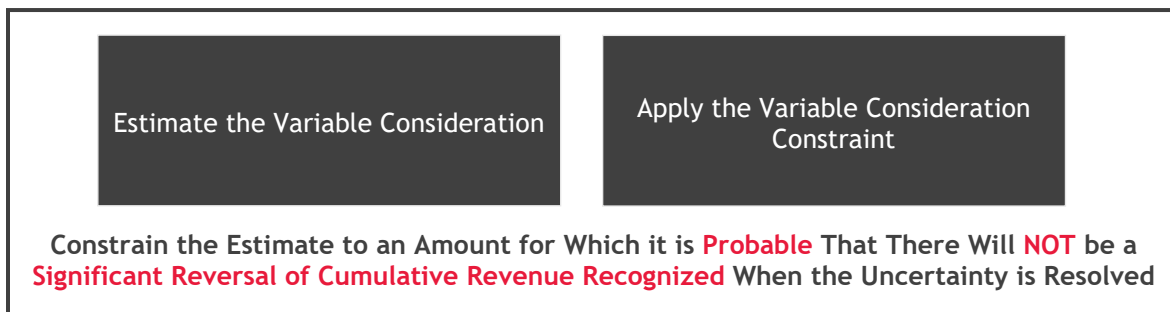
### 4.3.3 Constraining Estimates of Variable Consideration



#### FASB REFERENCES

ASC 606-10-32-11 and 32-12

Estimating the amount of variable consideration introduces uncertainty to the measurement of revenue. To reduce the possibility that variable consideration recognized in one reporting period is reversed in a subsequent period, the inclusion of an estimated amount of variable consideration in the transaction price is limited to the amount for which it is probable that there will not be a significant reversal of cumulative revenue recognized when the uncertainty from the variable consideration is subsequently resolved. This is known as the “variable consideration constraint.” The variable consideration constraint restricts revenue recognition by using measurement uncertainty as the basis for determining if (or how much) revenue to recognize.



The term “probable” is widely used and understood in practice and is defined in U.S. GAAP as “the future event or events are likely to occur” (ASC 450, *Contingencies*).

In assessing whether it is probable that a significant reversal of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity evaluates both:

- ▶ The likelihood of a revenue reversal
- ▶ The magnitude of the revenue reversal



#### ASSESSING THE PROBABILITY OF A SIGNIFICANT REVERSAL OF CUMULATIVE REVENUE RECOGNIZED

An entity must consider all facts and circumstances and use significant judgment when assessing the probability of a significant reversal of cumulative revenue recognized. Factors that may increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, the following:

- ▶ The consideration is highly susceptible to factors outside the entity’s influence, including:
  - Volatility in a market
  - The judgment or actions of third parties (for example, when the amount of variable consideration varies based on the customer’s subsequent sales)
  - Weather conditions
  - A high risk of obsolescence of the promised good or service
- ▶ Uncertainty regarding the amount of variable 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 either limited or 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.
- ▶ The contract has many possible variable consideration amounts.

In BC212 of ASU 2014-09, the FASB stated that the analysis an entity would undertake to determine the likelihood of whether a significant revenue reversal could occur would still be largely qualitative, and it did not expect an entity to prepare a quantitative analysis each time it performed that analysis.

In developing the variable consideration constraint guidance, the FASB's intention was not to eliminate the use of estimates, which are common and necessary in financial reporting, but rather to make sure that those estimates are robust and result in useful information.

The FASB decided to focus the variable consideration constraint on possible downward adjustments (that is, revenue reversals), rather than on all revenue adjustments (that is, both downward and upward adjustments), because users of financial statements indicated that revenue is more relevant if it is not expected to be subject to significant future reversals.

#### **BDO INSIGHTS – CONSTRAINING ESTIMATES OF VARIABLE CONSIDERATION**

When variable consideration has a wide range of potential outcomes (for example, from zero to \$100,000 depending on number of website visits), it is unlikely that the transaction price will be constrained to zero, because that outcome would be highly unlikely.

Additionally, when an entity applies the portfolio practical expedient to multiple similar contracts or performance obligations, it would be rare for variable consideration included in the transaction price to be fully constrained, because that would require an assumption that the outcome of every instance of uncertainty would be zero.

Regardless of whether an entity elects to use the portfolio practical expedient, we believe that an entity must consider its past experience with similar contracts with similar customers when determining the amount of variable consideration to be included in the transaction price, unless the experience with those past contracts is not reflective of the expected outcome of the current contract, which would be unusual.

The constraint may reduce the amount of variable consideration included in the transaction price to zero when the outcome is binary (for example, zero or \$100,000 bonus based on the achievement of a performance milestone), and significant uncertainty exists relating to the outcome.

In addition, in some instances the requirement to limit the estimated variable consideration to an amount that is not probable of being reversed could result in recognizing revenue in an amount that is less than an entity's best estimate. See Example 4-4 for an illustration.

Reaching a conclusion on whether and how much to constrain the estimate of variable considerations requires the application of professional judgment, based on the facts and circumstances.



#### **TRG DISCUSSIONS – VARIABLE CONSIDERATION AND CONSTRAINING ESTIMATE – IS THE CONSTRAINT APPLIED AT THE CONTRACT OR PERFORMANCE OBLIGATION LEVEL?**

Some contracts that include more than one performance obligation have both fixed and variable consideration. The TRG considered whether the requirement to constrain the recognition of any variable consideration should apply at the contract level or performance obligation level when the variable consideration has not been allocated

proportionately to all performance obligations in a contract. See Chapter 5 for discussion on allocation of consideration to performance obligations.

In January 2015, the TRG generally agreed that the constraint on variable consideration is applied at the contract level and not at the performance obligation level. This is because the unit of account for determining the transaction price in Step 3 is the contract.



### TRG DISCUSSIONS – PORTFOLIO PRACTICAL EXPEDIENT AND APPLICATION OF VARIABLE CONSIDERATION CONSTRAINT

In July 2015, the TRG discussed the application of the optional portfolio approach practical expedient (see Section 1.6 for related discussion) that allows entities to apply ASC 606 to a portfolio of contracts with similar characteristics instead of individual contracts. TRG members agreed that estimating the transaction price using the evidence obtained from other similar contracts ('portfolio of data') is different from applying the portfolio practical expedient.

One example of the practical effect of this distinction could be when an entity is developing an estimate of variable consideration for a single contract using the expected value method. The TRG conclusion means that the entity is not necessarily applying the portfolio practical expedient when considering historical data for other similar contracts. Therefore, there is no need to comply with the restriction on the use of the portfolio practical expedient, which is to conclude that there is a reasonable expectation that the effects on the financial statements from applying the guidance to a portfolio of contracts would not differ materially from applying the guidance to individual contracts within the portfolio.

The TRG also discussed the application of the variable consideration constraint, which limits revenue recognition to the amount for which it is probable that there will not be a significant reversal of revenue previously recognized when the uncertainty over the amount of revenue is resolved. TRG members discussed whether ASC 606 requires applying the constraint to a portfolio of contracts when a portfolio of data was used to estimate variable consideration or whether the constraint can be applied at an individual contract level. The TRG concluded that the approach followed is linked to whether the entity concludes that it should use the expected value approach or the most likely amount method when it estimates the transaction price. If an entity uses the expected value approach, then it would be consistent and appropriate to use the portfolio of data to estimate variable consideration. If the most likely amount method is followed, then a portfolio approach should not be used.

#### 4.3.4 Is Estimating Variable Consideration and Applying the Constraint a Two-Step Process?



#### FASB REFERENCES

ASC 606-10-32-8 and ASC 606-10-32-11

The variable consideration constraint guidance first requires an entity to estimate the consideration to which the entity will be entitled. The entity then assesses whether the objective of the variable consideration constraint guidance can be met – that is, by determining whether it is probable that a significant revenue reversal will not occur when the uncertainty from the variable consideration is subsequently resolved. If the entity determines that it is probable that the inclusion of its estimate will not result in a significant revenue reversal, that amount is included in the transaction price.

In BC215 of ASU 2014-09, the FASB stated that an entity would not be required to strictly follow those two steps if the entity's process for estimating variable consideration already incorporates the principles on which the guidance for constraining estimates of variable consideration is based. For example, an entity might estimate revenue from sales of goods with a right of return; a sale with a right of return creates variability in the transaction price – see Section 4.3.8 for related discussion. In that case, the entity might not practically need to estimate the expected revenue and then apply the constraint guidance to that estimate in a two-step process, if the entity's calculation of the estimated revenue incorporates the entity's expectations of returns at a level at which it is probable that the cumulative amount of revenue recognized would not result in a significant revenue reversal.

### 4.3.5 Sales-Based or Usage-Based Royalty for Licenses of IP

ASC 606 includes an exception from estimating and constraining variable consideration for variable consideration in the form of a sales-based or usage-based royalty that is promised in exchange for a license of IP. See Section 7.7 for discussion on licenses of IP and the exception from estimating variable consideration.

### 4.3.6 Reassessment of Variable Consideration



#### FASB REFERENCES

ASC 606-10-32-14

An entity must update the estimated transaction price (including its assessment of whether an estimate of variable consideration is constrained) at the end of each reporting period to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The estimated amount of variable consideration may change at each reporting date as more information becomes available and there is greater certainty about the expected amount of consideration. See Section 4.8 for discussion on accounting for changes in the transaction price.

#### EXAMPLE 4-3 (ADAPTED FROM ASC 606-10-55-208 THROUGH 55-212): PRICE CONCESSIONS – ESTIMATE OF VARIABLE CONSIDERATION IS NOT CONSTRAINED

An entity enters a contract with a customer, a retailer, on December 1, 20X1. The entity transfers 10,000 products at contract inception. Following are the pricing terms:

- ▶ The contractually stated price per product is \$20. That is, the total contractually stated price is \$200,000.
- ▶ The customer is obligated to make payments when the customer sells the products to the end customers.

The entity has past experience that the customer generally sells the products within 60 days of receiving them.

Based on its past practices and to maintain its customer relationship, the entity anticipates granting a price concession to its customer to enable the customer to discount the product and move it quickly through the distribution chain. Therefore, the entity determines that the consideration in the contract is variable even though the contract stipulates a fixed price.

The entity considers the following:

- ▶ It has significant experience selling this and similar products.
- ▶ The observable historical data indicates that the entity grants an average price concession of 25% of the sales price for these products.
- ▶ Current market information indicates that a 25% price concession will be sufficient to quickly move the products through the distribution chain
- ▶ The entity has not granted a price concession significantly greater than 25% in many years.

The entity decides to use the expected value method to estimate the variable consideration because the entity expects that method to better predict the amount of consideration to which it will be entitled. This is because

there is a range of possible outcomes for how the variability in pricing will be resolved. The entity estimates the transaction price to be \$150,000 ( $\$15 \times 10,000$  products) under the expected value method.

The entity considers the following to determine whether the estimated amount of variable consideration of \$150,000 can be included in the transaction price or must be constrained:

- ▶ It has significant previous experience with this product and current market information that supports its estimate.
- ▶ Despite some uncertainty resulting from factors outside its influence, the entity expects the price to be resolved within a short time frame based on its current market estimates.

Therefore, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, \$150,000) will not occur when the uncertainty regarding the total amount of price concessions is resolved. Consequently, the entity includes \$150,000 in the transaction price, recognizes revenue of \$150,000 when the products are transferred on December 1, 20X1 (see Chapter 6 for discussion on Step 5 on recognizing revenue) and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved.

#### **EXAMPLE 4-4 (ADAPTED FROM ASC 606-10-55-208 THROUGH 55-215): PRICE CONCESSIONS – ESTIMATE OF VARIABLE CONSIDERATION IS CONSTRAINED**

Consider the same fact pattern as in Example 4-3, with the following differences:

- ▶ While the entity has experience selling similar products:
  - The products have a high risk of obsolescence.
  - The entity is experiencing high volatility in the pricing of its products.
- ▶ The observable historical data indicates that the entity grants a broad range of price concessions ranging from 20% to 60% of the sales price for similar products.
- ▶ Current market information also suggests that a 15% to 50% reduction in price may be necessary to move the products through the distribution chain.

The entity decides to use the expected value method for the same reasons stated in Example 4-3. The entity estimates that a discount of 40% will be provided. Therefore, the estimated variable consideration is \$120,000 ( $\$12 \times 10,000$  products).

The entity considers the following to determine whether the estimated amount of variable consideration of \$120,000 can be included in the transaction price or must be constrained:

- ▶ The amount of consideration is highly susceptible to factors outside the entity's influence because of the risk of obsolescence.
- ▶ It is likely that the entity will be required to provide a broad range of price concessions to move the products quickly through the distribution chain.

As a result, the entity cannot conclude that it is probable that a significant reversal of cumulative revenue recognized will not occur if \$120,000 (that is, 40% discount on the sale price) is included in the transaction price. Therefore, the entity cannot include its estimate of \$120,000 in the transaction price. The entity considers the following:

- ▶ While the entity's historical price concessions have ranged from 20% to 60%, current market information suggests that a price concession of 15% to 50% will be necessary.
- ▶ An analysis shows that its 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 \$100,000 in the transaction price (that is, 50% discount on the sale price). Therefore, the entity includes \$100,000 in the transaction price, recognizes revenue of \$100,000 when the products are transferred on December 1, 20X1 (see Chapter 6 for discussion on Step 5 on recognizing revenue), and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved.

#### **BDO INSIGHTS – CONSTRAINING ESTIMATES OF VARIABLE CONSIDERATION IN EXAMPLE 4-4**

In Example 4-4, although the amount of revenue recognized when the products were transferred to the retailer was restricted due to the identified uncertainties, there was sufficient evidence to support the immediate recognition of a portion of the estimated transaction price. For entities in the early stages of their operations, particularly those operating in relatively new sectors, it is possible that application of the constraint will result in little, or no revenue being recognized on the date on which control over goods or services transfers to customers, with revenue recognition being postponed until a later date. However, in those circumstances, the inventory transferred to customers would be derecognized with an associated cost of sales at the point at which control passes to the customers. The estimate of variable consideration and appropriate constraint would then be reassessed at each reporting date, with a corresponding amount of revenue being recognized as appropriate in each period.

#### **EXAMPLE 4-5 (ADAPTED FROM ASC 606-10-55-216 THROUGH 55-220): VOLUME DISCOUNT INCENTIVE – RETROSPECTIVE REDUCTION**

An entity enters a contract with a customer on January 1, 20X1, to sell a product for \$10 per unit. The price per unit is retrospectively reduced to \$9 per unit, if the customer purchases more than 10,000 units of the product in a calendar year.

The entity determines that the consideration in the contract is variable because of the retrospective reduction in price per unit of the products sold to the customer.

##### **Constraining Estimates of Variable Consideration**

The entity sells 100 units of the product to the customer in the first quarter ended March 31, 20X1. On that date, the entity estimates that the customer's purchases will not exceed the 10,000-unit threshold required for the volume discount in the calendar year. The entity considers that it has significant experience with this product and the purchasing pattern of the customer. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, \$10 per unit) will not occur when the uncertainty regarding the total number of products purchased in that calendar year is resolved.

Therefore, the entity recognizes revenue of \$1,000 (100 units × \$10 per unit) for the quarter ended March 31, 20X1.

##### **Reassessment of Variable Consideration**

In April 20X1, the entity's customer acquires another entity and in the second quarter ended June 30, 20X1, purchases an additional 5,000 products. Considering the new fact, the entity estimates that the customer's purchases will exceed the 10,000-unit threshold for the calendar year and, therefore, it will be required to retrospectively reduce the price per unit to \$9.

Therefore, the entity updates its transaction price (and cumulative revenue recognized) to \$45,900 (5,100 units × \$9 per unit) to reflect the reduced price per unit of \$9 for the sale of 5,100 units.



The entity recognizes \$44,900 in the quarter ended June 30, 20X1. The amount is calculated as \$45,000 for the sale of the 5,000 units (5,000 units x \$9 per unit) less the change in transaction price of \$100 (100 units x \$1 price reduction per unit). See Section 4.8 for a discussion of changes in the transaction price.

**EXAMPLE 4-6 (ADAPTED FROM ASC 606-10-55-221 THROUGH 55-225): MANAGEMENT FEES SUBJECT TO THE CONSTRAINT**

An entity enters a contract with a customer to provide asset management services for four years in exchange for:

- ▶ A 2.5% quarterly management fee based on the customer's assets under management at the end of each quarter
- ▶ A performance-based incentive fee of 18% of the fund's return in excess of the return of an observable market index over the past four-year period.

The entity determines that both the management fee and the performance fee are variable consideration in the contract.

At contract inception, the entity observes that:

- ▶ The promised consideration in the contract is dependent on the market and, thus, is highly susceptible to factors outside the entity's influence.
- ▶ The incentive fee has many possible consideration amounts.
- ▶ 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 determines that it 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.

At each reporting date, the entity updates its estimate of the transaction price and concludes that:

- ▶ It can include the actual amount of the quarterly management fee in the transaction price because the uncertainty related to the market is resolved.
- ▶ It cannot include its estimate of the incentive fee for future periods in the transaction price at those dates because there has been no change in its assessment of the likelihood of significant revenue reversal since contract inception. That is, 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.

Note that the entity recognizes the quarterly management fee at the end of each quarter to which the fee relates (rather than over the four-year term). This is because the quarterly management fee relates to the distinct services provided during the corresponding quarter and the requirements in ASC 606-10-32-40 regarding an exception in allocating variable consideration are met – see Section 5.5 for discussion on that guidance.



### 4.3.7 Refund Liability



#### FASB REFERENCES

ASC 606-10-32-10

An entity must 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, those amounts are not included in the transaction price). The refund liability and corresponding change in the transaction price is updated at the end of each reporting period for changes in circumstances. An entity applies the guidance in Section 4.3.8 to account for a refund liability relating to a sale with a right of return.

### 4.3.8 Sale With a Right of Return



#### FASB REFERENCES

ASC 606-10-55-22 through 55-29

An entity may transfer control of a product to a customer and also grant the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive a full or partial refund of any consideration paid, another product in exchange, or a credit that can be applied against amounts owed, or that will be owed, to the entity.

An entity's promise to stand ready to accept a returned product during the return period is not accounted for as a performance obligation in Step 2. Rather, a sale with a right of return creates variability in the transaction price, and an entity must apply the guidance on estimating variable consideration (including the guidance on constraining estimates of variable consideration) to determine the amount of consideration to which the entity expects to be entitled (that is, excluding the products expected to be returned).

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 on sales with a right of return.

Additionally, contracts in which a customer may return a defective product in exchange for a functioning product are evaluated in accordance with the guidance on warranties. See Section 3.5 for discussion on accounting for warranties.

For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity does not recognize revenue when it transfers products to customers but rather recognizes those amounts received (or receivable) as a refund liability. Recognition of revenue is limited to the amount of consideration to which the entity expects to be entitled and therefore, amounts received for products expected to be returned are not recognized in revenue. The entity also recognizes an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

Subsequently, at the end of each reporting period, the entity must 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, of revenue recognized. In addition, an entity must also update the asset and adjustment to cost of sales representing its right to recover products upon settling the refund liability.

**EXAMPLE 4-7 (ADAPTED FROM ASC 606-10-55-202 THROUGH 55-207): RIGHT OF RETURN**

An entity enters 100 contracts with customers. Each contract includes the sale of one product for \$10 for a total consideration of \$1,000 (100 total products × \$10). Customers pay cash when control of a product transfers to the customer. The entity's customary business practice is to allow customers to return any unused product within 30 days for a full refund. The entity's cost of each product is \$6.

The entity applies the portfolio approach to the 100 contracts because it reasonably expects that the effects on the financial statements from applying a portfolio approach would not differ materially from applying the guidance to the individual contracts within the portfolio.

The entity determines that the consideration received from the customer is variable because the contract allows a customer to return the products.

The entity decides to use the expected value method to estimate the variable consideration, which is the method that it expects to better predict the amount of consideration to which it will be entitled because there is a range of possible outcomes for how the variability will be resolved. Using the expected value method, the entity estimates that 3 products will be returned, and 97 products will not be returned.

The entity also applies the guidance on constraining variable consideration to determine whether the estimated amount of variable consideration of \$970 (\$10 × 97 products) can be included in the transaction price. The entity determines that:

- ▶ Although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class.
- ▶ The uncertainty will be resolved within a short time frame because the return period is 30-days.

Therefore, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, \$970) will not occur as the uncertainty is subsequently resolved over the return period.

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

Upon transfer of control of the 100 products, the entity recognizes revenue of \$970 and does not recognize revenue for 3 products that it expects to be returned (see Chapter 6 for discussion on recognizing revenue). The entity records the following journal entries:

Debit	Cash	\$	1,000	\$10 × 100 products transferred to customers
Credit	Revenue		\$ 970	\$10 × 97 products not expected to be returned
Credit	Refund Liability		30	\$10 × 3 products expected to be returned

(Recognition of revenue and a refund liability for the payment received.)

Debit	Cost of Sales	\$	582	\$6 × 97 products not expected to be returned
Credit	Asset		18	\$6 × 3 products for which it has the right to recover products upon settling refund liability
Credit	Inventory		\$ 600	\$6 × 100 products transferred to customers

(Recognition of cost of sales for products not expected to be returned and an asset for the products expected to be returned.)

## 4.4 SIGNIFICANT FINANCING COMPONENT



### FASB REFERENCES

ASC 606-10-32-15 and 32-16

Some contracts with customers include a financing component, which may either be explicitly identified in the contract or implied by the contractual payment terms of the contract. A contract that has a financing component conceptually includes two transactions: one for the sale of goods or services, and one for the financing. For example, a construction entity may require a customer to pay in advance for a long-term construction contract because the construction entity requires funds to obtain materials to carry out the contract. In the absence of the advance payment from the customer, the construction entity would typically need to borrow the funds from another party (for example, banks). The construction entity would need to pay finance charges on those borrowings and would therefore be likely to recoup those borrowing costs from the customer through a higher transaction price. However, the fair value of the goods and services transferred to the customer would be the same, the only difference being the party extending the financing to the construction entity. The amount of the construction entity's revenue must not vary based on whether the construction entity receives financing from the customer or from a third party.

Therefore, the transaction price is adjusted for the effects of the time value of money if the timing of payments provides the customer or the entity with a significant benefit of financing the transfer of goods or services. In those circumstances, the contract contains a significant financing component, and adjustment to the transaction price is made to reflect this financing component in the contract.



### THE OBJECTIVE OF ADJUSTING THE CONSIDERATION FOR A SIGNIFICANT FINANCING COMPONENT

The objective of adjusting the promised amount of consideration in a contract for a significant financing component is for an entity to recognize revenue at an amount that reflects the price that a customer would pay for the promised goods or services if the customer pays cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price).

### 4.4.1 Identifying A Significant Financing Component



### FASB REFERENCES

ASC 606-10-32-16 and 32-17

An entity must consider all relevant facts and circumstances in assessing whether a financing component exists in a contract and whether that financing component is significant to the contract, including:

- ▶ The difference, if any, between the amount of consideration and the cash selling price of the goods or services
- ▶ The combined effect of both:
  - The expected length of time between when the entity transfers the goods or services to the customer and when the customer pays for those goods or services
  - The prevailing interest rates in the relevant market

**FACTORS TO DETERMINE THAT A SIGNIFICANT FINANCING COMPONENT DOES NOT EXIST**

Notwithstanding the above assessment, a contract with a customer does not include a significant financing component if any of the following factors exist:

- ▶ The customer has made advance payment for the goods or services and the timing of the transfer of those goods or services is at the discretion of the customer.
- ▶ A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that variable consideration varies based on the occurrence or nonoccurrence of a future event that is not substantially within the control of either the customer or the entity (for example, if the variable consideration is a sales-based royalty).
- ▶ 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 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 perform under the contract.

**4.4.1.1 Practical Expedient****FASB REFERENCES**

ASC 606-10-32-18

An entity may elect a practical expedient to not make adjustments for the effects of a significant financing component if, at contract inception, the entity expects that the period between when revenue is recognized for the transfer of the goods or services and the date of payment from the customer will be one year or less.

**BDO INSIGHTS – SIGNIFICANT FINANCING COMPONENT – PRACTICAL EXPEDIENT**

In some cases, an entity may be eligible to elect the practical expedient even if providing financing to its customers is a significant component of its revenue transactions. For example, consider a scenario in which an entity resells consumer products to low-credit quality customers at a high interest rate using extended payment terms that do not exceed one year. Even if the customer must make all payments within one year from the date revenue is recognized and the entity is thus eligible to elect the practical expedient, we believe the entity must consider whether the resulting financial reporting would provide the most relevant and useful information to users of its financial statements before electing the practical expedient. Entities must also consider the disclosure objective in ASC 606-10-50-1 and provide sufficient footnote disclosures about such arrangements – see Chapter 8 for discussion on disclosure requirements.

**EXAMPLE 4-8 (ADAPTED FROM ASC 606-10-55-227 THROUGH 55-232): SIGNIFICANT FINANCING COMPONENT AND RIGHT OF RETURN**

An entity sells a product to a customer for \$125, payable in 25 months after delivery. The customer obtains control of the product at contract inception and has the right to return the product within 90 days from delivery.

The cash selling price of the product is \$99 and the entity's cost of the product is \$75.

The entity observes the difference between the amount of promised consideration of \$125 and the cash selling price of \$99 at the date that the goods are transferred to the customer and thus determines that the contract includes a significant financing component. This is because the cash selling price differs from the promised consideration and no other factors indicate that this difference arises for reasons other than financing.

**EXAMPLE 4-9 (ADAPTED FROM ASC 606-10-55-233 AND 55-234): WITHHELD PAYMENTS ON A LONG-TERM CONTRACT**

A construction entity enters a contract for the construction of a building. The performance obligation will be satisfied over time (see Chapter 6 for discussion on satisfaction of performance obligations). The contract includes the following payment terms:

- ▶ The entity will receive scheduled milestone payments based on the performance by the entity throughout the contract term of two years.
- ▶ The milestone payments are scheduled to coincide with the entity's expected performance over the two-year contract term.
- ▶ A specified percentage of each milestone payment is withheld by the customer throughout the contract term and paid to the entity only when the building is complete. The withheld amounts are commonly known as retainage.

The construction entity concludes that the contract does not include a significant financing component because:

- ▶ The milestone payments coincide with the entity's performance.
- ▶ The contract requires retainage for reasons other than the provision of finance because the withholding of retainage is intended to protect the customer from the entity failing to adequately complete its obligations under the contract.

**TRG DISCUSSIONS — ANALYZING FINANCING COMPONENT WHEN THE PROMISED CONSIDERATION IS EQUAL TO THE CASH SELLING PRICE**

In March 2015, the TRG discussed whether the guidance that includes the objective for adjusting the promised amount of consideration for a significant financing component (ASC 606-10-32-16) implies that there is never a significant financing component when the amount of promised consideration is equal to the cash selling price. In certain industries, it may be common for the promised consideration and cash selling price to be equal. The following examples were considered:

- ▶ Example 1 — A customer can purchase a piece of equipment for \$1,200 and then will be eligible to purchase service for the equipment for \$100 each month under a month-to-month service contract. However, the customer could choose to pay zero for the equipment on day one and have the option to sign a note to pay \$1,200 over a 24-month period without an additional charge for interest and still pay \$100 each month for service.

- ▶ Example 2 – A furniture retailer offers a promotion for a \$2,000 dining set. Customers have the option to obtain 0% financing for three years as part of this special promotion or to pay the entire amount at the time of purchase.

While the list price of the goods is equal to the promised consideration in the contract in these examples, it is important to note that the list price might not always equal the cash selling price and a contract might have an implied interest rate that is different from a stated interest rate. For example, if a customer offers to pay cash upfront when the entity is offering “free” financing, the customer might be able to pay less than the list price. In other words, the true cash selling price might be less than the list price. This notion is consistent in concept with the guidance in ASC 606-10-32-32, which states that a contractually stated price or a list price for a good or service may be but should not be presumed to be the standalone selling price of that good or service.

If the list price, the cash selling price, and the promised consideration are all equal, an entity should not automatically assume that there is no significant financing component. The difference, if any, between the amount of promised consideration and the cash selling price is a factor (that is, it is one of two factors in ASC 606-10-32-16, not the only factor), not a presumption, in determining whether a significant financing component exists. An entity must consider all relevant facts and circumstances. Therefore, the one fact that the cash selling price is equal to the selling price in the contract would not be the totality of the assessment.

An entity must carefully evaluate whether the list price, the cash selling price, and the promised consideration are all, in fact, equal. If the list price, the cash selling price, and the promised consideration are all, in fact, equal, that might indicate that the contract does not include a significant financing component. However, that does not imply that a financing component cannot exist if list price, cash selling price, and promised consideration are equal.

Determining a “cash selling price” may require judgment. The fact that an entity provides “zero interest financing” does not necessarily mean that the cash selling price is the same as the price another customer will pay over time. An entity must consider the cash selling price as compared to the promised consideration in making the evaluation based on the overall facts and circumstances of the arrangement.

It is also possible that a financing component exists but is not significant. An entity is required to apply judgment in determining whether the financing component is significant or not.



## TRG DISCUSSIONS – FINANCING COMPONENT – OTHER ISSUES

In January and March 2015, the TRG discussed several questions about whether a contract includes a significant financing component.

TRG members agreed that there is no presumption in ASC 606 that a significant financing component exists when there is a difference in timing between when goods and services are transferred and when the promised consideration is paid. An entity needs to apply judgment to determine whether the payment terms provide financing or are for another reason. Many TRG members stated that significant judgment will be required in some circumstances to determine whether a transaction includes a significant financing component.

TRG members agreed that ASC 606 does not preclude accounting for financing components that are not significant in the context of the contract.

TRG members also stated that it may not always be clear if cash collected relates to a specific performance obligation. Therefore, judgment is needed to determine if the practical expedient related to significant financing component can be applied in scenarios in which there is a single payment stream for multiple performance obligations.

## 4.4.2 Accounting for a Significant Financing Component



### FASB REFERENCES

ASC 606-10-32-19 and 32-20

When the existence of a significant financing component is identified, an entity determines the discount rate. To meet the objective of adjusting the consideration in a contract for a significant financing component so that an entity recognizes in revenue the cash selling price of a good or service transferred, an entity uses 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 (which may include assets transferred in the contract). That rate may be determined 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. As an example, a lower than market interest rate might be granted as a sales incentive rather than because of the creditworthiness of the customer.

After contract inception, an entity does not update the discount rate for changes in interest rates or other circumstances (for example, a change in the assessment of the customer's credit risk). In BC243 of ASU 2014-09, the FASB stated that an entity should not update the discount rate for a subsequent change in circumstances because in the measurement of the transaction price, an entity should reflect only the discount rate that is determined at contract inception. This approach is consistent with valuing noncash consideration at contract inception (see Section 4.5).

#### EXAMPLE 4-10: ACCOUNTING FOR A SIGNIFICANT FINANCING COMPONENT

An entity enters a contract with a customer to build and supply a new machine. Control over the completed machine will pass to the customer after two years. (That is, the entity's performance obligation will be satisfied at a point in time after two years). The contract contains two payment options. Either the customer can pay \$5 million after two years when it obtains control of the machine, or the customer can pay \$4 million at contract inception.

The customer pays \$4 million at contract inception.

The entity considers the significant period of time between the date of payment by the customer and the transfer of the machine to the customer and the effect of prevailing market rates of interest. The entity concludes that there is a financing component, which is significant to the contract.

The interest rate implicit in the transaction is 11.8%. However, because the entity is effectively borrowing from its customer, the entity is also required to consider its own incremental borrowing rate, which is determined to be 6%.

The journal entries required are as follows:

#### At contract inception:

Debit	Cash	\$4,000,000	
Credit	Contract Liability		\$4,000,000

(Recognition of a contract liability for the payment in advance.)

#### Over the two-year construction period:

Debit	Interest expense	\$ 494,000	
Credit	Contract Liability		\$ 494,000

(Accretion of the contract liability at a rate of 6%.)



**At the date of transfer of the machine to the customer:**

Debit	Contract Liability	\$ 4,494,000	
Credit	Revenue		\$ 4,494,000

(Recognition of revenue upon the transfer of machine to the customer.)

**BDO INSIGHTS – SIGNIFICANT FINANCING COMPONENT**

To identify whether there is a significant financing component, an entity compares the timing of payment and the timing of transfer of control of the related goods or services. How and when the activities related to satisfying the performance obligation(s) are carried out is not relevant.

For example, when activities related to satisfying a performance obligation are performed over a period of time, but the revenue related to that performance obligation is recognized at a point in time (such as in Example 4-10), accounting for a significant financing component may be required. In other words, the fact that the activities are carried out over a period of time is not relevant when comparing the timing of payment to the point in time at which the good or service is transferred to the customer to determine whether a significant financing component exists. See Chapter 6 for discussion on whether revenue is recognized at a point in time or over time.

An entity must also consider whether interest expense arising from adjusting the transaction price for the effect of a significant financing component should be capitalized into the costs of particular assets in accordance with other U.S. GAAP (such as ASC 330, *Inventory*).

An entity presents the effects of financing (interest income or interest expense) separately from revenue from contracts with customers in the income statement. 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 – see Chapter 8 for discussion on presentation of contract assets, receivables, and contract liabilities.

Additionally, in accounting for the effects of the time value of money, an entity must consider the subsequent measurement guidance in ASC 835-30, *Interest – Imputation of Interest*, specifically the guidance in ASC 835-30-45-1A through 45-3 on presentation of the discount and premium in the financial statements and the guidance in ASC 835-30-55-2 and 55-3 on the application of the effective interest method.


**TRG DISCUSSIONS – FINANCING COMPONENT – CONTRACT INCLUDES MULTIPLE PERFORMANCE OBLIGATIONS**

In March 2015, the TRG acknowledged that calculating the adjustment of revenue in arrangements that contain significant financing components and determining how to apply the significant financing component guidance when there are multiple performance obligations may be complex in some scenarios. However, the standard provides a framework to address those issues. In calculating the impact of a significant financing component, ASC 606 provides guidance on selecting a discount rate and other U.S. GAAP provide guidance on subsequent accounting.

The TRG also agreed that it may be appropriate in some circumstances to attribute a significant financing component to one or more, but not all, of the performance obligations in the contract. Practically, this might be in a manner analogous to the guidance on allocating variable consideration or allocating a discount – see Chapter 5 for discussion on allocation of consideration.



## 4.5 NONCASH CONSIDERATION



### FASB REFERENCES

ASC 606-10-32-21 through 32-24

In some cases, an entity might enter a contract with a customer where the payment is in a form other than cash. The noncash consideration could be in the form of goods or services, a financial instrument (such as stock or warrants), or property, plant, and equipment. For example, an entity might accept shares of the customer's stock as payment.

An entity must measure noncash consideration at its estimated fair value at contract inception (that is, the date at which the five contract existence criteria in Step 1 are met) to determine the transaction price for contracts in which a customer promises noncash consideration. If an entity cannot reasonably estimate the fair value of the noncash consideration, the noncash consideration is measured 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.

### **BDO INSIGHTS – ESTIMATING FAIR VALUE OF NONCASH CONSIDERATION**

Estimating the fair value of the noncash consideration received in exchange for transferring goods or services could be challenging in certain circumstances, for example, when an entity receives shares in a private entity that is in a start-up stage. However, we believe it would be unusual for an entity to assert that it cannot reasonably estimate the fair value of the noncash consideration, especially if it is in the form of a financial instrument (for example, shares).

Once recognized, any asset arising from the noncash consideration is measured and accounted for in accordance with other relevant U.S. GAAP.

The fair value of noncash consideration may vary after contract inception because of the form of the consideration. For example, the price of a share received by an entity from a customer in exchange for transferring goods or services may change subsequently. 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 changes for reasons other than the form of the consideration (for example, the exercise price of a share option changes based on the entity's performance), an entity must apply the guidance on estimating and constraining variable consideration. If the reasons underlying the change in the fair value of noncash consideration include both the form of the consideration and reasons other than the form of the consideration, then an entity must apply the guidance on variable consideration only to the variability resulting from reasons other than the form of the consideration.

A customer might contribute goods or services to an entity (for example, a customer for a construction contract might supply materials, equipment, or labor, which the entity will use in performing the construction services). In those circumstances, an entity must assess whether it obtains control of the contributed goods or services. If so, those contributed goods or services are accounted for as noncash consideration received from the customer, and the contractual transaction price is increased by the estimated fair value of the noncash consideration. Similarly, the value of such contributed materials is included in the cost of the good or service, effectively resulting in a gross up of the income statement. If the entity does not obtain control of the contributed goods or services, then its estimated fair value is not included in the transaction price.

Entities must also consider whether contracts involving the receipt of noncash consideration represent contracts with customers and are thus within the scope of ASC 606. For example, ASC 606 does not apply to:

- ▶ Barter transactions in which two entities exchange nonmonetary items in the same line of business to facilitate sales to customers (see Chapter 1 for discussion on nonmonetary exchanges)
- ▶ Transactions in which an entity accepts a noncash item (for example, shares in a customer entity) in settlement of a debt owed to the entity

**EXAMPLE 4-11 (ADAPTED FROM ASC 606-10-55-248 THROUGH 55-250): ENTITLEMENT TO NONCASH CONSIDERATION**

An entity enters a contract with a customer on January 1, 20X1, to provide a weekly service for one year (that is, 52 weeks). Work begins immediately. The entity concludes that the service is a single performance obligation 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 (a time-based measure of progress)).

The customer promises 200 shares of its common stock for each week of service as the consideration for the services (that is, 10,400 shares for the contract). The contractual terms require that the shares must be paid upon the successful completion of each week of service.

To determine the transaction price (and, hence, the amount of revenue to be recognized), the entity measures the estimated fair value of 10,400 shares at contract inception on January 1, 20X1. The estimated fair value of 10,400 shares is the transaction price for the contract and is recognized in revenue as the services are transferred to the customer – see Chapter 6 for discussion on revenue recognition when (or as) a performance obligation is satisfied.

Any changes in the fair value of the 10,400 shares after contract inception is not reflected in the transaction price. Upon receipt of the shares, the entity applies other U.S. GAAP to determine whether and how any changes in fair value that occur after January 1, 20X1, is recognized.

**BDO INSIGHTS – NONCASH CONSIDERATION**

Because of the requirement to measure the fair value of noncash consideration at contract inception in determining the transaction price in Step 3, an entity may recognize a gain or loss in the income statement upon the initial recognition of the noncash consideration if the noncash consideration is received after contract inception. To illustrate, assume in Example 4-11 that the fair value of the shares changes after contract inception due to the form of the consideration. Assuming that the revenue recognition criteria are met when the shares are actually received (or become receivable) a week after contract inception, the entity will recognize the following at that date:

- ▶ Revenue measured using the fair value of the shares at contract inception (included in the transaction price)
- ▶ A financial asset for the shares at its then current fair value under ASC 321
- ▶ A gain or loss in the income statement for any changes in the fair value of the shares between contract inception and the date at which they are received (or become receivable)

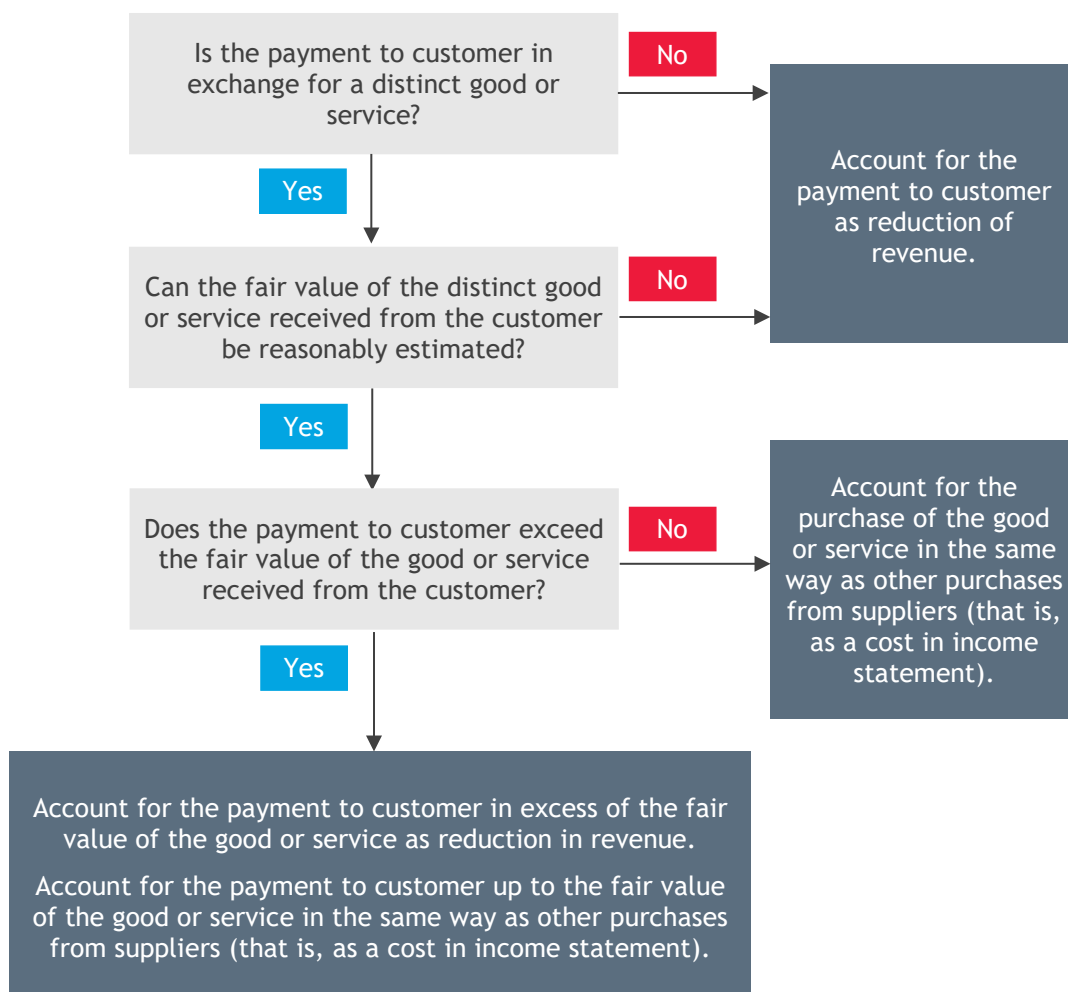
## 4.6 CONSIDERATION PAYABLE TO A CUSTOMER



### FASB REFERENCES

ASC 606-10-32-25 through 32-27 and ASC 606-10-55-251 through 55-254

The following diagram gives an overview of an entity's recognition of consideration payable to a customer:



In some cases, a contract between an entity and a customer may require an entity to pay consideration to its customers or customer's customer (for example, an entity may sell a product to a distributor and subsequently issue a credit to a customer of that distributor). Consideration payable to a customer includes:

- ▶ Cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer)
- ▶ 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)
- ▶ Equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments)

Consideration payable to a customer might be a payment in exchange for goods or services received from the customer, or a discount or refund for goods or services transferred to the customer, or a combination of both. 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, an entity may overpay for the goods or services it purchases from its customer and the customer may make inflated payments to the entity for purchasing goods or services from the entity. To depict revenue faithfully in those cases, any amount accounted for as a payment to the customer for goods or services received is limited to the fair value of those goods or services, with any amount in excess of the fair value recognized as a reduction of the transaction price (and, therefore, revenue).



#### CONSIDERATION PAYABLE TO A CUSTOMER MAY BE ACCOUNTED FOR AS A REDUCTION OF REVENUE

Accordingly, an entity must 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 that the customer transfers to the entity. See Chapter 3 for discussion on distinct goods or services.

If consideration payable to a customer is in exchange for a distinct good or service from the customer, an entity accounts for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. However, 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 must account for such an excess as a reduction of the transaction price (and, therefore, revenue). If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it must account for all of the consideration payable to the customer as a reduction of the transaction price (and, therefore, revenue).



#### CONSIDERATION PAYABLE TO A CUSTOMER MAY BE VARIABLE

If the consideration payable to a customer includes a variable amount, an entity must estimate the transaction price and assess whether the estimate of variable consideration must be constrained. See Section 4.3 for discussion on estimating and constraining variable consideration.

If consideration payable to a customer is accounted for as a reduction of the transaction price (and, therefore, revenue), an entity recognizes the reduction of revenue when (or as) the later of either of the following events occurs:

- ▶ The entity recognizes revenue for the transfer of the related goods or services to the customer – see Chapter 6 for discussion of when to recognize revenue.
- ▶ The entity pays or promises to pay (explicitly or implicitly based on entity's customary business practices) the consideration even if the payment is conditional on a future event. For example, a promise to pay a customer that is conditional on the customer making a specified number of purchases would be reflected in the transaction price when the entity makes the promise; note that this promise represents variable consideration and, therefore, the guidance on estimating variable consideration and constraining that estimate (that is, the probability of the customer making the future purchases) must also be considered.

If a payment to a customer is accounted for as a reduction of the transaction price, an entity recognizes less revenue when (or as) it satisfies the related performance obligation(s). However, in some cases, an entity promises to pay consideration to a customer only after it has satisfied its performance obligations and therefore after it has recognized revenue. In that case, a reduction in revenue is recognized immediately.

### BDO INSIGHTS – CONSIDERATION PAYABLE TO A CUSTOMER THAT IS VARIABLE – IMPLIED PRICE CONCESSION – TIMING OF RECOGNITION

An entity's past practice of providing discounts or other price concessions may represent an implied consideration payable to a customer in the form of variable consideration. Variable consideration is generally estimated and recognized in revenue before the uncertainty underlying the variability is resolved. If the implied payment to customer is variable, it may be recognized in revenue (as a reduction) before the entity makes the payment or explicitly promises to make the payment to the customer. See Section 4.3 for discussion on variable consideration.



### TRG DISCUSSIONS – INTERACTION OF THE GUIDANCE ON VARIABLE CONSIDERATION AND CONSIDERATION PAYABLE TO A CUSTOMER

In January 2015 and March 2015, the TRG discussed the appropriate timing for recognizing consideration payable to a customer that is variable. The TRG stated that the guidance on consideration payable to a customer states that such amounts are recognized as a reduction of revenue at the “later of” when:

- ▶ The related revenue is recognized
- ▶ The entity pays or promises to pay such consideration

Some TRG members highlighted that if an entity intends to provide its customer with a price concession when entering the contract (regardless of the form of the price concession, for example, cash payment, rebate, account credit, or coupon), then the contract includes variable consideration, and the entity must consider that price concession when estimating variable consideration. If the contract includes variable consideration because of an expected price concession, then the entity would not wait until it has communicated the price concession to the customer to recognize a reduction in revenue under the “later of” requirement. Instead, it re-estimates the expected price concession at each reporting date. The TRG considered the following example:

*An entity that manufactures consumer goods enters into a contract to sell a new product to a customer (a retail store chain) on December 15th. Before delivering any of the new products to the retail store chain, the entity's marketing department assesses whether the entity should offer \$1-off coupons in newspapers to encourage customers to buy the new product. The entity will reimburse the retail store chain for any coupons that are redeemed. The entity has not historically entered into similar coupon offerings in the past.*

*The entity delivers the new consumer goods (1,000 units at \$10/unit) to the retail store chain on December 28th. Assume for this example, that the customer has no right to return the products. On December 31st, the entity decides to make the coupon offering. On January 2nd, the entity communicates to its customers that it will reimburse the retail store chain on March 30th for any coupons redeemed by the retail store's customers. Assume the entity prepares its financial statements based on a calendar year end.*

TRG members generally agreed that the reversal of revenue from consideration payable to a customer must be made at the earlier of the date that there is a change in the transaction price (see Section 4.8 for discussion on changes in transaction price) or the date at which the consideration payable to a customer is promised, especially in circumstances in which the entity has a past practice of granting a discount. This determination requires judgment.

In the example above, at contract inception, the entity must consider its past practice and other factors (for example, its intent to offer coupons or if the customer has a reasonable expectation that a concession will be provided in the form of consideration payable to the customer) to determine whether the transaction price is variable. If so, the coupon offering constitutes variable consideration, which reduces the transaction price. If all requirements in Step 5 have been met to recognize revenue for the sale of 1,000 units of consumer goods on December 28, the entity would reduce the revenue recognized on that date to reflect the estimated amount of coupon offering (consideration payable to customer). That estimate will be reassessed on December 31 (the

reporting date) in accordance with the guidance on variable consideration (see Section 4.3.6 for discussion on reassessment of variable consideration).

If the coupon offering does not constitute variable consideration, then the guidance on variable consideration is not applicable and the “*later of*” requirement on recognizing consideration payable to a customer applies. In that scenario, the entity would reduce its revenue to recognize the coupon offering on January 2.



## TRG DISCUSSIONS – CONSIDERATION PAYABLE TO A CUSTOMER – DISTRIBUTION CHAIN

The guidance on consideration payable to a customer refers to payments made “to other parties that purchase the entity’s goods or services from the customer.” BC255 of ASU 2014-09 refers to payments an entity makes to “its customers or to its customer’s customer (for example, an entity may sell a product to a dealer or distributor and subsequently pay amounts to or provide a cash incentive to a customer of that dealer or distributor).”

In March 2015, the TRG discussed whether the guidance on consideration payable to a customer applies only to payments to customers in the distribution chain of an entity or whether “customer’s customer” is interpreted more broadly.

The TRG considered an example in which an entity that is acting as an agent views the principal in the arrangement as its customer. The agent may make incentive payments to parties that purchase the principal’s good or service. In many cases, these incentives are not part of the contract with the principal, or a promise made explicitly or implicitly to the principal. The principal may, however, be aware of the agent’s incentive program. The agent makes incentive payments to the principal’s customer, such as providing coupons or cash rebates, to increase the volume of transactions on which it earns its agency fee. However, the principal’s customers are not purchasing the agent’s goods or services.

Most TRG members supported the view that an entity’s customers include those parties in the distribution chain and might include a customer’s customer outside the distribution chain. An entity must identify its customer in each revenue transaction and entities within the distribution chain. In addition, an entity that is acting as an agent (that is, arranging for another party to provide goods or services), might identify multiple customers depending on the facts and circumstances of the arrangement. That is, the entity might view both the principal and the end customer as customers in the arrangement. Regardless of whether an entity concludes that the principal’s end customer is also a customer of the entity, a payment to a principal’s end customer that is contractually required based on an agreement between the entity and the principal represents consideration payable to a customer.

## BDO INSIGHTS – CONSIDERATION PAYABLE TO A CUSTOMER – DISTRIBUTION CHAIN

An entity may make payments to a third party on behalf of the customer who may be outside the distribution chain of the customer. Consistent with the TRG discussions on distribution chain, we believe the guidance on consideration payable to customer is interpreted broadly and may include payments made to a third party on a customer’s (or customer’s customer’s) behalf. For example, an entity may agree to pay certain transaction costs, such as broker fees, on behalf of its customer. Because the entity is not the principal in the arrangement with the broker, but instead is paying the broker at its customer’s direction, the payment would be recognized as a reduction in revenue.



## TRG DISCUSSIONS – SCOPE OF CONSIDERATION PAYABLE TO A CUSTOMER GUIDANCE

In January 2015 and March 2015, the TRG discussed which payments to a customer are within the scope of the guidance on consideration payable to a customer. The TRG members had differing opinions about which one of the following two views is correct:

- ▶ An entity should assess all consideration payable to a customer (View A).
- ▶ An entity should assess only consideration payable to a customer included in a contract (or combination of contracts) with the customer (View B).

The FASB staff concluded that View A is the only supportable interpretation because the FASB acknowledged in BC257 of ASU 2014-09 that the receipt of consideration from a customer and the payment of consideration to a customer can be linked even if they are separate events. While some TRG members favored View B, all TRG members generally agreed that an entity must evaluate a payment to a customer (or to a customer's customer) – particularly when no goods or services have been transferred – to determine the commercial substance of the payment and whether the payment is linked to a revenue contract with the customer.

### EXAMPLE 4-12: CONSIDERATION PAYABLE TO CUSTOMER

An entity sells a product to its customer for \$100. The contract requires the entity to pay the customer \$25.

#### Scenario A

The customer is not providing any distinct goods and services to the entity. Therefore, the transaction price (and, hence, revenue) recognized by the entity for the sale of the product is reduced to \$75 (that is, \$100 - \$25).

#### Scenario B

The contract requires the customer to provide a service to the entity. That service is considered distinct, and its estimated fair value is \$25. Therefore, the transaction price (and, hence, revenue) recognized by the entity for the sale of the product is \$100. The entity separately recognizes the purchase of services from its customer for \$25 under other U.S. GAAP.

#### Scenario C

Consider the same facts in Scenario B with the exception that the estimated fair value of the distinct service provided by the customer to the entity is \$15. Therefore, the transaction price (and, hence, revenue) recognized by the entity for the sale of the product is reduced to \$90 (that is, \$100 - \$10). \$10 is the excess of the consideration payable to the customer (\$25) over the fair value of the distinct service that the entity receives from the customer (\$15). The entity separately recognizes the purchase of services from its customer for \$15 under other U.S. GAAP.

### 4.6.1 Determining Whether a Good or Service Received From a Customer is Distinct

To determine whether a payment to a customer is recognized as a reduction in revenue or as a cost in the income statement, an entity must determine whether it receives a distinct good or service from the customer. See discussion in Chapter 3 on determining whether a good or service is distinct.

### EXAMPLE 4-13 (ADAPTED FROM ASC 606-10-55-251 THROUGH 55-254): CONSIDERATION PAYABLE TO CUSTOMER

An entity that manufactures consumer products enters a contract to sell goods to a customer (a large supermarket group) for a period of one year. The customer is contractually required to purchase at least \$10 million of goods during the year.



Additionally, the customer is contractually required to make changes to the shelving at the stores that will sell the retail goods. To compensate the customer for making those changes to shelving, the entity makes a nonrefundable payment of \$1 million to the customer at contract inception.

The payment by the entity to its customer does not result in the entity obtaining a distinct good or service. This is because although the customer will use the shelving to sell the retail goods purchased from the entity, the entity does not obtain control of any rights to those shelves.

Therefore, the entity accounts for the \$1 million payment to the customer as a reduction in the transaction price when the entity recognizes revenue for the transfer of retail goods. The \$1 million payment is recorded as an asset and is amortized as a reduction of revenue as the related sales of retail goods are recognized, resulting in total revenue recognition of \$9 million for the contract.

### **BDO INSIGHTS – DISTINCT GOOD OR SERVICE – SLOTTING FEES**

A manufacturer often pays consideration to a retailer to obtain a prominent positioning for the manufacturer's goods in the retailer's shops. Those payments are sometimes referred to as slotting fees. Whether the retailer provides a distinct good or service to the manufacturer can depend on the specific facts and circumstances, specifically, whether the manufacturer obtains control of a good or service provided by the retailer. However, we believe it would be rare for this type of payment to result in the manufacturer receiving control of a distinct good or service.

### **BDO INSIGHTS – GOOD OR SERVICE RECEIVED FROM A CUSTOMER**

Accounting for payments to customers is a key aspect of ASC 606, which may have a significant effect on the financial statements of an entity. ASC 606 focuses on whether a good or service received from a customer is distinct to determine whether a payment to a customer is accounted for as a reduction in revenue or as a cost in the income statement. Sometimes, general terms such as marketing fees, advertising fees, transportation fees or warehousing fees are used to describe payments to customers. While those types of fees may be commonly presented as selling expenses or cost of sales in practice, entities must not assume that is the appropriate presentation when they are included in a contract with a customer. Rather, entities must carefully evaluate whether the payments to customers are made in exchange for distinct goods or services. If the good or service received from the customer is not distinct, the payment to the customer is presented as a reduction of revenue, rather than as a cost of sales or selling expense.

Determining whether a good or service is distinct requires the application of professional judgment, based on the facts and circumstances.

### **BDO INSIGHTS – DISTINCT GOOD OR SERVICE – MARKETING ACTIVITIES**

Sometimes it is challenging to determine whether a payment to a customer is in exchange for a distinct good or service when an entity compensates its customer for the costs of marketing the entity's products. We believe the following indicators may be relevant when determining whether the marketing activities provide a service that is distinct from the sales of the entity's products to that customer:

- ▶ Does the marketing activity reach end consumers beyond customers of the entity's customers?
- ▶ Could the specific marketing activities be obtained from an unrelated third party also?



- ▶ Are the marketing activities expected to result in an increase in sales to parties other than the customer providing the marketing services?
- ▶ Which entity controls the marketing activities, including making decisions about the content of the marketing materials?

An entity may sell goods or services to a customer, for example, a retailer, for further resale and the entity may receive in-store marketing services from the retailer (or digital advertising services on the retailer's website) to promote the resale of those goods or services to end customers. In that scenario, we believe it would be unusual to conclude that the marketing service is distinct from the revenue transaction because the retailer would not provide the marketing services if it were not also purchasing the goods or services from the entity.



## TRG DISCUSSIONS – UPFRONT PAYMENT TO A CUSTOMER OR POTENTIAL CUSTOMER

In November 2016, the TRG discussed the accounting for upfront payments to customers. An entity may make an upfront payment to a customer, for example, to:

- ▶ Reimburse the customer for costs associated with entering a contract (such as costs for setting up a new vendor or costs to shut down operations that will be outsourced to the vendor).
- ▶ Obtain a contract with a customer in a competitive environment (pay-to-play or exclusivity).
- ▶ Provide additional incentives or discounts to customers.

Upfront payments to customers that are not in exchange for a distinct good or service are accounted for as a reduction of the transaction price. However, recognizing a payment to a customer as a reduction in revenue may result in a loss recognition in certain scenarios. For example:

- ▶ An entity may make an upfront payment to a potential customer in anticipation of future purchases from the customer before obtaining a contract with the customer.
- ▶ An entity may make an upfront payment to a customer with whom the entity has a contract. However, the upfront payment may relate to the current contract as well as an anticipated future contracts.

The TRG discussed the following two views about the timing of when the reduction in revenue for an upfront payment should be recorded:

- ▶ View A – Payments to customers are capitalized and amortized as a reduction of revenue as the related goods or services that are expected to be purchased by the customer are transferred to the customer. The asset is assessed for impairment in subsequent reporting periods. Under this view, the payment to a customer might be recognized in profit or loss over a period that is longer than the current legally enforceable contract. This view is only appropriate if the payment meets the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*, and future purchases are expected. See Section 7.7 for discussion on accounting for a contract asset in a contract with a customer.
- ▶ View B – Payments to customers are recognized as a reduction of revenue from the existing contract. If a contract with the customer does not exist, then the entire payment is immediately recognized in profit or loss. The TRG noted that to apply this view, the payment must relate to the existing contract only.

TRG members agreed that applying either view is not a policy election. Rather, an entity must understand the reasons for the payment, the rights and obligations resulting from the payment (if any), the nature of the promise(s) in the contract (if any), and other relevant facts and circumstances for each arrangement when determining the appropriate accounting.

Finally, the TRG stated that the assessment requires significant judgment in some cases and appropriate disclosures in the financial statements might be important.

### **BDO INSIGHTS – AMOUNTS RECEIVED FROM A SUPPLIER**

Although ASC 606 addresses an entity's accounting for consideration payable to a customer, it does not directly address how an entity accounts for amounts received from a supplier. ASC 705-20, *Cost of Sales and Services – Accounting for Consideration Received from a Vendor*, provides guidance on accounting for consideration received from a supplier. We believe that in Example 4-13 the supermarket should reflect a reduction in the cost of inventory purchased (and, hence, ultimately a reduction in cost of sales) rather than revenue or a contribution offset against the costs of changing the shelving. Specifically, the supermarket should recognize a \$1 million liability for the “slotting fee” it received, which should be an offset against the cost of inventory when the future purchases occur.

In that example, the manufacturer is not the retailer's customer; that is, the changes to the shelving are not an output of the retailer's ordinary activities and do not represent a good or service that is distinct from its purchases from the manufacturer. This results in consistency in the accounting between the manufacturer and the retailer because if the manufacturer is not receiving a distinct good or service for the consideration paid to the retailer, then the retailer is similarly not providing a distinct good or service to the manufacturer. This treatment is consistent with the guidance in ASC 705-20.

However, in other circumstances, a retailer can receive consideration from manufacturers that would constitute revenue for the retailer. This is illustrated by the following three scenarios:

#### **Scenario A – Discount granted based on purchases not related to manufacturers' products**

A manufacturer and a retailer agree on a promotion under which:

- ▶ The retailer's customers receive coupons based on their total purchases in the retailer's store regardless of whether the purchased products are manufactured by the manufacturer or another party (assume \$10 coupon for each \$100 of purchases).
- ▶ The retailer's customers use the coupons to acquire the manufacturers' products at a discounted price in the retailer's stores.
- ▶ The difference between the sales price and the discounted price granted to the customer is borne by the manufacturer.

The manufacturer's product has a selling price of \$60. An end customer purchases that product from the retailer in exchange for three coupons with a total value of \$30 and cash of \$30. The manufacturer reimburses \$30 cash to the retailer, which is the face value of the coupons used by the end customer. The retailer recognizes revenue in amount of \$60, which includes the \$30 cash received from the end customer and the \$30 cash reimbursement from the manufacturer for the coupon used by the end customer.

#### **Scenario B – Promotional discount granted to the customer**

A manufacturer and a retailer agree on a promotional pricing for a product manufactured by the manufacturer and sold by the retailer to end customers. The retailer generally purchases the manufacturer's product for a price of \$85 for sale to end customers at \$102. During the promotional period, the retailer sells the product for \$97 to its customers. The incremental discount of \$5 compared to the regular retail price of \$102 is reimbursed by the manufacturer.

For each sale of the product, the retailer recognizes revenue in amount of \$102, which includes the price paid by its customer (\$97) plus the amount reimbursed by the manufacturer (\$5).

#### **Scenario C – Discount granted to the end-customer based on coupons issued by the manufacturer**

A manufacturer (not the retailer) initiates a promotional campaign under which end customers receive coupons issued by the manufacturer when they purchase the manufacturer's products from a retailer. When customers use the coupons, the difference between the retail price and the discounted price is borne by the manufacturer. Assume a customer receives a coupon for \$10 off of the purchase of one of the manufacturer's products.

The manufacturer's product has a selling price of \$60 and an end customer purchases the product in exchange for a coupon (with a value of \$10) and cash of \$50. The retailer receives \$10 from the manufacturer. The retailer

recognizes revenue in an amount of \$60, which includes the \$50 cash received from the end customer and the \$10 cash reimbursement from the manufacturer for the coupon used by the end customer.

#### All Scenarios – Payment on behalf of customer

In all three scenarios, although the payments received by the retailer are from the manufacturer (that is, its supplier), the payments are received on behalf of the retailer's customer and, hence, the retailer recognizes the amounts due from the manufacturer as revenue. If the manufacturer reimburses the retailer at an amount that exactly matches the discount that the end-customer receives, the coupon has in effect been issued by the manufacturer (not the retailer) to the end customer and, therefore, is recognized as revenue by the retailer. In those scenarios, there is no payment to a customer from the perspective of the retailer and therefore, there is no reduction in revenue or a rebate for the cost of inventory sold.

However, from the manufacturer's perspective, the reimbursement of coupons is a payment to its customer (that is, the retailer), and, therefore, results in a reduction of revenue recognized by the manufacturer.

### 4.6.2 Equity Instruments Granted as Consideration Payable to a Customer



#### FASB REFERENCES

ASC 606-10-32-23, ASC 606-10-32-25A, ASC 606-10-55-88A and 55-88B

Equity instruments granted by an entity in conjunction with selling goods or services are measured and classified under ASC 718, *Compensation – Stock Compensation*. The equity instrument is measured at the grant date in accordance with ASC 718 (for both equity-classified and liability-classified share-based payment awards). Changes in the measurement of the equity instrument (through the application of ASC 718) after the grant date that are due to the form of the consideration are not included in the transaction price. Rather, changes due to the form of the consideration are reflected elsewhere in the grantor's income statement.

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 considered changes due to the form of the consideration and, hence, are reflected in the transaction price (and, therefore, revenue).

If the number of equity instruments promised in a contract is variable because of a service condition or a performance condition that affects the vesting of an award, an entity must estimate the number of equity instruments that it will be obligated to issue to its customer and update that estimate of the number of equity instruments until the award ultimately vests in accordance with ASC 718. Additionally, in accordance with ASC 718, the entity must include the effect of any market conditions and service or performance conditions that affect factors other than vesting when measuring each instrument. Examples of factors other than vesting are included in ASC 718-10-30-15.

Additionally, 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, the estimate is based on the fair value of the award at the reporting dates that occur before the grant date. An entity must 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 must 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.

## 4.7 NONREFUNDABLE UPFRONT FEES



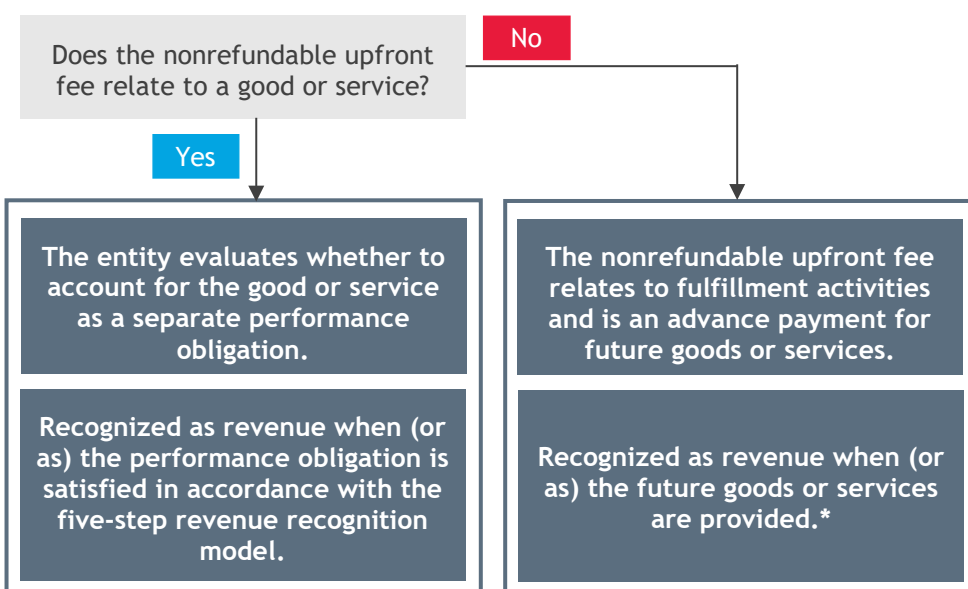
### FASB REFERENCES

ASC 606-10-55-50 through 55-53

An entity may charge a customer a nonrefundable upfront fee at or near contract inception. Examples include:

- ▶ Joining fees for health club membership contracts
- ▶ Activation fees for telecommunication contracts
- ▶ Setup fees in some services contracts (for example, SaaS contracts)
- ▶ Initial fees in some supply contracts

The following diagram illustrates the key accounting considerations for nonrefundable upfront fees:



\*Revenue recognition period generally extends beyond the initial contract term if the entity grants the customer a renewal option that is determined to be a material right.

When a contract includes a nonrefundable upfront fee, an entity assesses whether that fee relates to the transfer of a promised good or service in Step 2 and accounts for the fee as follows:

- ▶ If the nonrefundable upfront fee relates to a good or service, the entity evaluates whether to account for the good or service as a separate performance obligation.
- ▶ If the nonrefundable upfront fee does not result in the transfer of a promised good or service to the customer but rather relates to fulfillment activities, the fee is an advance payment for future goods or services and, therefore, is recognized as revenue when those future goods or services are provided.
  - The revenue recognition period generally extends beyond the initial contract term if the entity grants the customer renewal options for the contract, which are determined to be material rights – see Section 7.4 for related discussion.

In many cases, even though a nonrefundable upfront fee may relate to an activity that the entity must undertake at or near contract inception to fulfill the contract, that activity may not result in the transfer of a promised good or service to the customer but rather may be a fulfillment activity.

See Chapters 3 and 6 for discussion on identifying fulfillment activities and performance obligations in a contract and recognizing revenue when or as the performance obligations are satisfied.

**EXAMPLE 4-14 (ADAPTED FROM 606-10-55-358 THROUGH 55-360): NONREFUNDABLE UPFRONT FEE – MATERIAL RIGHT VERSUS ADVANCE PAYMENT FOR SERVICES TO BE PROVIDED IN FUTURE**

A technology entity enters a contract with a customer to provide SaaS for one year. The contract includes standard terms and conditions that are the same for all customers. The customer is contractually required to pay a nominal nonrefundable upfront fee in return for the entity setting up the customer in the entity's systems and processes. The customer can renew the contract each year at the standalone selling price of the services and is not required to pay any additional fee after the initial set up.

The entity observes that:

- ▶ Its initial setup activities do not transfer a good or service to the customer and, therefore, do not give rise to a performance obligation.
- ▶ Although the contract can be renewed without paying another upfront fee, the amount of the fee is not significant to the price of the services during the renewal period.

Therefore, the entity concludes that the renewal option is priced at the standalone selling price of the services and, thus, does not provide a material right to the customer – see Section 7.4 for discussion on material rights.

The entity determines that the upfront fee is, in effect, an advance payment for the services to be provided in future. Therefore, it includes the nonrefundable upfront fee in the transaction price in Step 3 and recognizes it as revenue for SaaS as SaaS is provided. See Chapter 6 for discussion on recognizing revenue when or as a performance obligation is satisfied.

#### 4.7.1 Costs Related to Nonrefundable Upfront Fees

An entity may charge a nonrefundable upfront fee in part as compensation for costs incurred in setting up a contract or other administrative tasks. If those setup activities do not satisfy a performance obligation, but are rather fulfillment activities (see Section 3.2 for discussion on fulfillment activities), the entity must:

- ▶ Disregard those setup activities and the related costs when measuring progress to recognize revenue because the costs of setup activities do not depict the transfer of services to the customer.
- ▶ Assess whether the costs incurred in setting up a contract result in an asset that is recognized in accordance with ASC 340-40-25-5 – see Section 7.7 for discussion on contract costs.

## 4.8 CHANGES IN THE TRANSACTION PRICE



### FASB REFERENCES

ASC 606-10-32-42 through 32-45

The transaction price for a contract can change after contract inception 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.

An entity must allocate any subsequent changes in the transaction price to the performance obligations in the contract on the same basis as at contract inception. That is, an entity does not reallocate the transaction price to reflect any changes in standalone selling prices after contract inception.

Additionally, an entity allocates 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 form part of a single performance obligation if the criteria for the variable consideration allocation exception are met (see Section 5.5 for discussion on the variable consideration allocation exception).

An amount allocated to a satisfied performance obligation, if any, is recognized as revenue or as a reduction of revenue in the period in which the transaction price changes. See Example 4-5 in this chapter for an illustration of this concept.

A change in the transaction price that arises due to a contract modification is accounted for in accordance with the guidance on contract modifications (see Section 7.3 for related discussion). However, for a change in the transaction price that occurs after a contract modification, an entity must allocate the change in the transaction price in one of the following ways, as applicable:

- ▶ **If the modification is accounted for as a termination of the existing contract and the creation of a new contract (in accordance with ASC 606-10-25-13(a))** – An entity must 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.
- ▶ **In all other cases in which the modification is not accounted for as a separate contract (in accordance with ASC 606-10-25-12)** – An entity must allocate the change in the transaction price to the remaining performance obligations in the modified contract, that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification.

See Examples 7-9 and 7-11 in Chapter 7 for illustrations of accounting for changes in the transaction price that arise due to contract modifications.

The standard requires an entity to update its estimate of the transaction price throughout the contract to depict conditions that exist at the end of each reporting period (and changes in conditions during the reporting period) because an entity may revise its expectations about the amount of consideration to which it expects to be entitled after contract inception as uncertainties are resolved or as new information becomes available about remaining uncertainties. BC224 of ASU 2014-09 states that reflecting current assessments of the amount of consideration to which the entity expects to be entitled provides more useful information to users of financial statements than retaining the initial estimates, especially for long-term contracts that are subject to significant changes in conditions during the lives of the contracts.

In addition, BC227 and BC228 of ASU 2014-09 state that an entity is required to allocate a change in the transaction price to all the performance obligations in the contract because the resulting cumulative revenue recognized depicts the revenue that the entity would have recognized at the end of the subsequent reporting period if the entity had the information at contract inception. Therefore, the transaction price that is allocated to performance obligations that have already been satisfied is immediately recognized as revenue or as a reduction of revenue.

In some cases, while an entity might make an estimate of the amount of variable consideration to include in the transaction price at the end of a reporting period, information relating to the variable consideration might arise between the end of the reporting period and the date when the financial statements are issued or available to be issued. The FASB decided not to provide guidance on the accounting in these situations because the accounting for subsequent events is addressed in ASC 855, *Subsequent Events*.

#### **BDO INSIGHTS – EFFECT OF RECOGNIZED AND NONRECOGNIZED SUBSEQUENT EVENTS ON TRANSACTION PRICE**

ASC 855 requires an entity to distinguish between recognized and nonrecognized subsequent events. A recognized subsequent event provides additional evidence about conditions that existed as of the date of the balance sheet while nonrecognized subsequent events provide information about conditions that arose after the balance sheet date. We believe most information related to an entity's estimate of variable consideration provide better evidence of the conditions that existed at the balance sheet date and thus is generally considered a recognized subsequent event that must be reflected in an entity's estimate of variable consideration.

For example, in the healthcare industry, payments for services are often received from governmental agencies, such as Medicare or Medicaid. Those payments are subject to regulatory review and audit. If a healthcare entity receives information from a government payor indicating that reimbursement rates will be higher or lower than

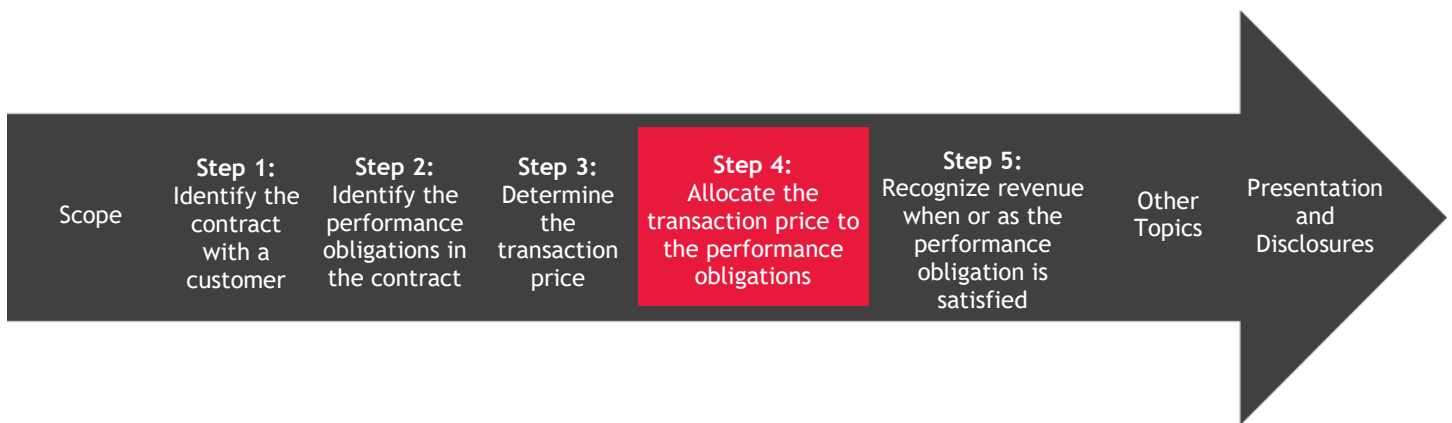
expected before the financial statements are issued or available to be issued, the healthcare entity must consider that new information when assessing its estimates of variable consideration.

However, events that arise after the balance sheet date are sometimes considered nonrecognized subsequent events. For example, receipt of FDA approval after the balance sheet date is generally considered a nonrecognized subsequent event that does not result in recognition of a milestone payment based on FDA approval as of the balance sheet date.

In some cases, determining whether information obtained after the end of a reporting period provides additional information about the amount of revenue to which an entity is entitled may require the application of professional judgment, based on the facts and circumstances.



# CHAPTER 5 – STEP 4: ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS



## 5.1 OVERVIEW

After determining the transaction price for the contract in Step 3, at contract inception, an entity must allocate the transaction price to the performance obligations identified in the contract in Step 2. ASC 606 includes an allocation objective and generally requires the allocation of transaction price to each performance obligation based on the relative standalone selling price of the goods or services underlying each performance obligation. Exceptions to the general allocation based on relative standalone selling prices exist for certain discounts and variable consideration.

In Step 4, determining the appropriate standalone selling price for each performance obligation is the key first step to appropriately determining the amount to allocate to each performance obligation in a contract. The amount allocated to each performance obligation is ultimately recognized in revenue when (or as) that performance obligation is satisfied.

The following diagram summarizes the key concepts in Step 4:



**Allocation Objective**

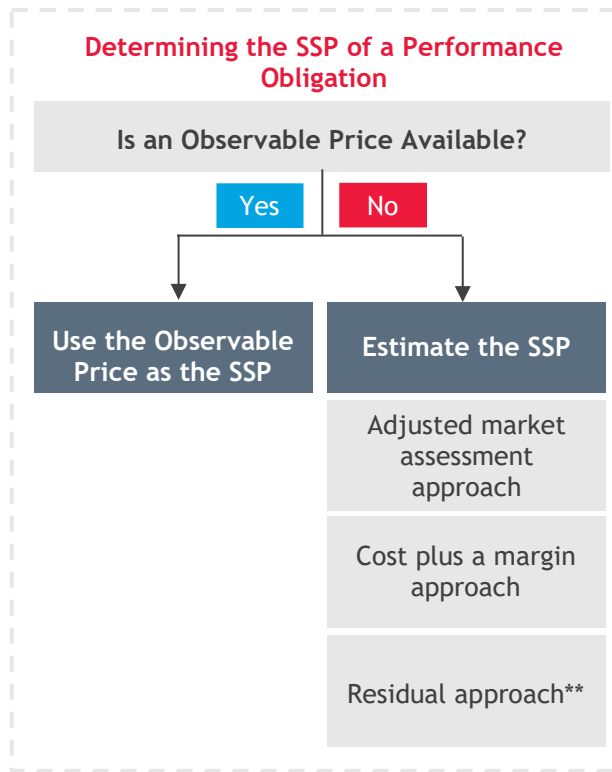
Allocate the transaction price to each performance obligation in an amount that depicts the amount the entity expects to be entitled in exchange for transferring that performance obligation to the customer.\*

**General Allocation Model**  
Allocate the transaction price to all performance obligations based on relative SSPs.

**Exception for Allocation of Discount**

**Exception for Allocation of Variable Consideration**

**Consider Interaction with the Series Guidance**  
(See Section 3.4)



\*If the performance obligation is a series of distinct goods or services, allocate the transaction price to each distinct good or service in an amount that depicts the amount to which the entity expects to be entitled in exchange for transferring that distinct good or service to the customer. See Section 3.4 for discussion on the series guidance.

\*\*Use of residual approach has certain restrictions – see Section 5.3 for related discussion

## 5.2 ALLOCATION OBJECTIVE



### FASB REFERENCES

ASC 606-10-32-28 through 32-29

The objective in Step 4 is to allocate an amount of transaction price to each performance obligation (or distinct good or service) that reflects the consideration to which an entity expects to be entitled in exchange for transferring the distinct goods or services (comprising each identified performance obligation) to the customer. This concept is generally referred to as the “*allocation objective*.”

### 5.2.1 General Allocation Model



### FASB REFERENCES

ASC 606-20

Standalone selling price is defined as “*the price at which an entity would sell a promised good or service separately to a customer.*”

To meet the allocation objective, an entity generally allocates the transaction price to all performance obligations identified in the contract in proportion to the standalone selling prices of those performance obligations at contract inception (that is, on a relative standalone selling price basis). This allocation approach is sometimes referred to as the general allocation model. BC266 of ASU 2014-09 states that in most cases an allocation based on standalone selling prices faithfully depicts the different margins applicable to multiple promised goods or services sold together in a contract.

There are certain exceptions to the general allocation model for discounts and variable considerations – see Sections 5.4 and 5.5 for related discussion.

#### **BDO INSIGHTS – APPROPRIATE LEVEL FOR DETERMINING STANDALONE SELLING PRICE**

The standalone selling price is determined at the performance obligation level. When a single performance obligation is comprised of multiple goods or services, the standalone selling price of that performance obligation is determined by considering the price at which an entity would sell the bundle separately to a customer, which could be different than the sum of the prices at which an entity would separately sell the individual goods or services comprising the bundle.

For example, consider an entity that sells solar panels and related design and installation services as a bundle which constitutes a single performance obligation. The entity enters a contract to sell that bundle, along with a distinct service (post-installation maintenance service), to a customer. To allocate the transaction price to the two performance obligations, that is, the bundle and the maintenance service, the entity must assess the standalone selling price of the bundle and maintenance service. In determining the standalone selling price of the bundle, the entity must consider the price at which it would sell the bundle separately to a customer, rather than the price at which it would separately sell the promised goods or services underlying the bundle (solar panels and design and installation services) to a customer.

### 5.2.2 Allocation if the Contract Includes One Performance Obligation

An entity does not allocate the transaction price if a contract has only one performance obligation (that is, Step 4 is not applicable). However, if a contract includes a series of distinct goods or services identified as a single performance obligation (see Section 3.4), then the guidance on allocation of variable consideration may be applicable – see Section 5.5 for related discussion.

## 5.3 ALLOCATION BASED ON STANDALONE SELLING PRICE



### FASB REFERENCES

ASC 606-10-32-31 through 32-35

At contract inception, an entity must determine the standalone selling price of each performance obligation in the contract and allocate the transaction price to each performance obligation on a relative standalone selling price basis.

### 5.3.1 Directly Observable Standalone Selling Price

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.



### CONTRACTUALLY STATED PRICE IS NOT PRESUMED TO BE THE STANDALONE SELLING PRICE

While a contractually stated price or a list price for a good or service may be the standalone selling price of that good or service, it must not be presumed to be the standalone selling price. For example, an entity might typically grant discounts from its list prices, or it might not sell the distinct good or service separately from other goods or services. In those scenarios, the list price of a distinct good or service does not provide a directly observable price of that good or service.

### BDO INSIGHTS – DIRECTLY OBSERVABLE STANDALONE SELLING PRICE

Sometimes an entity always sells certain goods or services that are each distinct together at a bundled price. In determining the standalone selling price of each good and service in the bundle, the entity cannot use the bundled price as the directly observable standalone selling price of each good and service.

For example, consider an entity that always sells certain electronic equipment and a related service together. The entity also sells other goods and services, for example, electrical services and home improvement services. Assume each good and service is a separate performance obligation. The entity enters a contract with a customer to sell an electronic equipment and the related service, which comprises an entertainment system and a related installation service. To allocate the consideration in the contract to each performance obligation on a relative standalone selling price, the entity evaluates whether the standalone selling price of each performance obligation is directly observable. The entity determines that:

- ▶ The standalone selling price of the entertainment system and installation service is directly observable because the entity often sells each separately to customers at its list price.
- ▶ The standalone selling prices of the electronic equipment and related service (each a separate performance obligation comprising the entertainment system) are not directly observable because the equipment and related service are always sold together, and the list price reflects the price for the bundle.

The standalone selling prices of the electronic equipment and related service comprising the entertainment system are not directly observable even if the equipment and related service are priced separately in the contract. Because they are never sold on a standalone basis, the entity cannot assume that the contract price is the standalone selling price.

Therefore, the entity must estimate the standalone selling price of the electronic equipment and related service – see Section 5.3.2 for related discussion.

### 5.3.2 Estimating Standalone Selling Price

If a standalone selling price is not directly observable, an entity estimates the standalone selling price at an amount that would result in the allocation of transaction price meeting the allocation objective.



#### INFORMATION CONSIDERED IN ESTIMATING STANDALONE SELLING PRICE

In estimating a standalone selling price, an entity must consider all information that is reasonably available to the entity, including:

- ▶ Market conditions
- ▶ Entity-specific factors
- ▶ Information about the customer or class of customer

In considering the information available to estimate a standalone selling price, an entity must:

- ▶ Maximize the use of observable inputs
- ▶ Apply estimation methods consistently in similar circumstances

#### BDO INSIGHTS – ESTIMATING STANDALONE SELLING PRICE – RANGE

A question comes up in practice as to whether the standalone selling price must be estimated as a precise amount or whether it could be estimated as a range. While ASC 606 is silent on this question, we believe the standalone selling price of a performance obligation can be derived from a range of amounts if all of the below conditions are met:

- ▶ The range is sufficiently narrow
- ▶ The entity would sell the performance obligation separately to a customer at any point within the range
- ▶ The resulting allocation outcome is consistent with the allocation objective

Determining an appropriate range of standalone selling prices requires the application of professional judgment, based on the facts and circumstances. An entity must maximize the use of observable inputs and consider the circumstances of the contract (for example, class of customer) in determining the range.

The use of a range is not appropriate when the standalone selling prices are so widely dispersed that an appropriate standalone selling price for a performance obligation in a transaction is not determinable.

**BDO INSIGHTS – SIGNIFICANCE OF STANDALONE SELLING PRICE IN DISAGGREGATED REVENUE DISCLOSURES**

A contract with a customer may include multiple performance obligations that have the same pattern and timing for revenue recognition. This would happen when:

- ▶ Multiple performance obligations are satisfied at the same point in time. For example, this would happen in a contract to deliver 10 products (each a separate performance obligation satisfied at a point time) that are all delivered at the same point in time rather than at different points in time.
- ▶ Multiple performance obligations are satisfied concurrently over time over the same term and have the same measure of progress. For example, this would happen in a contract to provide SaaS and customer support that are coterminous and have a time-based measure of progress.

In each of these situations, because control of the performance obligations is transferred to the customer at the same time, the allocation of the consideration in the contract to the performance obligations (or distinct services) may have no practical effect on the amount and timing of revenue recognition. However, if an entity presents the performance obligations in separate lines in the income statement or if its disaggregated revenue disclosure results in separate disclosure of the distinct performance obligations, then the entity must determine standalone selling prices of its performance obligations in accordance with ASC 606. The entity cannot presume the contractually stated or list price is the standalone selling price of each. In other words, an entity would need to determine standalone selling prices to comply with the presentation and disclosure requirements even if, as a practical matter, it does not allocate the transaction price in Step 4 (because all the performance obligations have same pattern and timing for revenue recognition).

See Chapters 6 and 8 for discussion on recognizing revenue and disclosure requirements, respectively.

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

- ▶ Adjusted market assessment approach
- ▶ Expected cost plus a margin approach
- ▶ Residual approach

While ASC 606 does not specify a hierarchy of evidence to estimate the standalone selling price of a good or service, BC274 of ASU 2014-09 states the FASB's decision to emphasize that an entity must maximize the use of observable inputs when developing estimates of standalone selling prices. Further, BC268 of ASU 2014-09 states that the estimation approaches (adjusted market assessment approach, expected cost plus a margin approach and residual approach) are "examples of suitable estimation methods for estimating the standalone selling price." It also states that the FASB decided not to preclude or prescribe any particular method for estimating a standalone selling price so long as the estimate is a faithful representation of the price at which the entity would sell the distinct good or service if it were sold separately to the customer. The method used by an entity to estimate a standalone selling price must maximize the use of observable inputs and must be applied consistently to estimate the standalone selling prices of other goods or services with similar characteristics.

Additionally, in BC269 of ASU 2014-09, the FASB observed that when developing processes for determining standalone selling prices, an entity must consider all reasonably available information based on the specific facts and circumstances, including:

- ▶ Reasonably available data points, such as a standalone selling price of the good or service, the costs incurred to manufacture or provide the good or service, related profit margins, published price listings, third-party or industry pricing, and the pricing of other goods or services in the same contract
- ▶ Market conditions, including supply and demand for the good or service in the market, competition, restrictions, and trends
- ▶ Entity-specific factors, such as business pricing strategy and practices
- ▶ Information about the customer or class of customer, such as type of customer, geographical region, and distribution channel

### 5.3.2.1 Adjusted Market Assessment Approach

This approach:

- ▶ Requires an evaluation of the market in which an entity sells goods or services to estimate the price that a customer in that market would be willing to pay for those goods or services
- ▶ May 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

### 5.3.2.2 Expected Cost Plus a Margin Approach

This approach requires an entity to forecast its expected costs of satisfying a performance obligation and then add an appropriate profit margin.

### 5.3.2.3 Residual Approach

This approach requires an estimation of 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.

This approach may be used to estimate the standalone selling price of a good or service only if both of the following conditions are met:

- ▶ The entity has observable standalone selling prices for one or more other goods or services promised in the contract
- ▶ One of the following criteria is met:
  - 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.
  - 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.

Furthermore, a combination of methods may be used to estimate the standalone selling prices of the goods or services in a contract if two or more of those goods or services have highly variable or uncertain standalone selling prices. For example, a residual approach may be used to estimate the aggregate standalone selling price for multiple promised goods or services with highly variable or uncertain standalone selling prices and then another method may be used 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. However, to use the residual approach to estimate the aggregate standalone selling price for multiple promised goods or services, the observable standalone selling prices of other goods or services promised in the contract must be available.

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 must evaluate whether allocating the transaction price at those estimated standalone selling prices would be consistent with both of the following:

- ▶ The allocation objective.
- ▶ The requirement in ASC 606-10-32-33 to estimate the standalone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective.

Additionally, BC273 of ASU 2014-09 states that when the residual approach is used to determine the standalone selling price of a distinct good or service, the outcome of this approach cannot realistically result in a standalone selling price of zero if the good or service is in fact distinct. To be distinct, a good or service must have value on a standalone basis. Therefore, if the residual approach results in no, or very little, consideration being allocated to a performance obligation, the entity must consider whether that estimate is appropriate in those circumstances. If not, the entity must use another method to estimate standalone selling price.

**BDO INSIGHTS – RESIDUAL APPROACH – SOFTWARE LICENSE AND MAINTENANCE SERVICE**

In some situations, a distinct good or service is never sold separately by an entity. Instead, it is sold as part of a bundle, which may be sold for a broad range of amounts. This is common in the software industry where software licenses are often bundled with maintenance for an initial period. Software maintenance (Post Contract Support (PCS)) can typically be renewed after the initial period on a standalone basis. However, the license and the PCS could represent separate performance obligations even though the entity might never sell one without the other (see Chapter 3 for discussion on identifying separate performance obligations).

In certain circumstances, an entity may have strong pricing policies for PCS by which the entity charges customers a fixed amount for maintenance renewals, and the price does not vary from customer to customer. This could also be the case if PCS renewals are stated as a percentage of the list price of a license (that is, the list price before any customer-specific discounts or adjustments) provided that the list price is not subject to significant regular, artificial adjustments.

This scenario leads to the question of whether it would be acceptable for an entity to apply the residual approach to establish the standalone selling price for a license that is never sold separately.

We believe using a residual approach to calculate the standalone selling price of the software license is appropriate if an entity can identify that the pricing variability that exists in the software license and PCS bundle is attributable to the software license, and that the standalone selling price of the PCS is not highly variable. Although an entity may not sell the software license on its own for a broad range of amounts, the entity may sell a bundle that contains both software and PCS for a broad range of amounts. There may be observable evidence that a PCS renewal is always sold for either a fixed amount, or a fixed percentage of the list price or of the contractual price of the software license. In this case, an entity can identify that it is the license component of the bundle that is sold to different customers for a broad range of amounts, and not the PCS (because there is an observable standalone selling price for the PCS). If there are no other goods or services in the bundle for which observable standalone selling price does not exist, then the use of the residual approach may be appropriate to calculate the standalone selling price of the license.

Determining standalone selling prices of software licenses and PCS requires application of professional judgment, based on the facts and circumstances.

**EXAMPLE 5-1 (ADAPTED FROM ASC 606-10-55-256 THROUGH 55-258): ALLOCATION METHODOLOGY**

An entity sells three products (A, B, and C) to a customer for \$200. Each product will be transferred to the customer at a different point in time. Assume each product represents a separate performance obligation, which is satisfied at a point in time.

Product A is regularly sold separately for \$100 and, therefore, the standalone selling price of product A is directly observable. Products B and C are not sold separately and, therefore, the standalone selling price of products B and C are not directly observable. The entity estimates the standalone selling prices of products B and C as \$50 and \$150, respectively.

Product	SSP
A	\$ 100
B	50
C	150
Total	<u>\$ 300</u>

There is no evidence that suggests the discount of \$100 (sum of the standalone selling prices, \$300, less the transaction price, \$200) relates entirely to one, or a group of two, of the products being sold (see Section 5.4 for discussion on allocation of a discount). Therefore, the discount is allocated proportionately to the three products and the allocated transaction price is as follows:

Product	Allocated Transaction Price
A	$(200 \times (100/300)) = \$67$
B	$(200 \times (50/300)) = \$33$
C	$(200 \times (150/300)) = \$100$
Total	<u>\$200</u>

## 5.4 ALLOCATION OF A DISCOUNT



### FASB REFERENCES

ASC 606-10-32-36 through 32-38

While the general allocation model based on relative standalone selling prices is the default method for allocating the transaction price, the allocation of a discount using relative standalone selling prices may not always result in a faithful depiction of the amount of consideration to which the entity expects to be entitled from the customer. For example, in a contract that includes both a high-margin and a low-margin item, the allocation of a discount based on the relative standalone selling prices could result in a loss on one part of the contract although the contract may be profitable in total. Therefore, the standard includes an exception to the general allocation model for allocation of a discount (hereinafter, referred to as “discount allocation exception”).

A discount exists if the sum of the standalone selling prices of the goods or services in a contract exceeds the consideration payable by the customer.

Unless there is observable evidence that an entire discount relates to only one or some (but not all) performance obligations in a contract, the discount is allocated proportionately to all performance obligations in the contract based on relative standalone selling prices.

### 5.4.1 Observable Evidence and Specific Allocation of a Discount

The entire discount is allocated to only one or some (but not all) performance obligations in a contract if all of the following three criteria are met:

- ▶ **Regular standalone sales** – Each distinct good or service (or each bundle of distinct goods or services) in the contract is sold regularly by the entity on a standalone basis.
- ▶ **Regular standalone sales of a bundle at discount** – A bundle (or bundles) of some of those distinct goods or services are also sold regularly by the entity on a standalone basis at a discount to the sum of the standalone selling prices of the goods or services in each bundle.
- ▶ **Discount in the contract is substantially the same as the discount in regular standalone sales of a bundle** – The discount attributable to each bundle of goods or services in regular standalone sales of the bundle is substantially the same as the discount in the contract. Additionally, an analysis of the goods or services in each bundle provides observable evidence of the performance obligation(s) to which the entire discount in the contract relates.

For example, observable evidence that a discount relates to only some (but not all) performance obligations in a contract may exist if a contract includes a discount for the sale of three goods but two of those goods are also often sold together at a discount to the sum of the standalone selling prices of those two goods.





### HIERARCHY IN APPLYING THE DISCOUNT ALLOCATION EXCEPTION AND THE RESIDUAL APPROACH FOR ESTIMATING STANDALONE SELLING PRICE

If a discount is allocated entirely to one or more performance obligations in the contract, an entity must allocate the discount before using the residual approach to estimate the standalone selling price of a good or service. See Examples 5-2, 5-3 and 5-4 in this chapter.

#### 5.4.2 Application of the Discount Allocation Exception

BC283 of ASU 2014-09 states that discount allocation exception would generally apply to contracts in which there are at least three performance obligations. This is because an entity could show that a discount relates to two or more performance obligations when it has observable information supporting the standalone selling price of a bundle of those promised goods or services when they are sold together. While it may be possible for an entity to have sufficient evidence to allocate a discount to only one performance obligation, the FASB expected that to occur in rare cases only.

In BC282 of ASU 2014-09, the FASB considered whether the discount allocation exception is too restrictive, which might result in outcomes that are inconsistent with the economics of some transactions. The FASB's view was that the discount allocation exception is included to maintain the rigor and discipline of a relative standalone selling price allocation and therefore it appropriately limits the situations in which a discount would not be allocated pro rata to all performance obligations in the contract. In other words, limiting the applicability of discount allocation exception was intentional.

#### EXAMPLE 5-2 (ADAPTED FROM ASC 606-10-55-259 THROUGH 55-269): ALLOCATING A DISCOUNT AND RESIDUAL APPROACH

An entity regularly sells three products (A, B, and C) individually and has, therefore, established the following directly observable standalone selling prices:

Product	SSP
A	\$ 80
B	110
C	90
Total	<u>\$ 280</u>

Additionally, the entity regularly sells products B and C together for \$120. Assume each product represents a separate performance obligation, which is satisfied at a point in time.

The entity enters a contract to sell three products (A, B, and C) to a customer for \$200. Each product will be transferred to the customer at a different point in time. The contract includes a discount of \$80 (sum of the standalone selling prices, \$280, less the transaction price, \$200) for the sale of three products together. However, the entity has evidence that products B and C are regularly sold together at \$120 rather than at \$200 (\$110 + \$90, the sum of their standalone selling prices). That is, a discount of \$80 is regularly applied to the sale of products B and C together. Therefore, the entire discount of \$80 in the contract is allocated to products B and C only. The selling price attributed to products B and C is determined first and a residual amount is attributed to product A.

The entity allocates \$120 of the transaction price (which incorporates the entire discount of \$80) to the products B and C (standalone selling price of \$110 and \$90 respectively) as follows:

Product	Allocated Transaction Price
B	$(\$120 \times (\$110/\$200)) = \$66$
C	$(\$120 \times (\$90/\$200)) = \$54$
Total	<b>\$120</b>

The residual transaction price of \$80 ( $\$200 - \$120$ ) is allocated to product A.

**EXAMPLE 5-3 (ADAPTED FROM ASC 606-10-55-259 THROUGH 55-269): ALLOCATING A DISCOUNT AND RESIDUAL APPROACH – RESIDUAL APPROACH IS APPROPRIATE**

Consider the same facts in Example 5-2 except the contract also includes the sale of an additional product D and the consideration payable by the customer is \$260. Each product will be transferred to the customer at a different point in time. The standalone selling price of product D is highly variable because it is sold to different customers for a broad range of amounts (\$30 - \$90). Therefore, the entity decides to use the residual approach to estimate the standalone selling price of product D.

Before applying the residual approach to estimate the standalone selling price of product D, the entity considers whether any discount must be specifically allocated to one or more (but not all) performance obligations in the contract.

As discussed in Example 5-2, the entity has observable standalone selling prices for standalone sale of product A (\$80) and bundled sale of products B and C together (\$120). That is, there is observable evidence that \$200 of the transaction price must be allocated to products A, B and C and a \$80 discount must be allocated entirely to products B and C together. The entity determines the estimated standalone selling price of product D \$60 under the residual approach as follows:

Product	SSP
A	\$ 80
B and C	120
D	60
Total	<b>\$ 260</b>

The entity considers whether the resulting allocation is consistent with the allocation objective and the guidance on estimating the standalone selling price. The entity concludes that the resulting allocation is appropriate because \$60 allocated to product D is within the range of its observable selling prices (\$30 - \$90).

**EXAMPLE 5-4 (ADAPTED FROM ASC 606-10-55-259 THROUGH 55-269): ALLOCATING A DISCOUNT AND RESIDUAL APPROACH – RESIDUAL APPROACH IS NOT APPROPRIATE**

Consider the same facts in Example 5-3 except the consideration payable by the customer is \$210. In this case, the residual approach would result in an estimated standalone selling price of \$10 for product D ( $\$210$  transaction price less  $\$200$  allocated to products A, B, and C). The entity observes that \$10 does not approximate the standalone selling price of product D, which ranges from \$30 - \$90. Therefore, the entity concludes that \$10 would not

faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for the sale of product D.

Therefore, the entity reviews its observable data, including sales and margin reports, to estimate the standalone selling price of product D using another suitable method. In this case, the entity allocates the transaction price of \$210 to products A, B, C and D on a relative standalone selling price basis.

### BDO INSIGHTS – ALLOCATION OF DISCOUNT

It is common for entities in the retail sector to ‘bundle’ several different goods together and sell them at a discount. Although the approach set out in ASC 606 appears straightforward, determining an appropriate basis to allocate discounts and evaluating whether the allocation objective is met requires the application of professional judgment, based on the facts and circumstances. This may be particularly complex if an entity also expects to apply a residual approach. For example, the entity may have to consider the range of prices at which each good within a bundle has historically been sold separately to appropriately apply the discount allocation exception and the residual approach.

## 5.5 ALLOCATION OF VARIABLE CONSIDERATION



### FASB REFERENCES

ASC 606-10-32-39 through 32-41

The application of the general allocation model based on relative standalone selling prices to a contract that includes multiple performance obligations and variable consideration results in the allocation of variable consideration to all performance obligations in the contract. However, this may not necessarily result in a faithful depiction of the amount of consideration to which the entity expects to be entitled from the customer upon satisfying a particular performance obligation if the variable consideration does not relate to all the performance obligations in the contract. For example, an entity may contract to sell two products that are delivered at different points in time with a bonus fee payable by the customer that is contingent on the timely delivery of only the second product. In that example, it might be inappropriate to allocate the bonus (a variable consideration that is included in the transaction price) to both products. Therefore, an exception to the general allocation model was provided for allocation of variable consideration (hereinafter, referred to as the “variable consideration allocation exception”).

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

- ▶ One or more, but not all, performance obligations in the contract. This would apply if, for example, a bonus is contingent on an entity transferring a good or service within a specified period of time.
- ▶ One or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation (see Section 3.4 for discussion on the series guidance). This would apply if, for example, the consideration promised for the second year of a two-year cleaning service contract will increase based on movements in a consumer price index.

The variable consideration allocation exception states that an entity allocates a variable amount of consideration (and subsequent changes to that amount) entirely to a single performance obligation (or a distinct good or service that forms part of a single performance obligation that meets the definition of a series) if both of the following criteria are met:

- ▶ The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- ▶ When considering all of the performance obligations and payment terms in the contract, the allocation of the variable amount in its entirety to a performance obligation (or distinct good or service) is consistent with the allocation objective that the transaction price must be allocated to each performance obligation (or distinct good or service) to reflect the consideration to which the entity expects to be entitled in exchange for transferring the promised good or service.

An entity applies the general allocation model (see Section 5.2.1) and the discount allocation exception (see Section 5.4) to allocate the remaining amount of transaction price that does not meet the criteria for the variable consideration allocation exception.



### TRG DISCUSSIONS — ALLOCATION OF VARIABLE CONSIDERATION TO A DISTINCT GOOD OR SERVICE IN A SERIES

In July 2015, the TRG discussed whether the allocation of variable consideration to a distinct good or service in a series is required to be based on standalone selling prices. That could have limited the number of transactions that qualify for the variable consideration allocation exception because it might imply that each distinct service that is substantially the same would need to be allocated the same amount (absolute value) of variable consideration.

ASC 606-10-32-29 states that to meet the allocation objective, an entity shall allocate the transaction price to each performance obligation on a relative standalone selling price basis. However, that paragraph specifically excludes ASC 606-10-32-39 through 32-41 on allocating variable consideration to a distinct service in a series from this requirement. Additionally, ASC 606-10-32-30 states that the guidance in ASC 606-10-32-31 through 32-41 on the relative standalone selling price allocation does not apply to the allocation of variable consideration. BC280 of ASU 2014-09 describes that while standalone selling price is the default method for determining whether the allocation objective is met, the FASB decided that other methods could be used in certain instances and, therefore, included the guidance on allocating variable consideration.

Based on the above considerations, the TRG agreed that an allocation based on relative standalone selling prices is not required to meet the allocation objective when allocating variable consideration to a distinct good or service in a series. However, as illustrated in Example 35 in ASC 606 (see adaptations in Examples 5-5 and 5-6 in this chapter) where variable consideration is allocated to different performance obligations, standalone selling prices in some cases might be utilized (but are not required to be utilized) to determine the reasonableness of the allocation.

The FASB did not describe other methods that could be used to comply with the allocation objective other than stating in ASC 606-10-32-40(b) that an entity must consider all the payment terms and performance obligations. For instance, an entity might consider its effort to fulfill the obligation and whether the variable consideration is commensurate with the value provided to the customer. As such, an entity must apply reasonable judgment to determine whether the allocation results in a reasonable outcome.

The following examples were discussed by the TRG. The examples below are not all-inclusive, and there could be other reasons why a variable fee would or would not meet the allocation objective.

#### Example A

IT Seller and IT Buyer execute a 10-year IT Outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term. For example, the IT seller will provide server capacity, manage the customer's software portfolio, and run an IT help desk. The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power, number of software applications used, or number of employees supported, and the price per unit differs for each type of activity.

Before the delivery of the service, IT Seller performs certain initial set-up activities to be able to provide the other services in the contract. IT Seller charges the IT Buyer a nonrefundable upfront fee related to the transition activities. IT Seller concludes that the set-up activities do not transfer services to the customer.

The per unit price IT Seller charges declines over the life of the contract. The agreed upon pricing at the onset of the contract is considered to reflect market pricing. The pricing decreases to reflect the associated costs decreasing over the term of the contract as the level of effort to complete the tasks decreases. Initially, the tasks are performed by more expensive personnel for activities that require more effort. Later in the contract, the level of effort for the activities decreases, and the tasks are performed by less expensive personnel. The contract includes a price benchmarking clause whereby the IT Buyer engages a third-party benchmarking firm to compare the contract pricing to current market rates at certain points in the contract term. There is an automatic prospective price adjustment if the benchmark is significantly below IT Seller's price.

Assume IT Seller concludes that there is a single performance obligation that is satisfied over time because the customer simultaneously receives and consumes the benefits provided by its services as it performs.

In this example, the events that trigger the variable consideration are the same throughout the contract, but the price per unit decreases each year. Even with the declining prices, the allocation objective could be met if the pricing is based on market terms or the changes in price are substantive and linked to changes in the entity's cost to fulfill the obligation or value provided to the customer based on the third-party benchmarking data.

#### **Example B**

Transaction Processor (TP) enters a 10-year agreement with a customer. Over the 10-year period, TP will provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use TP's system to process all of its transactions; however, the ultimate quantity of transactions is not known. TP concludes that the customer simultaneously receives and consumes the benefits as it performs.

TP charges the customer on a per transaction basis. For each transaction, the customer is charged a contractual rate per transaction and a percentage of the total dollars processed. TP also charges the customer a fixed upfront fee at the beginning of the contract.

If the nature of the entity's promise is a single service to process as many transactions as the customer requires, the fees based on quantity processed and the fees based on a percentage of dollars processed could meet the allocation objective for each month of service. For example, the allocation objective could be met if the fees are priced consistently throughout the contract and the rates charged are consistent with the entity's standard pricing practices with similar customers.

#### **Example C**

Hotel manager (HM) enters a 20-year agreement to manage properties on behalf of the customer. HM receives monthly consideration based on 1% of monthly rental revenue, reimbursement of labor costs incurred to perform the service and an annual incentive payment based upon 8% of gross operating profit. HM concludes that the customer simultaneously receives and consumes the benefits provided by its services as it performs.

In this example, the base monthly fees could meet the allocation objective for each month because there is a consistent measure throughout the contract period that reflects the value to the customer each month (the % of monthly sales). Similarly, if the labor cost reimbursements are commensurate with the entity's efforts to fulfill the promise each day, then the allocation objective for those variable fees could also be met. Finally, the allocation objective could also be met for the incentive fee if it reflects the value delivered to the customer for the annual period (reflected by the profits earned) and is reasonable compared to the incentive fees that could be earned in other periods.

**EXAMPLE 5-5 (ADAPTED FROM ASC 606-10-55-270 THROUGH 55-279): ALLOCATION OF VARIABLE CONSIDERATION – ENTIRELY TO ONE PERFORMANCE OBLIGATION**

An entity enters a contract with a customer for two licenses of IP (licenses A and B). Assume each license represents a separate performance obligation, which is satisfied at a point in time when it is transferred to the customer. The standalone selling prices of licenses A and B are \$1,200 and \$1,500, respectively.

The consideration payable by the customer is as follows:

- ▶ License A: a fixed amount of \$1,200
- ▶ License B: a royalty payment of 5% of the selling price of the customer's future sales of products that use the IP to which license B relates

The entity estimates that the amount of sales-based royalties that it will be entitled to in respect of license B will be about \$1,500.

The entity then considers the criteria in the variable consideration allocation exception to determine the allocation of the transaction price to each of the two licenses. The entity determines that:

- ▶ The variable consideration (sales-based royalty) relates specifically to an outcome from the entity's performance obligation to transfer license B (that is, the customer's subsequent sales of products that use that license).
- ▶ Allocating the expected sales-based royalty amounts of \$1,500 entirely to license B is consistent with the allocation objective, because the estimated amount of royalties approximates the standalone selling price of license B (\$1,500) and the fixed amount of \$1,200 approximates the standalone selling price of license A. Based on an assessment of the facts and circumstances relating to both licenses, the entity determines that allocating some of the fixed consideration (\$1,200) to license B in addition to all of the variable consideration would not meet the allocation objective.

Therefore, the entity allocates the transaction price as follows in accordance with the variable consideration allocation exception:

- ▶ License A: \$1,200
- ▶ License B: the variable royalty payment

Although revenue of \$1,200 will be recognized for license A when it is transferred to the customer, no revenue will be recognized when license B is transferred to the customer. Sales-based royalties allocated to license B are not recognized before the subsequent sales of the customer's products that use license B take place because of the exception in ASC 606-10-55-65 that precludes estimation of sales- or usage-based royalties for licenses of IP (see Section 7.5 for discussion on licensing).

In contrast to this example, the allocation of variable consideration is different in Example 5-6 below because the contractual prices do not reflect standalone selling prices of the licenses.

**EXAMPLE 5-6 (ADAPTED FROM ASC 606-10-55-270 THROUGH 55-279): ALLOCATION OF VARIABLE CONSIDERATION – BASED ON STANDALONE SELLING PRICES**

Assume the same fact pattern in Example 5-5, except that the prices included in the contract are:

- ▶ License A: a fixed amount of \$450
- ▶ License B: a royalty payment of 7.5% of the selling price of the customer's future sales of products that use license B

The entity estimates that the amount of sales-based royalties that it will be entitled to in respect of license B will be about \$2,250.

The entity then considers the criteria in the variable consideration allocation exception to determine the allocation of the transaction price to each of the two licenses. The entity determines that in this case, although the variable

payments (the sales-based royalties) relate solely to the transfer of license B, allocating the variable consideration only to license B would be inappropriate. This is because allocating \$450 to license A and \$2,250 to license B would not reflect a reasonable allocation based on the standalone selling prices of those two licenses. As a result, the entity must apply the general allocation model based on relative standalone selling prices.

#### Allocation of the fixed consideration

The entity allocates the fixed amount of \$450 to the two licenses based on their standalone selling prices. This allocation is calculated as:

Product	Allocated Transaction Price
License A	$(\$450 \times (\$1,200 / \$2,700)) = \$200$
License B	$(\$450 \times (\$1,500 / \$2,700)) = \$250$
Total	<u>\$450</u>

#### Allocation of the variable consideration

As the sales by the customer of products that use license B occur, the sales-based royalties are allocated to licenses A and B on a relative standalone selling price basis.

#### Revenue Recognition at Contract Inception

Assume license A is transferred to the customer three months after contract inception and license B is transferred at contract inception.

- ▶ Revenue of \$200 is recognized for license A three months after the contract inception when license A is transferred to the customer.
- ▶ Revenue of \$250 is recognized for license B at contract inception when license B is transferred to the customer.
- ▶ Recognition of the sales-based royalty allocated to each of the two licenses is deferred to future periods because ASC 606-10-55-65 precludes the recognition of sales-based royalty before the related sales occur (see Section 7.5 for discussion on licensing).

Although the royalty relates solely to the transfer of license B, the allocation of the fixed consideration (\$450) to license A and the entire sales-based royalties to license B (estimated at \$2,250) is disproportionate in comparison with the standalone selling prices of the two licenses. That is, there is pricing interdependency between the two licenses, which indicates that some of the royalty generated by license B in fact relates to the sale of license A, and some of the fixed license fee (\$450) stated in the legal contract as relating solely to license A also relates to the sale of license B.

See Example 7-32 in Chapter 7 (a continuation of this example) for a discussion of the recognition of sales-based royalties in revenue.

#### EXAMPLE 5-7: ALLOCATION OF VARIABLE CONSIDERATION – ENTIRELY TO ONE PERFORMANCE OBLIGATION

Assume the same fact pattern in Example 5-5, except that the prices included in the contract are:

- ▶ License A: a fixed amount of \$1,950
- ▶ License B: a royalty payment of 2.5% of the selling price of the customer's future sales of products that use license B

The entity estimates that the amount of sales-based royalties that it will be entitled to in respect of license B will be about \$750.

The entity then considers the criteria in the variable consideration allocation exception to determine the allocation of the transaction price to each of the two licenses. The entity determines that:



- ▶ The variable consideration (sales-based royalty) relates specifically to an outcome from the entity's performance obligation to transfer license B (that is, the customer's subsequent sales of products that use that license).
- ▶ Allocating the expected sales-based royalty amounts of \$750 entirely to license B is consistent with the allocation objective. Although the estimated amount of royalties is less than the standalone selling price of license B (\$1,500), the fixed amount of \$1,950 is also greater than the standalone selling price of license A (\$1,200). Therefore, the entity concludes that the fixed amount of \$1,950 should be allocated to both licenses A and B after allocating the expected sales-based royalty amounts of \$750 entirely to license B.

#### Allocation of the fixed consideration

The entity allocates the fixed amount of \$1,950 to the two licenses based on their standalone selling prices after allocating the variable amount to license B.

This allocation is calculated as:

Product	Allocated Transaction Price
License A	$(\$1,950 \times (\$1,200/\$1,950)) = \$1,200$
License B	$(\$1,950 \times ((\$1,500-750)/\$1,950)) = \$750$
Total	<u>\$1,950</u>



#### TRG DISCUSSIONS – ALLOCATION HIERARCHY – VARIABLE CONSIDERATION AND DISCOUNT

In March 2015, the TRG considered an arrangement that included both variable consideration and a discount and discussed whether the guidance in ASC 606 on allocating discounts to only one or some (but not all) performance obligations in a contract is different from the guidance on allocating variable consideration to only one or some (but not all) performance obligations.

TRG members agreed that ASC 606 establishes a hierarchy for allocating variable consideration, including variable discounts. When a contract includes variable consideration, an entity first applies the guidance on allocating variable consideration before considering the guidance on allocating discounts.

TRG members also stated that not all discounts are variable and that if a discount is fixed, that discount does not give rise to variable consideration. In those cases, an entity would apply the guidance for the allocation of discounts and not the guidance for the allocation of variable consideration.



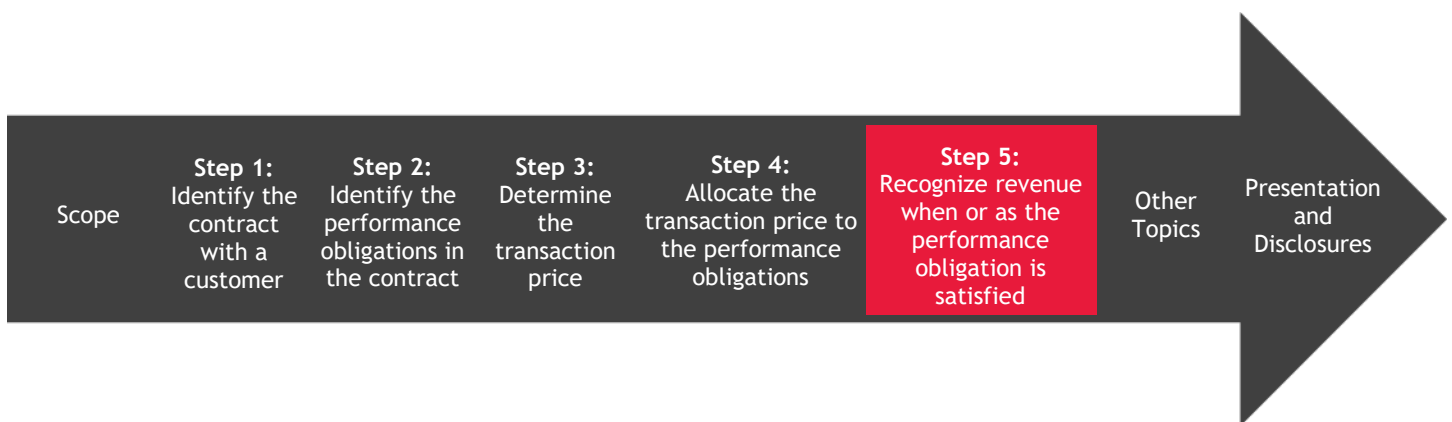
**BDO INSIGHTS – ALLOCATION OF VARIABLE CONSIDERATION AND DISCOUNT**

Some contracts with customers include both variable consideration and a discount that is variable. In that scenario, a question arises regarding the sequence of applying the guidance on allocation of variable consideration and the guidance on allocation of discount. Consistent with the TRG discussions above, we believe an entity must first apply the guidance on variable consideration allocation and then apply the general allocation guidance or the guidance on allocation of a discount to the remaining amount of the transaction price. An entity first needs to determine whether the discount is variable consideration. Determining whether a discount is a variable consideration, and its appropriate allocation, requires the application of professional judgment, based on facts and circumstances.

In the absence of specific guidance in ASC 606, we believe multiple approaches could be acceptable for determining the amount that represents a discount (rather than variable consideration) and hence is not within the scope of the guidance on variable consideration allocation. Any approach selected must result in an allocation that is consistent with the criteria for the variable consideration allocation exception and the allocation objective.



# CHAPTER 6 – STEP 5: RECOGNIZE REVENUE WHEN OR AS THE PERFORMANCE OBLIGATION IS SATISFIED

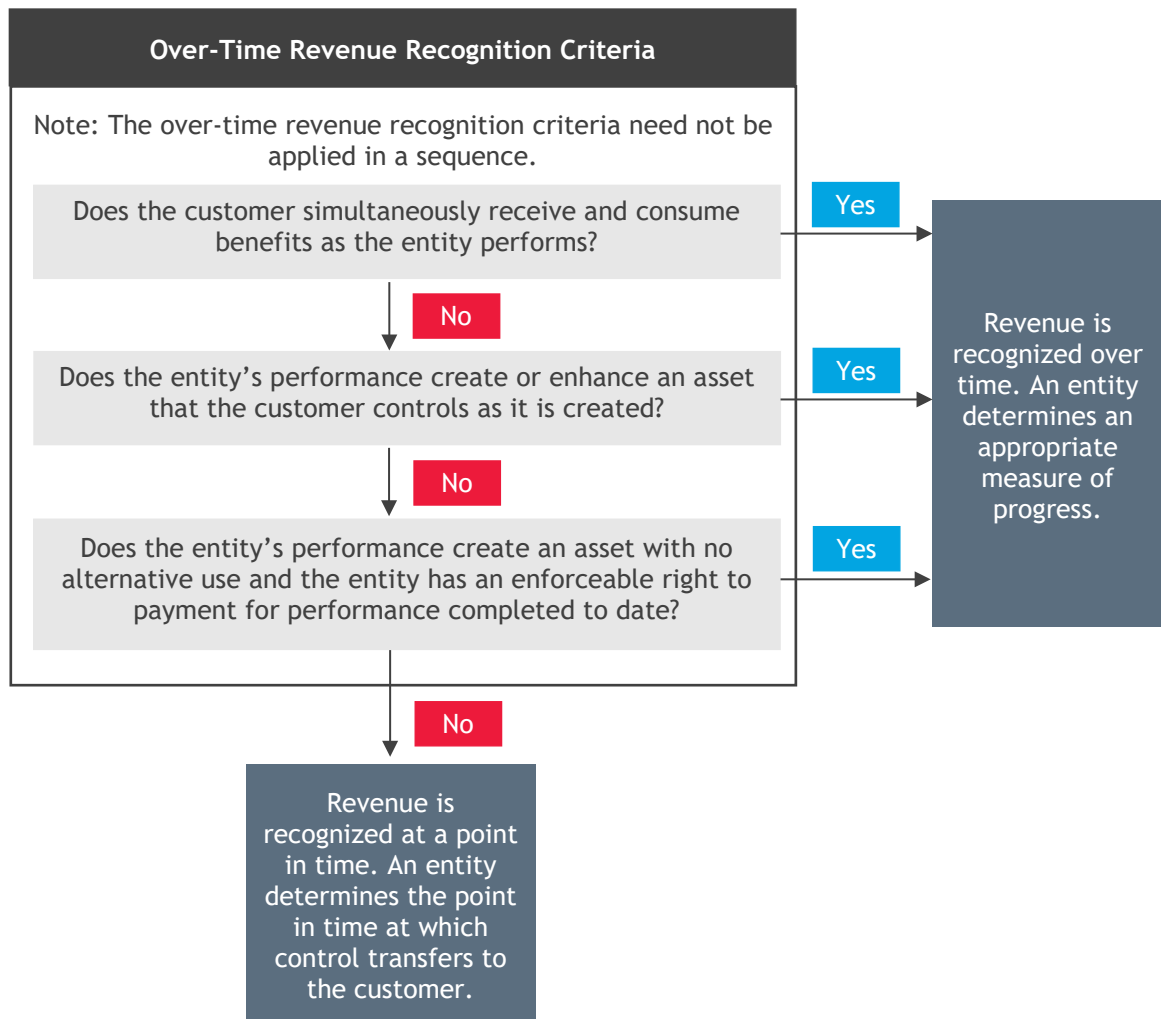


## 6.1 OVERVIEW

After allocating (in Step 4) the transaction price (determined in Step 3) to the performance obligations identified in the contract (in Step 2), an entity assesses when it satisfies each performance obligation by transferring a promised good or service to the customer and recognizes revenue allocated to each performance obligation when (or as) that performance obligation is satisfied. An entity satisfies its performance obligation in a contract by transferring control of the promised good or service underlying that performance obligation to the customer, which may be at a point in time or over time. Therefore, assessing when control of a good or service is transferred to a customer is a critical aspect of Step 5.

Control in the context of ASC 606 is the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. ASC 606 includes certain indicators to help apply the control principle.

ASC 606 includes three criteria to determine whether a performance obligation is satisfied over time. An entity must first consider those criteria to determine if a performance obligation is satisfied over time. If none of those criteria are met, then the performance obligation is satisfied at a point in time. The entity is then required to consider the indicators of control to determine at what point in time the control transfers to the customer. The following diagram gives an overview of those requirements:



## 6.2 SATISFACTION OF PERFORMANCE OBLIGATIONS



### FASB REFERENCES

ASC 606-10-25-23 through 25-25

An entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred to a customer when (or as) the customer obtains control of that asset. Goods and services are assets, even if only momentarily, when received and used (as in the case of many services) by customers.

At contract inception, an entity must determine whether it satisfies the performance obligation identified in Step 2 over time or at a point in time. A performance obligation is satisfied at a point in time if an entity does not satisfy the performance obligation over time.

### BDO INSIGHTS – SEQUENCE FOR DETERMINING WHETHER A PERFORMANCE OBLIGATION IS SATISFIED OVER TIME OR AT A POINT IN TIME

ASC 606 establishes a sequence for analyzing whether a performance obligation is satisfied at a point in time or over time. The three criteria in ASC 606-10-25-27 establish whether a performance obligation is satisfied over time (see Section 6.3 for more discussion). An entity must first evaluate each performance obligation against each of those criteria to conclude whether a performance obligation is satisfied over time. If none of the over time revenue recognition criteria are met, then the performance obligation is satisfied at a point in time. An entity cannot omit the analysis of the over time revenue recognition criteria and default to a conclusion that a performance obligation is satisfied at a point in time. Rather, to conclude that a performance obligation is satisfied at a point in time, an entity must first conclude that none of the over time revenue recognition criteria are met.

#### 6.2.1 Notion of Control



#### FASB REFERENCES

ASC 606-10-25-25 and 25-26 and ASC 606-10-25-30

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.

BC120 of ASU 2014-09 states that the description of control in ASC 606 is based on the meaning of control in the definition of an asset in the FASB's conceptual framework. The components that make up the description of control are explained below:

- ▶ **Ability** – A customer must have the present right to direct the use of, and obtain substantially all of the remaining benefits from, an asset for an entity to recognize revenue related to the transfer of that asset to the customer. For example, in a contract that requires a manufacturer to construct an asset for a particular customer, it might be clear that the customer will ultimately have the right to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, the manufacturer must not recognize revenue until the customer has obtained that right (which based on the contract, might occur during production or afterwards).
- ▶ **Direct the use of** – A customer's ability to direct the use of an asset refers to the customer's right to deploy that asset in its activities, to allow another entity to deploy that asset in its activities, or to restrict another entity from deploying that asset.
- ▶ **Obtain the benefits from** – The customer must have the ability to obtain substantially all of the remaining benefits from an asset to obtain control of it. The benefits from a good or service are the potential cash flows (either an increase in cash inflows or a decrease in cash outflows) that can be obtained directly or indirectly, for example by:
  - Using the asset to produce goods or provide services (including public services)
  - Using the asset to enhance the value of other assets
  - Using the asset to settle liabilities or reduce expenses
  - Selling or exchanging the asset
  - Pledging the asset to secure a loan
  - Holding the asset

BC121 of ASU 2014-09 states that the assessment of when control has transferred to a customer could be applied from the perspective of either the entity selling the good or service or the customer purchasing the good or service. Therefore, revenue could be recognized when the entity surrenders control of a good or service or when the customer obtains control of that good or service. Although in many cases both perspectives lead to the same result, the FASB decided that control must be assessed primarily from the perspective of the customer to minimize the risk of an entity recognizing revenue from undertaking activities that do not coincide with the transfer of goods or services to the customer.

ASC 606 provides the following non-exhaustive list of indicators that control has transferred to the customer:

- ▶ The entity has a present right to payment for the asset.
- ▶ The customer has legal title to the asset.
- ▶ The entity has transferred physical possession of the asset.
- ▶ The customer has the significant risks and rewards of ownership of the asset.
- ▶ The customer has accepted the asset.

See Section 6.5 for discussion on each of the indicators of control.



### REPURCHASE RIGHTS

Additionally, in evaluating whether a customer obtains control of an asset, an entity must consider any agreement to repurchase the asset, or a component of that asset, transferred to the customer. See Section 6.6 for discussion on repurchase rights.

### BDO INSIGHTS – REVENUE RECOGNITION IS BASED ON TRANSFER OF CONTROL (NOT RISKS AND REWARDS)

Revenue recognition under ASC 606 is based on the transfer of control rather than risks and rewards only. Under the control model, an analysis of risks and rewards is only one of the many factors considered in determining whether and when revenue is recognized. Revenue recognition based on the notion of control (rather than risks and rewards) may significantly affect the timing and pattern of revenue recognition in certain industries.

## 6.3 PERFORMANCE OBLIGATIONS SATISFIED OVER TIME



### FASB REFERENCES

ASC 606-10-25-27

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

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

The three criteria provide an objective basis for assessing when control transfers over time and, thus, when a performance obligation is satisfied over time.

### 6.3.1 Customer Simultaneously Receives and Consumes Benefits as the Entity Performs



#### FASB REFERENCES

ASC 606-10-25-27(a), ASC 606-10-55-5 and 55-6

If a customer simultaneously receives and consumes the benefits provided by an entity's performance as the entity performs, then the entity transfers control of a good or service underlying a performance obligation to the customer over time and, therefore, revenue attributed to that performance obligation is recognized over time.

For some types of performance obligations, the analysis 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 is straightforward. For example, for routine or recurring services, such as a cleaning service, the receipt and simultaneous consumption by the customer of the benefits of the entity's performance may be readily identified.

In many typical service contracts, an entity's performance creates an asset only momentarily because that asset is simultaneously received and consumed by the customer. In those cases, 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 and thus, the entity's performance obligation is satisfied over time.

#### **BDO INSIGHTS – ANALYZING WHETHER THE CUSTOMER SIMULTANEOUSLY RECEIVES AND CONSUMES BENEFITS**

Although the standard includes cleaning services as an example of a performance obligation satisfied over time, entities must carefully analyze cleaning contracts to appropriately identify the performance obligation(s) and determine the pattern of satisfaction of the performance obligation(s) identified. For example, consider a three-year cleaning contract of an office building in which the windows are cleaned once every six months (and requires five days to complete), carpets are deep cleaned once a month (and takes place over a weekend), and trash disposal and vacuuming is done daily outside normal office working hours. In this fact pattern, each cleaning activity may constitute a separate performance condition, and if so, it would be necessary to allocate the transaction price to each of the performance obligations. The transaction price allocated to window cleaning and the deep cleaning of carpets would be recognized as those activities take place (rather than ratably over the three-year contractual period).

Similarly, in certain industries, such as the airline industry, an entity may provide ongoing maintenance for critical equipment such as airplane engines, as well as periodic overhaul services. While both the ongoing maintenance and overhaul services likely meet the criterion to be recognized over time (because the customer simultaneously receives and consumes the benefits provided by the entity), the entity would likely conclude that the ongoing maintenance and overhaul services are distinct performance obligations, each with different timing for revenue recognition. As such, the transaction price must be allocated to the ongoing maintenance activities and overhaul activities, and the allocated amounts are recognized in revenue as those separate activities take place.

#### 6.3.1.1 Substantial Reperformance of the Performance Completed to Date



#### FASB REFERENCES

ASC 606-10-55-159 and 55-160

For some types of performance obligations in service-type contracts, 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 because the notion of "benefit" can be subjective. 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 another entity were to fulfill the remaining performance obligation to the customer.



#### **DETERMINING WHETHER ANOTHER ENTITY WOULD NOT NEED TO SUBSTANTIALLY REPERFORM THE COMPLETED WORK**

In determining whether another entity would not need to substantially reperform the work the entity has completed to date, an entity must make both of the following assumptions:

- ▶ Disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity.
- ▶ 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 (for example, a partially completed service or item of property, plant, and equipment) and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

BC126 of ASU 2014-09 states that the assessment of whether another entity would need to substantially reperform the performance completed to date can be used as an objective basis for determining whether the customer receives benefit from the entity's performance as it is provided. BC127 of ASU 2014-09 states that an entity disregards any contractual or practical limitations in assessing whether another entity would need to substantially reperform the performance completed to date because the objective of the criterion on whether the customer receives benefit from the entity's performance as it is provided is to determine whether control of the goods or services has already been transferred to the customer. This is done by using a hypothetical assessment of what another entity would need to do if it were to take over the remaining performance requirements. Therefore, actual, practical, or contractual limitations on the remaining performance have no bearing on the assessment of whether the entity has transferred control of the goods or services provided to a customer to date.

#### **EXAMPLE 6-1 (ADAPTED FROM ASC 606-10-55-159 AND 55-160): CUSTOMER SIMULTANEOUSLY RECEIVES AND CONSUMES THE BENEFITS**

An entity enters a contract with a customer to provide monthly payroll processing services to a customer for one year. Assume the promised payroll processing services are accounted for as a single performance obligation in accordance with the series guidance (see Section 3.4 for discussion on the series guidance).

The performance obligation is satisfied over time 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. This is demonstrated by another entity not needing to reperform payroll processing services for the service that the entity has provided to date.

In performing the above assessment, the entity disregards any practical limitations on transferring the remaining performance obligation, for example, any setup activities that may be undertaken by another entity.

The entity recognizes revenue over time by measuring its progress toward complete satisfaction of that performance obligation – see Section 6.4 for discussion on measure of progress.

**EXAMPLE 6-2: CUSTOMER SIMULTANEOUSLY RECEIVES AND CONSUMES THE BENEFITS**

A shipping entity enters a contract with a customer to transport goods from New York to Rotterdam (Netherlands). When the entity enters the contract, the ship used to transport the goods is docked in Miami. At the reporting date, the goods have been collected from New York, and the ship is half-way across the Atlantic Ocean.

The entity concludes that it can recognize revenue for its performance completed to date (that is, transportation of goods from New York to a location half-way across the Atlantic Ocean) because another entity would not need to re-perform the transportation services provided to date. In reaching that conclusion, the entity disregards the practical limitation from a hypothetical transfer of the goods from its ship to another shipping entity's ship in the middle of the Atlantic Ocean.

Therefore, the entity recognizes revenue over time by measuring its progress toward complete satisfaction of that performance obligation – see Section 6.4 for discussion on measure of progress.

**BDO INSIGHTS – EXAMPLE 6-2 AND SHIPPING CONTRACTS**

Careful analysis of shipping contracts may be required because in some circumstances, those contracts may contain a lease of the ship used to transport goods because the customer has the right to direct the use of the ship for a period of time. In those cases, ASC 842 may also apply to the contract (rather than only ASC 606). If a shipping contract includes services (for example, providing crew for the ship) with the lease of the ship, then the services would be within the scope of ASC 606 and the lease would be within the scope of ASC 842.<sup>8</sup> However, if the shipping contract does not include the transfer of a good or service within the scope of ASC 606, then the entire contract would be accounted for as a lease under ASC 842 (that is, no part of the contract would be within the scope of ASC 606). If the arrangement is accounted for under ASC 842, lease income (assuming the lease is classified as an operating lease under ASC 842) would be recognized from the date of lease commencement (that is, right to direct the use of the ship passes to the customer), which could result in lease income being recognized as the ship sails from Miami to New York.

If the contract does not contain a lease and is instead accounted for as a promise to provide shipping services under ASC 606, revenue is not recognized to reflect the effort required to move the ship from Miami, its location at contract inception, to New York because the shipping entity does not provide any service to the customer during that part of the overall journey. Rather, the entity recognizes revenue at the reporting date to reflect the extent to which the goods have been transported from New York to Rotterdam. Additionally, the entity must consider whether the costs for the journey from Miami to New York represent costs to fulfill the contract that is accounted for under ASC 340-40 (see Section 7.7 for discussion on contract costs).

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<sup>8</sup> ASC 842-10-15-42A provides a lessor an accounting policy election to combine certain non-lease components (such as services) within the scope of ASC 606 with a lease component in a contract and account for the combined component under ASC 606 or ASC 842 based on whether the lease or non-lease component is predominant. See our Blueprint, [Accounting for Leases Under ASC 842](#), for guidance on ASC 842.





## TRG DISCUSSIONS – TRANSFER OF CONTROL – COMMODITIES

In July 2015, the TRG discussed whether the control of a commodity (such as gas, electricity, or heating oil) is transferred at a point in time or over time.

The TRG members generally agreed that all known facts and circumstances must be considered when determining whether a customer simultaneously receives and consumes the benefits of a commodity. These facts and circumstances might include, for example, the following:

- ▶ Contract terms
- ▶ Customer infrastructure
- ▶ Whether or not the commodity can be stored

Therefore, depending on the facts and circumstances surrounding the sale of commodity, revenue may or may not be recognized over time. For example, a performance obligation to provide natural gas to a residential location on an as-needed basis would likely meet the over time revenue recognition criterion on whether the customer simultaneously receives benefits from the entity's performance as the entity performs because the residential household likely would not have the ability to store gas and instead would pay for any gas that is delivered as it is used. Conversely, a contract to deliver a fixed amount of natural gas to a reseller of that gas would likely not meet that over time revenue recognition criterion because the contract includes a fixed amount of gas to be delivered, and the customer/reseller would likely have the intent and ability to store the gas until it is resold to an end consumer.

BC128 of ASU 2014-09 states that the over time revenue recognition criterion on whether the customer simultaneously receives benefits from the entity's performance as the entity performs is not intended to apply to contracts in which the entity's performance is not immediately consumed by the customer, which would be typical in cases when the entity's performance results in an asset such as work in process in a construction contract. If an entity applies ASC 606 to contracts in which the entity's performance results in an asset (which could be tangible or intangible) being created or enhanced, it considers the other two over time revenue recognition criteria – see Sections 6.3.2 and 6.3.3. for related discussion.

### 6.3.2 Performance Creates or Enhances an Asset That the Customer Controls As It Is Created



#### FASB REFERENCES

ASC 606-10-25-27(b) and ASC 606-10-55-7

If an entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced, then the entity transfers control of a good or service underlying a performance obligation to the customer over time and, therefore, revenue attributed to that performance obligation is recognized over time. In those cases, because the customer controls any work in process, the customer is obtaining the benefits of the goods or services that the entity is providing and, thus, the performance obligation is satisfied over time.

To determine whether a customer controls an asset that is being created or enhanced by an entity's performance as it is created or enhanced, an entity must apply the guidance on control, including considering whether the indicators of control are met related to any work in process as the promises are being delivered. See Section 6.2.1 for discussion on the notion of control.

The asset being created or enhanced by an entity could be either tangible or intangible, for example, a building that is being constructed by an entity on land owned by the customer, or customized software being integrated into a customer's existing IT infrastructure.

BC130 of ASU 2014-09 states that the basis for the over time revenue recognition criterion on whether an entity's performance creates or enhances an asset that the customer controls is consistent with the rationale underlying the percentage-of-completion revenue recognition approach in the prior revenue recognition guidance. That prior guidance acknowledged that in many construction contracts, the entity in effect agrees to sell its rights to the asset (that is, work in process) as the entity performs, which effectively results in a continuous sale (that is, the customer controls the work in process) that occurs as the work progresses.

The criterion on whether an entity's performance creates or enhances an asset that the customer controls is most likely relevant when a customer clearly controls the asset as it is created or enhanced, for example, when an asset is being constructed by an entity on the customer's premises. For some performance obligations, it may be unclear whether the asset that is created or enhanced is controlled by the customer. In those cases, it can be more challenging to determine when control transfers. Therefore, the standard includes the third over time revenue recognition criterion – see Section 6.3.3 for related discussion.

### **BDO INSIGHTS – ANALYSIS OF OVER TIME REVENUE RECOGNITION CRITERIA IN CONTRACTS WITH THE U.S. FEDERAL GOVERNMENT**

Contracts with the U.S. federal government under Federal Acquisition Regulations (FAR) generally require analysis under the over time revenue recognition criteria in ASC 606-10-25-27(b) and 25-27(c) (that is, the criterion on whether an entity's performance creates or enhances an asset that the customer controls and the criterion on whether an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date).

Contracts governed by FAR generally include termination clauses that provide the federal government with the right to obtain any work in process throughout the contract period if the contract is terminated before completion. The customer's ability to terminate the contract and obtain the interim work product is an indicator of control that must be analyzed with other rights, such as rights to payment, legal title, but which often results in meeting the criterion that an entity's performance creates or enhances an asset that the customer controls.

Contracts governed by FAR may also contain substantive contractual restrictions that prevent an entity from redirecting completed products to another entity if the contract with the federal government is terminated. The entity also typically has an enforceable right to payment for performance completed to date under the standard FAR payment terms, resulting in those contracts meeting the criterion that an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date. See Section 6.3.3. for discussion on the over time revenue recognition criterion.

### **6.3.3 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**



#### **FASB REFERENCES**

ASC 606-10-25-27(c)

If an 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 created to date, then the entity transfers control of a good or service underlying a performance obligation to the customer over time and, therefore, revenue attributed to that performance obligation is recognized over time.

BC132 of ASU 2014-09 states that the application of the two over time revenue recognition criteria discussed in Sections 6.3.1 and 6.3.2 could be challenging in some fact patterns and, therefore, provided the third criterion to help with the assessment of control. The FASB observed that this criterion may be necessary for services that are specific to a customer (for example, consulting services that ultimately result in a professional opinion specifically for the customer) as well as for the creation of tangible or intangible goods.

This criterion consists of two sub-criteria:

- ▶ No “alternative use”
- ▶ An enforceable “right to payment”

BC142 of ASU 2014-09 explains why the assessment of control in this criterion requires both no “alternative use” and a “right to payment.” Specifically, if an asset that an entity is creating does not have an alternative use to the entity, then the entity is effectively constructing an asset at the direction of the customer. Therefore, the entity will want to be economically protected from the risk of the customer terminating the contract and leaving the entity with no asset or an asset that has little value to the entity. That protection will be established by requiring the customer to pay for the entity’s performance completed to date if the contract is terminated before completion. Therefore, the fact that the customer is obligated to pay for the entity’s performance (or, in other words, is unable to avoid paying for that performance) implies that the customer has obtained the benefits from the entity’s performance. This is consistent with other exchange contracts when a customer is typically be obligated to pay only if it has received control of goods or services in the exchange. The notions of “alternative use” and “right to payment” are discussed in Sections 6.3.3.1 and 6.3.3.2.

#### 6.3.3.1 Performance Does Not Create an Asset With an Alternative Use



#### FASB REFERENCES

ASC 606-10-25-28, ASC 606-10-55-8 and 55-9

An asset created by an entity’s performance does not have an alternative use to an entity if either of the following applies:

- ▶ The entity is restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset.
- ▶ The entity is limited practically from readily directing the asset in its completed state for another use.

At contract inception, an entity must assess whether the asset in its completed form has an alternative use to the entity. After contract inception, an entity does 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 (see Section 7.3 for discussion on accounting for contract modifications). BC140 of ASU 2014-09 states that the requirement to assess alternative use at contract inception only is intended to avoid a continual reassessment of whether the asset has an alternative use, which could lead to a pattern of performance (and, therefore, revenue recognition) that is not useful.



#### CONTRACTUAL RESTRICTIONS AND PRACTICAL LIMITATIONS

Additionally, in assessing whether an asset has an alternative use to an entity, an entity must 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. However, the possibility of the contract with the customer being terminated is not relevant in assessing whether the entity would be able to readily direct the asset for another use.

##### 6.3.3.1.1 Substantive Contractual Restriction

A contractual restriction on an entity’s ability to direct an asset for another use must be substantive for the asset to have no 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.

- ▶ 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. This might apply when the asset being sold is mass produced, and it would be straightforward to substitute an equivalent item for a particular item subject to an existing contract, with the original item being sold to another customer. This would apply even if each of the items produced could be specified individually by each customer from a range of options because it is straightforward to produce another item with the same options and, therefore, meet the requirements of a particular contract.

#### EXAMPLE 6-3: SUBSTANTIVE CONTRACTUAL RESTRICTION – SALE OF REAL ESTATE

A contract for the sale of real estate with a contractual restriction on the seller's ability to direct an asset for another use is typically considered substantive if the seller is prohibited from selling the asset to another customer. For example, a seller typically cannot substitute a different condominium unit for the one contracted for by the customer, even if the two condominium units are substantially the same, as might be the case for two condominium units with identical floor plans in the same building.

#### EXAMPLE 6-4: CONTRACTUAL RESTRICTION IS NOT SUBSTANTIVE – SALE OF A CAR

Generally, a contract for the sale of a car with customer-specific customizations (exterior color, wheels, interior finishes, etc.) does not include a substantive contractual restriction on the seller's ability to direct that car for another use, for example, by selling that car to another customer. Even if the contract prohibited selling the car to another customer, each car produced could be customized by each customer from a range of optional extras and the seller could produce another car with the same options without incurring significant costs to meet the requirements of a particular contract.



#### CONTRACTUAL RESTRICTIONS THAT PROVIDE A PROTECTIVE RIGHT TO THE CUSTOMER

Contractual restrictions that provide a protective right to the customer are not sufficient to establish that an asset has no alternative use to the entity. BC138 of ASU 2014-09 states that a protective right typically results in the entity having the practical ability to physically substitute or redirect the asset without the customer's awareness of or objections to the change. Consider an example in which a contract states that an entity cannot transfer a good because a customer has legal title to the goods in the contract. However, the customer's 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 for little cost. In that example, the contractual restriction is merely a protective right and does not indicate that control of the goods has transferred to the customer.

### 6.3.3.1.2 Practical Limitation



#### FASB REFERENCES

ASC 606-10-55-10

A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss could arise because the entity would either incur significant costs to rework the asset or 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 customer-specific design specifications or are located in remote areas.

BC134 through BC138 of ASU 2014-09 explain further the concept of "alternative use" and how to consider whether a contractual or practical restriction exists. First, the notion of "alternative use" was developed to exclude the circumstances in which an entity's performance would not result in the transfer of control of goods or services to the customer over time. Specifically, when the entity's performance creates an asset with an alternative use to the entity, for example a standard inventory-type item that could be used to fulfil different contracts with different customers, the entity could readily direct the asset to another customer. In those cases, the customer cannot control the asset as it is being created because absent any contractual restrictions, the customer does not have the ability to restrict the entity from directing that asset to another customer.

Further, when an entity creates an asset that is highly customized for a specific customer, the asset would be less likely to have an alternative use to the entity 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 that case, the customer could be regarded as receiving the benefit of that performance and, as a result, having control of the goods or services (that is, the asset being created) as the performance occurs if the entity also has a right to payment (see Section 6.3.3.2 for related discussion).

In addition, although the level of customization might be a helpful factor to consider in assessing whether an asset has an alternative use, it is not a determinative factor. This is because in some cases (for example, some real estate contracts), an asset may be standardized but still might have no alternative use to an entity because of substantive contractual restrictions that prevent the entity from readily directing the asset to another customer. If a contract precludes an entity from transferring an asset to another customer and that restriction is substantive, the entity does not have an alternative use for that asset because it is legally obligated to direct the asset to the customer. This fact indicates that the customer controls the asset as it is created because the customer has the present ability to restrict the entity from directing that asset to another customer if the entity also has a right to payment (see Section 6.3.3.2 for related discussion).

In determining whether the entity is limited practically from directing the asset for another use, an entity should consider the characteristics of the asset that will ultimately be transferred to the customer. This is because, for some assets, the critical factor in making the assessment is whether the asset that is ultimately transferred could be redirected without a significant cost of rework rather than the period of time for which the asset has no alternative use. This may be relevant in some manufacturing contracts in which the basic design of the asset is the same across multiple contracts, but the customization in each contract is substantial. Therefore, redirecting the asset from one contract in its completed state to another customer requires significant rework.

Requiring an entity to consider contractual and practical restrictions is seemingly contradictory to the requirement to ignore contractual and practical limitations when applying the over-time revenue recognition criterion on whether the customer simultaneously receives benefits from the entity's performance as the entity performs (see Section 6.3.1). In BC139 of ASU 2014-09, the FASB stated that this difference is appropriate and added that although the objective of both criteria is to assess when control transfers over time, each criterion provides a different method for assessing when that control transfers because the criteria were designed to apply to different scenarios.

**EXAMPLE 6-5: (ADAPTED FROM ASC 606-10-55-165 THROUGH 55-168) — ASSET HAS NO ALTERNATIVE USE TO THE ENTITY**

An entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differ substantially, based on each customer's needs and the type of technology that is incorporated into the satellite.

The entity enters a contract with a customer to build a specialized satellite. The contract does not preclude the entity from directing the completed satellite to another customer. Assume that the entity's sole performance obligation in the contract is to build the satellite.

The entity assesses at contract inception whether its performance obligation to build the satellite is satisfied over time. The entity observes that 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 specific satellite to another customer. As a result, the entity determines that the satellite built for the customer has no alternative use to the entity because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.

**EXAMPLE 6-6: ASSET IN ITS COMPLETED FORM HAS NO ALTERNATIVE USE TO THE ENTITY**

A manufacturing entity manufactures metal pipe fittings for industrial use. The entity manufactures generic pipe fittings for off-the-shelf sales and customized pipe fittings for the specialized needs of a specific customer. The entity often uses a generic pipe fitting to customize it according to a customer's specifications. The entity is unable to sell a customized pipe fitting to other customers.

The entity enters a contract with a customer to manufacture a customized pipe fitting. The contract does not preclude the entity from directing the customized pipe fitting to another customer. The basic design of the customized pipe fitting (for example, metal type, shape, etc.) is the same as for a generic pipe fitting.

Assume that the entity's sole performance obligation in the contract is to manufacture a customized pipe fitting.

The entity assesses at contract inception whether its performance obligation to manufacture a customized pipe fitting is satisfied over time. Because the basic design of the specialized pipe fitting is the same as for a generic pipe fitting, the entity can redirect the work in process (asset) to another customer or for another purpose until the customization begins in the manufacturing process. In other words, the asset remains generic and interchangeable up to a certain point in the manufacturing process. However, the completed asset (the customized pipe fitting) cannot be sold to another customer and redirecting it to another customer or redirecting it for another purpose would require significant rework.

Therefore, the entity determines that the customized pipe fitting (that is, the asset in its completed form) has no alternative use to the entity regardless of the following:

- ▶ The asset is generic and can be redirected to another customer or for another purpose up to a certain point in the manufacturing process.
- ▶ The entity is not contractually precluded from directing the specialized pipe fitting to another customer.

Assuming the entity has an enforceable right to payment for performance completed to date (see Section 6.3.3.2 for related discussion), the performance obligation for the customized pipe fitting is satisfied over time, and the entity recognizes revenue over time during the manufacturing process. However, the entity begins to recognize revenue only when the customization begins in the manufacturing process. Before the customization begins, the entity's performance does not transfer an asset to the customer but rather creates an asset (inventory) for the entity. See Section 6.4 for discussion on measure of progress for recognizing revenue.

### 6.3.3.2 The Entity Has an Enforceable Right to Payment for Performance Completed to Date



#### FASB REFERENCES

ASC 606-10-25-27(c) and ASC 606-10-25-29

Concluding that an asset has no alternative use is not sufficient to conclude that a customer controls an asset as it is being constructed. Rather, an entity must also have an enforceable “right to payment” for performance completed to date to demonstrate that a customer controls an asset that has no alternative use as it is being created.



#### EVALUATING ENFORCEABLE RIGHT TO PAYMENT FOR PERFORMANCE COMPLETED TO DATE

An entity must consider the terms of the contract, as well as any applicable laws, when evaluating whether it has an enforceable right to payment for performance completed to date.

While the right to payment for performance completed to date need not be for a fixed amount, the entity must be entitled to an amount that at least compensates the entity for performance completed to date at all times throughout the duration of the contract if the contract is terminated by the customer or another party for reasons other than the entity’s failure to perform as promised.

#### 6.3.3.2.1 Amount That at Least Compensates the Entity for Performance Completed to Date



#### FASB REFERENCES

ASC 606-10-55-11

An amount that compensates 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 or profit if the contract was terminated.



#### REASONABLE PROFIT MARGIN

Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised. However, an entity must be entitled at all times throughout the contract duration to compensation for either of the following amounts:

- ▶ 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)
- ▶ 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



**BDO INSIGHTS – CONTRACTS PRICED AT LOSS AT CONTRACT INCEPTION**

Sometimes contracts with customers are priced at a loss at contract inception. ASC 606-10-55-11 uses the term “reasonable profit margin” to describe what would constitute the amount that would at least compensate an entity for performance completed to date. We believe “reasonable profit margin” could be interpreted as the applicable loss margin in a contract that is priced at a loss at contract inception. If an entity is entitled to a proportionate amount of the transaction price (even if it is priced at loss) for performance completed to date at all times throughout the contract duration, then the entity is entitled to an amount that would at least compensate it for performance completed to date. See Section 7.6 for a discussion of onerous contracts.

BC143 of ASU 2014-09 states the FASB’s intent that the term “right to payment” refers to a payment that compensates an entity for its performance completed to date rather than, for example, a payment of a deposit or a payment to compensate the entity for inconvenience or loss of profit. The underlying objective of the third over time revenue recognition criterion (whether an entity’s performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date) is to determine whether the entity is transferring control of goods or services to the customer as an asset is being created for that customer. Therefore, assuming rational behavior by the seller and no broader perceived economic benefits that might exist outside the scope of the contract with the customer, the seller would only agree to transfer control of the goods or services to the customer if the seller is compensated for the costs from fulfilling the contract and it receives a profit margin that includes a return on those costs.

BC144 of ASU 2014-09 further states that the compensation to which the entity would be entitled upon termination by the customer might not always be the contract margin because the value transferred to a customer in a prematurely terminated contract may not be proportional to the value if the contract was completed. However, to demonstrate compensation for performance completed to date, the compensation must be either:

- ▶ Based on a reasonable proportion of the entity’s expected profit margin
- ▶ Represent a reasonable return on the entity’s cost of capital

Furthermore, in analyzing the compensation to which the entity would be entitled upon termination by the customer, the focus must be on the amount to which the entity would be entitled upon termination rather than the amount for which the entity might ultimately be willing to settle in a negotiation.

#### 6.3.3.2.2 Existence and Enforceability of Right to Payment



#### FASB REFERENCES

ASC 606-10-55-12 through 55-15

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 could 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 must consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract was terminated before completion for reasons other than the entity’s failure to perform as promised.

In BC145 of ASU 2014-09, the FASB clarified that an entity need not have a present unconditional right to payment. Instead, it must have an enforceable right to demand and retain payment for performance completed to date if the customer were to terminate the contract without cause before completion because the contractual payment terms might not always align with an entity’s enforceable rights to payment for performance completed to date. For example, consider a contract in which a consulting entity agrees to provide a report at the end of the contract for a fixed amount that is conditional on providing that report. If the consulting entity were performing under that contract, it would have a right to payment for performance completed to date if the contractual terms or local laws require the



customer to compensate the entity for work completed to date if the customer terminates the contract without cause before completion.

In some contracts, a customer may have a right to terminate the contract only at specified times during the contract term, or the customer may 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 contractually agreed consideration in exchange for those goods or services. In those situations, 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. This would be the case if the contract or other local laws require the entity and the customer to complete their respective obligations (often referred to as specific performance).



#### ASSESSMENT OF A RIGHT TO PAYMENT MAY EXTEND BEYOND THE CONTRACTUAL TERMS

In assessing the existence and enforceability of a right to payment for performance completed to date, an entity must consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This may include assessing whether:

- ▶ Legislation, administrative practice, or legal precedent confers upon the entity a right to payment for performance completed to date even if that right is not contractually specified.
- ▶ Relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect.
- ▶ 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.



#### ASSESSMENT OF ENFORCEABLE RIGHT TO PAYMENT – PAYMENT SCHEDULE

A payment schedule and other related information specified in a contract do not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the contractually specified payment schedule and related information identify the timing and amount of consideration that is payable by a customer, the payment schedule and related information might not necessarily provide evidence of the entity's right to payment for performance completed to date. For example, a contract with a payment schedule 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. In addition, a payment schedule may not adequately compensate an entity for work performed at all points during the contract.

**ASSESSMENT OF ENFORCEABLE RIGHT TO PAYMENT — 100% NONREFUNDABLE UPFRONT PAYMENT**

BC146 of ASU 2014-09 includes discussion on whether a 100% nonrefundable upfront payment would meet the “right to payment for performance completed to date” criterion because a 100% payment would at least compensate the entity for work completed to date throughout the contract. This type of payment would meet the “right to payment for performance completed to date” criterion if the entity had an enforceable right to retain (and not refund) that payment if the customer terminated the contract; otherwise, it is questionable whether the entity actually has a right to payment.

In addition, different countries and sub-national jurisdictions may provide entities with legal rights that are applicable but are not explicitly included in the contracts. For example, a contract might refer to compliance with applicable laws but not specify precisely what these laws are. Therefore, in the absence of contractually specified terms that provide evidence of an enforceable right to payment for performance completed to date, an entity may need to review relevant legal precedence in its jurisdiction.

**BDO INSIGHTS — ANALYZING RIGHT TO PAYMENT WHEN CONTRACT TERMS ARE SILENT**

We generally believe if 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 based on the following interpretation from the FASB staff at the Private Company Council meeting held on June 26, 2018:

*“The staff understands that questions have arisen about how to handle contracts in circumstances in which the entity creates a good with no alternative use and the contract with the customer does not specify by its written terms the entity’s right to payment upon contract termination. Some stakeholders have asked whether it was the FASB’s intent that companies analyze every law in every jurisdiction to determine whether there is recoverability. In the staff’s view, a reasonable interpretation of the guidance is 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.”<sup>9</sup>*

However, there may be circumstances in which an enforceable right to payment exists even though the contract is silent as to such rights. If an entity asserts that it has such rights, we believe the entity must support its assertion with legislation, administrative practice, or legal precedence confirming that an enforceable right to payment exists in the relevant jurisdiction. The fact that the entity would have a basis for making a claim against the counterparty in a court of law would not be sufficient to support that an enforceable right to payment exists.

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<sup>9</sup> FASB Staff Private Company Council Memo, Definition of an Accounting Contract and Short Cycle Manufacturing (Right to Payment).

**EXAMPLE 6-7 (ADAPTED FROM ASC 606-10-55-161 THROUGH 55-164): ASSESSING ALTERNATIVE USE AND RIGHT TO PAYMENT**

An entity enters a contract with a customer to provide a consulting service to the customer. The service will result in the entity providing a professional opinion related to customer-specific facts and circumstances. If the customer terminates the contract for reasons other than the entity's failure to perform as promised, the customer is contractually required to compensate the entity for its costs incurred plus a 15% margin, which approximates the profit margin that the entity earns from similar contracts.

The entity assesses at contract inception whether its performance obligation to provide a consulting service with a professional opinion is satisfied over time.

The entity then evaluates the criterion on whether the entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance completed to date. The entity determines that criterion is met because of both of the following factors:

- ▶ The development of the professional opinion creates an asset with no alternative use to the entity because the professional opinion relates to customer-specific facts and circumstances. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.
- ▶ 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.

Therefore, the entity determines that its performance obligation is satisfied over time and recognizes revenue over time. See Section 6.4 for discussion on measure of progress.

**EXAMPLE 6-8 (ADAPTED FROM ASC 606-10-55-169 THROUGH 55-172): ENFORCEABLE RIGHT TO PAYMENT FOR PERFORMANCE COMPLETED TO DATE**

An entity enters a contract with a customer to build an item of equipment based on the customer's unique specifications. The contractually stated payment schedule requires the customer to make payments as follows:

- ▶ An advance payment of 10% of the contract price at contract inception
- ▶ Regular payments throughout the construction period amounting to 50% of the contract price
- ▶ A final payment of 40% of the contract price after construction is complete and the equipment has passed the prescribed performance tests

The payments are nonrefundable unless the entity fails to perform as promised. The entity is entitled to retain any progress payments received from the customer if the customer terminates the contract before completion. The entity has no further rights to compensation from the customer.

The entity assesses at contract inception whether its performance obligation to build the equipment is satisfied over time. Because the equipment is constructed to the customer's unique specifications, the entity concludes that the equipment has no alternative use.

As part of that assessment, the entity considers whether the entity has an enforceable right to payment for performance completed to date if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. The entity observes that it has the right to receive nonrefundable payments from the customer at various times during the contract term. However, the cumulative amount of those payments is not expected to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date at all points throughout the contract term. Instead, the cumulative amount of consideration paid by the customer at various times during the contract term might be less than the selling price of the partially completed item of equipment at that time. Therefore, the entity determines that it does not have a right to payment for performance completed to date for the duration of the contract.

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 the criterion on whether an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date.

Assume that the entity also concludes that it does not meet the other two over time revenue recognition criteria (see Sections 6.3.1 and 6.3.2). Thus, the entity's performance obligation is not satisfied over time and the entity accounts for the construction of the equipment as a performance obligation satisfied at a point in time – see Section 6.5 for discussion on performance obligations satisfied at a point in time.

#### EXAMPLE 6-9: ENFORCEABLE RIGHT TO PAYMENT

A manufacturing entity entered a contract with a customer to produce a highly specialized good that has no alternative use to the entity because it is prohibited from selling that product to another customer. The customer commits to purchase a certain volume of the goods over the contract term because it needs a continuous supply of the product to avoid interruptions to its production process.

The contract includes the following terms:

- ▶ The customer must compensate the entity for an amount equal to all costs incurred by the entity to date plus an agreed upon margin if the customer terminates the contract without cause.
- ▶ Payment by the customer is due upon delivery of the product.
- ▶ Goods are shipped under free on board (FOB) destination terms\* to the customer's international premises, and the entity insures the shipment against potential losses and damages that might affect the goods. Therefore, the customer will not pay for the products before delivery.
- ▶ Shipment timing averages 30 days from the entity's warehouse to the customer's international premises.

The entity determines that its performance obligation in the contract to manufacture and supply the goods does not meet the over time recognition criteria in Sections 6.3.1 and 6.3.2 because:

- ▶ The customer does not consume the economic benefits of the goods while the entity is producing the goods.
- ▶ The customer does not control the goods while they are in production because among other factors, the entity is producing the goods on the entity's premises.

The entity considers whether it has an enforceable right to payment for performance completed to date and concludes that it has a contractual right to recover all costs incurred plus an appropriate margin at all times throughout the contract's duration. Therefore, the entity has a present right to payment for any production completed to date.

The entity also considers that the customer has no obligation to pay in the event that goods are lost or damaged during the shipping period but concludes that failure by the entity to complete its contractual obligations because the goods are lost or damaged during the shipping period does not mean that the entity does not have an enforceable right to payment for performance completed to date. The possibility that an entity might not perform its contractual obligations is not relevant to the analysis of whether a performance obligation is satisfied over time. Additionally, we believe that if there were a significant risk that an entity might not be able to perform its contractual obligations such that it would not be entitled to payment, then it might not be able to conclude that collection of substantially all of the consideration is probable, and hence, a contract may not exist for accounting purposes in Step 1 – see Section 2.2 for related discussion.

\*Under FOB destination terms, the buyer takes delivery of goods being shipped by a supplier once the goods arrive at the buyer's receiving dock.

**EXAMPLE 6-10 (ADAPTED FROM ASC 606-10-55-173 THROUGH 55-182): ASSESSING WHETHER A PERFORMANCE OBLIGATION IS SATISFIED AT A POINT IN TIME OR OVER TIME – ENTITY DOES NOT HAVE AN ENFORCEABLE RIGHT TO PAYMENT FOR PERFORMANCE COMPLETED TO DATE**

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

The customer pays an upfront deposit upon entering the contract. The remainder of the price is payable upon contract completion when the customer obtains physical possession of the unit.

The following terms apply to the upfront deposit:

- ▶ The entity must refund the deposit to the customer only if the entity fails to complete construction of the unit in accordance with the contract, but the entity has the right to retain the deposit if the customer defaults on the contract before completion of the unit
- ▶ The deposit represents only 20% of the purchase price

The entity assesses at contract inception whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time and observes the following:

- ▶ It has a right to the upfront deposit only until the construction of the unit is complete, at which time the remainder of the purchase price is due. If the customer terminates the contract, they forfeit the deposit but are not obligated to make any additional payments.
- ▶ The upfront deposit is not sufficient to provide a profit margin at all points during the contract.

Therefore, the entity determines that it does not have an enforceable right to payment for work completed to date. Accordingly, the entity's performance obligation is not a performance obligation satisfied over time. Since none of the other over time revenue recognition criteria are met, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time – see Section 6.5 for discussion on performance obligations satisfied at a point in time.

**EXAMPLE 6-11 (ADAPTED FROM ASC 606-10-55-173 THROUGH 55-182): ASSESSING WHETHER A PERFORMANCE OBLIGATION IS SATISFIED AT A POINT IN TIME OR OVER TIME - ENTITY HAS AN ENFORCEABLE RIGHT TO PAYMENT FOR PERFORMANCE COMPLETED TO DATE**

Assume the same facts in Example 6-10 except the customer pays a nonrefundable deposit upon entering the contract and must make progress payments during construction of the unit. Substantive contractual terms preclude the entity from being able to direct the unit to another customer. Additionally, the customer does not have the right to terminate the contract unless the entity fails to perform as promised.

The following payment terms and local laws are applicable:

- ▶ If the customer defaults on its obligations by failing to make the promised progress payments, the entity has a right to all of the consideration promised in the contract if it completes the construction of the unit.
- ▶ The local courts have previously upheld similar rights that entitle builders to require the customer to perform, subject to the builder meeting its obligations under the contract.

The entity determines at contract inception that its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time because:

- ▶ The unit (asset) created by the entity's performance has no alternative use to the entity because the contract precludes the entity from transferring that specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity can direct the asset to another customer.

- ▶ The contractual terms and practices in the legal jurisdiction indicate that the entity has a right to payment for performance completed to date. This is because if the customer were to default on its obligations, the entity has an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.

Therefore, the criterion on whether an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date is met.

The entity recognizes revenue over time by measuring the progress toward complete satisfaction of the performance obligation – see Section 6.4 for discussion on measure of progress.

### **BDO INSIGHTS – EXAMPLE 6-11 AND CERTAIN CONSTRUCTION CONTRACTS**

When constructing certain buildings, such as a multi-unit residential complex, an entity may have entered into contracts with multiple customers for the construction of individual units within the complex. The entity accounts for each contract with a customer separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction works (that is, the foundation and basic structure) and the construction of common areas may need to be reflected when measuring its progress toward complete satisfaction of its performance obligations in each contract. See Section 6.4 for discussion on measure of progress.

### **EXAMPLE 6-12 (ADAPTED FROM ASC 606-10-55-173 THROUGH 55-182): ASSESSING WHETHER A PERFORMANCE OBLIGATION IS SATISFIED AT A POINT IN TIME OR OVER TIME - ENTITY HAS AN ENFORCEABLE RIGHT TO PAYMENT FOR PERFORMANCE COMPLETED TO DATE**

Assume the same facts in Example 6-11 except that in the event of a default by the customer, the entity can exercise either of the following rights:

- ▶ Require the customer to perform as required under the contract
- ▶ Cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price

Regardless of the fact that the entity could cancel the contract (in which case the customer would be obligated to the entity to transfer control of the partially completed unit to the entity and pay the specified penalty), 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 if the customer defaults on its obligations does not affect the assessment of whether the entity has a right to payment for performance completed to date, provided that the entity's rights to require the customer to continue to perform as required under the contract (by paying the promised consideration) are enforceable.



### CONCLUSION ON WHETHER AN ASSET HAS AN ALTERNATIVE USE MAY CHANGE IN SUBSEQUENT CONTRACTS

In certain scenarios, an entity's conclusion that an asset has no alternative use to the entity may be reassessed for subsequent contracts with customers and could result in a different conclusion. Entities must monitor changes in product and market, such as increases in customer base and the emergence of an expanded resale market, to determine whether a reassessment of the conclusion that the asset has no alternative use is warranted for subsequent contracts. See Example 6-13, which illustrates one such fact pattern.

However, the conclusion about whether an asset has an alternative use is not reassessed after contract inception for a specific contract unless that contract is modified and the modified contract is not accounted for as a separate contract. See Section 7.3 for a discussion on contract modification.

#### EXAMPLE 6-13: SUBSEQUENT CHANGE TO ASSESSMENT OF WHETHER ASSET HAS AN ALTERNATIVE USE TO THE ENTITY

A manufacturing entity creates certain original parts for sale to an Original Equipment Manufacturer (OEM) who is developing certain new products. Initially, the parts do not have an alternative use to the manufacturing entity because they can only be sold to the OEM. Assume that the entity has a present right to payment for any production completed to date. Therefore, the performance obligation in the contract is satisfied over time.

After a certain period of time, an aftermarket emerges such that the parts can now also be sold to other customers because additional parts are manufactured under subsequent contracts entered with either the OEM or other customers in the aftermarket. The existence of several customers for the parts suggests that as more parts are manufactured under a new contract with a customer, those parts could typically be sold to other customers, with subsequent production of additional units being used to satisfy the original contract. This indicates that once an aftermarket emerges, the manufacturing entity may have an alternative use for parts being manufactured under any particular contract with a customer. Therefore, the conditions for recognizing revenue over time may not be met for contracts entered after the aftermarket develops.

## 6.4 MEASURING PROGRESS TOWARD COMPLETE SATISFACTION OF A PERFORMANCE OBLIGATION

For each performance obligation satisfied over time, an entity recognizes revenue over time by measuring the progress toward complete satisfaction of that performance obligation.

### 6.4.1 The Objective of Measuring Progress



#### FASB REFERENCES

ASC 606-10-25-31

The objective in measuring progress toward complete satisfaction of a performance obligation is to depict an entity's performance in transferring control of promised goods or services to a customer (that is, the satisfaction of an entity's performance obligation).



## 6.4.2 Methods for Measuring Progress



### FASB REFERENCES

ASC 606-10-25-32 through 25-35

Appropriate methods of measuring progress include output methods and input methods. An entity must consider the nature of the good or service that it promised to transfer to the customer to determine the appropriate method for measuring progress for a specific performance obligation.

An entity must apply:

- ▶ A single method of measuring progress for each performance obligation satisfied over time
- ▶ That method consistently to similar performance obligations and in similar circumstances

### BDO INSIGHTS – SELECTION OF MEASURE OF PROGRESS

Determining an appropriate measure of progress may require significant judgment, based on the facts and circumstances. While ASC 606 does not require an entity to select a particular measure of progress for a particular type of performance obligation, an entity does not have a free choice. Instead, the measure selected must reasonably reflect the transfer of control of the promised goods or services to the customer. Therefore, an entity must carefully consider whether the selected measure of progress meets that objective.

When applying a method for measuring progress, an entity must:

- ▶ Exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer
- ▶ Include in the measure of progress any goods or services for which the entity transfers control to a customer when satisfying that performance obligation

An entity must remeasure its progress toward complete satisfaction of a performance obligation satisfied over time at the end of each reporting period.

Additionally, an entity must update its measure of progress to reflect any changes in the outcome of the performance obligation as circumstances change over time. Such changes to an entity's measure of progress are accounted for as a change in an accounting estimate in accordance with ASC 250.



### TRG DISCUSSIONS – MEASURE OF PROGRESS

In July 2015, the TRG discussed how to measure progress when multiple goods or services are included in a single performance obligation. Although a performance obligation may contain multiple goods or services, the standard requires entities to apply a single method to measure progress toward the satisfaction of each performance obligation. Entities cannot apply one method to one part of a performance obligation and a different method to another part of that performance obligation.

TRG members stated that in some circumstances it may be difficult to identify a single measure of progress that reflects the entity's performance appropriately, which might indicate (albeit not definitively) that the entity has not correctly identified the separate performance obligations. That is, there might be more than one performance obligation.



### 6.4.2.1 Output Methods



#### FASB REFERENCES

ASC 606-10-55-17 through 55-19

The application of an output method results in revenue recognition based on 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
- ▶ Units produced or units delivered

In evaluating whether to apply an output method to measure its progress, an entity must consider whether the output selected would faithfully depict the entity's performance toward complete satisfaction of the performance obligation. An output method does not provide a faithful depiction of the entity's performance if the output selected fails 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 (which exclude consideration for any work in process in the measurement of the output) 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 that is controlled by the customer.

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 to measure progress towards complete satisfaction of a performance obligation — see Section 6.4.2.2 for discussion on input methods.

#### **EXAMPLE 6-14 (ADAPTED FROM ASC 606-10-55-184 THROUGH 55-186): MEASURING PROGRESS WHEN MAKING GOODS OR SERVICES AVAILABLE**

An entity, an owner and manager of gymnasiums, contracts with a customer for one year of access to any of its gymnasiums. The customer has unlimited use of the gymnasiums and promises to pay \$150 each month.

The entity determines that its promise to the customer is to provide a service of making the gymnasiums available for the customer to use as and when the customer wishes. That is, the entity's promise is a stand-ready obligation because the extent to which the customer uses the gymnasiums 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 gymnasiums available. Therefore, the entity's performance obligation is satisfied over time.

In considering the appropriate measure of progress, the entity evaluates the nature of its performance obligation and determines that the customer benefits from the entity's service of making the gymnasiums available evenly throughout the year. That is, the customer benefits from having the gymnasiums available to use, regardless of whether the customer uses it or not. Therefore, the entity concludes that the best measure of progress toward complete satisfaction of its performance obligation is a time-based measure and recognizes revenue on a straight-line basis throughout the year at \$150 per month.

## 6.4.2.1.1 As-Invoiced Practical Expedient



## FASB REFERENCES

ASC 606-10-55-18

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



## TRG DISCUSSIONS – AS-INVOICED PRACTICAL EXPEDIENT – UPFRONT PAYMENTS

In July 2015, the TRG members agreed that an entity is not precluded from applying the as-invoiced practical expedient in situations in which the price per unit changes during the duration of the contract. They noted that application of the practical expedient in those situations involves an analysis of the facts and circumstances of the arrangement to determine whether the amount invoiced for goods or services reasonably represents the value to the customer of the entity's performance completed to date. This assessment may but is not required to include an assessment of market or standalone selling price.

The TRG considered the following two examples and agreed that the as-invoiced practical expedient applies to both:

**Example A: Sale of Electricity**

An energy entity, Power Seller, and its customer enter a contract for the purchase and sale of electricity over a contract duration of six years. The customer is obligated to purchase 10 megawatts (MW) of electricity per hour for each hour during the contract term (that is, 87,600 MWh per annual period) at the following prices that contemplate the forward market price of electricity at contract inception:

- ▶ Years 1-2: \$50/MWh
- ▶ Years 3-4: \$55/MWh
- ▶ Years 5-6: \$60/MWh

The transaction price, which represents the amount of consideration to which Power Seller expects to be entitled in exchange for transferring electricity to the customer, is \$28,908,000 (calculated as the annual contract prices per MWh multiplied by annual contract quantities).

Power Seller concludes that the promise to sell electricity represents one performance obligation that will be satisfied over time.

Power Seller concludes that the as-invoiced practical expedient applies because the amount that will be billed to the customer corresponds directly with the value to the customer of Power Seller's performance completed to date. The amount that will be billed is based on both (a) the units of power transferred to the customer and (b) a rate per unit of power that is priced by reference to one or more market indicators (for example, the observable forward commodity price curve).

While the rate per unit of power is not the same for the duration of the contract, the rates per unit reflect the value to the customer because the rates are based on one or more market indicators. When assessing the applicability of the expedient, a fixed price is not always required for the duration of the contract. However, a price increase or decrease must be based on the value of those later units to the customer. Determining whether the price change is consistent with the value to the customer often requires the use of judgment.

**Example B: IT Outsourcing Arrangement**

IT Seller and its customer enter an IT outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term of ten years. IT Seller's activities include, for example, providing server capacity, managing the customer's software portfolio and running an IT help desk. Each activity has a contractual minimum volume.

IT Seller concludes that each of the activities described will be satisfied over time.

The following are the payment terms:

- ▶ The price per unit differs for each type of activity.
- ▶ IT Seller invoices the customer monthly.
- ▶ The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power, number of software applications used, or number of employees supported.
- ▶ The agreed upon pricing at contract inception reflects market pricing.
- ▶ The pricing decreases to reflect the associated costs decreasing over the term of the contract as the level of effort to complete the tasks decreases. While initially the tasks are performed by more expensive personnel for activities that require more effort, the level of effort for the activities decreases later in the contract term, and the tasks are performed by less expensive personnel.
- ▶ The contract includes a price benchmarking clause whereby the customer engages a third-party benchmarking firm to compare the contract pricing to current market rates at certain points in the contract term. There is an automatic prospective price adjustment if the benchmark is significantly below IT Seller's price.
- ▶ Although each activity has a contractual minimum, the fixed minimum amount is not considered substantive because the customer is expected to exceed that minimum (in part, based on historical experience). Therefore, the customer pays the IT Seller the relevant price per unit and the amount billed to the customer reflects the rates and amounts (price and quantities) for the activities provided.

The TRG agreed that the as-invoiced practical expedient is applicable because the amount billed to the customer corresponds directly with the value to the customer of IT Seller's performance to date. Similar to Example A, although the rates change for the respective activities over the duration of the arrangement, those rates reflect the value to the customer, which is corroborated by both of the following:

- ▶ The benchmarking (market) adjustment
- ▶ Declining costs (and level of effort) of providing the tasks that correspond with the declining pricing of the activities

Even though there are multiple activities in this example, the conditions to apply the as-invoiced practical expedient are met because the amounts invoiced correspond with the value to the customer of each incremental activity that the IT Seller provides to the customer (that is, the IT Seller's performance completed to date).

Additionally, the FASB staff stated that while not included in the examples above, if a contract includes a volume discount that is not substantive, then the value to the customer could directly correspond to the amount billed.

**TRG DISCUSSIONS – AS-INVICED PRACTICAL EXPEDIENT – UPFRONT PAYMENT AND BACK-END REBATE**

In July 2015, the TRG agreed that the mere existence of an upfront payment or a back-end rebate in an arrangement does not preclude an entity from applying the as-invoiced practical expedient. However, they stated that an assessment of the significance of those upfront and back-end fees relative to the variable consideration in the arrangement would likely be important in determining whether the expedient applies.

**TRG DISCUSSIONS – EXISTENCE OF AN INVOICE OR PAYMENT SCHEDULE**

In July 2015, the TRG agreed that the mere fact that an entity and its customer agree on an invoice or payment schedule does not automatically mean the amount an entity has the right to invoice at a given point corresponds directly with the value to the customer for the goods or services provided to date. For example, the customer might request lower payments earlier in the duration of the contract and higher payments later in the duration to increase its operating cash flow in the short term. As another example, the entity might request a significant payment early in the duration of the contract to reduce credit risk or to have the customer demonstrate that it is committed to a long-term service arrangement. The application of the as-invoiced practical expedient in those situations involves an analysis of the facts and circumstances of the arrangement to determine whether the amount invoiced for goods or services reasonably represents the value to the customer of the entity's performance completed to date.

**BDO INSIGHTS – AS-INVICED PRACTICAL EXPEDIENT**

To apply the as-invoiced practical expedient, an entity must conclude that the amount that will be invoiced to the customer over the term of the contract corresponds directly with the value to the customer of the entity's performance completed to date throughout the contract term. Analyzing whether the invoiced amount corresponds directly with the value to the customer might be complex and requires the application of professional judgment, based on the facts and circumstances. Because of the complexity of this analysis, we have observed limited use of the expedient in practice.

Additionally, we have observed in practice that when the performance obligation is a series of distinct services satisfied over time (see Section 3.4 for related discussion) and the variable consideration allocation exception (see Section 5.5 for related discussion) applies, the resulting revenue recognition may be similar to the outcomes under the as-invoiced practical expedient. In those cases, applying the five-step revenue recognition model may be more straightforward, and an entity may forego the expedient to avoid the burden of corroborating that it is applicable.

For example, consider a professional services entity that provides consulting services at a per-hour fee, which increases annually in a multi-year contract (that is, the fee is variable). The fee is billed monthly. The contract includes a single performance obligation, which is a series of distinct services satisfied over time. Each day of service is distinct. The criteria for the variable consideration allocation exception are met because the terms of the monthly fee relate specifically to the entity's efforts to satisfy the distinct consulting services provided in a month, and the resulting allocation is consistent with the allocation objective. Therefore, the entity recognizes the monthly invoiced amount in revenue in the month to which the invoice relates. This approach to recognizing revenue is more straightforward than determining whether the as-invoiced practical expedient applies, which would require an analysis of whether the increases in fees correspond directly with the value to the customer of the entity's performance completed to date throughout the contract term.

In many cases, the measurement of revenue recognized for performance obligations satisfied over time may not be the same as amounts invoiced to a customer. In those circumstances, an entity recognizes either a contract asset or a contract liability for the difference between cumulative revenue recognized for a contract and cumulative amounts invoiced to the customer.

#### 6.4.2.2 Input Methods



#### FASB REFERENCES

ASC 606-10-55-20 and 55-21

The application of an input method results in revenue recognition based on an entity's efforts or inputs to the satisfaction of a performance obligation 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. Examples of input methods include:

- ▶ Resources used
- ▶ Labor hours expended
- ▶ Costs incurred
- ▶ Time elapsed
- ▶ Machine hours used

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, to comply with the objective of measuring progress, an entity must exclude from an input method the effects of any inputs that do not depict the entity's performance in transferring control of goods or services to the customer.

Following are examples of certain adjustments to the measure of progress that may be required when using a cost-based input method:

- ▶ **Significant inefficiencies** – If a cost incurred does not contribute to an entity's progress in satisfying the performance obligation, its effect must be excluded from the cost-based input method. For example, an entity would not recognize revenue based on costs incurred that are attributable to significant inefficiencies in its performance that were not reflected in the price of the contract (such as, the costs of unexpected amounts of wasted materials, labor or other resources that were incurred to satisfy the performance obligation).
- ▶ **Uninstalled materials** – If a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation, 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:
  - The good is not distinct
  - The customer is expected to obtain control of the good significantly before receiving 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
  - 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 – see Section 7.2 for discussion on principal versus agent considerations)

#### 6.4.2.2.1 Learning Curve

When determining the appropriate costs to include in the measure of progress and whether some of costs incurred are attributable to significant inefficiencies, an entity must consider the effects of any learning curves. A learning curve is the effect of efficiencies realized over time when an entity's costs of performing a task decline in relation to the number of times the entity performs that task. A learning curve can exist independently of a contract with a customer. For example, a typical contract manufacturer may become more efficient in its production process over time as it manufactures a product multiple times.

BC314 of ASU 2014-09 states that when an entity's performance obligation is satisfied over time, applying a measure of progress based on costs incurred would result in a higher recognition of revenue and expense for the early units produced compared to the later units if the entity incurs higher costs to produce the early units and relatively lower costs to produce the later units as production efficiencies are gained. In that scenario, a higher recognition of revenue and expense for the early units produced is appropriate because of the greater value of the entity's performance in the early part of the contract. This is because if an entity were to sell only one unit, it would charge a customer a higher price for that unit than the average unit price the customer pays when the customer purchases more than one unit.

#### EXAMPLE 6-15 (ADAPTED FROM ASC 606-10-55-187 THROUGH 55-192): UNINSTALLED MATERIALS

An entity enters a contract with a customer in October 20X2 to refurbish a multi-story building and install new elevators for total consideration of \$500,000 (the transaction price). Assume that the promised refurbishment service, including the installation of elevators, is a single performance obligation. The entity determines that the performance obligation is satisfied over time because the customer owns the building and controls the output of the refurbishment as the entity performs.

Total expected costs are \$400,000, including \$150,000 for the elevators—expected costs are summarized below.

##### Expected Costs:

Elevators	\$ 150,000	37.5% of total expected costs
Other costs	250,000	62.5% of total expected costs
<b>Total Expected Costs</b>	<b>\$ 400,000</b>	

The elevators are paid for and delivered at the site in November 20X2. The entity determines that it acts as a principal because it obtains control of the elevators before they are transferred to the customer. See Section 7.2 for discussion on principal versus agent considerations.

In considering the appropriate measure of progress, the entity evaluates the nature of its performance obligation and determines that an input method based on costs is appropriate to measure its progress toward complete satisfaction of the performance obligation. The entity then assesses whether the costs incurred to procure the elevators are proportionate to the entity's progress in satisfying its performance obligation. The entity observes the following:

- ▶ Although the elevators will not be installed until June 20X3, the customer obtains control of the elevators when it is delivered to the site in November 20X2.
- ▶ The costs to procure the elevators (\$150,000) are significant relative to the total expected costs to completely satisfy the performance obligation (\$400,000).
- ▶ The entity is not involved in designing or manufacturing the elevators.
- ▶ As of December 31, 20X2, the entity has incurred other costs equaling \$50,000 out of the total expected other costs (excluding elevators) of \$250,000.

The entity observes that the control of the elevators has passed to the customer in November 20X2 and therefore, recognition of \$150,000 (the costs for elevators) as an asset would be inappropriate and \$150,000 must be expensed. However, the entity also determines that it would be inappropriate to recognize 37.5% of total contract revenue related to the costs for elevators and related profit because it has made limited progress in satisfying its performance obligation to refurbish the building.

Based on the above analysis, the entity concludes that including the costs to procure the elevators (\$150,000) in the measure of progress would overstate the extent of the entity's performance at December 31, 20X2. Therefore, 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
- ▶ Recognizes revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (that is, at a zero margin)

As of December 31, 20X2, the entity observes that performance is 20% complete, calculated as \$50,000 (other costs incurred) divided by \$250,000 (total expected other costs). Therefore, at December 31, 20X2, the entity recognizes the following:

Revenue	\$ 220,000	Calculated as (20% of \$350,000) plus \$150,000, the costs for elevators. \$350,000 is calculated as \$500,000 less \$150,000, the costs for elevators.
Cost of Goods Sold	200,000	Calculated as \$50,000 (other costs incurred) plus \$150,000 (the costs incurred for elevators).
Profit	\$ 20,000	

#### **BDO INSIGHTS – COST-BASED INPUT METHODS**

Cost-based input methods are commonly used as a measure of progress for revenue recognition in multiple industries. While ASC 606 allows the use of a cost-based input method to measure progress to recognize revenue, it provides very limited guidance on how to calculate the costs incurred and total expected costs (that is, the numerator and denominator), which provide the basis (or percentage) for recognizing a portion of the transaction price as revenue. Entities must carefully consider other U.S. GAAP that may be applicable to appropriately calculate the costs included in the numerator and the denominator. Significant inaccuracies in calculating costs may result in inappropriate revenue recognition. For example, not accruing costs incurred until invoices are paid may result in under-recognition of costs incurred and therefore an understatement of revenue.

#### **BDO INSIGHTS – OVER TIME REVENUE RECOGNITION AND WORK IN PROCESS**

For performance obligations that are satisfied over time, an entity generally does not recognize any work in process under ASC 330 (or an asset under other U.S. GAAP), because the fundamental principle underlying over time revenue recognition is that control of the good or service is transferred to the customer continuously as the entity fulfills its contractual obligations. Any inventory or raw material costs that are specific to a performance obligation satisfied over time are expensed as those costs are assigned to that performance obligation and placed into production. As a result, if output methods are used to measure performance to date, entities may often find that profit margins vary over the contractual period. In some cases, losses may be experienced in some periods, particularly in the early stages of the contract, even though the contract is anticipated to be profitable overall because the measurement of cumulative (or periodic) outputs driving the amount of revenue recognized may not be commensurate with the cumulative (or periodic) costs incurred.



**BDO INSIGHTS – MEASURE OF PROGRESS – CUSTOMIZED PRODUCT THAT IS GENERIC UP TO A POINT IN THE CONSTRUCTION OR MANUFACTURING PROCESS**

An entity may construct or manufacture a customized product that remains generic up to the point in the construction or manufacturing process when the customization begins but has no alternative use to the entity in its completed form. See Example 6-6 for a related discussion. If the entity has an enforceable right to payment for performance completed to date, it recognizes revenue over the construction or manufacturing process.

However, before the customization, the entity's performance does not transfer an asset to the customer but rather creates an asset (inventory) for the entity, because the entity can redirect the generic asset to another customer or for another purpose. Only when the customization begins does the entity's performance transfer the work in process (asset) to the customer as the entity performs. Therefore, the entity begins to recognize revenue over time only when the customization begins.

If an entity uses a costs-based measure of progress, the costs incurred before customization are included in the measure of progress to determine the revenue to be recognized, and any related asset recognized for the work in process (for example, inventory) is recognized in expense at that point.

**BDO INSIGHTS – ACCOUNTING FOR PARTIAL SATISFACTION OF A PERFORMANCE OBLIGATION BEFORE THE CONTRACT EXISTENCE CRITERIA ARE MET**

Sometimes an entity may start providing goods or services which comprise a performance obligation satisfied over time before the contract existence criteria in Step 1 are met – see Section 2.2 for discussion on contract existence criteria. Regardless of the entity's ongoing performance to satisfy the performance obligation over time, it may not recognize revenue before the contract existence criteria are met. Rather, the entity begins to recognize revenue when the contract existence criteria are met. This fact pattern may arise, for example, when an entity starts to manufacture a highly customized good or provide a service in advance of obtaining an expected contract from a customer. When the entity subsequently determines that the contract existence criteria are met, the question arises as to whether revenue is recognized prospectively from contract inception or if there is a cumulative catch-up adjustment for the work done to date.

Consistent with views expressed at the TRG meeting in March 2015, when a similar issue was discussed, we believe revenue is recognized on a cumulative catch-up basis because ASC 606 requires an entity to recognize revenue when (or as) an entity satisfies performance obligations by transferring promised goods or services to a customer. This occurs when (or as) the customer obtains control of the good or service. If at the point at which the contract existence criteria are met the entity has satisfied part or all of certain performance obligations by transferring fully or partially completed goods or services to its customer, the entity must recognize in revenue the related amount of consideration to which it expects to be entitled.

Recognizing revenue on a prospective basis only from the point in time at which the contract existence criteria are met is inconsistent with the notion of control underlying the five-step revenue recognition model because the control of certain goods or services is transferred to the customer at contract inception.

Note that the costs incurred for those arrangements may have to be recognized before the revenue recognition begins. See Section 7.7 for a discussion of accounting for contract costs.





## TRG DISCUSSIONS – STAND-READY OBLIGATIONS

In January 2015, the TRG discussed the nature of an entity's promise in stand-ready obligations and how an entity should measure progress towards completion of a stand-ready obligation that is satisfied over time.

As discussed in Chapter 3, a stand-ready performance obligation is one in which the entity provides a service of standing ready to provide goods or services. The customer consumes and receives benefit from a stand-ready obligation from the assurance that a resource is available to it when and if needed or called upon.

Following are the examples of different types of stand-ready obligations that were considered by the TRG:

- ▶ Obligations in which the delivery of the good(s), service(s) or IP underlying the obligation is within the control of the entity, but for which the entity must still further develop its good(s), service(s) or IP. For example, a software entity might promise to transfer unspecified software upgrades at the entity's discretion, or a pharmaceutical entity might promise to provide when-and-if-available updates to previously licensed IP based on advances in R&D.
- ▶ Obligations in which the delivery of the underlying good(s) or service(s) is outside the control of the entity and customer. For example, an entity promises to remove snow from an airport's runways in exchange for a fixed fee each year.
- ▶ Obligations in which the delivery of the underlying good(s) or service(s) is within the control of the customer. For example, an entity might agree to provide periodic maintenance on a customer's equipment after a pre-established amount of usage by the customer.
- ▶ Obligations to make a good or service available to the customer continuously, such as a gym or health club membership.

TRG members agreed that an entity must exercise judgment in determining the appropriate method to measure progress towards satisfaction of a stand-ready obligation over time, and the substance of the stand-ready obligation must be considered to align the measurement of progress towards complete satisfaction of the performance obligation with the nature of the entity's promise. The TRG also observed that while a straight-line measure of progress might not always be conceptually pure, it might be the most reasonable estimate an entity can make for a stand-ready obligation.

## BDO INSIGHTS – MEASURE OF PROGRESS FOR A STAND-READY PERFORMANCE OBLIGATION

Consistent with the TRG discussion, we believe an entity must not default to straight-line measure of progress for a stand-ready performance obligation. Rather, an entity must consider the nature of its obligation and the relevant facts and circumstances to determine the appropriate method for measuring its progress in satisfying its stand-ready obligation. For example, consider an entity that enters an annual contract with a customer to provide snow removal services in New York. While the nature of the entity's promise is to stand-ready to remove snow as it falls, a straight-line measure of progress is not appropriate for revenue recognition because it would not reflect the pattern of benefit of the snow removal services to the customer or the entity's effort in providing those services. Rather, the entire consideration allocated to the entity's obligation for snow removal must be recognized during the winter months when snow is expected to fall in New York. Note that this pattern could be different, for example, in Alaska which receives more snowfall than New York or Texas which receives less snowfall than New York.

### 6.4.3 Reasonable Measures of Progress



#### FASB REFERENCES

ASC 606-10-25-36 and 25-37

An entity recognizes 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.

In some circumstances (for example, in the initial stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation but may expect to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity recognizes revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

BC179 of ASU 2014-09 states that unless the entity can recognize an asset from the costs to fulfill a contract, any costs related to the promise would not represent an asset of the entity and therefore is recognized as expenses as they are incurred. See Section 7.7 for discussion on contract costs.

BC180 of ASU 2014-09 further states that in cases in which an entity cannot reasonably measure its progress toward complete satisfaction of a performance obligation, but nevertheless expects eventually to recover the costs incurred in satisfying the performance obligation, the entity must recognize at least some amount of revenue to reflect the fact that it is making progress in satisfying the performance obligation. Therefore, the FASB concluded that in those cases, an entity must recognize revenue for the satisfaction of the performance obligation only to the extent of the costs incurred. However, the FASB also concluded that an entity must stop using that method when it can reasonably measure its progress toward complete satisfaction of the performance obligation and select an appropriate method to measure progress.

#### **BDO INSIGHTS – INABILITY TO REASONABLY MEASURE PROGRESS IS EXPECTED TO BE RARE**

We believe it would be rare that an entity could not reasonably measure its progress toward complete satisfaction of a performance obligation. The guidance in ASC 606 is consistent with the prior revenue recognition guidance in ASC 605-35, *Revenue – Construction-Type and Production-Type Contracts*, superseded by ASC 606. While the language in ASC 605-35-25-59 was not carried forward into ASC 606, we believe the concepts articulated there are still relevant. Specifically, that paragraph stated that there is a presumption that entities whose business model involves the production of goods or services under contractual arrangements do have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion model and persuasive evidence to the contrary is necessary to overcome that presumption. We believe a similar presumption exists under ASC 606 that entities who promise goods or services that meet the criteria to be accounted for over time can make reliable estimates of progress and persuasive evidence is needed to overcome that presumption.

## 6.5 PERFORMANCE OBLIGATIONS SATISFIED AT A POINT IN TIME



### FASB REFERENCES

ASC 606-10-25-30

An entity satisfies a performance obligation at a point in time if the performance obligation does not meet the criteria for being satisfied over time. For a performance obligation satisfied at a point in time, the performance obligation is satisfied at the point in time at which control of the goods or services transfers to the customer. 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 must consider the guidance on control – see Section 6.2 for discussion on control.

Additionally, an entity must consider indicators of the transfer of control, which include, but are not limited to, the following:

- ▶ **The entity has a present right to payment for the asset** – A customer’s present obligation to pay for an asset 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.
- ▶ **The customer has legal title to the asset** – Legal title may indicate whether the entity or a customer 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. However, if an entity retains legal title solely as protection against the customer’s failure to pay, those protective rights of the entity would not preclude the customer from obtaining control of an asset.
- ▶ **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 necessarily coincide with control of an asset. For example, in some repurchase agreements or 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. Accounting for repurchase agreements, consignment arrangements and bill-and-hold arrangements are discussed in Sections 6.6, 6.7, and 6.8, respectively.
- ▶ **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 must 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 transfer control of a car to a customer without yet satisfying an additional performance obligation to provide maintenance services related to the transferred car. BC154 of ASU 2014-09 states the FASB’s belief that risks and rewards can be a helpful factor to consider when determining the transfer of control and can often be a consequence of controlling an asset. However, whether the customer has the significant risks and rewards of ownership is only one indicator of control and does not change the principle of determining the transfer of goods or services based on the transfer of control.
- ▶ **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. An entity must evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred – see Section 6.9 for related discussion.



## INDICATORS OF CONTROL – NOT A CHECKLIST

BC155 of ASU 2014-09 states that the indicators of control are not a list of conditions that must be met before an entity can conclude that control of a good or service has transferred to a customer. Rather, the indicators are a list of factors that are often present if a customer has control of an asset. That list is provided to assist entities in applying the principle of control. Accordingly, all indicators need not be present for an entity to conclude that it has transferred control of a good or service.

### EXAMPLE 6-16: RISK AND REWARD VERSUS TRANSFER OF CONTROL

A property development entity enters contracts with customers to sell separate units of residential or commercial properties in multi-unit developments (for example, apartment blocks or office buildings).

- ▶ On January 1, 20X1, a customer enters a binding contract for the unit and pays a 10% deposit of the contractually agreed purchase price.
- ▶ The unit is incomplete at January 1, 20X1, (for example, because the unit has been sold off plan, or some but not all of construction activities have been completed); the entity must complete the construction of the unit on June 1, 20X2.
- ▶ From the point in time when construction of the unit is complete, the customer assumes certain ownership risks, including risks from damage to the unit caused by an event (for example, severe weather) or by unrelated third parties.
- ▶ On June 15, 20X2, the customer must pay the balance of purchase price and take ownership, with legal title passing from the entity to its customer.
- ▶ If the customer does not fulfill its contractual obligation to pay the balance of the consideration on June 15, 20X2:
  - The entity has the right to retain the 10% deposit that was paid on January 1, 20X1.
  - The customer is contractually required to compensate the entity for certain loss of profit – the customer is required to pay the shortfall to the entity if the entity is unable to obtain a price of at least 90% of the contractually agreed price from sale to another customer.
  - The local courts in the entity's jurisdiction will likely enforce the compensation clauses stated above, based on the substantial legal precedence.
- ▶ The customer is exposed to subsequent changes in the market value of the unit from January 1, 20X1, because the customer has entered a binding sales contract.
- ▶ The customer is not allowed to occupy or sublet the unit and may have either limited or no rights to access the unit until June 15, 20X2. Additionally, the customer does not have the right to make any changes to the unit or to pledge it as security in transactions such as a lending arrangement until June 15, 20X2.

Assume the unit is the sole performance obligation in the contract.

The entity first considers whether the performance obligation is satisfied over time and hence revenue must be recognized over time. If none of the over time revenue recognition criteria are met, then revenue must be recognized at a point in time.

In determining whether the performance obligation is satisfied over time, the entity considers it has a right to only the upfront deposit until the unit's construction is complete. Accordingly, the entity determines that it does not have an enforceable right to payment for work completed to date at all times for the contract's duration. Therefore, the entity's performance obligation is not satisfied over time in accordance with the criterion on whether an entity's performance creates an asset with no alternative use to the entity and the entity has an

enforceable right to payment for performance created to date. Since none of the other over time revenue recognition criteria are met, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time.

In determining the point in time at which the performance obligation is satisfied, the entity considers that although the customer assumes certain risks at January 1, 20X1, and June 1, 20X2, the restrictions over the customer's ability to derive benefits from the unit until June 15, 20X2, indicate that control of the unit does not transfer to the customer until June 15, 20X2.

Therefore, the entity recognizes revenue from the sale of unit on June 15, 20X2.

### BDO INSIGHTS – SIGNIFICANCE OF LOCAL LAWS IN DETERMINING THE PATTERN OF REVENUE RECOGNITION

In determining when to recognize revenue, it is important to understand the legal environment as well as the contractual terms and conditions because local laws and regulations may affect the assessment of whether control transfers to the customer at a point in time or over time and if at a point in time, the specific date.

Additionally, application of the over-time revenue recognition criterion in Section 6.3.3 (whether an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date) particularly affects the pattern and timing of revenue recognition in multiple industries, for example, contract manufacturing. Entities must carefully consider their specific contracts with customers and legal environments to determine the appropriate patterns of revenue recognition under ASC 606.

## 6.6 REPURCHASE AGREEMENTS



### FASB REFERENCES

ASC 606-10-55-66 and 55-67

A repurchase agreement is a contract in which an entity sells an asset to a customer and also promises to or has the right to, either in the same contract or in another contract, repurchase the asset. The repurchased asset may be any of the following:

- ▶ The asset that was originally sold to the customer
- ▶ An asset that is substantially the same as the asset originally sold to the customer
- ▶ Another asset of which the asset that was originally sold is a component

Repurchase agreements generally come in three forms:

- ▶ **A forward** – An entity's obligation to repurchase the asset.
- ▶ **A call option** – An entity's right to repurchase the asset.
- ▶ **A put option** – An entity's obligation to repurchase the asset at the customer's request.

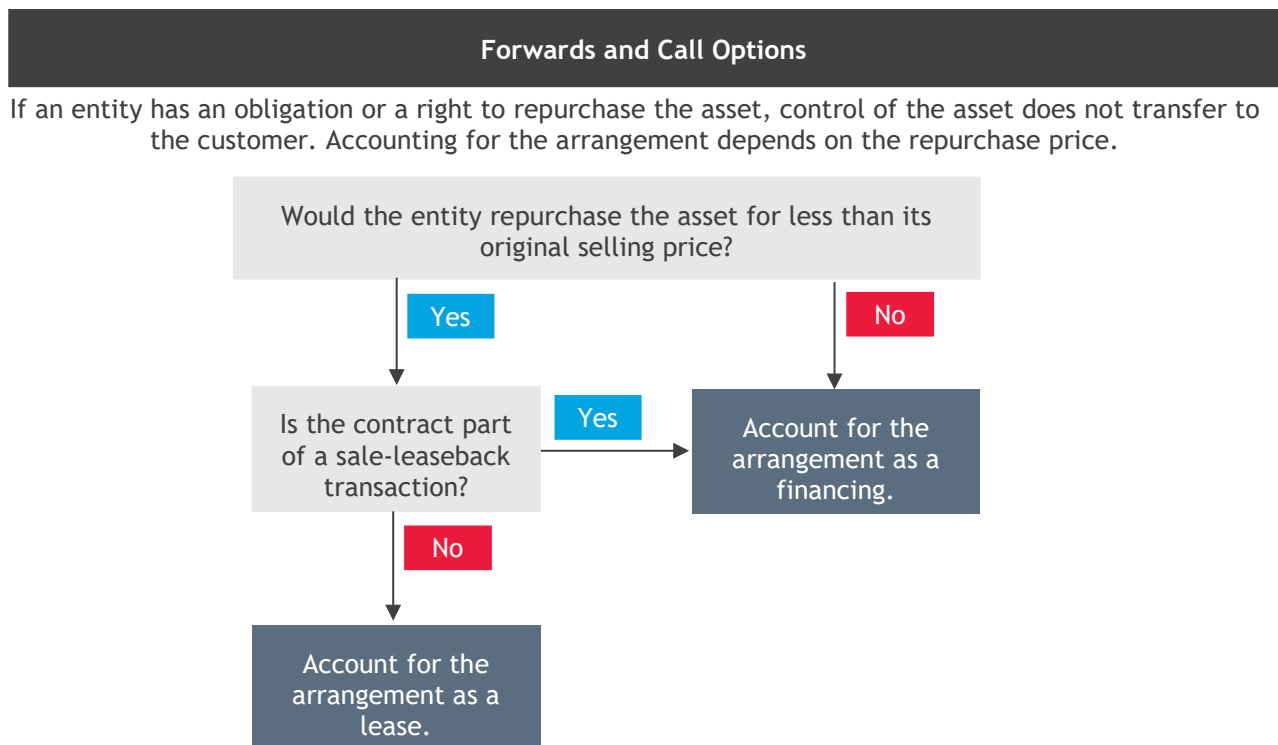
### 6.6.1 A Forward or a Call Option



#### FASB REFERENCES

ASC 606-10-55-68 through 55-71

The following diagram provides an overview of the accounting considerations for repurchase rights in a forward or call option:



If an entity has an obligation or a right to repurchase the asset (that is, a forward or a call option), then 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. Therefore, an entity does not recognize revenue for that contract but instead, depending on the repurchase price of the asset as compared to its original selling price, accounts for that contract as a lease or financing.

► **A financing arrangement** — 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, then the entity must account for the arrangement as a financing arrangement. An entity accounts for a financing arrangement as follows:

- Continue to recognize the asset
- Recognize a financial liability for any consideration received from the customer
- Recognize as interest (and, if applicable, as processing or holding costs (for example, insurance)) the difference, if any, between the amount of consideration received from the customer and the amount of consideration to be paid to the customer

- ▶ **A lease** – If the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset and the contract is not part of a sale-leaseback transaction, then the entity must account for the arrangement as a lease in accordance with ASC 842.<sup>10</sup> If the contract is part of a sale-leaseback transaction, then the entity must account for the arrangement as a financing arrangement and not as a sale-leaseback under ASC 842 -40.

BC427 of ASU 2014-09 states that an entity does not consider the likelihood that a call option will be exercised because the existence of the call option effectively limits the customer's ability to control the asset. However, a nonsubstantive call option is ignored in assessing whether and when the customer obtains control of a good.

An entity considers the time value of money when comparing the repurchase price with the selling price of the asset.

An entity must derecognize the liability and recognize revenue if the call option lapses unexercised.

#### **BDO INSIGHTS – CONTINGENTLY EXERCISABLE REPURCHASE RIGHT HELD BY AN ENTITY**

ASC 606 does not include guidance on contingently exercisable repurchase right held by an entity. An entity must carefully evaluate the substance of a repurchase right and the surrounding facts and circumstances and determine whether control of an asset underlying the contingent repurchase right has transferred to a customer. An entity may consider factors such as:

- ▶ The nature of the contingency
- ▶ Whether the contingency is within the control of the entity or customer
- ▶ The likelihood that the contingency will be met (but not the likelihood of exercise of the repurchase right)

The existence of a contingently exercisable repurchase right does not always preclude transfer of control to the customer. For example, if the contingency is outside the control of an entity, the entity may conclude that control has transferred to the customer and account for the transaction as a sale with a right of return.

#### **EXAMPLE 6-17 (ADAPTED FROM ASC 606-10-55-401 THROUGH 55-407): REPURCHASE AGREEMENTS – CALL OPTION: FINANCING**

An entity enters a contract with a customer for the sale of an item of equipment on January 1, 20X1, for \$10 million.

The contract includes a call option that provides the entity the right to repurchase the asset for \$11 million on or before December 31, 20X1.

The entity determines that control of the equipment does not transfer to the customer on January 1, 20X1, because the entity has a right to repurchase the asset, which limits the customer in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Therefore, the entity accounts for the transaction as a financing arrangement because the exercise price of the call option (\$11 million) is more than the original selling price (\$10 million). The entity:

- ▶ Does not derecognize the equipment
- ▶ Recognizes the cash received as a financial liability
- ▶ Recognizes interest expense for the difference between the exercise price (\$11 million) and the cash received (\$10 million), which increases the liability

If the option lapses unexercised on January 1, 20X2, the entity would derecognize the liability and recognize revenue of \$11 million.

<sup>10</sup> See our Blueprint, [Accounting for Leases Under ASC 842](#), for guidance on ASC 842.

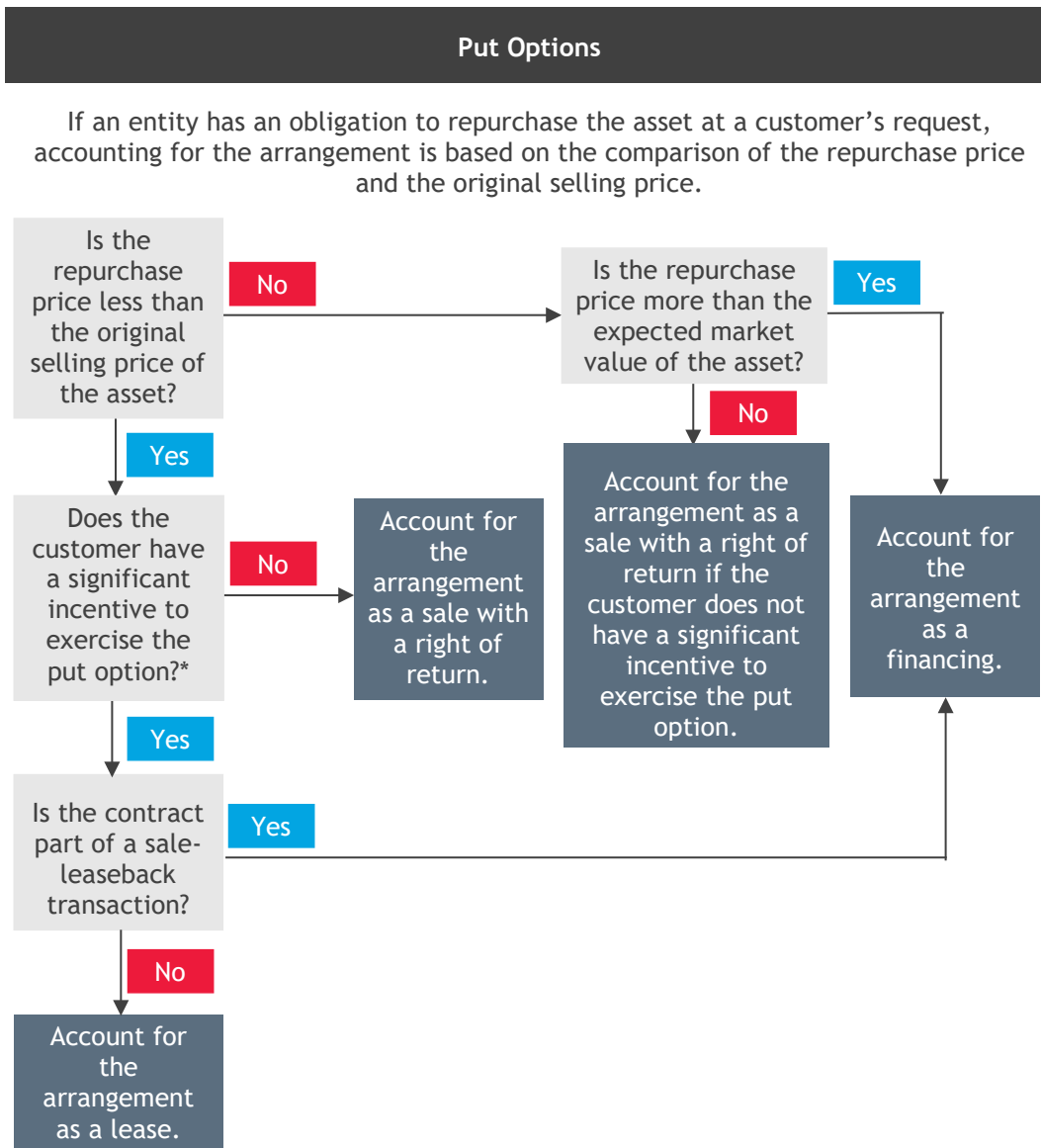
6.6.2 A Put Option



FASB REFERENCES

ASC 606-10-55-72 through 55-78

The following diagram gives an overview of the accounting considerations for an entity’s repurchase obligation in a put option:



\*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.



If an entity has an obligation to repurchase the asset at the customer's request, the appropriate accounting treatment is determined based on a comparison of the repurchase price and the original selling price.

#### 6.6.2.1 Repurchase Price is Lower Than the Original Selling Price

If the customer can require an entity to repurchase the asset at a price that is lower than the original selling price of the asset, then the entity considers at contract inception whether the customer has a significant economic incentive to exercise that right. The exercise of that right by the customer results in the customer effectively paying the entity consideration for the right to use that asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right and the contract is not part of a sale-leaseback transaction, then the entity must account for the agreement as a lease in accordance with ASC 842.<sup>11</sup> If the contract is part of a sale-leaseback transaction, then the entity must account for the arrangement as a financing arrangement and not as a sale-leaseback under ASC 842-40.

However, if the customer does not have a significant economic incentive to exercise its right at a price lower than the original selling price of the asset, then the entity accounts for the agreement as if it were the sale of a product with a right of return (see Section 4.3.8 for discussion on sale with a right of return).

To determine whether a customer has a significant economic incentive to exercise its right, an entity must 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, a repurchase price that is expected to significantly exceed the market value of the asset at the date of repurchase may indicate that the customer has a significant economic incentive to exercise the put option.

#### 6.6.2.2 Repurchase Price is Equal to or Greater Than the Original Selling Price

If the repurchase price of the asset is equal to or greater than the original selling price, the accounting is based on a comparison the repurchase price and expected market value of the asset as follows:

- ▶ If the repurchase price of the asset is more than the expected market value of the asset, then the contract is in effect a financing arrangement. An entity must recognize a financial liability equal to the amount of consideration received, and the asset is not derecognized. Any difference between the consideration received from the customer and the amount paid to the customer in the future when the put right is exercised is recognized as interest expense, and as other holding costs such as insurance if applicable. If the put option lapses unexercised, entity derecognizes the liability and recognizes revenue.
- ▶ If the repurchase price of the asset 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 must account for the contract as if it were the sale of a product with a right of return (see Section 4.3.8 for discussion on sale with a right of return).

An entity considers the time value of money when comparing the repurchase price with the selling price of the asset.

#### **BDO INSIGHTS – REPURCHASE AGREEMENTS**

The guidance on repurchase agreements in ASC 606 may have a significant impact in some industries. For example, an entity may sell a car to a customer while providing the customer a right to require the entity to repurchase the car for a specified price after a period of time. Careful consideration of the exercise price of a customer put option is required to determine the nature of the arrangement as a sale or lease. Additionally, an entity must carefully identify the various parties to the arrangements and their rights or obligations. For example, an entity must consider:

- ▶ Whether the entity itself or an unrelated third-party finance entity grants the put option to the customer
- ▶ If an unrelated third-party finance entity grants the put option to the customer, whether there are any associated contractual arrangements between the entity and that third-party finance entity

<sup>11</sup> See our Blueprint, [Accounting for Leases Under ASC 842](#), for guidance on ASC 842.

Reaching conclusions about accounting for repurchase agreements requires the application of professional judgment, based on the facts and circumstances.

**EXAMPLE 6-18 (ADAPTED FROM ASC 606-10-55-401 THROUGH 55-407): REPURCHASE AGREEMENTS – PUT OPTION: LEASE**

An entity enters a contract with a customer for the sale of an item of equipment on January 1, 20X1, for \$10 million.

The contract includes a put option that obliges the entity to repurchase the equipment at the customer's request for \$9 million on or before December 31, 20X1. The market value is expected to be \$7.5 million on December 31, 20X1.

To determine the accounting for the transfer of the equipment, the entity assesses at contract inception whether the customer has a significant economic incentive to exercise the put option. The entity observes that the repurchase price (\$9 million) significantly exceeds the expected market value (\$7.5 million) of the asset at the date of repurchase and, therefore, concludes that the customer has a significant economic incentive to exercise the put option. The entity determines there are no other relevant factors to consider in assessing whether the customer has a significant economic incentive to exercise the put option.

Therefore, the entity concludes that control of the equipment 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 equipment. The entity accounts for the transaction as a lease under ASC 842.<sup>12</sup>

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<sup>12</sup> See our Blueprint, [Accounting for Leases Under ASC 842](#), for guidance on ASC 842.

**EXAMPLE 6-19: REPURCHASE AGREEMENTS – CUSTOMER PUT OPTION**

An entity, a manufacturer of industrial equipment, enters a contract with a customer to sell an item of equipment to the customer for a sales price of \$750. The cost of manufacturing the equipment is \$500. The expected useful life of the equipment is five years.

The contract provides the customer with a right to return the equipment to the entity after two years in exchange for a predetermined amount of \$450 (the repurchase price). At contract inception, the fair value of the equipment after two years is expected to be in the range of \$425 to \$475 with a linear distribution of expected values (that is, the mean of the various estimates is \$450). The present value of the repayment obligation, discounted at the entity's incremental borrowing rate of 6%, is \$400.

The entity observes the following at contract inception:

- ▶ The repurchase price of \$450 is less than the original sales price of \$750.
- ▶ The customer does not have a significant economic incentive to exercise the option to return the equipment because the repurchase price is not significantly more than the expected market value of the equipment, and no other factor would compel the customer to exercise the option.

Therefore, the entity accounts for the transaction as a sale with a right of return (see Section 4.3.8 for related discussion).

**6.7 CONSIGNMENT ARRANGEMENTS****FASB REFERENCES**

ASC 606-10-55-79 and 55-80

When an entity delivers a product to another party (for example, a dealer, retailer, or distributor) for resale to end customers, the entity must evaluate whether that other party has obtained control of the product at that point in time. A product delivered to another party may be held in a consignment arrangement if that other party has not obtained control of the product.

**REVENUE CANNOT BE RECOGNIZED FOR CONSIGNMENT ARRANGEMENTS**

An entity cannot recognize revenue upon delivery of a product to another party if the delivered product is held on consignment.

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

- ▶ The product is controlled by the entity until a specified event occurs (for example, the subsequent sale of the product to a customer of the dealer, retailer, or distributor) or until a specified period expires.
- ▶ The entity can require the return of the product or transfer the product to a third party (for example, another dealer, retailer, or distributor).
- ▶ The dealer, retailer, or distributor does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

**BDO INSIGHTS – CONTRACTS WITH PRICE PROTECTION CLAUSES**

Sometimes an entity may provide certain pricing protection to its customers who resell its products to end customers. For example, an entity might provide a retrospective reduction in the purchase price if the entity lowers its price in the future or if the entity agrees to sell similar products to another customer at a lower price. Clauses such as “most favored nation” or “most favored customer” are common for providing such pricing protection to a customer. Additionally, an entity may allow a customer (reseller) to return unsold items for a refund. While such provisions limit the customer’s risks associated with purchasing the goods, they do not necessarily preclude the customer from obtaining control of the items. Instead, these types of provisions typically result in the price per item being variable. See Section 4.3 for discussion on accounting for variable consideration.

**6.8 BILL-AND-HOLD ARRANGEMENTS****FASB REFERENCES**

ASC 606-10-55-81 through 55-84

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 a bill-and-hold arrangement because the customer lacks available space for the product or because of delays in the customer’s production schedules.

When considering an entity has satisfied its performance obligation to transfer a product under a bill-and-hold arrangement, an entity must evaluate when the customer obtains control of that product. For some contracts, control of a product is transferred to customer 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 those cases:

- ▶ 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.
- ▶ The entity does not control the product but rather provides custodial services to the customer over the customer’s asset.

**ADDITIONAL REVENUE RECOGNITION CRITERIA FOR BILL-AND-HOLD ARRANGEMENTS**

In addition to applying the guidance on transfer of control (see Section 6.2 for related discussion), all of the following criteria must be met for a customer to have obtained control of a product in a bill-and-hold arrangement:

- ▶ The reason for the bill-and-hold arrangement must be substantive (for example, the customer requests the arrangement).
- ▶ The product must be identified separately as belonging to the customer.
- ▶ The product currently must be ready for physical transfer to the customer.
- ▶ The entity cannot have the ability to use the product or to direct it to another customer.

If an entity recognizes revenue for the sale of a product on a bill-and-hold basis, the entity must consider whether it has any remaining performance obligations (for example, for custodial services) to which the entity needs to allocate a

portion of the transaction price. See Chapters 3 and 5 for discussion on identification of performance obligations and allocation of transaction price to the performance obligations, respectively.

#### EXAMPLE 6-20 (ADAPTED FROM ASC 606-10-55-409 THROUGH 55-413): BILL-AND-HOLD ARRANGEMENT

An entity enters a contract with a customer on January 1, 20X1, for the sale of an item of equipment and spare parts. The manufacturing lead time for the equipment and spare parts is two years. Assume that the promises to transfer the equipment and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time.

Upon completion of manufacturing, the entity demonstrates that the equipment and spare parts meet the contractually agreed-upon specifications.

On December 31, 20X2, the customer pays for both the equipment and spare parts but only takes physical possession of the equipment. 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 proximity to the customer's factory.

Following are additional details of the arrangement that indicate all of the criteria for transfer of control in the bill-and-hold arrangement are met:

- ▶ The customer has legal title to the spare parts.
- ▶ The parts can be identified as belonging to the customer.
- ▶ The entity stores the spare parts in a separate section of its warehouse.
- ▶ The parts are ready for immediate shipment at the customer's request.
- ▶ The entity expects to hold the spare parts for two to four years, and the entity does not have the ability to use the spare parts or direct them to another customer.

The entity identifies the promise to provide custodial services as a performance obligation because it is a service provided to the customer that is distinct from the equipment and spare parts.

Therefore, the entity accounts for three performance obligations in the contract: the promises to provide the equipment, 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:

- ▶ **Equipment** – The entity determines that control of the equipment transfers to the customer on December 31, 20X2, when the customer takes physical possession.
- ▶ **Spare parts** – In determining the point in time at which control of the spare parts transfers to the customer, the entity notes the following and recognizes revenue for the spare parts on December 31, 20X2, when control transfers to the customer:
  - The entity has received payment.
  - The customer has legal title to the spare parts.
  - The customer has inspected and accepted the spare parts.
  - All criteria for transfer of control in the bill-and-hold arrangement are met, which is necessary for the entity to recognize revenue in a bill-and-hold arrangement.
- ▶ **Custodial services** – The entity determines that the performance obligation to provide custodial services is satisfied over time as those services are provided.

See Sections 6.2, 6.3, and 6.5 for discussion on transfer of control and whether a performance obligation is satisfied over time or at a point in time.

**BDO INSIGHTS – BILL-AND-HOLD ARRANGEMENTS**

Under ASC 606, some types of bill-and-hold arrangements may not qualify for revenue recognition until the delivery of the product to the customer's site or shipment (depending on the terms of the contract). Reaching a conclusion on when revenue from a bill-and-hold arrangement is recognized requires the application of professional judgment, based on the facts and circumstances.

Additionally, careful consideration of the terms of bill-and-hold arrangements is required to determine whether there are additional performance obligations (for example, custodial services) to which some of the transaction price for the sale of goods must be allocated. Promises that are immaterial to the contract are not required to be accounted for as distinct performance obligations – see Chapter 3 for a discussion of identifying performance obligations. However, we believe it would be rare for custodial services included in a bill-and-hold arrangement to be considered immaterial in the context of the contract even if the standalone selling price of such services is quantitatively small. In order to apply bill-and-hold accounting, the reason for the arrangement must be substantive, which indicates that the custodial services are likely important to the customer and thus qualitatively material.

## 6.9 CUSTOMER ACCEPTANCE

**FASB REFERENCES**

ASC 606-10-25-30(e) and ASC 606-10-55-85 through 55-88

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 must consider such clauses when evaluating when a customer obtains control of a good or service.

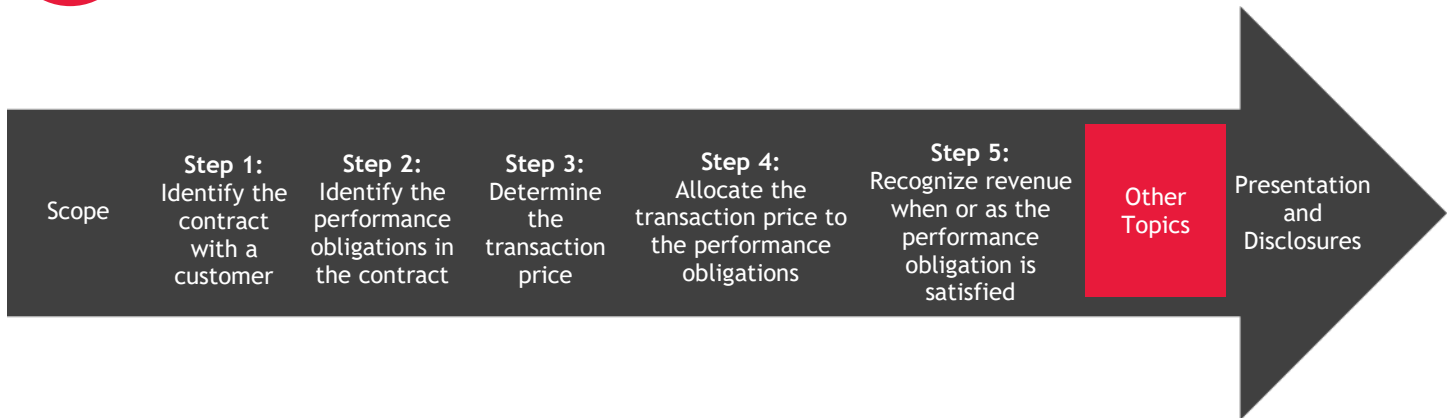
If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. An entity would determine whether the criteria related to customer acceptance have been met before receiving confirmation of the customer's acceptance if, for example, the customer acceptance clause is based on meeting specified size and weight characteristics of the product. An 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 (for example, upon delivery), the entity still must consider if there are any remaining performance obligations (for example, installation or maintenance of the equipment) and evaluate whether to account for them separately.

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 the entity cannot determine that the customer can direct the use of, and obtain substantially all of the remaining benefits from, the good or service until the customer's acceptance is received.

Additionally, 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, then control of the product is not transferred to the customer until either the customer accepts the product, or the trial period lapses.



## CHAPTER 7 – OTHER TOPICS



### 7.1 OVERVIEW

This chapter includes a detailed discussion of certain other key concepts in ASC 606 that are critical in applying the five-step revenue recognition model discussed in prior chapters. Those concepts include:

- ▶ Principal versus agent considerations
- ▶ Contract modification
- ▶ Customer options for additional goods or services
- ▶ Licensing
- ▶ Onerous contracts
- ▶ Contract costs

### 7.2 PRINCIPAL VERSUS AGENT CONSIDERATIONS



#### FASB REFERENCES

ASC 606-10-55-36 and 55-36A

ASC 606 includes guidance on performing a principal versus agent assessment when a third party is involved in providing goods or services to a customer. An entity is a principal and therefore recognizes revenue on a gross basis if it controls a good or service before transferring it to the customer. An entity is an agent and therefore recognizes revenue on a net basis if it arranges for a good or service provided by another entity. The standard includes indicators and examples to assist with the analysis



### DETERMINE THE NATURE OF AN ENTITY'S PROMISE IN A THREE-PARTY ARRANGEMENT

When a third party is involved in providing goods or services to a customer, an entity must determine whether the nature of its promise is to:

- ▶ Provide the specified goods or services itself – that is, the entity is a principal
- ▶ Arrange for those goods or services to be provided by the third party – that is, the entity is an agent

To determine the nature of its promise, an entity must:

- ▶ Identify the specified goods or services provided to the customer (for example, a right to a good or service provided by a third party)
- ▶ Assess whether it controls each specified good or service before it is transferred to the customer – see Section 7.2.2 for discussion on control

### BDO INSIGHTS – USING THE PRINCIPAL VERSUS AGENT GUIDANCE TO IDENTIFY THE CUSTOMER

The guidance in ASC 606 on performing a principal versus agent assessment is written from the viewpoint of the intermediary entity that obtains a good or service from a third party and subsequently sells that good or service to a customer. In that scenario, the entity may conclude either of the following:

- ▶ It is the principal in which case the cost of the good or service procured from the third party will be reported as an operating expense (that is, cost of goods sold or cost of services).
- ▶ It is an agent in which case the cost of the good or service will be reported net in revenue.

However, in many cases the entity performing the principal versus agent assessment may be the party that provides the good or service to a third party, who then transfers the good or service to an end customer. In that case, the entity is considered a principal in the transaction because it controls the good or service before transferring it to the interim buyer. In that fact pattern, the assessment focuses on whether the interim buyer or the end customer is the entity's customer. To identify its customer, the entity must assess whether its immediate buyer is a principal or an agent in the sale to the end customer.

- ▶ If the entity concludes that the interim buyer is the principal in the sale to the end customer, then its customer is the interim buyer, and the entity's revenue is the amount charged to the interim buyer. Any subsequent increase in price charged to the end customer by the interim buyer is not reflected in the entity's income statement.
- ▶ If the entity concludes that the interim buyer is acting as the entity's agent, and the end customer is the entity's customer, then the amount charged to the end customer by the interim buyer is recognized as the entity's revenue, and any difference between that amount and the amount charged to the interim buyer is reflected as an operating expense (that is, cost of goods sold, cost of services, or selling expense). However, when an entity does not have visibility into the price charged by the interim buyer to the end customer, that unknown amount is excluded from the entity's revenue (that is, the entity does not estimate the amount charged by the interim buyer to the end customer).



### **BDO INSIGHTS – INTERRELATIONSHIP BETWEEN IDENTIFYING THE CUSTOMER (STEP 1) AND PERFORMANCE OBLIGATIONS (STEP 2)**

The first step in applying the principal versus agent analysis is appropriately identifying the good or service that an entity has promised to transfer to the customer (the specified good or service). In some arrangements, identification of the good or service that an entity has promised to transfer may inform the conclusion about which party is the entity's customer. That is, the identification of the entity's obligations may be intertwined with the identification of the entity's customer(s).

For example, consider a technology platform entity that has developed an app to connect car drivers to end customers to receive car rides. The end customers download the app at no cost to connect with car drivers and make payments to the technology platform entity. If the entity determines that the nature of its promise is to connect the driver to the end customer (rather than to provide ride services to the end customer), then the entity would conclude that its customer is the driver (not the end customer). Reaching a conclusion about identifying the obligation(s) and the customers requires the application of professional judgment, based on the facts and circumstances.

#### **7.2.1 Unit of Account**



#### **FASB REFERENCES**

ASC 606-10-55-36

An entity must determine 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) provided to the customer (see Chapter 3 for discussion on distinct goods or services).



#### **CONTRACTS WITH MULTIPLE SPECIFIED GOODS OR SERVICES**

If a contract with a customer includes multiple specified goods or services, an entity could be a principal for some specified goods or services and an agent for others. See Example 7-6 in this chapter.

Note that the guidance on principal versus agent considerations in ASC 606 refers to the term “specified good or service” transferred to the customer, rather than “performance obligation.” In BC10 of ASU 2016-08, the FASB stated that the use of the term “performance obligation” would have been confusing if the entity is an agent because an agent's performance obligation is to arrange for the other party to provide goods or services to the customer; the agent does not promise to provide the goods or services itself to the end customer. Accordingly, the good or service provided to the end customer is not the performance obligation of the agent.

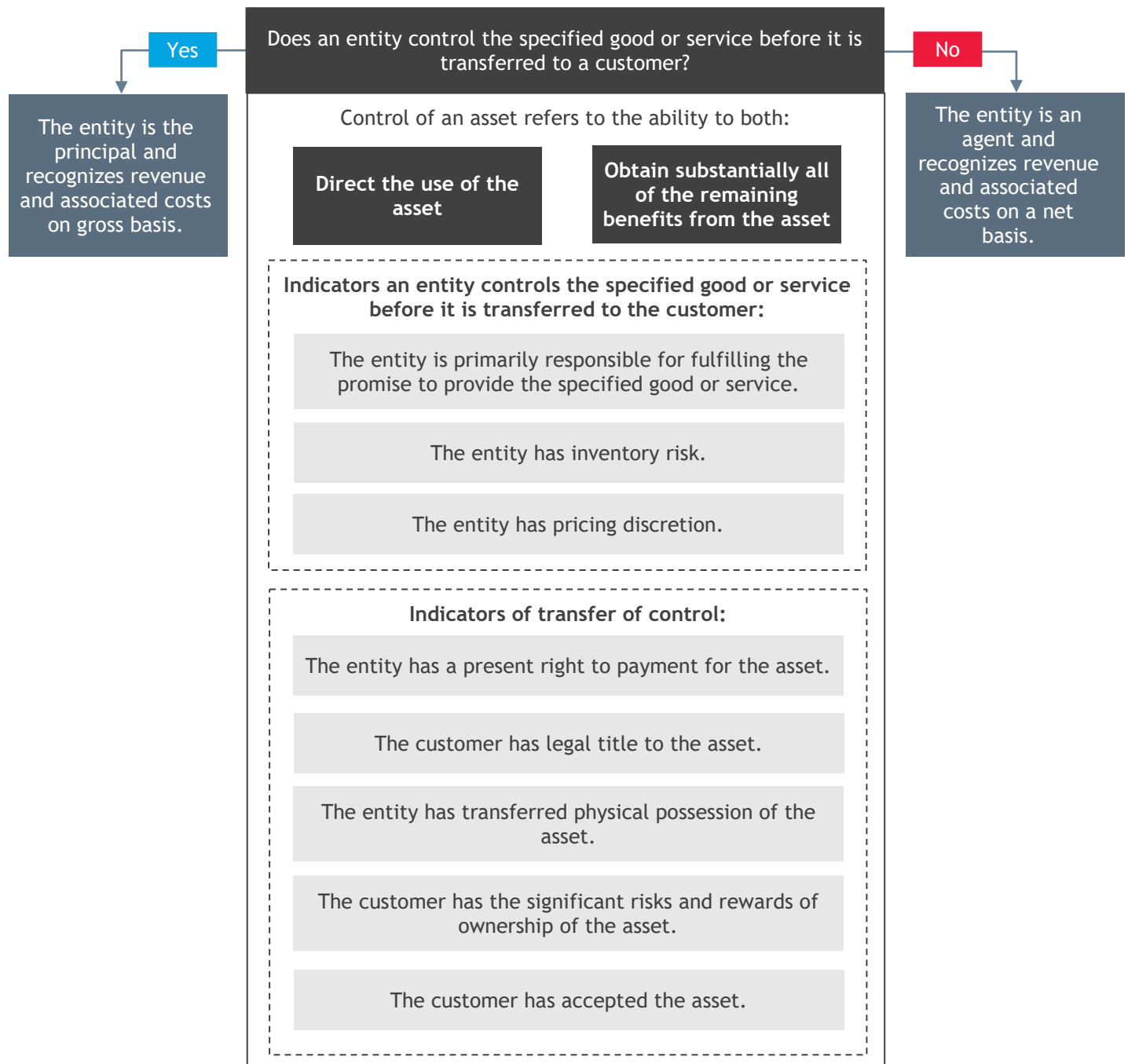
7.2.2 Assessment of Control



FASB REFERENCES

ASC 606-10-55-37, ASC 606-10-55-37A, and ASC 606-10-55-38

The following diagram illustrates the key considerations in assessing whether an entity controls the specified good or service transferred to a customer and the related accounting outcome:



An entity is:

- ▶ A principal if it controls the specified good or service before that good or service is transferred to a customer. An entity that is a principal recognizes revenue when (or as) it satisfies a performance obligation in the gross amount of consideration to which it expects to be entitled in exchange for the good or service transferred.
- ▶ An agent if the entity's performance obligation is to arrange for the provision of the specified good or service by a third party. An entity that is an agent does not control the specified good or service provided by a third party before that good or service is transferred to the customer. An entity that is an agent recognizes revenue when (or as) it satisfies a performance obligation of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services provided by the other party. That fee or commission may be the net amount of consideration that the entity retains after paying the third party the consideration received in exchange for the goods or services provided by that party.

When a third 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 good or another asset from the third party that it then transfers to the customer (see Example 7-4 in this chapter)
- ▶ A right to a service performed by the third party, which gives it the ability to direct that third party to provide the service to the customer on its behalf (see Example 7-3 in this chapter)
- ▶ A good or service from the third party that it then combines with other goods or services in providing the specified good or service to the customer (see Example 7-2 in this chapter)

#### 7.2.2.1 Significant Integration Service

An entity controls the specified good or service before that good or service is transferred to the customer if the entity provides a significant service of integrating goods or services (see Section 3.3.2.1 for a discussion of significant integration services) provided by a third party into the specified good or service for which the customer has contracted. In that fact pattern, the entity first obtains control of the inputs to the specified good or service (which include goods or services from third parties) and directs their use to create the combined output that is the specified good or service. For example, an entity that is a principal in providing project management service to a customer may combine specialized equipment manufactured by a third party with the entity's project management service.

#### 7.2.2.2 Effect of Legal Title on Assessment of Control

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, which is sometimes referred to as a "flash title."



#### FLASH TITLE TO A GOOD OR SERVICE

A flash title to a good or service is not a conclusive indicator of control in and of itself.

#### 7.2.2.3 Third Party Engaged by the Principal

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.

If a third party assumes an 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 does not recognize revenue for that performance obligation. Instead, the entity evaluates 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).

### 7.2.3 Indicators of Control



#### FASB REFERENCES

ASC 606-10-55-39

In some instances, it may not be clear whether an entity controls a good or service before transferring it to a customer. To assist with the assessment of control, ASC 606 provides the following non-exclusive list of indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore the principal for the specified good or service):

<b>Primary Responsibility</b>		<p>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.</p>
<b>Inventory Risk</b>		<p>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. As an 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.</p>
<b>Discretion in Pricing</b>		<p>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 and obtain substantially all of the remaining benefits from that good or service. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices to generate more revenue from its service of arranging for goods or services provided by other parties to customers.</p>



#### INDICATORS OF CONTROL DO NOT OVERRIDE THE CONTROL PRINCIPLE

The indicators of control do not override the control principle (see Section 6.2.1 for discussion on the notion of control) but rather assist entities in evaluating the control principle. The indicators 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. Additionally, different indicators may provide more persuasive evidence in different contracts.

**BDO INSIGHTS – INDICATORS OF CONTROL ARE HELPFUL (NOT NECESSARILY CONCLUSIVE)**

The control indicators in ASC 606 serve only to help an entity determine whether it controls the good or service being transferred if it is not obvious from the terms of the arrangement. A weighted assessment of the indicators themselves does not necessarily result in a conclusion of principal or agent. Rather, the conclusive determination of principal or agent is made based on the notion of control.

In addition, the principal versus agent assessment focuses on the nature of the performance obligations and whether the entity controls the good or service before transferring it to the end customer instead of determining whether the entity is exposed to the risks and rewards of the transaction.

Reaching a conclusion about whether an entity is the principal or agent in a three-party revenue transaction requires the application of professional judgment, based on the facts and circumstances.

**EXAMPLE 7-1 (ADAPTED FROM ASC 606-10-55-317 THROUGH 55-319): ARRANGING FOR THE PROVISION OF GOODS OR SERVICES – ENTITY IS AN AGENT**

An entity operates a website that enables end customers to purchase goods from a range of suppliers who deliver the goods directly to the customers. Following are the key terms of the entity's contracts with suppliers:

- ▶ The entity is entitled to a 10% commission on the sales price of the good purchased when an end customer purchases a good via the entity's website.
- ▶ The supplier sets the prices. The entity's website facilitates payment between the supplier and the customer.
- ▶ The entity requires payment from end customers before processing orders on its website; all orders are nonrefundable.
- ▶ The entity has no further obligations to the end customer after arranging for the goods provided to the customer.

To determine whether the entity's performance obligation is to provide the specified goods itself (that is, the entity is a principal) or to arrange for those goods to be provided by the supplier (that is, the entity is an agent), the entity identifies the specified good or service provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

The entity observes that the website it operates is a marketplace where suppliers offer their goods to end customers for purchase. Accordingly, the entity determines that the specified goods provided to end customers that use the website are the goods provided by the suppliers, and no other goods or services are promised to end customers by the entity.

The entity concludes that it does not have the ability to direct the use of the goods transferred to the end customers at any time because:

- ▶ It cannot direct the goods to parties other than the end customer or prevent the supplier from transferring those goods to the end customer.
- ▶ It does not control the suppliers' inventory of goods used to fulfill the orders placed by end customers using the website.

Therefore, the entity concludes that it does not control the goods before they are transferred to end customers that order goods using the website. In reaching that conclusion, the entity determines that the following indicators provide further evidence that it does not control the specified goods before they are transferred to the end customers.

- ▶ The entity is neither obliged to provide the goods if the supplier fails to transfer the goods to the end customer nor responsible for the acceptability of the goods. Rather, the supplier is primarily responsible for fulfilling the promise to provide the goods to the end customer.

- ▶ The entity does not commit to obtain the goods from the supplier before the goods are purchased by the end customer and does not accept responsibility for any damaged or returned goods. Therefore, the entity does not take inventory risk at any time before or after the goods are transferred to the customer.
- ▶ The sales price is set by the supplier and the entity does not have discretion in establishing prices for the supplier's goods.

Therefore, the entity concludes that it is an agent and that its performance obligation is to arrange for the provision of goods by the supplier to the end customer. The entity satisfies its promise to arrange for the goods provided by the supplier to the end customer when the customer purchases the goods. At that point in time, the entity recognizes revenue equal to the agency commission to which it is entitled.

**EXAMPLE 7-2 (ADAPTED FROM ASC 606-10-55-320 THROUGH 55-324): PROMISE TO PROVIDE GOODS OR SERVICES – ENTITY IS A PRINCIPAL**

An entity enters a contract with a customer to deliver equipment with unique specifications under the following terms:

- ▶ The entity and the customer develop the specifications for the equipment and negotiate the selling price.
- ▶ The entity communicates those agreed upon specifications for the equipment to a third-party supplier that the entity contracts with to manufacture the equipment. The entity and the supplier agree on a price paid by the entity for that equipment. The entity's profit is based on the difference between the sales price negotiated with the customer and the price charged by the supplier.
- ▶ The entity arranges to have the supplier deliver the equipment directly to the customer.
- ▶ Upon delivery of the equipment to the customer, the entity is contractually required to pay the supplier the price agreed to by the entity and the supplier for manufacturing the equipment.
- ▶ The entity invoices the customer for the agreed-upon price with 30-day payment terms.
- ▶ The contract between the entity and the customer requires the customer to seek remedies for defects in the equipment from the supplier under the supplier's warranty. However, the entity is responsible for any corrections to the equipment required resulting from errors in specifications.

To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services provided by another party (that is, the entity is an agent), the entity first identifies the specified good or service provided to the customer and then assesses whether it controls that good or service before the good or service is transferred to the customer.

The entity concludes that it has promised to provide the customer with specialized equipment designed by the entity:

- ▶ Although it has subcontracted the manufacturing of the equipment to the supplier, the design and manufacturing of the equipment are not distinct because they are not separately identifiable (that is, there is a single performance obligation).
- ▶ It is responsible for the overall management of the contract (for example, by making sure the manufacturing service conforms to the specifications) and therefore provides a significant service of integrating those items into the combined output – the specialized equipment – for which the customer has contracted.
- ▶ The activities pertaining to the design and overall management of the contract are highly interrelated with the equipment. 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 making sure any associated rework required conforms with the revised specifications.

Based on the above analysis, the entity identifies the specified good provided to the customer as the specialized equipment.

The entity concludes that it controls the specialized equipment before that equipment is transferred to the customer based on the below:

- ▶ The entity provides the significant integration service necessary to produce the specialized equipment.
- ▶ The entity directs the use of the supplier's manufacturing service as an input in creating the combined output that is the specialized equipment.
- ▶ Even though the supplier delivers the specialized equipment to the customer, the supplier has no ability to direct its use. The terms of the contract between the entity and the supplier preclude the supplier from using the specialized equipment for another purpose or directing it to another customer.
- ▶ The entity obtains the remaining benefits from the specialized equipment by being entitled to the consideration in the contract from the customer.

Based on the above analysis, the entity concludes that it is a principal in the transaction. The entity does not consider the indicators of control (see Section 7.2.3) because the evaluation 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.

#### **EXAMPLE 7-3 (ADAPTED FROM ASC 606-10-55-324A THROUGH 55-324G): PROMISE TO PROVIDE GOODS OR SERVICES – ENTITY IS A PRINCIPAL**

An entity enters a contract with a customer to provide cleaning services at the customer's offices under the following terms:

- ▶ The entity and the customer agree on the scope of the services and negotiate the price.
- ▶ The entity is responsible for making sure the services are performed in accordance with the terms and conditions in the contract.
- ▶ The entity invoices the customer monthly for the agreed-upon price with 15-day payment terms.

The entity routinely engages third-party service providers to provide cleaning services to its customers. When the entity obtains a contract from a customer, the entity enters a contract with one of those third-party service providers, which directs the service provider to perform cleaning services for the customer. While the payment terms in the contracts with the service providers generally are aligned with the payment terms in the entity's contracts with customers, the entity is obliged to pay the service provider even if the customer fails to pay.

To determine whether the entity is a principal or an agent, the entity first identifies the specified good or service provided to the customer and then assesses whether it controls that good or service before the good or service is transferred to the customer.

The entity observes that the specified services provided to the customer are the cleaning 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 cleaning services from the service provider after entering 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 cleaning 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 cleaning services obtained by the entity from the service provider is not the specified good or service in its contract with the customer.

The entity concludes that it controls the specified services before they are provided to the customer. The entity obtains control of a right to cleaning 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. Additionally, the



entity concludes that the following indicators of control (see Section 7.2.3) provide further evidence that the entity controls the cleaning services before they are provided to the customer:

- ▶ The entity is primarily responsible for fulfilling the promise to provide cleaning 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 to make sure the services are performed and are acceptable to the customer. That is, the entity is responsible for fulfillment 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.
- ▶ The entity has discretion in setting the price for the services to the customer.

The entity observes that it has mitigated its inventory risk with respect to the cleaning services as it does not commit itself to obtain the services from the service provider before obtaining the contract with the customer. Nevertheless, the entity concludes that it controls the office cleaning services before they are provided to the customer based on the evidence stated in the paragraph above.

Therefore, the entity is a principal in the transaction and recognizes revenue equal to the consideration to which it is entitled from the customer in exchange for the cleaning services. The entity recognizes amounts paid to the third-party service provider as cost of sales.

#### **EXAMPLE 7-4 (ADAPTED FROM ASC 606-10-55-325 THROUGH 55-329): PROMISE TO PROVIDE GOODS OR SERVICES – ENTITY IS A PRINCIPAL**

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

The entity enters contracts with its customers to resell the tickets. Following are the key terms of its arrangements with its customers:

- ▶ The entity determines the prices at which the airline tickets will be sold to its customers.
- ▶ The entity sells the tickets and collects the consideration from customers when the tickets are purchased.
- ▶ The entity assists the customers in resolving complaints about the service provided by the airlines. However, each airline (not the entity) is responsible for fulfilling obligations from the ticket, including remedies to a customer for dissatisfaction with the service.

To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services provided by another party (that is, the entity is an agent), the entity first identifies the specified good or service provided to the customer and then assesses whether it controls that good or service before the good or service is transferred to the customer.

The entity concludes that with each ticket that it commits itself to purchase from the airline, it obtains control of a right to fly on a specified flight (in the form of a ticket) that the entity then transfers to one of its customers. Therefore, the entity determines that the specified good or service provided to its customer is that right to a seat on a specific flight that the entity controls. The entity observes that no other goods or services are promised to the customer.

The entity controls the right to each flight before it transfers that specified right to one of its customers because:

- ▶ The entity has the ability to direct the use of that right by deciding whether to use the ticket to fulfill a contract with a customer and if so, which contract it will fulfill.
- ▶ The entity has the ability to obtain the remaining benefits from that right by either reselling the ticket and obtaining all of the proceeds from the sale or, alternatively, using the ticket itself.



The following indicators of control (see Section 7.2.3) also provide relevant evidence that the entity controls each specified right (ticket) before it is transferred to the customer.

- ▶ The entity has inventory risk on 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 establishes the price that the customer will pay for the specified ticket.

Therefore, 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.

#### 7.2.4 Determining Whether the Specified Good or Service is the Right to a Good or Service or the Underlying Good or Service

It could be challenging to determine when the specified good or service is the right to a good or service and when it is the underlying good or service itself in a principal versus agent evaluation.

For example, in Example 7-4, it could be difficult to determine whether the specified good or service is a right to the flight (the ticket) or the flight itself. In BC26 through BC28 of ASU 2016-08, the FASB stated that assessing whether the entity controls a right to a good or service is important to the principal versus agent evaluation and observed that there may be judgment involved in identifying the specified good or service in some cases. The FASB highlighted certain distinctions between the fact pattern in Examples 7-3 and 7-4:

- ▶ In Example 7-4, the ticket reseller itself does not transport the customers and it cannot change or modify the service (for example, change the flight time or destination). The ticket reseller 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 one location to another. Rather, the ticket reseller obtains tickets before a customer is identified for each of those tickets. The tickets represent specified rights to fly on specific flights operated by a third-party airline. The ticket reseller then transfers that specific right to the customer. Therefore, the customer obtains from the ticket reseller a specified asset (the ticket representing the right to fly on a specified flight) that the ticket reseller controlled. The ticket reseller controls a right to fly, which is an asset because it can:
  - Direct the use of the ticket by using the ticket itself, selling the ticket to any customer it wishes, or letting the ticket expire unused.
  - Obtain substantially all the remaining benefits of the ticket by either consuming the right or obtaining all of the cash flows from sale of that right.
- ▶ In contrast, Example 7-3 concludes that the specified good or service is the underlying cleaning services rather than a right to those services. In that example, the entity obtains the contract with the customer to provide the cleaning services before it engages a subcontractor (the third-party cleaning services provider) to perform those services. While the entity enters a contract to obtain cleaning services from the subcontractor after entering into the contract with the customer (but before the cleaning 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 cleaning 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 cleaning services and the customer is indifferent as to whether the subcontractor, the entity, or any other subcontractor carries out the cleaning services as long as those services are in accordance with the contractual terms. Conversely, in Example 7-4, the customer is not indifferent as to which ticket the ticket reseller transfers to it. The customer wants the ticket reseller to transfer a specific right that the customer will then control (that is, a ticket for a specific flight).

**EXAMPLE 7-5 (ADAPTED FROM ASC 606-10-55-330 THROUGH 55-334): ARRANGING FOR THE PROVISION OF GOODS OR SERVICES – ENTITY IS AN AGENT**

An entity sells vouchers that entitle customers to future meals at specified restaurants. The selling 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 \$10 for a voucher that entitles the customer to a meal at a restaurant that would otherwise cost \$20). Following are the key terms of the three-party arrangement:

- ▶ The entity purchases vouchers only as they are requested by the customers. That is, the entity does not purchase or commit itself to purchase vouchers in advance of the sale of a voucher to a customer.
- ▶ The entity sells the nonrefundable vouchers through its website.
- ▶ The entity and the restaurants jointly determine the selling price of the vouchers.
- ▶ Under the terms of its contracts with the restaurants, the entity is entitled to 20% of the selling price when it sells the voucher.
- ▶ The entity assists the customers in resolving complaints about the meals and has a buyer satisfaction program. However, the restaurant is responsible for fulfilling obligations from the voucher, including remedies to a customer for dissatisfaction with the service.

To determine whether the entity is a principal or an agent, the entity first 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.

The entity observes that a customer obtains a voucher for the restaurant that the customer selects. The entity does not engage the restaurants to provide meals to customers on the entity's behalf. Therefore, the entity concludes 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 which the customer purchases and can use itself or transfer to another person rather than purchasing the meal itself. The entity also observes it promises no other goods or services (other than the vouchers) to the customers.

The entity concludes that it does not control the voucher (right to a meal) at any time. In reaching this conclusion, the entity principally considers the following:

- ▶ The vouchers are created only at the time they are transferred to the customers and therefore do not exist before that transfer. Consequently, 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.
- ▶ 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 on the vouchers.

Based on the above analysis, the entity concludes that it is an agent in the arrangement to sell 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 20% commission it is entitled to upon the sale of each voucher.

**EXAMPLE 7-6 (ADAPTED FROM ASC 606-10-55-334A THROUGH 55-334F): ENTITY IS A PRINCIPAL AND AN AGENT IN THE SAME CONTRACT**

An entity sells services to assist its customers in more effectively targeting potential recruits for open job positions. The entity performs several services itself, for example, interviewing candidates and performing background checks. Below are the key terms of the three-party arrangement:

- ▶ The customer agrees to obtain a license to access a third-party's database of background information on potential recruits as part of the contract between the entity and the customer.
- ▶ The entity arranges for this license with the third party, but the customer contracts directly with the database provider for the license.
- ▶ 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 downtime or other technical issues.
- ▶ The entity collects payment on behalf of the third-party database provider as part of its overall invoicing to the customer.

To determine whether the entity is a principal or an agent, the entity first identifies the specified goods or services provided to the customer and then assesses whether it controls those goods or services before they are transferred to the customer.

Assume that the entity concludes that its recruitment services and the database access license are each distinct — see Chapter 3 for a related discussion. Accordingly, there are two specified goods or services provided to the customer:

- ▶ Access to the third-party's database
- ▶ Recruitment services

The entity concludes that it does not control the access to the third-party database before it is provided to the customer. The entity does not have the ability at any time to direct the use of the license because the customer contracts for the license directly with the third-party database provider. The entity does not control access to the provider's database. For example, the entity cannot grant access to the database to a party other than the customer or prevent the database provider from providing access to the customer.

In reaching that conclusion, the entity also considers the following indicators of control (see Section 7.2.3) that provide further evidence that it does not control access to the database before that access is provided to the customer:

- ▶ 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).
- ▶ 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.
- ▶ The entity does not have discretion in setting the price for the database access with the customer because the database provider sets that price.

Based on the above analysis, 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.

### **BDO INSIGHTS — PRINCIPAL VERSUS AGENT ANALYSIS IS COMPLEX**

In practice, determining whether an entity is acting as a principal or an agent can be sometimes difficult and may require significant judgment, based on the facts and circumstances. We expect those judgments to continue to be challenging when applying the guidance to certain complex arrangements. For example, transactions involving virtual goods and services are often executed in milliseconds and involve multiple counterparties. Consequently, control over a virtual good may transfer almost instantaneously, making it challenging to assess which party controls that good before it is transferred to the end customer.

Assessing whether an entity is acting as a principal, or an agent may also be complex in situations in which two parties collaborate to deliver a product on demand to a customer. Consider an example in which Entity A installs water filtration systems on Entity B's retail premises, where the product (filtered water) is delivered on demand by filtering water obtained from a municipal water supplier, with Entity B receiving a portion of the proceeds from the customer. Neither party would appear to control the underlying good (the water) before delivery to the customer, so assessing which entity is acting as the principal or the agent is challenging. We believe a principal must be identified in any three-party revenue transaction; that is, gross revenue must be presented by at least one party in a transaction even if significant collaboration exists with other entities in delivering an underlying good or service.

### **BDO INSIGHTS – SIGNIFICANCE OF CONTRACTS IN PRINCIPAL VERSUS AGENT ANALYSIS**

An entity may need to focus on the precise contractual terms in a three-party revenue transaction to determine the nature of the promises made (that is, what each party is providing) and the consideration earned by each party. In determining which party controls the good or service transferred to the end customer, we generally believe the existence of a contract with the end customer is a strong indicator that the counterparty controls the good or service transferred to the end customer. However, determining whether an entity is the principal or agent requires the application of professional judgment, based on the facts and circumstances.

### **BDO INSIGHTS – ‘DROP SHIPMENT’ ARRANGEMENTS**

‘Drop shipment’ arrangements illustrate the complexity of the principal versus agent analysis. Drop shipping is a supply chain management technique in which an entity does not keep physical stock of the goods it sells; it simply arranges for the sale between a customer and its supplier, and the supplier ships the good directly to the customer. This type of arrangement is becoming more common in the online retail environment, as it allows online retailers to keep less physical inventory on hand while still servicing their customers. In such instances, physical possession and legal title are likely less relevant in establishing whether the retailer who facilitates the shipment between its supplier and the end customer is a principal or an agent in the transaction. An entity must carefully consider other factors in determining whether it is acting as a principal or an agent in a drop-ship arrangement, including:

- ▶ Does the entity have latitude in establishing price?
- ▶ Does the entity only receive a fixed fee for establishing the relationship between the supplier and the customer?
- ▶ Who is responsible for customer satisfaction and addressing customer complaints, for example, in the case of product quality issues or returns?
- ▶ Are the goods customized or interchangeable for other goods?
- ▶ Which entity has the primary (or greater) responsibility towards the customer that receives the goods?
- ▶ Which party does the customer think it is buying from?

All of the above factors may inform the analysis of whether the entity controls the good (that is, whether the entity can direct the use of and derive substantially all of the benefits from the good) before it is transferred to the customer.



## SEC STAFF GUIDANCE

[Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments](#)

Sheri L. York, Professional Accounting Fellow, Office of the Chief Accountant

December 10, 2018

*The SEC staff discussed a preclearance related to a drop shipment arrangement in which a distributor, the registrant, never obtained physical possession of the goods because the goods were shipped directly from the manufacturer to the customer. In that fact pattern, the distributor maintained inventory for the majority of the goods sold. However, certain specialized goods were shipped by the manufacturer directly to the customer due to regulatory reasons. The SEC staff did not object to the conclusion that the distributor controlled the specialized goods before it was transferred to the customer because the distributor had the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods. Additionally, the distributor had the primary responsibility for fulfillment and pricing discretion. The SEC staff stated that the conclusion as to whether an entity is a principal or an agent requires a consideration of the definition of control, often including consideration of the indicators of control, of which inventory risk is only one of the possible indicators. In some circumstances, physical possession will not coincide with control of a specified good.*

## 7.3 CONTRACT MODIFICATIONS

### 7.3.1 Identifying Contract Modifications



## FASB REFERENCES

ASC 606-10-25-10 and 25-11

A contract modification is defined as a change in the scope or price of a contract that is approved by the parties to that 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.

Generally, an entity must continue to apply the guidance in ASC 606 to the existing contract until the contract modification is approved. However, a contract modification may exist even though the parties to the contract have a dispute about the scope or price 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. An entity must consider all relevant facts and circumstances, including the terms of the contract and other evidence to determine whether the rights and obligations that are created or changed by a modification are enforceable.

**BDO INSIGHTS – DETERMINING WHETHER A CONTRACT MODIFICATION HAS OCCURRED**

Determining whether a contract modification has occurred requires the application of professional judgment, based on the facts and circumstance. Generally, the legal form of an amendment to an existing contract does not affect the applicability of contract modification guidance. For example, contract modification guidance may be applicable if an amendment to a contract is legally structured by terminating the existing contract and executing a new contract (rather than executing an amendment to the original contract).

**UNPRICED CHANGE ORDERS**

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 must estimate the change to the transaction price arising from the modification in accordance with the guidance on estimating variable consideration and constraining estimates of variable consideration (see Section 4.3 for a discussion of estimating the transaction price, including variable consideration).

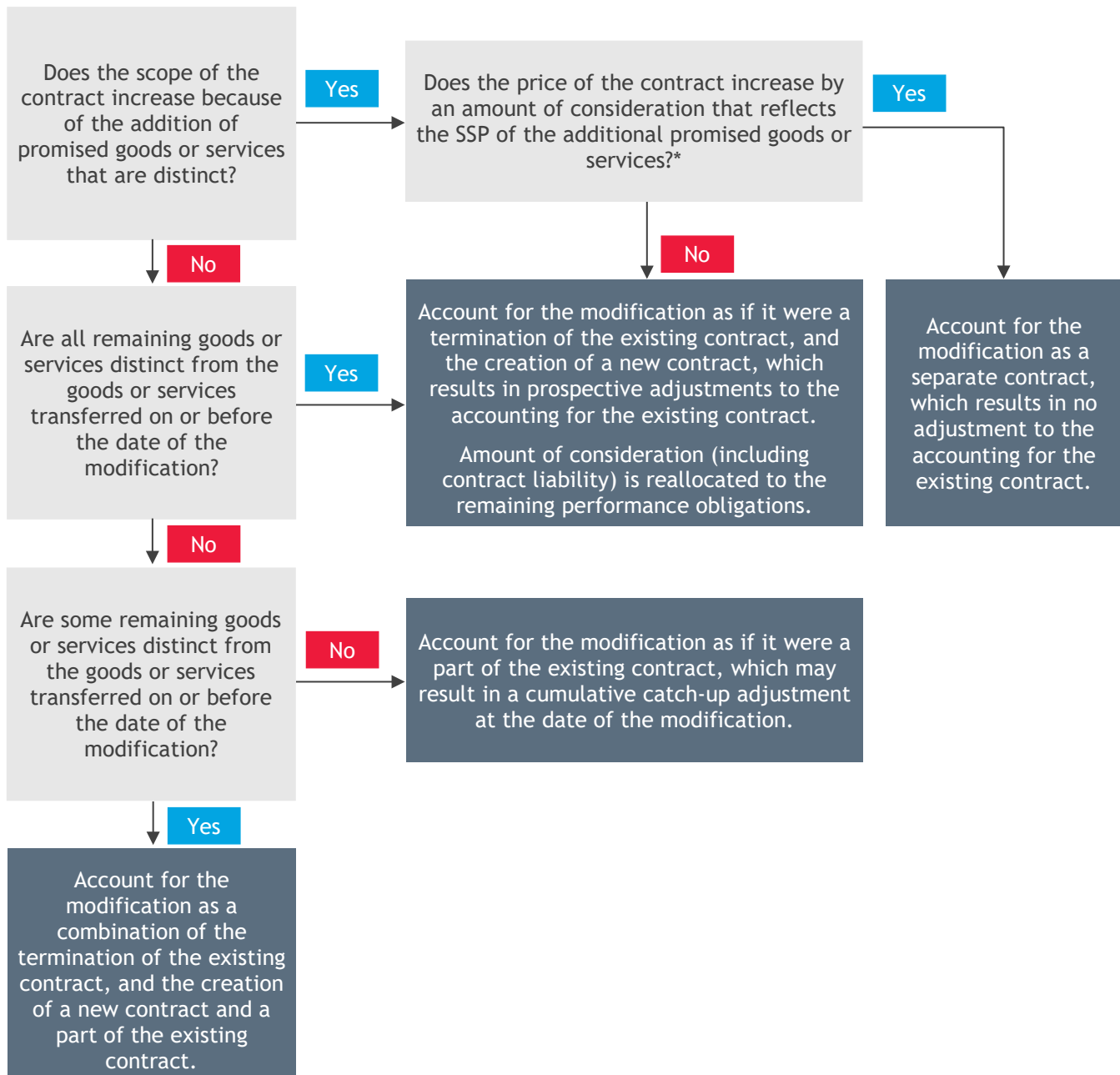
7.3.2 Accounting for Contract Modifications



FASB REFERENCES

ASC 606-10-25-12 and 25-13

The following diagram provides an overview of the accounting for contract modifications:



\*Including any appropriate adjustments to that SSP to reflect the circumstances of the particular contract

A contract modification is accounted for as a separate contract – and does not affect the accounting for the existing contract in any way – if both of the following conditions are met:

- ▶ The scope of the contract changes due to the addition of promised goods or services that are distinct
- ▶ The price of the contract increases by an amount of consideration that reflects the entity's standalone selling price of the additional promised goods or services, including any appropriate adjustments to that price to reflect the circumstances of the particular contract

If either of the two conditions stated above are not met, the accounting for the modification depends on whether the promised goods or services under the existing contract that have not yet transferred at the date of the contract modification (that is, the remaining goods or services) are distinct from any additional goods or services arising from the contract modification. The following approaches are applicable based on whether the remaining goods or services are distinct:

- ▶ **Termination of the existing contract and creation of a new contract** – If the remaining goods and services are distinct (or are distinct goods or services that constitute a series), the contract modification is accounted for as a replacement of the existing contract with a new contract. Any revenue and cost remaining unrecognized under the existing contract, and revenues and costs from the contract modification, are combined and accounted for prospectively as if it were a new contract. That is, there is no adjustment made to the revenue recognized to date under the existing contract.
- ▶ **Continuation of the existing contract** – If the remaining goods and services are not distinct, the contract modification is accounted for as part of the existing contract which may result in an upward or downward adjustment to revenue recognized to date under the existing contract (that is, a cumulative catch-up adjustment as of the date of the contract modification).
- ▶ **Combination of the two approaches above** – If some of the remaining goods or services are distinct and others are not, then the entity must apply judgment to determine how to account for the effects of the modification on the unsatisfied performance obligations in the modified contract. However, the approach must be consistent with the objectives of the two approaches described above.

#### **BDO INSIGHTS – ACCOUNTING FOR MODIFICATIONS WHEN ONLY SOME REMAINING PERFORMANCE OBLIGATIONS ARE DISTINCT**

Accounting for a modification in which only some (not all) of the remaining goods or services are distinct requires the application of professional judgment, based on the facts and circumstances. Multiple approaches may be acceptable as long as they are consistent with the objectives of the accounting approaches for a modification that is a termination of the existing contract and creation of a new contract and a modification that is a continuation of the existing contract. See Example 7-12 for an illustration of one acceptable approach.

While accounting for a modification that increases the scope (or promised goods or services) in a contract is more straightforward, significant judgment may be required in accounting for a modification that includes changes other than to increase the scope of the existing contract. See the following two examples adapted from ASC 606, which illustrate the accounting for:

- ▶ A modification to increase the quantity of goods sold to the customer (Example 7-7)
- ▶ A modification to increase the quantity of goods sold to the customer and provide a concession related to the goods already delivered under the existing contract (Example 7-8)



**EXAMPLE 7-7 (ADAPTED FROM ASC 606-10-55-111 THROUGH 55-116): MODIFICATION OF A CONTRACT FOR GOODS – ADDITIONAL GOODS FOR A PRICE THAT REFLECTS THE STANDALONE SELLING PRICE**

An entity enters a contract with a customer to sell 120 goods for \$12,000 (that is, \$100 per good). The goods are transferred to the customer over a six-month period. Assume that the entity transfers control of each product at a point in time. After the entity has transferred control of 60 goods to the customer, the contract is modified to require the delivery of an additional 30 goods (a total of 150 identical goods) to the customer.

Assume that the contract modification provides that the price for the additional 30 goods is an additional \$2,850 (that is, \$95 per good).

At the date of contract modification, the entity determines that:

- ▶ The pricing for the additional goods reflects the standalone selling price of the goods at that date.
- ▶ The additional products are distinct from the goods provided under the original contract.

Therefore, the entity accounts for the contract modification for the additional 30 goods as in effect a new and separate contract for future goods that does not affect the accounting for the existing contract. The entity recognizes revenue of \$100 per good for the 120 goods in the original contract and \$95 per good for the 30 goods in the new contract.

**EXAMPLE 7-8 (ADAPTED FROM ASC 606-10-55-111 THROUGH 55-116): MODIFICATION OF A CONTRACT FOR GOODS – ADDITIONAL GOODS FOR A PRICE THAT DOES NOT REFLECT THE STANDALONE SELLING PRICE**

Assume that in the fact pattern in Example 7-7, the parties agree on a price of \$80 per good as the price for the additional 30 goods. However, after that negotiation, the customer discovers that the initial 60 goods transferred to the customer contained minor defects that were unique to those delivered goods. The entity and customer agree that:

- ▶ The entity will issue a partial credit of \$15 per item to compensate the customer for the poor quality of those 60 goods (that is, \$900 credit for 60 goods).
- ▶ The credit of \$900 will be incorporated into the price that the entity charges for the additional 30 goods.

As a result, the contract modification specifies that the price for the additional 30 goods is \$1,500 (or \$50 per good), which consists of the agreed-upon price for the additional 30 goods of \$2,400 (or \$80 per good), less the credit of \$900.

At the time of modification:

- ▶ The entity recognizes the \$900 credit as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 goods (each a distinct performance obligation) transferred. This is because the \$900 concession relates to the 60 goods previously delivered.
- ▶ In evaluating the contract modification for the sale of the additional 30 goods, the entity determines that:
  - The remaining goods delivered are distinct from those already transferred.
  - The negotiated price of \$80 per good does not reflect the standalone selling price of the additional goods.

Therefore, the entity accounts for the contract modification as a termination of the original contract and the creation of a new contract.

As a result, the amount of revenue recognized for each of the remaining goods is a blended price of \$93.33 (which is calculated as  $[(\$100 \times 60 \text{ goods not yet transferred under the original contract}) + (\$80 \times 30 \text{ goods transferred under the contract modification})]$  divided by 90 remaining goods).

**EXAMPLE 7-9 (ADAPTED FROM ASC 606-10-55-117 THROUGH 55-124): CHANGE IN THE TRANSACTION PRICE AFTER A CONTRACT MODIFICATION**

On June 1, 20X0, an entity promises to transfer two distinct products, Products A and B, to a customer. Product A transfers to the customer at contract inception and Product B transfers on March 1, 20X1.

The consideration in the contract includes fixed consideration of \$1,000 and variable consideration that is estimated at \$200 at contract inception. Assume that both products have the same standalone selling price.

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 related to the variable consideration is resolved. Therefore, the transaction price for the contract is \$1,200.

Assume that the criteria for the variable consideration allocation exception (see Section 5.5) are not met. Based on the relative standalone selling prices of the two products, the entity allocates the transaction price of \$1,200 equally to the performance obligations for Products A and B.

The entity recognizes revenue of \$600 when Product A transfers to the customer at contract inception.

On November 30, 20X0, the scope of the contract is modified to:

- ▶ Add a promise to transfer Product C (in addition to the undelivered Product B under the original contract) to the customer on June 1, 20X1.
- ▶ Increase the price of the contract by \$300 (fixed consideration), which does not represent the standalone selling price of Product C. The standalone selling price of Product C is the same as the standalone selling prices of Products A and B.

At the date of the contract modification, the entity determines that:

- ▶ The remaining Products B and C are distinct from Product A, which had transferred to the customer before the modification.
- ▶ The promised consideration for the additional Product C does not represent its standalone selling price.

The entity accounts for the contract modification as if it were the termination of the existing contract and the creation of a new contract.

As a result, the consideration allocated to the remaining performance obligations (Products B and C) is \$900, which consists of:

- ▶ The transaction price from the original contract that had been allocated to Product B – \$600
- ▶ The consideration promised in the modification – \$300

The \$900 transaction price for the modified contract is allocated equally to the performance obligations for Products B and C based on their relative standalone selling prices. That is, \$450 is allocated to each performance obligation.

After the modification but before the delivery of Products B and C, 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, the increase in the transaction price of \$40 is attributable to variable consideration promised before the modification. Therefore, the change in the transaction price (a \$40 increase) is allocated to the performance obligations for Product A and Product B on the same basis as at contract inception (see Section 4.8 for discussion on changes in transaction price). That \$40 increase in transaction price is accounted for as follows:

- ▶ The entity recognizes revenue of \$20 for Product A in the period in which the change in the transaction price occurs.

- ▶ Because Product B had not transferred to the customer before the contract modification, the change in the transaction price that is attributable to Product B (\$20) 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 if that amount of variable consideration had been estimated and included in the transaction price at the time of the contract modification.
- ▶ Therefore, the entity allocates the \$20 increase in the transaction price for the modified contract equally to the performance obligations for Products B and C. This is because the products have the same standalone selling prices, and the variable consideration allocation exception criteria are not met (see Section 5.5 for related discussion). Consequently, the amount of the transaction price allocated to the performance obligations for Products B and C increases by \$10 to \$460 each.

On March 1, 20X1, the entity transfers Product B to the customer and recognizes revenue of \$460. On June 1, 20X1, the entity transfers Product C to the customer and recognizes revenue of \$460.

#### **EXAMPLE 7-10 (ADAPTED FROM ASC 606-10-55-125 THROUGH 55-128): MODIFICATION OF A SERVICES CONTRACT – INTERACTION OF THE CONTRACT MODIFICATION GUIDANCE AND THE SERIES PROVISION**

An entity enters a three-year contract with a customer to clean the customer's offices weekly. The customer promises to pay \$200,000 annually. Assume that the standalone selling price of the services at contract inception is \$200,000 annually. The entity recognizes revenue of \$200,000 per year during the first two years of providing services.

At contract inception, the entity assesses that each week of cleaning service is distinct. The entity determines that 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 (that is, the services transfer to the customer over time and use the same method (time-based) to measure progress). Therefore, even though each week of cleaning service is distinct, the entity accounts for the cleaning contract as a single performance obligation. (See Chapter 3 for discussion on identification of performance obligations including the series guidance.)

At the end of the second year, the entity and the customer modify the contract:

- ▶ The fee for the third year is reduced to \$160,000.
- ▶ The customer agrees to extend the contract for three additional years for consideration of \$400,000 payable in three equal annual installments of \$133,333 at the beginning of years 4, 5, and 6.

At the date of the modification, the entity determines:

- ▶ The additional services (for years 4 through 6) are distinct.
- ▶ The standalone selling price of the additional services at the date of contract modification (that is, the beginning of the third year) is \$160,000 per year. The entity's standalone selling price at the date of contract modification, multiplied by the additional three years of services, is \$480,000, which is deemed as an appropriate estimate of the standalone selling price of the multi-year contract.
- ▶ The price for the additional years of service does not reflect the standalone selling price of the additional services.

Therefore, the entity accounts for the modification as if it were a termination of the original contract and the creation of a new contract with consideration of \$560,000 for four years of cleaning service. The entity recognizes revenue of \$140,000 per year (\$560,000 divided by four years) as the services are provided over the remaining four years.

**EXAMPLE 7-11 (ADAPTED FROM ASC 606-10-55-129 THROUGH 55-133): MODIFICATION RESULTING IN A CUMULATIVE CATCH-UP ADJUSTMENT TO REVENUE**

A construction entity enters a contract with a customer to construct a building on a piece of land owned by the customer. The contract provides for fixed consideration of \$2 million and a performance bonus of \$400,000 if the building is completed within 24 months from contract inception.

The entity determines that the contract includes a single performance obligation (to construct the building). The entity determines that the customer controls the building during construction and therefore its performance obligation is satisfied over time. (See Chapters 3 and 6 for identifying performance obligations and recognizing revenue, respectively.)

At contract inception, in determining whether the bonus should be included in the transaction price, the entity observes:

- ▶ The completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals.
- ▶ The entity has limited experience with similar types of contracts.

Based on the above analysis, the entity does not include the \$400,000 bonus in the transaction price because it cannot conclude that it is probable that a significant reversal of cumulative revenue recognized will not occur. (See Section 4.3 for discussion on estimating variable consideration and the variable consideration constraint.)

At contract inception, the entity determines that a cost-based input measure provides an appropriate measure of progress toward complete satisfaction of the performance obligation.

The entity expects the following at contract inception:

Transaction Price	\$ 2,000,000
Expected Costs	1,400,000
Expected Profit (30%)	\$ 600,000

By the end of the first year, the entity has satisfied 60% of its performance obligation based on costs incurred to date (\$840,000) relative to total expected costs (\$1.4 million). The entity reassesses the variable consideration and concludes that the bonus is still fully constrained. Therefore, the cumulative revenue and costs recognized for the first year are:

Revenue	\$ 1,200,000
Expected Costs	840,000
Expected Profit (30%)	\$ 360,000

In the first quarter of the second year, the entity and the customer agree to modify the contract by changing the floor plan of the building. As a result:

- ▶ The fixed consideration and expected costs increase by \$300,000 and \$240,000, respectively. That is, total potential consideration after the modification is \$2.7 million (\$2.3 million fixed consideration + \$400,000 performance bonus).
- ▶ The allowable time for achieving the \$400,000 bonus is extended by 6 months to 30 months from the original contract inception date.

At the date of the modification, the entity considers its experience and the remaining work performed (which is primarily inside the building and not subject to weather conditions) and concludes it is probable that, including the bonus in the transaction price will not result in a significant reversal of cumulative revenue recognized. Therefore, the entity includes the \$400,000 in the transaction price.

In assessing the appropriate accounting for the contract modification, the entity concludes that the remaining goods and services provided under the modified contract are not distinct from the goods and services transferred on or before the date of contract modification.

Therefore, the entity accounts for the contract modification as if it were part of the original contract:

- ▶ The entity updates its measure of progress at the date of contract modification and estimates that it has satisfied 51.2% of its performance obligation (\$840,000 actual costs incurred divided by \$1,640,000 total expected costs).
- ▶ The entity recognizes additional revenue of \$182,400 [(51.2% complete × \$2,700,000 modified transaction price) less \$1,200,000 revenue recognized to date] at the date of the modification as a cumulative catch-up adjustment.

#### **EXAMPLE 7-12: MODIFICATION OF A CONTRACT – APPLICATION OF A COMBINATION OF MODIFICATION ACCOUNTING APPROACHES WHEN ONLY SOME REMAINING GOODS OR SERVICES ARE DISTINCT**

A technology entity enters a contract with a customer to provide the following goods and services:

- ▶ Three-year software license
- ▶ Significant software customizations
- ▶ One year of PCS, including maintenance and helpdesk services

At contract inception, the software customization services are expected to take four months. When customization services are 40% completed, a rival entity releases software that has additional functionality not currently available in the technology entity's software. The technology entity agrees to add the new functionality as part of the customization services at no extra cost to the customer. The technology entity expects the additional functionality to take an additional two months to complete.

At contract inception, the technology entity determines that the contract includes two performance obligations (see Chapter 3 for a discussion on identifying performance obligations):

- ▶ Customized software
- ▶ PCS

Additionally, at contract inception, the technology entity determines that:

- ▶ The customized software is transferred over time to the customer because the customer controls the customized software during customization
- ▶ The PCS is transferred over time to the customer because the customer simultaneously receives and consumes its benefit

(See Chapter 6 for a discussion of whether a performance obligation is satisfied over time.)

At the effective date of the modification, the technology entity observes that its remaining goods and services include:

- ▶ Remaining goods or services for the customized software with added functionality
- ▶ PCS, which has not transferred to the customer yet and will be transferred to the customer after the software customizations are complete

In assessing the appropriate accounting for the contract modification, the technology entity concludes that some of the remaining goods and services provided under the modified contract are distinct from the goods and services transferred on or before the date of contract modification while some are not.

- ▶ The customized software is in process at the effective date of the modification. The customization efforts completed prior to the contract modification are not distinct from the customization efforts remaining after the contract modification.

- ▶ PCS is distinct from the customized software.

The technology entity accounts for the contract modification by applying a combination of the two modification accounting approaches: (1) the termination of the existing contract and the creation of a new contract and (2) the continuation of the existing contract, as follows:

- ▶ Arrangement consideration is re-allocated between the two performance obligations based on the standalone selling price of the customized software, updated to reflect the additional promised functionality, and the original standalone selling price of the PCS.

- ▶ Amounts allocated to the customized software are accounted for as a part of the existing contract (that is, as a continuation of the existing contract) and a cumulative catch-up adjustment is made to reflect the new measure of progress.

- ▶ Amounts allocated to the PCS are accounted for as the termination of the existing contract and creation of a new contract and are deferred until the software customizations are completed and the PCS service period begins.

#### **BDO INSIGHTS – CONTRACT MODIFICATION GUIDANCE**

The application of the contract modification guidance requires the application of professional judgment, based on the facts and circumstances. The accounting outcome is based on whether the modified promises for goods or services are distinct and whether the distinct promises are priced at their standalone selling prices.

Additionally, application of the contract modification guidance to certain contracts for which revenue is recognized over time (for example, construction contracts and software application development contracts) may result in a downward or upward cumulative catch-up adjustment to revenue at the date of contract modification.

Therefore, entities must carefully evaluate changes in the scope or pricing of existing customer contracts to appropriately account for the effects of modifications on the amount and timing of revenue recognition.

## **7.4 CUSTOMER OPTIONS FOR ADDITIONAL GOODS OR SERVICES**

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
- ▶ Other discounts on future goods or services

### **7.4.1 Material Right**



#### **FASB REFERENCES**

ASC 606-10-25-16A and 25-16B, ASC 606-10-25-18(j), ASC 606-10-32-29 and ASC 606-10-55-42 through 55-45

An entity may grant its customer an option that allows the customer to purchase additional goods or services as part of or in conjunction with a contract. The option represents a promised good or service when the option provides the customer with a material right. That is, customer options for additional goods or services may represent a performance

obligation in Step 2 (see Chapter 3 for a discussion of performance obligations). The following guidance assists in applying Steps 2 through 5 to customer options that represent a material right to the customer.

#### 7.4.1.1 Identification of a Material Right (a Performance Obligation in Step 2)

Customer options for future goods or services represent a material right to the customer and hence a performance obligation in the contract if the option provides a material right to the customer that it would not receive without entering that contract. Therefore, 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 represents a material right. Conversely, if the option allows the customer 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.

A material right is a performance obligation identified in Step 2 of the five-step revenue recognition model and, therefore, the subsequent steps related to allocation of transaction price and recognition of revenue must be applied.



#### IMMATERIALITY EXCEPTION IN IDENTIFYING THE PERFORMANCE OBLIGATIONS IS NOT AVAILABLE FOR A MATERIAL RIGHT

An entity is not allowed to apply the immateriality exception in identifying the performance obligations in Step 2 to a customer option that is determined to represent a material right — see Section 3.2.5 for a discussion of the exception for immaterial promises in a contract.



#### TRG DISCUSSIONS — ASSESSMENT OF WHETHER AN OPTION GIVES RISE TO A MATERIAL RIGHT

In October 2014, the TRG discussed two issues from the evaluation on whether customer options to acquire additional goods and services give rise to a material right:

- ▶ Whether the evaluation should be performed only in the context of the current transaction or whether it should factor in past and expected future transactions
- ▶ Whether the evaluation should consider qualitative as well as quantitative factors

Most TRG members agreed that the evaluation should both:

- ▶ Factor in past and future transactions, as well as present ones
- ▶ Consider qualitative factors, such as whether the right accumulates over time as happens with loyalty points



#### TRG DISCUSSIONS — ASSESSMENT OF WHETHER VARIABLE QUANTITY CONSTITUTES A PURCHASE OPTION OR VARIABLE CONSIDERATION

In November 2015, the TRG considered how an entity should determine whether a contractual right to acquire additional goods or services represents an option to purchase additional goods and services or variable consideration based on a variable quantity. This question might arise, for example, if a software entity grants 500 licenses to use software for a fixed fee of \$500,000, with the price for additional users being \$800.



TRG members agreed that all facts and circumstances should be considered when analyzing contracts with similar provisions and that this analysis requires judgment. However, they concluded that the first step to distinguishing between optional goods or services and variable consideration for promised goods or services is to identify:

- ▶ The nature of the entity's promise to the customer
- ▶ The enforceable rights and obligations of the parties

With an option for additional goods or services, the customer has a present right to choose to purchase additional distinct goods or services (or change the goods and services delivered). Prior to the customer's exercise of that right, the entity is not presently obligated to provide those goods or services and the customer is not obligated to pay for those goods or services.

In contrast, in the case of variable consideration for a promised good or service, the entity and the customer previously executed a contract that requires the entity to transfer the promised good or service and the customer to pay for that promised good or service. The future events that trigger payment of additional consideration to the entity occur after (or as) control of the goods or services have (or are) transferred. When a contract includes variable consideration based on a customer's actions, those actions do not oblige the entity to provide additional distinct goods or services (or change the goods or services transferred), but rather, resolve the uncertainty from the amount of variable consideration that the customer is obligated to pay.

#### 7.4.1.2 Allocation of Transaction Price to Customer Options – Determination of Standalone Selling Price (Step 4)

When applying the general allocation model to allocate the transaction price to performance obligations on a relative standalone selling price basis (see Section 5.2.1), an entity must estimate the standalone selling price for a material right if the standalone selling price of the option is not directly observable. That estimate must reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

- ▶ Any discount that the customer could receive without exercising the option
- ▶ The likelihood that the option will be exercised

However, when the material right represents a renewal option, an entity may use an alternative approach to allocate the consideration. See Section 7.4.2 for a discussion of renewal options.

#### 7.4.1.3 Revenue Recognition for a Material Right (Step 5)

If an option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services. Therefore, the entity must recognize the related revenue when either of the following is applicable:

- ▶ Those future goods or services are transferred
- ▶ The option expires

If an option does not provide a material right to the customer, the entity has made a marketing offer which is accounted for in accordance with ASC 606 only when the customer exercises the option to purchase the additional goods or services.

#### EXAMPLE 7-13 (ADAPTED FROM ASC 606-10-55-134 AND 55-135): OPTION THAT PROVIDES THE CUSTOMER WITH A MATERIAL RIGHT – DISCOUNT VOUCHER

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

Because all customers will receive a 10% 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% (that is, the additional 30% discount). The entity accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of apparel.



To estimate the standalone selling price of the discount voucher, the entity estimates that:

- ▶ There is an 80% likelihood that a customer will redeem the voucher.
- ▶ A customer, on average, will purchase \$50 of additional products.

Based on the above, the entity's estimated standalone selling price of the discount voucher is \$12 (\$50 average purchase price of additional products × 30% incremental discount × 80% likelihood of exercising the option).

Based on the relative standalone selling prices of the shirt and the discount voucher, the entity allocated the \$100 transaction price as follows:

Performance Obligation	Standalone Selling Price
Shirt	\$ 100
Discount voucher	12
<b>Total</b>	<b>\$ 112</b>

Performance Obligation	Allocated Transaction Price	
Shirt	\$ 89	Calculated as \$100 * (\$100/\$112)
Discount voucher	11	Calculated as \$12 * (\$12/\$112)
<b>Total</b>	<b>\$ 100</b>	

The entity allocates \$89 to the shirt and recognizes revenue when control of the shirt transfers to the customer. 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 7-14 (ADAPTED FROM ASC 606-10-55-134 AND 55-135): OPTION THAT DOES NOT PROVIDE THE CUSTOMER WITH A MATERIAL RIGHT – ADDITIONAL GOODS OR SERVICES

An entity in the telecommunications industry enters a contract with a customer to provide a handset and monthly network service for three years. The network service includes up to 1,500 call minutes and 2,000 text messages each month for a fixed monthly fee. The customer may choose to purchase additional call minutes or texts in any month at contractually specified prices that are equal to their standalone selling prices.

The entity determines that the promises to provide the handset and network service are each separate performance obligations because:

- ▶ The customer can benefit from the handset and network service either on their own or with other resources that are readily available to the customer
- ▶ The handset and network service are separately identifiable

(See Chapter 3 for a discussion of performance obligations.)

In analyzing the customer's option to purchase additional call minutes or texts, the entity observes that the prices of the additional call minutes and texts reflect the standalone selling prices for those services. Therefore, the entity concludes 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. Rather, the entity has made a marketing offer that is accounted for in accordance with ASC 606 only when the customer exercises the option.

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. Therefore, 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.

#### EXAMPLE 7-15 (ADAPTED FROM ASC 606-10-55-353 THROUGH 55-356): CUSTOMER LOYALTY PROGRAM

A retail entity has a customer loyalty program that rewards a customer with one 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 loyalty points provide a material right to customers that they would not receive without entering a contract. Therefore, the entity concludes that the promise to provide loyalty points to the customer is a performance obligation.

Based on the historical data and other relevant evidence, the entity estimates that 9,500 points are expected to be redeemed. Based on the likelihood of redemption, the entity estimates a standalone selling price of \$0.95 per loyalty point, for a total value of points earned during the period equaling \$9,500.

The entity allocates the transaction price, \$100,000, to the product and the loyalty points on a relative standalone selling price basis as follows:

Product	\$ 91,324	Calculated as \$100,000 × (\$100,000/\$109,500)
Points	\$ 8,676	Calculated as \$9,500 × (\$9,500/\$109,500)

At the end of the first reporting period, 4,500 points have been redeemed, and the entity continues to expect 9,500 points to be redeemed in total. The entity recognizes the following related to the loyalty points at the end of the first reporting period:

- ▶ Revenue of \$4,110 [(4,500 points ÷ 9,500 points) × \$8,676]
- ▶ A contract liability of \$4,566 (\$8,676 - \$4,110) for the unredeemed points

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 remaining at the end of the second reporting period is \$1,073 (\$8,676 initial allocation - \$7,603 of cumulative revenue recognized).

#### BDO INSIGHTS – CUSTOMER LOYALTY ARRANGEMENTS AND PRINCIPAL VERSUS AGENT CONSIDERATIONS

The accounting illustrated in Example 7-15 in this chapter may not apply to all customer loyalty arrangements because the terms and conditions may differ. Especially when there are more than two parties to the arrangement, an entity must consider all facts and circumstances to determine the customer in the transaction that gives rise to the award credits. For example, a bank may issue loyalty points to a credit card customer, which can be redeemed by the customer at a third-party entity such as an airline, hotel, or restaurant. An entity must consider principal versus agent considerations to appropriately account for three-party revenue transactions – see Section 7.2 for a related discussion. Accounting for customer loyalty programs requires the application of professional judgment, based on facts and circumstances.

## 7.4.2 Renewal Options



### FASB REFERENCES

ASC 606-10-55-45

A renewal option is different from customer loyalty programs, discount vouchers, and many other discounts on future goods or service. With loyalty programs and vouchers, the underlying goods or services in the contract with the customer often has a different nature rather than being similar to the original goods or services in the original contract. A renewal option, in contrast, gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. Because of that difference, an entity may elect a practical alternative to estimate the standalone selling price of a renewal option that constitutes a material right.



### **PRACTICAL ALTERNATIVE TO ESTIMATE THE STANDALONE SELLING PRICE OF A RENEWAL OPTION THAT CONSTITUTES A MATERIAL RIGHT**

Instead of estimating the standalone selling price of the renewal option directly, an entity can elect a practical alternative 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 if both of the following conditions are met:

- ▶ The additional goods or services are similar to the original goods or services in the contract (that is, an entity continues to provide additional goods or services that are similar to what it was already providing). As a result, it may be more intuitive to view the goods or services underlying such options as part of the initial contract.
- ▶ The additional goods or services are provided in accordance with the terms of the original contract. As a result, the pricing of the additional goods or services cannot be changed beyond the parameters specified in the original contract.

In essence, this alternative approach allows an entity to treat the material right as if the optional goods or services were additional promises in the contract, and the consideration to be received when the option is exercised as additional consideration.

BC393 of ASU 2014-09 states that the practical alternative requires an entity to include the optional goods or services that it expects to provide and the corresponding consideration that it expects to receive in the initial measurement of the transaction price. The FASB reasoned that it would be simpler for an entity to view a contract with renewal options as a contract for its expected term (that is, including the expected renewal periods) rather than as a contract with a series of renewal options.

**EXAMPLE 7-16 (ADAPTED FROM ASC 606-10-55-343 THROUGH 55-352): OPTION THAT PROVIDES THE CUSTOMER WITH A MATERIAL RIGHT – RENEWAL OPTION**

An entity enters 100 separate contracts with customers to provide one year of maintenance services for \$10,000 per contract. The following are the key terms:

- ▶ At the end of the year, each customer has the contractual right (or option) to renew the maintenance contract for a second year by paying an additional \$10,000.
- ▶ Customers who renew for a second year are granted the option to renew for a third year for \$10,000.
- ▶ If customers do not sign up for the maintenance services initially (when the products are new) or allow the services to lapse, the entity charges significantly higher prices for annual maintenance services:
  - \$30,000 in Year 2
  - \$50,000 in Year 3

The entity evaluates the customer's renewal option for maintenance services in Step 2 and determines that:

- ▶ The renewal option provides a material right to the customer that it would not receive without entering the contract because the price for maintenance services is significantly higher if the customer elects to purchase the services only in Year 2 or 3.
- ▶ Part of each customer's payment of \$10,000 in Year 1 is, in effect, a nonrefundable prepayment of the services provided in a subsequent year.

Based on the above analysis, the entity concludes that the promise to provide the renewal option is a performance obligation.

The entity then observes that:

- ▶ The renewal option is for a continuation of maintenance services
- ▶ Those services are provided in accordance with the terms of the existing contract

In accordance with the practical alternative for estimating the standalone selling price of a renewal option, 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 under the renewal options (instead of determining the standalone selling prices for the renewal options directly).

At contract inception, the entity estimates that:

- ▶ 90 customers are expected to renew at the end of Year 1 (90% of contracts sold).
- ▶ 81 customers are expected to renew at the end of Year 2 (90% of the 90 customers that renewed at the end of Year 1 will also renew at the end of Year 2, that is, 81% of contracts sold).

Based on the above estimates, the entity determines that, at contract inception, the expected consideration for each contract is \$27,100 [ $\$10,000 + (90\% \times \$10,000) + (81\% \times \$10,000)$ ].

The entity also determines that recognizing revenue based on 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	\$ 6,000
Year 2	7,500
Year 3	10,000

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

	Expected Costs Adjusted for Likelihood of Contract Renewal		Allocation of Consideration Expected	
Year 1	\$ 6,000	(\$6,000 x 100%)	\$ 7,799	[((\$6,000/\$20,850) x \$27,100]
Year 2	6,750	(\$7,500 x 90%)	8,773	[((\$6,750/\$20,850) x \$27,100]
Year 3	8,100	(\$10,000 x 81%)	10,528	[((\$8,100/\$20,850) x \$27,100]
<b>Total</b>	<b>\$ 20,850</b>		<b>\$ 27,100</b>	

Therefore, at contract inception, the entity allocates \$220,100 of the consideration received to date [cash of \$1,000,000 - revenue to be recognized in Year 1 of \$779,900 ( $\$7,799 \times 100$ )] to the option to renew at the end of Year 1.

Assuming there is no change in the entity's expectations and the 90 customers renew as expected, at the end of the Year 1, the entity has collected cash of \$1,900,000 [ $(100 \times \$10,000) + (90 \times \$10,000)$ ], has recognized revenue of \$779,900 ( $\$7,799 \times 100$ ), and has recognized a contract liability of \$1,120,100.

Consequently, upon renewal at the end of Year 1, the entity allocates \$242,800 to the option to renew at the end of Year 2 [cumulative cash of \$1,900,000 - cumulative revenue recognized in Year 1 and to be recognized in Year 2 of \$1,657,000 ( $\$780,000 + \$8,770 \times 100$ )].

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.

#### EXAMPLE 7-17: GYMNASIUM MEMBERSHIP – RENEWAL OPTION

An entity operates gymnasiums for its members. To become a member, a customer must pay a one-time upfront joining fee of \$1,000 and an annual membership fee. At the end of each year, the customer has a right to renew the membership by paying the annual membership fee.

At contract inception, the entity assesses whether the upfront joining fee relates to the transfer of a promised good or service and concludes that it does not. Rather, the joining fee represents an advance payment for future gym services.

To determine whether the upfront fee should be recognized over the contract period (for example, one year) or based on expected renewal behavior (for example, potentially longer than one year), the entity must assess whether the renewal option provides a material right to the customer.

The entity observes that:

- ▶ The upfront joining fee, in effect, entitles the customer to renew the contract by paying the annual membership fee and avoiding the upfront joining fee in subsequent years.
- ▶ Because a member is not required to pay the upfront fee in renewal periods, the upfront fee essentially results in a discounted fee for subsequent membership periods when compared to the fee payable upon signing a new membership.

Based on the above observations, the entity concludes that the renewal option (that is, the customer's option to continue to purchase gymnasium services beyond Year 1) provides a material right to the customer and therefore is a separate performance obligation.

The entity estimates the number of renewal options the customers are expected to exercise and allocates the upfront fee plus the total annual fees for the current term and each expected renewal period to the current term and the expected renewal periods. Practically, this may result in:

- ▶ Straight-line recognition of the upfront fee over the expected membership term

- ▶ Recognition of each annual membership fee over the annual period to which it relates



### TRG DISCUSSIONS – ACCOUNTING FOR A CUSTOMER’S EXERCISE OF A MATERIAL RIGHT – CONTINUATION OF A CONTRACT OR CONTRACT MODIFICATION

ASC 606 does not provide explicit guidance on the accounting model to apply when an option that is a material right is exercised by the customer. The question that arises is whether it should be considered:

- ▶ A continuation of the original contract whereby the additional consideration would be allocated to the material right
- ▶ A contract modification, which could require consideration to be re-allocated between performance obligations
- ▶ Variable consideration

In March 2015, TRG members agreed that the exercise of a material right should be viewed as a continuation of the contract but also acknowledged the FASB staff’s view that it would be reasonable for an entity to account for it as either a continuation of the contract or a contract modification. The possibility of treating the amount allocated to the material right as variable consideration was rejected.

Additionally, TRG members observed that in most, but not all, cases the outcome of applying either acceptable approach would be similar. Only in cases in which the optional goods or services are determined to be not distinct from the original promised goods or services would the results appear to differ, because the application of the contract modification guidance may result in a cumulative catch-up adjustment to the revenue recognized (see Section 7.3 for a related discussion). However, the FASB staff observed that an entity typically would conclude that an optional good or service is distinct.

### BDO INSIGHTS – ACCOUNTING POLICY ELECTION TO ACCOUNT FOR A CUSTOMER’S EXERCISE OF A MATERIAL RIGHT

Based on the TRG discussions on accounting for a customer’s exercise of a material right as either a continuation of a contract or a contract modification, an entity needs to make an accounting policy election regarding the approach it uses to account for the exercise of material right. Determining the appropriate method to account for a customer’s exercise of a material right requires the application of judgment. An entity must consistently apply the method elected to similar types of material rights with similar facts and circumstances.

### EXAMPLE 7-18: RENEWAL OPTION – SPORTS SEASON TICKETS

An entity, a professional football club, regularly offers season tickets for the following season (Season 1) at a price of \$5,000. However, as part of a promotion drive, it offers customers the opportunity to buy a season ticket for the following season (Season 1) for \$8,000, which will also grant those customers the right to a 25% discount off the standard season ticket price for the subsequent 4 seasons (Seasons 2-5).

At contract inception, the entity makes the following estimates:

- ▶ The price of annual season tickets in future years is expected to remain at \$5,000.

- ▶ All customers that purchase a Season 1 ticket for \$8,000 are expected to exercise the option to purchase season tickets at a discount in Seasons 2-5 (that is, a 100% renewal rate is expected).

The entity determines that the practical alternative for estimating the standalone selling price of a renewal option is applicable because the services provided in Seasons 2-5:

- ▶ Are similar to the services provided in Season 1.
- ▶ Will be provided in accordance with the terms of the existing contract. The entity does not have a contractual right to change or withdraw the 25% discount offer.

Under the practical alternative election, the total transaction price is allocated to all of the season tickets that are expected to sell over the five-year period (that is, Seasons 1-5). In effect, the contract is viewed as a single contract for its expected term of five years (not a one-year contract with a series of renewal options) because all renewal options are expected to be exercised.

As a result, the total consideration receivable (\$8,000 in Season 1 plus \$3,750 for each of Seasons 2-5) is recognized evenly over the five-year period, resulting in revenue of \$4,600  $((\$8,000 + (\$5,000 * 4 * 0.75))/5)$  being recognized in each year.

For simplicity, no adjustment has been made for any potential financing component.

For each Season 1 ticket sold for \$8,000, it would not be appropriate for the entity to recognize \$5,000 during Season 1 and allocate \$3,000 to customer renewal options for Seasons 2-5 (rather than allocating \$8,000 to all five seasons based on relative standalone selling prices). That approach would result in separate contracts being accounted for in the initial and subsequent periods instead of a single overall contract for a five-year period. The allocation of \$3,000 to Seasons 2-5 would also be similar to the use of a residual approach for the allocation of the transaction price to the renewal options, which would also be inappropriate.



#### TRG DISCUSSIONS – ANALYZING CUSTOMER LIFE TO DETERMINE WHETHER A NONREFUNDABLE UPFRONT FEE PROVIDES A MATERIAL RIGHT TO THE CUSTOMER

In March 2015, the TRG discussed whether a one-time nonrefundable upfront fee (for example, an initial fee for health club membership or an activation fee telecommunication services) provides the customer with a material right. At that meeting, the TRG members stated that an entity's average customer life might indicate whether an upfront fee provides the customer with a material right. For example, a customer life that extends beyond a one-month contractual period may indicate the upfront fee incentivizes the customer to continue purchasing a health club membership or telecommunication services because the customer will not be charged an additional initial or activation fee in subsequent months, as opposed to incurring a similar upfront fee with a new entity.

#### BDO INSIGHTS – ANALYZING CUSTOMER LIFE TO DETERMINE THE EXISTENCE OF A MATERIAL RIGHT

In the context of the TRG discussions on analyzing customer life to determine whether a nonrefundable upfront fee provides a material right to the customer, customer life depends on both parties desiring to continue the relationship. For instance, gym memberships and telecommunication services are often provided on a month-to-month basis. In practice, there is no requirement for entities to guarantee the availability of monthly services, such that customers are the only parties with renewal rights. In such scenarios, the entities typically reserve the right to discontinue services in their terms and conditions. However, we believe a material right may nonetheless exist based on the reasonable expectation of additional purchases, as opposed to only those situations in which the customer obtains an enforceable right to additional purchases after the initial term. We believe this is consistent



with the discussion in BC87 of ASU 2014-09, which states that promises in the contract do not need to be enforceable by law but are rather identified based on a customer's expectations. If the customer has a valid expectation that the entity will transfer a good or service, then the customer would view those promises as part of the negotiated exchange.

Analyzing the accounting for upfront fees and determining the average customer life require the application of professional judgment, based on the facts and circumstances.

### 7.4.3 Early Renewal Rights

Entities often offer noncancellable contracts that provide the customer with the option to renew the contract prior to contract expiry. For example, this practice is common in the telecommunications industry and other industries where a product is sold at the inception of the contract with ongoing services provided over the contract period.

#### EXAMPLE 7-19: EARLY RENEWAL RIGHT – TELECOMMUNICATION DEVICE AND SERVICES

An entity in the telecommunications industry contracts with customers to sell a device and a package of services. Following are the key terms:

- ▶ The contract has a 24-month noncancellable term.
- ▶ Customer must pay 24 equal monthly installments. The entity allocates each installment between the device and the services on the same basis.
- ▶ The contract states that the customer has the option to renew the contract at any time after 21 months without penalty. No recovery is made for installments that would have been made during the period from renewal up to the end of the original 24-month contract period.
- ▶ The early renewal results in the customer obtaining a new device and the same services for a subsequent 24 months from the renewal date.
- ▶ The renewed contract is priced at the standalone selling price for that contract when the customer exercises the early renewal right.

The entity needs to determine the appropriate accounting for the customer's option to renew early (that is, prior to the end of the full 24-month contract term).

The entity observes that the early renewal right was embedded in the enforceable rights and obligations agreed to by the parties at contract inception. Therefore, the early renewal option is not a contract modification because it is not an amendment to the original rights and obligations of the parties. ASC 606 provides that a "contract modification exists when the parties to the contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract."

The entity observes that the option to renew early affects the amount of consideration to which the entity expects to be entitled for the device provided to the customer at contract inception the amount of consideration could vary depending on when customers exercise their option to renew. Further, because customers renew at the standalone selling price, there is no material right present. Consequently, the amount of consideration allocated to the device is considered variable.

The entity must therefore estimate the amount of variable consideration to which it will be entitled, subject to the constraint on variable consideration. As a result, variable consideration (that is, the monthly installments between months 21 and 24) will only be recognized as revenue to the extent that it is probable that there will not be a significant reversal of cumulative revenue recognized when the uncertainty over the variable consideration is resolved. (See Section 4.3 for a discussion of variable consideration.)

In this case, the uncertainty will be resolved when it is known whether the customers will exercise their early renewal rights which will affect the allocation of monthly installments between:



- ▶ The handset, for which revenue will be recognized upon transfer of control to the customer, generally at contract inception, with a related receivable being settled through the partial allocation of future monthly installments (see Chapter 8 for discussion on accounting for receivables)
- ▶ The services, for which revenue will be recognized over the period of the contract

The amount of variable consideration that is expected to be received will depend on the facts and circumstances in each case. However, to consider a period of more than 21 months for part or all of the customer base, clear evidence would be required of the expected pattern of exercise of the early renewal option.

#### 7.4.4 Customers' Unexercised Rights – Breakage



#### FASB REFERENCES

ASC 606-10-45-2, ASC 606-10-55-46 through 55-49

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. Upon receipt of a prepayment from a customer, an entity must 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 (see Chapter 8 for additional discussion on contract liability).

An entity must derecognize that contract liability and recognize revenue when it transfers those goods or services and therefore satisfies its performance obligation. However, customers may not always exercise all their contractual rights. Those unexercised rights are often referred to as breakage. Common examples include:

- ▶ Forfeiting balances on gift cards
- ▶ Not claiming loyalty points or air miles
- ▶ Nonrefundable theatre and travel tickets, where the customer foregoes amounts paid in advance if they do not attend the event
- ▶ Declining to exercise a renewal option that is accounted for as a material right

Depending on whether an entity expects to be entitled to a breakage amount, it accounts for any resulting breakage as follows:

- ▶ If an entity expects to be entitled to a breakage amount in a contract liability, it recognizes 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, it recognizes the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote.



#### CONSIDER VARIABLE CONSIDERATION CONSTRAINT TO DETERMINE BREAKAGE

To determine whether an entity expects to be entitled to a breakage amount, an entity must consider the guidance in Section 4.3 on constraining estimates of variable consideration. Specifically, an entity must only recognize breakage revenue to the extent that it is probable that there will not be a significant reversal of cumulative revenue recognized when the uncertainty related to the breakage is subsequently resolved.

An entity must not recognize breakage revenue for any consideration received that must be remitted to another party, for example, a government entity in accordance with applicable unclaimed property laws. Instead, the entity should continue to report the amounts as a liability, albeit due to the relevant third party, rather than as a contract liability or deferred revenue.

### **BDO INSIGHTS – ACCOUNTING FOR BREAKAGE LIABILITIES MAY REQUIRE LEGAL ANALYSIS**

Determining whether breakage liabilities are subject to unclaimed property laws is a legal question and may require judgment as the laws often vary by state. As a result, an entity could have multiple breakage liabilities that are accounted for differently. As such, entities may need to discuss their fact patterns with unclaimed property specialists. Accounting for breakage liabilities requires the application of professional judgment, based on the facts and circumstances.

Separately, this guidance does not address the accounting for dormancy or other fees charged to holders of unused stored-value products.

### **EXAMPLE 7-20: OPTION THAT PROVIDES THE CUSTOMER WITH A MATERIAL RIGHT – BREAKAGE**

(Continued from Example 7-18)

An entity sells 10,000 season tickets for \$8,000 each that grant customers the right to a 25% discount in each of the subsequent seasons 2-5. At the start of Season 1, the entity has therefore received \$80 million of which \$46 million is recognized as revenue in Season 1 and \$34 million relates to customers' renewal options.

The two extremes of potential outcomes are:

- ▶ If no customer exercises its renewal option, \$80 million would be received for Season 1
- ▶ If every customer exercises its renewal options for all of Seasons 2-5, then \$8.5 million will be recognized as revenue in each of Seasons 2-5 (that is, \$34 million or \$850 per season ticket holder per season)

The contractual terms of the renewal option stipulate that if a customer fails to renew a season ticket in any year, it loses its right to the 25% discount in all subsequent seasons. For example, if a season ticket holder renews at a 25% discount in Season 2 but does not renew its season ticket in Season 3, it would lose its right to a 25% discount in Seasons 4 and 5.

At the start of Season 2:

- ▶ The price of a standard season ticket rises to \$5,500.
- ▶ 800 customers do not exercise their renewal option and, hence, forfeit rights to a 25% discount in Seasons 3-5.
- ▶ 9,200 customers renew their season ticket at a price of \$4,125, calculated as the standard price of \$5,500 less the 25% discount.

The entity has no prior experience offering such discounts to customers and therefore cannot rely on historical experience to estimate whether it will be entitled to any breakage. However, it considers that the customers paid a premium for the current season tickets to obtain the future discount, indicating that most expect to exercise their renewal rights. Consequently, it concludes that it cannot recognize any of the \$34 million as breakage revenue prior to knowing that customers have forfeited their option (that is, by not renewing their season ticket) as to do otherwise could result in a significant reversal of revenue in future periods of the amount of breakage recognized. Therefore, the entity does not recognize any revenue in Season 1 for breakage.

At the start of Season 2, the entity recognizes \$2.72 million as breakage (that is, \$850 x 800 x 4). This recognition reflects that 800 customers have forfeited their renewal rights (valued at \$850 per season for each of Seasons 2-5) and is therefore accounted for as additional revenue earned for services provided in Season 1. The entity also recognizes:

- ▶ \$7.82 million during Season 2 (that is,  $\$850 \times 9,200$ ) reflecting that 9,200 customers exercised their renewal right for Season 2
- ▶ \$37.95 million during Season 2 (that is,  $\$4,125 \times 9,200$ ) reflecting the amounts paid by those 9,200 customers for the price paid for the Season 2 ticket

### BDO INSIGHTS – PERPETUAL CUSTOMER OPTIONS

In some cases, customer options are perpetual and do not have expiration dates (for example, air miles often have no expiry date). Some have questioned whether an entity applies the guidance on unexercised rights (or breakage) in those cases. We believe the guidance on constraining estimates of variable consideration applies to all customer options, such as breakage liabilities, including those that are perpetual.

The guidance on a customer option that is a material right requires an entity to estimate the standalone selling price of the option at contract inception. In determining the standalone selling price of the option, an entity must consider the likelihood that the option will be exercised. Additionally, an entity must recognize any change in the likelihood that the option will be exercised when estimating the measure of progress of the performance obligation related to the option.

In other words, the standalone selling price of the option is not updated after contract inception. Rather, the entity updates its estimate of the portion of the option that will be redeemed. This results in the entity recognizing revenue in proportion to the pattern or recognition of other performance obligations in the contract.

Once the number of options expected to be exercised have actually been exercised, the entity no longer recognizes a contract liability for the options.

In situations where a single option exists and the portfolio approach is not or cannot be applied, the standalone selling price of the option would still include the likelihood that the option will be exercised. The revenue related to the option would be recognized when the option is exercised or when it is determined that the likelihood of the option being exercised becomes remote.

### BDO INSIGHTS – TRACKING DATA TO ACCOUNT FOR BREAKAGE REVENUE COULD BE CHALLENGING

The model for recognizing breakage revenue can be challenging to apply in practice. For example, to recognize breakage “in proportion to the pattern of rights expected to be exercised” related to gift cards that are expected to expire unused, an entity must track gift card redemptions based on when the cards were sold. Entities should proactively work with any third-party program managers to make sure the manager will be able to provide adequate tracking and related reporting to support the entity’s recognition of breakage.

## 7.5 LICENSING



### FASB REFERENCES

ASC 606-10-55-54 through 55-65B

The promised good or service in a contract may include granting a license that establishes a customer’s rights over the IP of an entity. Licenses of IP may include, but are not limited to, licenses of:

- ▶ Software (other than software subject to a hosting arrangement<sup>13</sup> that does not meet the criteria in ASC 985-20-15-5,<sup>14</sup> commonly referred to as SaaS arrangement)
- ▶ Other technology, such as drug compounds or technical designs
- ▶ Media and entertainment (for example, motion pictures, music, podcasts)
- ▶ Franchises
- ▶ Patents, trademarks, and copyrights

Given the unique nature of a license, ASC 606 includes implementation guidance in to assist with the application of the five-step revenue recognition model to licenses.

### 7.5.1 Identification of Performance Obligations in a Contract That Includes a License (Step 2)

An entity may explicitly or implicitly promise to transfer other goods or services to the customer in addition to a promise to grant a license. 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 the guidance to identify each distinct promised good or service (that is, a performance obligation) in the contract, consistent with the requirement in Step 2 for any other contracts with customers that include multiple promises. See Chapter 3 for discussion on determining whether a promised good or service is distinct.

If the promise to grant a license is not distinct from other promised goods or services in the contract, an entity must account for the promise to grant a license and those other promised goods or services together as a single performance obligation.

Following are examples of licenses that are not distinct from other goods or services promised in the contract:

- ▶ A license that forms a component of a tangible good and is integral to the functionality of the good
- ▶ A license that the customer can benefit from only in conjunction with a related service, for example, an online service provided by the entity that enables, by granting a license, the customer to access content

When a single performance obligation includes a license (or licenses) of IP and one or more other goods or services, an entity considers the nature of the combined good or service for which the customer has contracted in:

- ▶ Determining whether that combined good or service is satisfied over time or at a point in time (see Section 7.5.2 and Chapter 6 for a discussion of satisfaction of performance obligations)
- ▶ Selecting an appropriate method for measuring progress if the combined good or service is satisfied over time (see Section 6.4 for a discussion of measure of progress)

In considering the nature of the combined good or service for which the customer has contracted, an entity must also consider whether the license that is part of the single performance obligation provides the customer with a right to use or a right to access IP.

### 7.5.2 Nature of License – Right to Access Versus Right to Use

To evaluate whether a license of IP transfers to a customer at a point in time or over time and hence whether revenue for the license is recognized at a point in time or over time, an entity must consider whether the nature of the entity's promise in granting the license to the customer is to provide the customer with a right to access or a right to use. The following diagram summarizes the guidance related to determining whether the nature of the IP right granted to a

<sup>13</sup> ASC 985-20 defines a hosting arrangement as “[i]n connection with accessing and using software products, an arrangement in which the customer of the software does not currently have possession of the software; rather, the customer accesses and uses the software on an as-needed basis.”

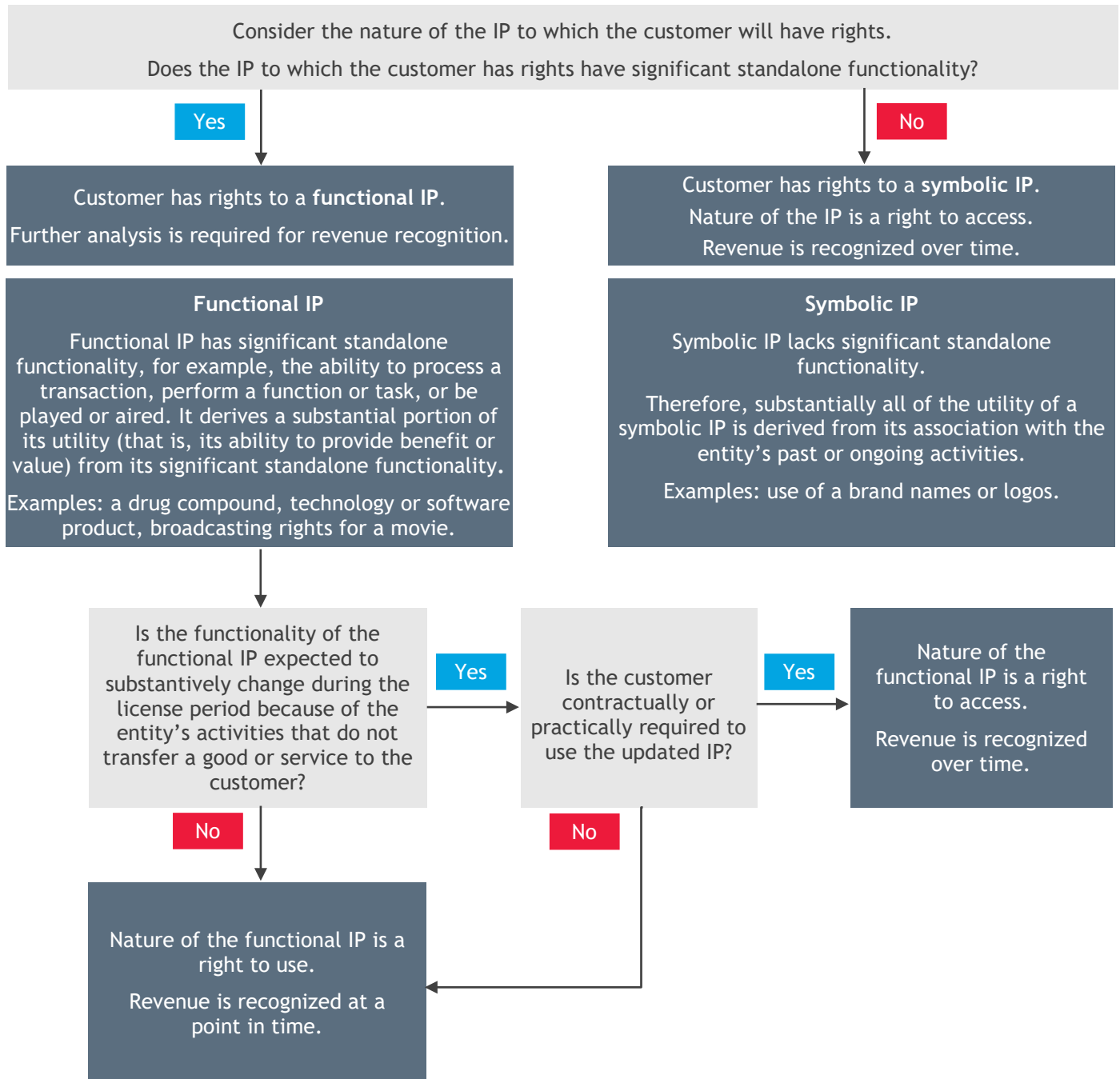
<sup>14</sup> The two criteria in ASC 985-20-15-5 are:

- ▶ The customer has the contractual right to take possession of a software subject to a hosting arrangement at any time during the hosting period without significant penalty.
- ▶ It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

customer is a right to access or a right of use and its effect on the timing and pattern of revenue recognition for the IP license.



The following diagram depicts the decision process in evaluating whether a license of IP is a license of functional IP or symbolic IP, and in determining whether the nature of an entity's promise in granting that license is to provide the customer with a right to access or a right to use the entity's IP. A discussion of functional and symbolic IP and related revenue recognition considerations follows the diagram.



### 7.5.2.1 Symbolic IP

A customer's ability to derive benefit from a license to symbolic IP depends on the entity continuing to support or maintain the IP. 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:

- ▶ Grant the customer rights to use and benefit from the entity's IP.
- ▶ 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 the utility of the IP. For example, the activities that an entity continues to undertake to support the utility of a franchise might include marketing and advertising to support the brand.

### 7.5.2.2 Functional IP

Generally, a license to functional IP grants a right to use the entity's IP as it exists at the point in time at which the license is granted. However, in certain instances, future changes to the underlying IP may result in the licenses being treated differently. Specifically, a license grants a right to access the entity's IP, which is recognized over time, if both of the following criteria are met:

- ▶ The functionality of the IP to which the customer has rights is expected to substantively change during the license period because of activities of the entity that do not transfer a promised good or service to the customer. Additional promised goods or services (for example, IP upgrade rights or rights to use or access additional IP) are not considered in assessing this criterion.
- ▶ The customer is contractually or practically required to use the updated IP resulting from the activities in the above criterion.

#### **BDO INSIGHTS – FUNCTIONAL IP THAT PROVIDES THE CUSTOMER A RIGHT TO ACCESS THE ENTITY'S IP**

The standard and an SEC staff speech in 2019 include two fact patterns where the two criteria discussed in Section 7.5.2.2 are met resulting in overtime revenue recognition for a functional IP:

- ▶ Example 3-9 in Chapter 3, adapted from ASC 606, illustrates a functional IP license to an anti-virus software that is combined with the updates to be provided on a when-and-if-available basis as a single performance obligation. In that fact pattern, the updates make sure that the customer's ability to benefit from the software would not decline significantly during the license term.
- ▶ An SEC staff speech in 2019 (see Section 3.3.2.4) described an arrangement in which a functional IP license for software was combined with the updates to be provided on a when-and-if-available basis as a single performance obligation. In that fact pattern, the software allows the customers (application developers) to build and monetize their own application on various third-party platforms. Because the third-party platforms undergo frequent updates, the software entity makes corresponding updates to its own software to make sure customers can continue to build applications that are compatible with all supported third-party platforms. Without the software updates, the customer's ability to benefit from the software would be significantly limited over the contract term because the customer would not be able to build applications that are compatible with the updated third-party platforms.

We believe that additional, albeit limited, scenarios may exist where functional IP may be combined with a service provided over time and hence, revenue from the functional IP would be recognized over time rather than at a point in time. Significant judgment is required to analyze the nature of functional IP sold with a service(s) that would substantively change the functionality of the IP and hence the benefit derived by the customer during the license term.

Because functional IP has significant standalone functionality, an entity's activities that do not substantively change that functionality do not significantly affect the utility of the IP to which the customer has rights. Therefore, an entity's promise to the customer in granting a license to functional IP does not include supporting or maintaining the IP. Any promise to support or maintain the functional IP would be a separate performance obligation. As a result, if a license to functional IP is a separate performance obligation and does not meet both the criteria in Section 7.5.2.2, it is satisfied at a point in time.



Additionally, guarantees provided by an entity that it has a valid patent to IP and that it will defend that patent from unauthorized use do not affect whether a license provides a right to access the entity's IP or a right to use the entity's IP. 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 7-21 (ADAPTED FROM ASC 606-10-55-362 THROUGH 55-363B): RIGHT TO USE – SOFTWARE LICENSE**

An entity, a software developer, enters a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support for a specified period. The software developer 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 competitor entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

The entity identifies four performance obligations in the contract:

- ▶ The software license
- ▶ Installation services
- ▶ Software updates
- ▶ Technical support

The entity assesses the nature of its promise to transfer the software license. The entity first concludes that the software license is functional IP because the software has significant standalone functionality from which the customer can derive substantial benefit regardless of the entity's ongoing business activities.

Further, the entity considers whether the functional license represents a right to access IP and concludes the following:

- ▶ While the functionality of the underlying software is expected to change during the license period because 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 because 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 two criteria in Section 7.5.2.2.
- ▶ The customer has the right to install, or not install, software updates when they are provided. Therefore, the criterion in Section 7.5.2.2 on whether the customer is contractually or practically required to use the updated IP would not be met even if the entity's activities to develop and provide software updates had met the other criterion in Section 7.5.2.2 on whether the functionality of the IP to which the customer has rights is expected to substantively change during the license period because of activities of the entity that do not transfer a promised good or service to the customer.

Based on the above analysis, the entity concludes that it has provided the customer with a right to use its software as it exists when the license is granted. Accordingly, the entity accounts for the software license performance obligation as a performance obligation satisfied at a point in time.

The entity recognizes revenue for the software license at the point in time at which the control of the license transfers to the customer (see Sections 6.2 and 6.5 for related discussion), which cannot occur before the customer can use and benefit from the license.

**EXAMPLE 7-22 (ADAPTED FROM ASC 606-10-55-383 THROUGH 55-388): RIGHT TO ACCESS – LICENSES TO USE IMAGES AND NAMES**

An entity, a creator of comic strips, licenses the use of the images and names of its characters in three of its comic strips to a customer for a five-year term. The customer, an operator of cruise ships, can use the entity's characters in various ways, for example in shows or parades, within reasonable guidelines. While there are main characters



involved in each of the comic strips, newly created characters appear and disappear regularly, and the images of the characters evolve over time.

The customer must pay a fixed payment of \$1 million in each year of the five-year term.

In assessing the goods and services promised to the customer, the entity concludes that:

- ▶ It has made no other promises to the customer other than the promise to grant a license.
- ▶ The additional activities from the license do not directly transfer a good or service to the customer.

Based on the above analysis, the entity concludes that its only performance obligation is to transfer the license.

The entity assesses the nature of its promise to transfer the license. The entity determines that:

- ▶ The licensed IP, that is, the character names and images, does not have standalone functionality. That is, 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.
- ▶ 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.

Based on the above analysis, the entity concludes that the nature of its promise is to grant the customer the right to access the entity's symbolic IP.

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 IP, the entity accounts for the promised license as a performance obligation satisfied over time.

The contract includes a single performance obligation, the license, so the entire consideration is allocated to the license.

The entity considers a measure of progress that best depicts its performance in the license – see related discussion in Section 6.4. The entity determines that a time-based method would be the most appropriate measure of progress toward complete satisfaction of the performance obligation because the contract provides the customer with an unlimited use of the licensed characters for a fixed term.

#### **EXAMPLE 7-23 (ADAPTED FROM ASC 606-10-55-367 THROUGH 55-374): IDENTIFYING A DISTINCT LICENSE**

A pharmaceutical entity enters a contract with a customer to:

- ▶ License to the customer its patent rights to an approved drug compound for 10 years
- ▶ Manufacture the drug for the customer for five years while the customer develops its own manufacturing capability

The drug is a mature product and, therefore, there is no expectation that the entity will undertake activities to change the drug (for example, to alter its chemical formula). There are no other promised goods or services in the contract.

Assume that the manufacturing process used to produce the drug is highly specialized in nature, and thus no other entity can manufacture the drug while the customer learns the manufacturing process and builds its own manufacturing capability. Therefore, the license cannot be purchased separately from the manufacturing service.

Based on the above analysis, the entity determines that the customer cannot benefit from the license without the manufacturing service. Therefore, the promises are not capable of being distinct and the license and manufacturing service are not distinct (see Sections 3.2 and 3.3). The entity accounts for the license and manufacturing service as a single performance obligation.

During the first five years, the customer benefits from the license only because of having access to a supply of the drug. Therefore, 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.

After the first five years, the customer retains solely the right to use the entity's functional IP (see Example 7-24 in this chapter), and no further performance (such as, manufacturing the drugs) is required of the entity during Years 6-10. The entity's performance under the contract will be complete at the end of Year 5.

#### EXAMPLE 7-24 (ADAPTED FROM ASC 606-10-55-367 THROUGH 55-374): IDENTIFYING A DISTINCT LICENSE

Assume in Example 7-23 that the manufacturing process used to produce the drug is not unique or specialized and several other entities also can manufacture the drug for the customer.

The entity assesses whether the promised goods and services (the license and the manufacturing service) are distinct (see Chapter 3 for related discussion) as follows:

- ▶ Because there are other entities that can provide the manufacturing service, the customer can benefit from the license together with readily available resources other than the entity's manufacturing service and can benefit from the manufacturing service together with the license transferred to it at the start of the contract. Therefore, the promises are capable of being distinct.
- ▶ The entity concludes that its promises to grant the license and provide the manufacturing service are separately identifiable. In concluding that the license and the manufacturing service are not inputs to a combined item in this contract, 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.
  - The entity is not providing a significant service of integrating the license and the manufacturing service into a combined output.
  - 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.

Therefore, 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.

Based on the above analysis, the entity concludes that its promises to grant the license and to provide the manufacturing service are distinct and there are two performance obligations:

- ▶ License
- ▶ Manufacturing service

The entity then assesses the nature of its promise to grant the license. The entity observes that:

- ▶ The license to patented drug formula has significant standalone functionality in the form of its ability to treat a disease or condition and, therefore, is a functional IP.
- ▶ There is no expectation that the entity will undertake activities to change the functionality of the drug formula during the license period.
- ▶ Because the IP has significant standalone functionality, any other activities the entity might undertake (for example, advertising to promote its drug formula or activities to develop other drug products) would not significantly affect the utility of the licensed IP.

Therefore, the entity concludes that the nature of the entity's promise in transferring the license is to provide a right to use the entity's functional IP. The entity accounts for the license as a performance obligation satisfied at a

point in time and recognizes revenue for it in when control of the license transfers to the customer (see Section 6.5) which cannot happen before the customer can use and benefit from the license.

In assessing 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 determines whether the manufacturing service is a performance obligation satisfied at a point in time or over time in accordance with the discussion in Chapter 6.

**EXAMPLE 7-25 (ADAPTED FROM ASC 606-10-55-395 THROUGH 55-399): ACCESS TO IP – NAME AND LOGO OF A SPORTS TEAM**

An entity, a well-known sports team, licenses the use of its name and logo to a customer for two years. 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 other merchandise for those two years. The customer is required to pay fixed consideration of \$4 million, and a royalty of 5% 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.

In assessing the goods and services promised to the customer, the entity concludes that:

- ▶ The only good or service promised to the customer 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.

Based on the above analysis, the entity concludes that the license is the only performance obligation in the contract.

The entity assesses the nature of the IP license (right to access the entity's IP or right to use the entity's IP) and concludes that it is symbolic IP because:

- ▶ 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 IP.
- ▶ 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, the team name and logo do not have an ability to perform or fulfill a task separate from their role as symbols of the entity's past and ongoing activities.

Based on the above analysis, the entity's promise in granting the license provides the customer with the right to access the entity's IP throughout the license period and the entity accounts for the promised license as a performance obligation satisfied over time.

**EXAMPLE 7-26 (ADAPTED FROM ASC 606-10-55-399A THROUGH 55-399J): RIGHT TO USE IP – BROADCAST RIGHTS**

An entity, a television production entity, licenses all the existing episodes of a popular television show (which consists of the first five seasons) to a customer. The show is presently in its sixth season, and the television production entity is producing episodes for that sixth season at the time the contract is entered, as well as promoting the show to attract further viewership. The Season 6 episodes in production are still subject to change before airing.

The customer obtains the right to broadcast the existing episodes, in sequential order, for three years. The customer is required to make fixed monthly payments of an equal amount throughout the three-year license period.

The show has been successful through the first five seasons, and the customer is aware that Season 6 is already in production and the entity continues to promote the show.

The entity assesses the goods and services promised to the customer and determines that:

- ▶ The license to broadcast the existing episodes is the only promise in the contract because the entity's activities to produce Season 6 and its continued promotion of the show do not transfer a promised good or service to the customer
- ▶ 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 – see below in this chapter for a discussion of attributes of a license)

Based on the above analysis, the entity determines that the single license to the completed Seasons 1-5 is the only performance obligation in this contract.

The entity assesses the nature of the IP license (right to access the entity's IP or right to use the entity's IP) and concludes that the license provides the customer with a right to use its functional IP because:

- ▶ The existing episodes have substantial standalone functionality at the point in time they are transferred to the customer because those 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 existing episodes are complete and not subject to change. Thus, there is no expectation that the functionality of the IP to which the customer has rights will change (that is, the criteria in Section 7.5.2.2 are not met).

Therefore, the license is a performance obligation satisfied at a point in time. The entity recognizes revenue for the license on the date that the customer is first allowed to air the licensed content, which is the date when the content is made available to the customer. The date the customer is first allowed to air the licensed content is the beginning of the period during which the customer can use and benefit from its right to use the IP.

#### **EXAMPLE 7-27 (ADAPTED FROM ASC 606-10-55-399A THROUGH 55-399J): RIGHT TO USE IP – BROADCAST RIGHTS**

Assume the same facts in Example 7-26 that the contract grants the customer the right to broadcast the existing episodes, in sequential order, over three years. Additionally, assume that the contract also grants the customer the right to broadcast the episodes being produced for Season 6 once all of those episodes are completed.

The entity assesses the goods and services promised to the customer and concludes that there are two promised goods or services in the contract:

- ▶ The license to the existing episodes (see Example 7-26)
- ▶ The license to the episodes comprising Season 6, when all of those episodes are completed.

The entity then evaluates whether the license to the existing episodes is distinct from the license to the Season 6 episodes when they are completed. The entity concludes that the two licenses are distinct from each other and are therefore separate performance obligations because:

- ▶ 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 6, when they are all completed, on their own and together with the right to air the existing completed content.
- ▶ Each of the two promises to transfer a license in the contract also is separately identifiable. That is, they do not together constitute a single overall promise to the customer. This conclusion is based on the following:
  - The existing episodes do not modify or customize the Season 6 episodes in production, and the existing episodes do not, together with the pending Season 6 episodes, result in a combined functionality or changed content.

- The right to air the existing content and the right to air the Season 6 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.
- 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 1-5 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 6).

The entity assesses the nature of the two separate IP licenses (that is, the license to the existing, completed episodes of the series and the license to episodes that will comprise Season 6 when completed) and concludes that both the licenses provide the customer with a right to use its functional IP as it exists at the point in time the licenses are granted because:

- ▶ The licensed IP (that is, the completed episodes in Seasons 1-5 and the episodes in Season 6, when completed) has significant standalone functionality separate from the entity's ongoing business activities, such as in producing additional IP (for example, future seasons) or in promoting the show, and completed episodes can be aired without the entity's further involvement.
- ▶ 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 Section 7.5.2.2 are not met.
- ▶ The activities expected to be undertaken by the entity to produce Season 6 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 1-5.

The entity recognizes the portion of the transaction price allocated to each license on the date that the customer is first allowed to first air the content included in each performance obligation. That date is the beginning of the period during which the customer can use and benefit from its right to use the licensed IP.

### 7.5.3 Other Licensing Considerations – Attributes of a License Versus Additional License



#### FASB REFERENCES

ASC 606-10-55-64, ASC 606-10-55-367 through 55-374, ASC 606-10-55-389 through 55-392D, ASC 606-10-55-395 through 55-399, ASC 606-10-55-399A through 55-399J, and ASC 606-10-55-399K through 55-399O

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 IP that the customer does not already control) must 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 IP 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 IP.

#### EXAMPLE 7-28 (ADAPTED FROM ASC 606-10-55-389 THROUGH 55-392D): RIGHT TO USE IP

An entity, a music record label, licenses a recording of a classical symphony by Beethoven to a customer. The customer, a consumer products entity, has the right to use the recorded symphony in all commercials, including television, radio, and online advertisements for three years in Canada starting on January 1, 20X1. The customer is required to pay fixed consideration of \$20,000 per month. The contract does not include any other goods or services to be provided by the entity. The contract is noncancellable.

In assessing the goods and services promised to the customer, the entity concludes that:

- ▶ Its only performance obligation is to grant the license
- ▶ The following are attributes of the promised license (not separate promises or performance obligations):
  - The term of the license (three years)
  - The geographical scope of the license, that is, the customer's right to use the symphony only in Canada
  - The defined uses for the recording, that is, in commercials

The entity considers the following in determining whether the promised license provides the customer with a right to use its IP as it exists at the point in time at which the license is granted:

- ▶ The Beethoven 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 IP is functional.
- ▶ 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 Section 7.5.2.2 are not met.

Based on the above analysis, the entity determines that the promised license, which provides the customer with a right to use the entity's IP, is a performance obligation satisfied at a point in time. The entity recognizes revenue when control of the license transfers to the customer (see Section 6.5), which cannot happen before the customer can use and benefit from the license.

#### **EXAMPLE 7-29 (ADAPTED FROM ASC 606-10-55-389 THROUGH 55-392D): RIGHT TO USE IP – LICENSE RENEWAL**

Assume that in Example 7-28, 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 Beethoven symphony for three additional years, subject to the same terms and conditions as the original license. The entity and the customer agree on a significantly discounted price of \$15,000 per month for the three-year renewal period.

The entity considers the contract combination guidance in Section 2.6 and assesses that the renewal was not entered at or near the same time as the original license and, therefore, is not combined with the initial contract.

The entity evaluates whether the license renewal must be treated as a new license or the modification of an existing license in accordance with the guidance on contract modification (see Section 7.3). Assume that the renewal is distinct. The entity notes that:

- ▶ If the price for the renewal reflects its standalone selling price, the renewal would be accounted for as a separate contract with the customer.
- ▶ If the price for the renewal does not reflect the standalone selling price of the renewal, the renewal would be accounted for as a modification of the original license contract.

The entity determines that the price for the renewal does not reflect the standalone selling price of the renewal and hence, the renewal is accounted for as modification of the original license contract, which requires a reallocation of remaining consideration between the existing license and the renewal.

The entity then determines when to recognize revenue attributable to the license renewal. The entity determines that the customer cannot use and benefit from the license renewal before the beginning of the three-year renewal period on January 1, 20X4. The entity concludes that regardless of the amount of consideration that is allocated to the renewal, revenue for the renewal cannot be recognized before January 1, 20X4.

**EXAMPLE 7-30 (ADAPTED FROM ASC 606-10-55-399K THROUGH 55-399O): DISTINGUISHING MULTIPLE LICENSES FROM ATTRIBUTES OF A SINGLE LICENSE**

On December 15, 20X0, an entity enters a contract with a customer that allows the customer to embed the entity's functional IP in two classes of the customer's consumer products (Class 1 and Class 2) for four years beginning on January 1, 20X1. Following are the key terms:

- ▶ During the first year of the license period, the customer can embed the entity's IP only in Class 1.
- ▶ Beginning in Year 2 (that is, beginning on January 1, 20X2), the customer is allowed to embed the entity's IP in Class 2.
- ▶ The entity provides (or otherwise makes available – for example, makes available for download) a copy of the IP to the customer on December 20, 20X0.

There is no expectation that the entity will undertake activities to change the functionality of the IP during the license period. There are no other promised goods or services in the contract.

In identifying the goods and services promised to the customer in the contract (see Chapter 2), the entity considers whether the contract grants the customer:

- ▶ A single promise with an attribute that during Year 1 of the contract the customer is restricted from embedding the IP in the Class 2 consumer products.
- ▶ Two promises. That is, a license for a right to embed the entity's IP in Class 1 for a four-year period beginning on January 1, 20X1, and a right to embed the entity's IP in Class 2 for a three-year period beginning on January 1, 20X2.

The entity determines that the provision in the contract stipulating that the right for the customer to embed the entity's IP in Class 2 only commences one year after the right for the customer to embed the entity's IP in Class 1 begins. This provision means that after the customer can begin to use and benefit from its right to embed the entity's IP in Class 1 on January 1, 20X1, the entity must still fulfill a second promise to transfer an additional right to use the licensed IP. That is, the entity must still fulfill its promise to grant the customer the right to embed the entity's IP in Class 2. The entity does not transfer control of the right to embed the entity's IP in Class 2 before the customer can begin to use and benefit from that right on January 1, 20X2.

The entity concludes that the contract includes two promises:

- ▶ The four-year license to embed the entity's IP in Class 1
- ▶ The three-year license to embed the entity's IP in Class 2

The entity then concludes that the first promise and the second promise are distinct from each other because:

- ▶ The customer can benefit from each license on its own and independently of the other. Therefore, each license is capable of being distinct.
- ▶ The promise to transfer each license is separately identifiable (that is, distinct in the context of the contract) because:
  - The entity is not providing any integration service with respect to the two licenses (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 license significantly modifies nor customizes the other.
  - 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.
  - Additionally, neither the Class 1 license nor the Class 2 license is integral to the customer's ability to use or benefit from the other.

Because each right is distinct, they constitute separate performance obligations.

Based on the nature of the licensed IP and the fact that there is no expectation that the entity will undertake activities to change the functionality of the IP 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 IP, and the entity's promise to transfer each license is therefore satisfied at a point in time.

The entity determines the point in time at which the revenue allocable to each performance obligation must be recognized. 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.

#### 7.5.4 Sales-Based or Usage-Based Royalties



##### FASB REFERENCES

ASC 606-10-55-64 through 55-65B, ASC 606-10-55-395 through 55-399, ASC 606-10-55-393 and 55-394, and ASC 606-10-55-375 through 55-382

The standard includes an exception from the requirements in Step 3 to estimate and constrain variable consideration (see Section 4.3 for discussion on variable consideration) that is a sales-based or usage-based royalty promised in exchange for a license of IP (referred to hereinafter as "royalty exception"). An entity recognizes revenue for such sales-based or usage-based royalty only when (or as) the later of the following events occurs:

- ▶ The subsequent sale or usage occurs
- ▶ 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)



##### SEC STAFF GUIDANCE

###### [Remarks before the 35th Annual SEC and Financial Reporting Institute Conference](#)

Wesley R. Bricker, Deputy Chief Accountant, Office of the Chief Accountant

June 9, 2016

###### *Recognition of Sales- And Usage-Based Royalty*

*An SEC staff speech stated that ASC 606 does not contain a lag period exception when an entity is unable to obtain licensee usage information before issuing the financial statements. As such, entities are required to estimate the unreported royalty usage for the period in which the usage occurs.*

#### **BDO INSIGHTS – ROYALTY EXCEPTION AND ESTIMATING UNREPORTED ROYALTY USAGE**

In the context of the SEC Staff Guidance on recognition of sales- and usage-based royalty, an entity that is required to estimate any unreported royalty usage must develop an accounting policy regarding whether to apply the variable consideration constraint (see Section 4.3). We believe either approach is acceptable, provided it is consistently applied.



**BDO INSIGHTS – ROYALTY EXCEPTION AND ALLOCATION CONSIDERATIONS IN STEP 4**

The interaction of the royalty exception and the requirement to consider standalone selling prices when allocating consideration to multiple performance obligations in a contract can lead to patterns of revenue recognition that differ from the amounts stated in the contract. This arises, for example, in cases where two or more licenses of IP that are to be transferred to a customer at different points in times are included in a single contract, and the prices specified in the contract do not reflect the standalone selling prices of the licenses. The “*later of*” approach in Section 7.5.4 prevents the amount and timing of revenue recognition from being affected by what might be considered artificial price allocations in contracts.

**APPLICABILITY OF THE ROYALTY EXCEPTION**

The royalty exception applies if either of the following requirements are met:

- ▶ The royalty relates only to a license of IP.
- ▶ A license of IP is the predominant item to which the royalty relates. For example, the license of IP 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.

If either of the above requirements are met, that is, the royalty relates solely or predominantly to a license of IP, then the royalty exception applies.

If the royalty does not relate solely or predominantly to a license of IP, then the general guidance on estimating the variable consideration and constraining that estimate applies. See Section 4.3 for discussion on variable consideration.

In some contracts, an IP license is offered with other goods or services in exchange for a consideration in the form of a sales-based or usage-based royalty. For example, software licenses with post-contract customer support, franchise licenses with training services, biotechnology, and pharmaceutical licenses sold with R&D services or a promise to manufacture a drug for the customer. If a contract includes a license and other goods or services:

- ▶ Regardless of whether the other goods or services are distinct from the license, the royalty exception applies if the license is the predominant item in the arrangement.
- ▶ If a single license is not the predominant item in the contract to which the royalty relates but the royalty predominantly relates to two or more licenses, the royalty exception applies.
- ▶ If the license is not the predominant item in the contract, the royalty income represents variable consideration, which must be estimated and constrained (see Section 4.3 for related discussion) and allocated to each performance condition, including the license based on relative standalone selling prices unless the allocation exception for variable consideration or a discount is met (see Chapter 5 for discussion on allocation). The revenue allocated to each performance obligation is recognized at a point in time or over time based on when control of the good or service is transferred to the customer (see Chapter 6 and Section 7.5.2 for related discussion).

**APPLICABILITY OF THE ROYALTY EXCEPTION – SAAS**

The applicability of royalty exception is explicitly limited to licenses of IP and cannot be applied to sales- or usage-based royalties in exchange for providing other goods or service including SaaS.

**EXAMPLE 7-31 (ADAPTED FROM ASC 606-10-55-395 THROUGH 55-399): ACCESS TO IP – NAME AND LOGO OF A SPORTS TEAM – ROYALTY EXCEPTION**

This example is based on the facts in Example 7-25, which have been repeated here for readability.

An entity, a well-known sports team, licenses the use of its name and logo to a customer for two years. 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 other merchandise for those two years. The customer is required to pay fixed consideration of \$4 million and a royalty of 5% 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.

In assessing the goods and services promised to the customer, the entity concludes that:

- ▶ The only performance obligation in the contract is the license.
- ▶ The license is a symbolic IP and the entity's promise in granting the license provides the customer with the right to access the entity's IP throughout the license period.
- ▶ The performance obligation is satisfied over time over the two-year license term.

The entity recognizes the consideration from the customer as follows:

- ▶ Fixed consideration allocable to the license is recognized over time over the two-year license term but not before the customer can use and benefit from the license. The entity considers the guidance in Section 6.4 to identify the measure of progress that best depicts the entity's performance in satisfying the license.
- ▶ Variable consideration in the form of a sales-based royalty is recognized in accordance with the royalty exception because the royalty relates solely to the license that is the only performance obligation in the contract. The entity recognizes revenue from the sales-based royalty when the customer's subsequent sales of items using the team name or logo occur.

That is, the entity concludes that ratable recognition of the fixed consideration of \$4 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 (see Section 6.4 for discussion on measure of progress).

**EXAMPLE 7-32 (ADAPTED FROM ASC 606-10-55-270 THROUGH 55-279): ALLOCATION OF SALES-BASED ROYALTY AND APPLICATION OF ROYALTY EXCEPTION**

(This is a continuation of Example 5-6 in Chapter 5. The fact pattern is repeated here for readability.)

An entity enters a contract with a customer for two licenses of IP (licenses A and B). Assume each license represents a separate performance obligation, which is satisfied at a point in time when it is transferred to the customer. The standalone selling prices of licenses A and B are \$1,200 and \$1,500, respectively. The consideration for the contract includes the following:

- ▶ License A: a fixed amount of \$450
- ▶ License B: a royalty payment of 7.5% of the selling price of the customer's future sales of products that use license B

The entity estimates that the amount of sales-based royalties that it will be entitled to in respect of license B will be \$2,250.

The entity then considers the criteria in the variable consideration allocation exception (see Section 5.5) to determine the allocation of the transaction price to each of the two licenses. The entity determines that although the sales-based royalties relate solely to the transfer of license B, allocating that variable consideration only to license B would be inappropriate. This is because allocating \$450 to license A and \$2,250 to license B would not reflect a reasonable allocation based on the standalone selling prices of those two licenses. As a result, the entity must apply the general allocation model based on relative standalone selling prices.

### Allocation of the Fixed Consideration

The entity allocates the fixed amount of \$450 to the two licenses based on their standalone selling prices. This allocation is calculated as:

Product	Allocated Transaction Price
License A	$(\$450 \times (\$1,200 / \$2,700)) = \$200$
License B	$(\$450 \times (\$1,500 / \$2,700)) = \$250$
Total	<u>\$450</u>

### Allocation of the Variable Consideration

As the sales by the customer of products that use license B occur, the sales-based royalty will also be allocated to licenses A and B on a relative standalone selling price basis.

### Revenue Recognition at Contract Inception

Assume license A is transferred to the customer three months after contract inception and license B is transferred at contract inception. Revenue of \$200 is recognized for license A three months after the contract inception when license A is transferred to the customer. Revenue of \$250 will be recognized for license B at contract inception when license B is transferred to the customer.

Recognition of the sales-based royalty allocated to each of the two licenses is deferred to future periods because the recognition of sales-based royalty before the related sales occur is precluded.

Note that although the royalty is calculated solely based on sales related to license B, the allocation of the fixed consideration (\$450) to license A and the entire sales-based royalties to license B (estimated at \$2,250) is disproportionate in comparison with the standalone selling prices of the two licenses. That is, there is pricing interdependency between the two licenses, which indicates that some of the royalty generated by license B in fact relates to the sale of license A, and some of the fixed license fee (\$450) stated in the legal contract as relating solely to license A relates the sale of license B also.

### Subsequent Revenue Recognition for Sales-based Royalties

Assume that the royalty in an amount of \$300 is due from the customer in the first month based on first month of sales by the customer of products that use license B. Therefore, the entity recognizes:

- ▶ \$133  $(\$300 \times \$1,200 \div \$2,700)$  allocated to license A as contract liability. Although the subsequent sale by the entity's customer has occurred, the performance obligation to which the sales-based royalty has been allocated has not been satisfied.
- ▶ \$167  $(\$300 \times \$1,500 \div \$2,700)$  allocated to license B as revenue because license B has been transferred to the customer and is therefore a satisfied performance obligation.

### EXAMPLE 7-33 (ADAPTED FROM ASC 606-10-55-393 AND 55-394): SALES-BASED ROYALTY PROMISED IN EXCHANGE FOR A LICENSE OF IP AND OTHER GOODS AND SERVICES

A movie distribution entity enters a contract with a customer, an operator of movie theatres. The entity agrees to:

- ▶ Grant a license that provides the customer/operator the right to show the movie in its theatres for four weeks.
- ▶ Provide memorabilia from the filming to the operator for display at the operator's theatres before the beginning of the four-week airing period.
- ▶ Sponsor radio advertisements for the movie on popular radio stations in the customer's geographical area throughout the four-week airing period.

In exchange for the license and the additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for the movie (that is, variable consideration in the form of a sales-based royalty), which is the only consideration the entity is entitled to under the contract.

The entity concludes that the license to show the movie 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. Therefore, the royalty exception applies. The entity will recognize all sales-based royalties in revenue as and when the subsequent sale or usage occurs.

#### **EXAMPLE 7-34 (ADAPTED FROM ASC 606-10-55-375 THROUGH 55-382): FRANCHISE RIGHTS AND SALES-BASED ROYALTY**

An entity enters a contract with a customer for the following:

- ▶ Grant of a franchise license that provides the customer with the right to use the entity's trade name and sell the entity's goods for five years.
- ▶ Sale of the equipment necessary to operate a franchise store.

The customer is required to pay the following:

- ▶ In exchange for granting the license, a fixed upfront fee of \$1 million and a sales-based royalty of 5% of the customer's sales for the term of the license.
- ▶ In exchange for the equipment, fixed consideration of \$150,000, which is payable when the equipment is delivered.

#### **Identifying Performance Obligations**

The entity considers the guidance in Chapter 3 determine which promised goods and services are distinct. The entity observes that as a franchisor, it has developed a customary business practice to undertake certain activities, for example, analyzing the consumers' changing preferences and implementing product improvements, pricing strategies, marketing campaigns, and operational efficiencies to support the franchise name. However, those activities do not directly transfer goods or services to the customer.

The entity determines that:

- ▶ The promised goods and services to the customer are the franchise license and the equipment.
- ▶ The two promises are capable of being distinct because 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 two promises are separately identifiable – 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 IP is not a component of, and does not significantly modify, the equipment.
  - The license and the equipment are not highly interdependent or highly interrelated because the entity would be able to fulfill each promise (to license the franchise or to transfer the equipment) independently of the other.

Based, on the above, the entity has two performance obligations:

- ▶ The franchise license
- ▶ The equipment

### Allocating the Transaction Price

The transaction price includes fixed consideration of \$1,150,000 and variable consideration (5% of the customer's sales from the franchise store). Assume that the standalone selling price of the equipment is \$150,000 and the entity regularly licenses franchises in exchange for 5% of customer sales and a similar upfront fee.

The entity determines that the sales-based royalty must be allocated entirely to the franchise license under the variable consideration allocation exception (see Section 5.5) because:

- ▶ The variable consideration relates entirely to the entity's promise to grant the franchise license.
- ▶ Allocating \$150,000 to the equipment and allocating the sales-based royalty (and 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.

### Licensing

The entity assesses the nature of the entity's promise to grant the franchise license and concludes that the nature of its promise is to provide the customer a right to access the entity's symbolic IP. In reaching that conclusion, the entity observes that:

- ▶ The trade name and logo have limited standalone functionality.
- ▶ The utility of the goods developed by the entity is derived largely from the goods' association with the franchise brand.
- ▶ Substantially all of the utility inherent in the trade name, logo, and rights to goods 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.

As the entity grants a license to symbolic IP, it provides the customer a right to access the entity's IP, and the entity's performance obligation to transfer the license is satisfied over time. The entity recognizes the fixed consideration allocable to the license performance obligation over time when the customer can begin to use and benefit from the license. The entity identifies the measure of progress that best depicts the entity's performance in satisfying the license (see Section 6.4 for related discussion).

Because the sales-based royalty relates specifically to the franchise license, the entity applies the royalty exception and recognizes revenue from the sales-based royalty as and when the sales occur.

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 depicts the entity's performance toward complete satisfaction of the franchise license to which the sales-based royalty has been allocated.

### BDO INSIGHTS – WHAT IS CONSIDERED A ROYALTY?

The term “*royalty*” is not defined in ASC 606. There are some cases where it is not clear whether a payment structure is eligible for the application of the royalty exception. Certain payment terms may be in-substance sales- or usage-based royalties, even if the contract does not label the payments as royalties. Additionally, there are situations where the amount of consideration is similar to a bonus and depends on the customer's subsequent sales or usage, even though the amount is not calculated based on each sale or usage. For example:

- ▶ An entity licenses IP in exchange for a payment of \$10 million if cumulative sales of the licensee's products making use of the IP exceeds \$100 million over a specified five-year period.
- ▶ An entity licenses IP in exchange for payments calculated based on the sales of the licensee's products that make use of the IP subject to certain thresholds: no royalty is payable if licensee's sales are less than \$10 million, a royalty of 1% is payable if the sales are between \$10 million and \$25 million, and a royalty of 2% is payable if the sales are more than \$25 million.

In our view, the royalty exception applies to these fact patterns because the consideration is based on the sales to the customer's customer regardless of whether it is described as a royalty. This conclusion is based on the discussion in BC70 of ASU 2016-10 that states "... for a license of IP for which the consideration is based on the customer's subsequent sales or usage, an entity should not recognize any revenue for the variable amounts until the uncertainty is resolved (that is, when a customer's subsequent sales or usage occurs)." We believe the FASB's intention is for entities to apply the exception to variable consideration that relates to licenses of IP and is based on the customer's subsequent sales or usage regardless of whether it is labelled as a royalty or whether it is structured so that consideration accumulates evenly over all sales or usage.

However, this view must not be applied to contract clauses that have no economic substance (that is, the payment is in effect fixed and does not vary based on sales or usage). For example, a contract that includes royalty payments calculated as a defined percentage of sales but subject to a guaranteed minimum contains a fixed payment equal to the guaranteed minimum.

### **BDO INSIGHTS – ROYALTY SUBJECT TO A GUARANTEED MINIMUM AMOUNT**

Some licenses of IP include a guaranteed minimum amount, plus incremental royalties above a specified threshold. In that scenario, the amount and timing of revenue recognition depends on whether the license meets the criteria for recognition at a point in time (functional IP) or over time (symbolic IP).

When the license meets the criteria for point-in-time revenue recognition, the fixed guaranteed minimum must be recognized when the performance obligation is satisfied, that is, when the license is transferred to the customer. This treatment would be consistent with treatment for a license provided on a fixed fee basis.

When the license meets the criteria for over time revenue recognition, an entity must consider the facts and circumstances and apply judgment to determine an appropriate approach that depicts progress towards the satisfaction of the performance obligation. In determining the pattern of revenue recognition factors to consider include:

- ▶ What is the appropriate measure of progress, time, or the underlying sales or usage?
- ▶ Is the guaranteed minimum substantive?
- ▶ Are the royalties expected to exceed the guaranteed minimum?

We believe multiple approaches may be acceptable depending on the facts and circumstances, as illustrated in Example 7-35 in this chapter.

### **EXAMPLE 7-35: SALES-BASED ROYALTY PROMISED IN EXCHANGE FOR A LICENSE OF IP WITH MINIMUM GUARANTEE**

An entity enters a five-year noncancellable contract to license its IP to a customer. The license requires the customer to pay a sales-based royalty of 5% of the customer's gross sales associated with the IP. However, the total royalties paid over the five-year license term must meet or exceed a minimum guaranteed amount of \$5,000. The expected royalties over the term of the license are:

Year 1	\$ 750
Year 2	1,500
Year 3	2,000
Year 4	1,000
Year 5	3,000
<b>Total</b>	<b>\$ 8,250</b>

In each of the cases below, it is assumed that:

- ▶ Actual royalties received in each year equal the above expected royalties.
- ▶ The customer can use and benefit from the license at the beginning of Year 1.

#### Case A: Functional IP License – Point in Time Revenue Recognition

If the license represents a right to use functional IP, that is, it meets the criteria for recognition at a point in time, the entity recognizes revenue as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties Received	\$ 750	\$ 1,500	\$ 2,000	\$ 1,000	\$ 3,000
Cumulative Royalties	750	2,250	4,250	5,250	8,250
Annual Revenue	5,000	-	-	250	3,000
Cumulative Revenue	\$ 5,000	\$ 5,000	\$ 5,000	\$ 5,250	\$ 8,250

#### Case B: Over Time

If the license represents the right to access symbolic IP, that is, it meets the criteria for recognition over time, the entity applies judgment in light of the specific facts and circumstances. We believe a number of potential approaches may be acceptable.

- ▶ **Approach 1:** This approach is only appropriate when the royalties are expected to exceed the minimum guarantee. The entity recognizes the royalty as revenue as the customer's gross sales associated with the IP occur. This approach is based on the underlying sales/usage being the appropriate measure on which to recognize revenue and results in annual revenue being equal to the amount of royalties received each year.

	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties Received	\$ 750	\$ 1,500	\$ 2,000	\$ 1,000	\$ 3,000
Cumulative Royalties	750	2,250	4,250	5,250	8,250
Annual Revenue	750	1,500	2,000	1,000	3,000
Cumulative Revenue	\$ 750	\$ 2,250	\$ 4,250	\$ 5,250	\$ 8,250

- ▶ **Approach 2:** This approach also is only appropriate when the royalties are expected to exceed the minimum guarantee. The entity recognizes revenue equal to the lesser of the pro rata portion of the minimum guarantee earned to date and the royalties earned during the period, subject to a cap of the cumulative royalties earned to date.

	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties Received	\$ 750	\$ 1,500	\$ 2,000	\$ 1,000	\$ 3,000
Cumulative Royalties	750	2,250	4,250	5,250	8,250
Annual Revenue	1,000	1,250	2,000	1,000	3,000
Cumulative Revenue	\$ 1,000	\$ 2,250	\$ 4,250	\$ 5,250	\$ 8,250

- ▶ **Approach 3:** The entity recognizes the minimum guarantee (fixed consideration) using a reasonable measure of progress and recognizes royalties only when cumulative royalties exceed the minimum guarantee. Assuming time is the measure of progress, \$1,000 (that is, \$5,000 over 5 years) is recognized in revenue each year. Royalties in excess of \$5,000 are recognized in the year received, which results in the additional \$250 and \$3,000 recognized in Years 4 and 5.



	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties Received	\$ 750	\$ 1,500	\$ 2,000	\$ 1,000	\$ 3,000
Cumulative Royalties	750	2,250	4,250	5,250	8,250
Annual Revenue	1,000	1,000	1,000	1,250	4,000
Cumulative Revenue	\$ 1,000	\$ 2,000	\$ 3,000	\$ 4,250	\$ 8,250

### BDO INSIGHTS – RECOGNITION OF REVENUE FROM ROYALTIES

Royalty revenue from licenses of IP can only be recognized once the subsequent sale or usage and related performance have both occurred. This exception applies to licenses of IP regardless of whether the license is a functional IP satisfied at a point in time or a symbolic IP satisfied over time. Additionally, the five-step revenue recognition model in ASC 606 provides that revenue from performance obligations satisfied over time is recognized by measuring the progress towards satisfaction of that performance obligation (see Section 6.4 for discussion on measure of progress). 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).

The royalty rate for a symbolic IP license (that provides a customer with a right to access an entity's IP over time) may not necessarily be constant over the license term. That scenario leads to the question of which guidance takes precedence:

- ▶ The requirement to recognize royalties at the rate specified in a contract (that is, royalty exception)
- ▶ The requirement to measure revenue by reference to the entity's progress towards satisfying a performance condition

In our view, while the royalty exception overrides the requirement to estimate and constrain variable consideration, it does not take precedence over the general revenue recognition requirement to measure revenue by reference to the entity's progress towards satisfying a performance condition.

As discussed in BC71 of ASU 2016-10, the requirement that a sales-based or usage-based royalty cannot be recognized in revenue before the performance obligation to which some or all of the royalty has been allocated has been fully or partially satisfied (see Section 7.5.4) is intended to make sure that the royalty exception does not subvert one of the key principles of ASC 606, which is to recognize revenue only when (or as) an entity satisfies a performance obligation. An entity must recognize revenue from a sales- or usage-based royalty when (or as) the customer's subsequent sales or usage occur "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." The following Example 7-36 illustrates revenue recognition considerations for the grant of a symbolic IP license in exchange for sales-based royalties that decline over the license term.

#### EXAMPLE 7-36: DECLINING SALES-BASED ROYALTY PROMISED IN EXCHANGE FOR A LICENSE OF SYMBOLIC IP

An entity enters a noncancellable license agreement with a customer for a five-year period in exchange for a sales-based royalty. The licensee agrees to the following sales-based royalty rates: Year 1: 10%, Year 2: 8%, Year 3: 6%, Year 4: 4%, Year 5: 2%.

The entity determines that the license gives its customer the right to access the entity's IP as it may exist from time to time throughout the license period, and not at the point in time when the license was granted. That is, the license is a symbolic IP satisfied over time.

At contract inception, the entity estimates that:



- ▶ The customer's sales on which the royalty is based will be approximately equal for each of the five years of the license term.
- ▶ Any activities undertaken by the entity affecting its IP will be performed on an even and continuous basis throughout the license period.

Considering the nature of its obligations, the entity determines that following the legal form of the declining royalty payments (that is, recognizing royalty rates of 10% in Year 1, 8% in Year 2, and so forth) would not appropriately depict its progress in satisfying its performance obligation for the symbolic IP license.

The entity considers the guidance that sales-based royalties must be recognized on the later of (a) when the sale or usage occurs and (b) satisfaction of the performance obligation to which the royalty relates. That guidance does not provide that all of the royalty received/receivable must necessarily be recognized in the period of receipt or in the period in which the royalty becomes receivable. Rather, that guidance precludes the recognition of royalty revenue until the performance obligation to which the royalty has been allocated has been satisfied (or partially satisfied). That is, the entity must consider whether some of the royalty received/receivable must be deferred to ensure compliance with the requirement to measure revenue based on performance to date.

Based on historical data and estimates, the entity determines that it must initially apply an average expected royalty rate of 6%. It re-assesses that estimate at each reporting date throughout the license period to determine whether the rate applied remains appropriate.

#### 7.5.4.1 In-substance Sale of IP

The application of the royalty exception is limited to licenses of IP and is not available for other revenue transactions, including sales of IP. In some industries (for example, pharmaceuticals) an entity may grant a customer an exclusive perpetual license to its IP but retain the legal title to the IP. This may be viewed as an in-substance sale of the IP to the customer. In considering whether the royalty exception is applicable to an in-substance sale of IP, the FASB clarified in BC78 of ASU 2016-10 that an entity must not discern whether a license to IP is an "in substance sale" of that IP in deciding whether the royalty exception applies. Rather, an entity considers the legal structure of the arrangement to determine whether the royalty exception applies. The royalty exception applies if the arrangement is legally structured as a license of IP, but not if the arrangement is legally structured as a sale of IP. In reaching that conclusion, the FASB stated that attempting to distinguish between licenses that are, or are not, in substance sales would add significant complexity to the guidance and that there can be legal differences between a contract for a license and a sale of IP that it may not be appropriate or feasible to ignore, or attempt to override, from an accounting perspective.

## 7.6 ONEROUS CONTRACTS (LOSS CONTRACTS)

ASC 606 does not include specific guidance for onerous contracts (loss contracts) with customers. Even though ASC 606 superseded the prior revenue recognition guidance in ASC 605, the existing guidance in ASC 605-20, *Revenue Recognition – Services*, and ASC 605-35 related to loss contracts was retained. If an entity has an onerous contract with a customer, it must consider the applicability of the guidance in ASC 605-20 and ASC 605-35. This section includes a discussion on the scope of the loss recognition guidance in ASC 605-20 and 605-35.

### BDO INSIGHTS – DIVERSITY MAY EXIST IN ACCOUNTING FOR ONEROUS CONTRACTS

Because of a lack of guidance in ASC 606 and the limited scope of the guidance in ASC 605, accounting for onerous contracts requires the application of professional judgment, based on the facts and circumstances. Diversity in accounting may exist for onerous contracts that are not specifically within the scope of the guidance in ASC 605-20 and ASC 605-35.

### 7.6.1 Recognition of Losses for Certain Extended Warranty and Product Maintenance Contracts Under ASC 605-20

ASC 605-20 has a narrow scope and includes limited but specific guidance on accounting for the provision for losses related to certain extended warranty and product maintenance contracts. An entity must carefully determine whether a loss-making warranty or maintenance contract is within the scope of ASC 605-20 and therefore whether the guidance in ASC 605-20 is applicable.

#### 7.6.1.1 Scope of ASC 605-20



#### FASB REFERENCES

ASC 605-20-05-1, ASC 605-20-15-1 through 15-3, ASC 605-20-20, and ASC 605-20-25-1

ASC 605-20 is applicable to all entities. It includes guidance on accounting for the provision for losses on separately priced extended warranty and product maintenance contracts. That guidance is not applicable to:

- ▶ Product warranties other than extended warranty or product maintenance contracts
- ▶ Guarantees accounted for as derivatives in accordance with ASC 815 or as insurance contracts in accordance with ASC 944



#### FASB REFERENCES

ASC 605-20-20

##### Extended warranty

*“An agreement to provide warranty protection in addition to the scope of coverage of the manufacturer’s original warranty, if any, or to extend the period of coverage provided by the manufacturer’s original warranty.”*

##### Product maintenance contracts

*“An agreement to perform certain agreed-upon services to maintain a product for a specified period of time. The terms of the contract may take different forms, such as an agreement to periodically perform a particular service a specified number of times over a specified period of time or an agreement to perform a particular service as the need arises over the term of the contract.”*

Separately priced extended warranty or product maintenance contracts include both of the following characteristics:

- ▶ These contracts provide warranty protection or product services.
- ▶ The contract price of these contracts is not included in the original price of the product covered by these contracts.

#### **BDO INSIGHTS – ASC 606 AND ASC 605-20 BOTH APPLY TO CONTRACTS WITHIN THE SCOPE OF ASC 605-20**

Entities that enter into extended warranty and product maintenance contracts with customers apply ASC 606 to account for those contracts. Those entities must consider the scope and requirements in ASC 605-20 to make sure that a loss contract within the scope of ASC 605-20 is identified and appropriately accounted for. In other words, the requirements under both ASC 606 and ASC 605-20 are applicable to contracts within the scope of ASC 605-20.

### 7.6.1.2 Identification and Recognition of a Loss Under ASC 605-20



#### FASB REFERENCES

##### ASC 605-20-25-6

*“A loss shall be recognized on extended warranty or product maintenance contracts if the sum of the 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.”*

An entity recognizes a loss first by expensing any asset recognized for the incremental costs of obtaining a contract, determined in accordance with ASC 340-40 for contracts within the scope of ASC 606 (see Section 7.7). If the loss is greater than the recognized asset for the incremental costs of obtaining a contract, an entity must recognize a liability for the excess.

#### **EXAMPLE 7-37: ONEROUS CONSTRUCTION CONTRACT - ASC 605-20**

An entity entered a contract with a customer to sell a generator powered by Liquid Natural Gas with a separately priced maintenance service under which the entity will maintain the generator for five years. Assume that the contract includes two performance obligations in accordance with ASC 606:

- ▶ Maintenance services that are satisfied over time
- ▶ A generator that is satisfied at a point in time

The maintenance services are within the scope of the guidance in ASC 605-20, but the generator is not within the scope of ASC 605-20 or ASC 605-35 (see Section 7.6.2 for a discussion on ASC 605-35).

In determining whether the guidance on onerous contracts is applicable, the entity considers that ASC 605-20 clearly applies to separately priced extended warranty contracts. The entity concluded that it must apply the onerous contract guidance in ASC 605-20 to the maintenance performance obligation only and not to the entire contract. However, because of the guidance in ASC 606 on allocating consideration to performance obligations (see Chapter 5 for details), a loss may be anticipated at contract inception for the maintenance services only if the overall contract is priced at a loss. The entity considers the allocation requirements in ASC 606 and determines that the contract is priced at a loss. The entity recognizes an initial loss on the maintenance services only when that performance obligation became effective (that is, after the generator was delivered and installed).

**EXAMPLE 7-38: ONEROUS CONSTRUCTION CONTRACT – ASC 605-20**

Assume the same facts in Example 7-37 except that the contract was not priced at a loss, and thus no loss was recognized at contract inception related to the maintenance services. However, at the end of the second year of the maintenance term, the entity reassesses the expected costs to be incurred during the remaining three years and concludes that the sum of those costs exceeds the remaining unrecognized revenue. Therefore, the entity recognizes a loss on the maintenance performance obligation at that time.

**7.6.2 Guidance in ASC 605-35 on Construction- and Production-Type Contracts**

ASC 605-35 has a narrow scope and includes limited but specific guidance on accounting for the provision for losses related to certain construction- and production-type contracts. An entity must carefully determine whether a loss-making construction- and production-type is within the scope of ASC 605-35 and therefore whether the guidance in ASC 605-35 is applicable.

**7.6.2.1 Scope of ASC 605-35****FASB REFERENCES**

ASC 605-35-05-1 and ASC 605-35-15-1 through 15-6

ASC 605-35 includes guidance on the accounting for a provision for losses on a contract for which specifications are provided by the customer for the construction of facilities or the production of goods or for the provision of related services. The definitions of the terms “contract” and “customer” are the same as under ASC 606 (see Sections 2.2 and 1.3 for those definitions, respectively).

**BDO INSIGHTS – ASC 606 AND ASC 605-35 BOTH APPLY TO CONTRACTS WITHIN THE SCOPE OF ASC 605-35**

Entities that enter into construction- and production-type contracts with customers apply ASC 606 to account for those contracts. Those entities must consider the scope and requirements in ASC 605-35 to make sure that a loss contract within the scope of ASC 605-35 is identified and appropriately accounted for. In other words, the requirements under both ASC 606 and ASC 605-35 are applicable to contracts within the scope of ASC 605-35.

The guidance in ASC 605-35 applies only to contractors, not all entities.

**FASB REFERENCES**

ASC 605-35-20

**Contractor**

*“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.”*

Contracts within the scope of ASC 605-35 are binding agreements between buyers and sellers under which the seller agrees to perform a service to the buyer's specifications in exchange for compensation. Specifications imposed on the buyer by a third party (for example, a government or regulatory agency or a bank), or by conditions in the marketplace are deemed to be buyer's specifications. Following is a non-exhaustive list of examples of contracts covered by ASC 605-35:

- ▶ 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). Generally, the type of contract under consideration here is for construction of a specific project, which are generally carried on at the job site. However, ASC 605-35 also applies in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant.
- ▶ Contracts to design and build ships and transport vessels.
- ▶ 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.
- ▶ Contracts for construction consulting service, such as under agency contracts or construction management agreements.
- ▶ Contracts for services performed by architects, engineers, or architectural or engineering design firms.
- ▶ Arrangements to deliver software or a software system, either alone or with other products or services, requiring significant production, software modification, or customization.

Following is a non-exhaustive list of contracts not covered by ASC 605-35:

- ▶ Sales by a manufacturer of goods produced in a standard manufacturing operation (even when 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 GAAP of inventory costing.
- ▶ Sales or supply contracts to provide goods from inventory or from homogeneous continuing production over a period.
- ▶ 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.
- ▶ Service contracts of health clubs, correspondence schools, and similar consumer-oriented entities that provide their services to their clients over an extended period.
- ▶ Magazine subscriptions.
- ▶ Contracts of NFPs to provide benefits to their members over a period in return for membership dues.
- ▶ Contracts for which other U.S. GAAP provides special methods of accounting, such as leases.
- ▶ Cost-plus-fixed-fee government contracts, which are discussed in ASC 912, *Contractors – Federal Government*, other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered.
- ▶ Federal government contracts within the scope of ASC 912.
- ▶ Service transactions between a seller and a purchaser in which, for a mutually agreed price, the seller performs, agrees to perform later, or agrees to maintain readiness to perform an act or acts, including allowing others to use entity resources that do not alone produce a tangible commodity or product as the principal intended result. For example, in a transaction between an architect and the customer of an architect, the architectural services (not plans) are usually the principal intended result for the customer.

#### 7.6.2.2 Recognizing a Loss Under ASC 605-35

If a contract is within the scope of ASC 605-35, an entity considers the following guidance to determine:

- ▶ The unit of account for recognizing a loss
- ▶ The amount and timing of recognizing the loss

## 7.6.2.2.1 Unit of Account for Recognizing a Loss Under ASC 605-35



## FASB REFERENCES

ASC 605-35-25-7, ASC 605-35-25-10, and ASC 605-35-25-47

An entity determines the need for a provision for losses at the contract level. However, an entity combines contracts to determine whether a provision for losses is needed when the contract combination criteria in ASC 606 are met. (See Section 2.6 for a discussion of contract combination guidance under ASC 606.) If contracts are combined, they are treated as a single unit of account in determining whether a provision for losses is needed.

**ACCOUNTING POLICY ELECTION FOR THE UNIT OF ACCOUNT FOR RECOGNIZING A LOSS**

As an accounting policy election, an entity may elect to determine the need for provisions for losses at either the contract level (including contracts that are combined) or the performance obligation level. An entity applies the requirement in ASC 606 to identify the performance obligations in a contract or in combined contracts. (See Chapter 3 for a discussion of identifying performance obligations.)

An entity must apply this accounting policy election in the same manner for similar types of contracts.

## 7.6.2.2.2 Recognition of a Loss Under ASC 605-35



## FASB REFERENCES

ASC 605-35-25-45 through 25-46A and ASC 606-35-25-48 through 25-49

For a contract (or combined contracts) on which a loss is anticipated, an entity makes a provision for the entire loss on the contract when the current estimates of the amount of consideration that an entity expects to receive in exchange for transferring promised goods or services to the customer, which is determined in accordance with ASC 606 (see Chapter 3 for related discussion), and contract cost indicate a loss. An entity must make provisions for losses in the period in which the losses become evident.

To determine the amount that an entity expects to receive, an entity:

- ▶ Uses the principles in ASC 606 to:
  - Determine the transaction price except for the guidance on constraining estimates of variable consideration.
  - Allocate the transaction price (see Chapters 4 and 5 for discussion of determining and allocating transaction price).
- ▶ Adjusts that amount to reflect the effects of the customer's credit risk.

The costs used to determine the estimated loss on a contract includes all costs to fulfill the contract (see Section 7.7 for a discussion of costs to fulfill a contract). Other factors considered in arriving at the projected loss on a contract include:

- ▶ Variable consideration (for example, performance penalties and rewards, and potential price redeterminations).
- ▶ Nonreimbursable costs on cost-plus contracts.
- ▶ Change orders that are accounted for as contract modifications in accordance with ASC 606 (see Section 7.3 for a discussion of contract modifications).

Losses on a cost-type contract could arise if, for example, the contract provides for guaranteed maximum reimbursable costs or performance penalties. In recognizing losses for accounting purposes, a contractor:

- ▶ Uses its normal cost accounting methods to determine the total cost overrun on the contract
- ▶ Includes provisions for performance penalties in losses

#### EXAMPLE 7-37: ONEROUS CONSTRUCTION CONTRACT – ASC 605-35

An entity entered a commercial contract to construct a green-energy battery system. The entity considered the following factors in determining whether the contract is in the scope of ASC 605-35:

- ▶ The system is being constructed on land owned by the customer
- ▶ The system is based on engineering designs developed by the entity to meet the customer's specifications

Based on these facts, the entity concludes that the commercial contract is within the scope of the guidance in ASC 605-35.

The contract includes a fixed purchase price of \$35 million, which is expected to provide a profit to the entity at contract inception. However, after six months the entity determines that due to unforeseen problems with the design, the costs to complete the project are now expected to exceed the fixed purchase price. The entity therefore recognizes a loss at that time in an amount equal to the difference between the remaining expected costs and the unrecognized revenue.

## 7.7 CONTRACT COSTS

ASC 340-40 was issued concurrently with ASC 606 and provides specific guidance on the accounting for both the incremental costs of obtaining and the costs incurred in fulfilling a contract with a customer within the scope of ASC 606. Contract costs are initially recognized as an asset and expensed on a systematic basis that is consistent with the pattern of transfer to the customer of the good or service to which those costs relate.

### 7.7.1 Incremental Costs of Obtaining a Contract



#### FASB REFERENCES

ASC 340-40-25-1 through 25-4

The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained. A sales commission that is paid only if the contract with a customer is executed is an example of a cost to obtain a contract.

#### 7.7.1.1 Recognition of Incremental Costs of Obtaining a Contract

An entity is required to recognize the incremental costs of obtaining a contract with a customer as an asset if the entity expects to recover those costs.

Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained are recognized as an expense when incurred unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained. All costs of running the business, including costs that are incurred with the intention of obtaining a contract with a customer that are not incremental are expensed unless capitalization is required or allowed under other area of U.S. GAAP (for example, ASC 360, *Property, Plant, and Equipment*).



**PRACTICAL EXPEDIENT TO EXPENSE CERTAIN INCREMENTAL COSTS OF OBTAINING A CONTRACT**

As a practical expedient, the incremental costs of obtaining a contract can be recognized as an immediate expense rather than capitalized if the period over which they would otherwise be expensed (or amortized) is one year or less.

**TRG DISCUSSIONS – IDENTIFYING INCREMENTAL COSTS TO OBTAIN A CONTRACT WITH A CUSTOMER**

In many cases, identifying incremental costs to obtain a contract may be relatively straight-forward. However, in other instances, commission structures may be more complex, resulting in questions about which payments qualify for deferral. The TRG considered this question and concluded that one way to identify the costs to be deferred is to consider whether the entity would incur the cost if the customer (or the entity) decided at the last minute not to execute the agreement. If the answer is yes, then the cost is not an incremental cost to obtain the contract.

To illustrate this concept, the TRG considered a scenario in which an entity pays an employee a fixed salary that is determined annually based on the employee's prior-year signed sales contracts and projected sales contracts for the current year. Although the salary is impacted by prior year sales and current year projected sales, it will be paid regardless of whether any level of sales is achieved. Therefore, the salary paid does not represent an incremental cost to acquire a contract and should not be deferred.

Conversely, the TRG considered a situation in which an entity pays a commission that is tiered based on the number of contracts or dollar amount of contracts obtained during an annual period. For example, the employee might earn no commission for the first nine contracts executed but earn 2% of the value of contracts 10-19 and 5% of the value of the 20th contract and beyond. The TRG concluded that the commissions paid in this scenario are incremental costs of obtaining a contract, and thus should be deferred pursuant to the guidance in ASC 340-40-25-1. The TRG stated that the fact that the commissions are paid on a pool of contracts rather than on each contract individually does not change the fact that the commissions would not have been incurred had the contracts not been obtained.

The TRG also clarified that the timing of paying the commission is not relevant in determining whether it should be recognized as an asset, only whether the commission is incremental or not. An entity would apply other U.S. GAAP to determine whether a liability for the commission payment should be recognized.

**EXAMPLE 7-40 (ADAPTED FROM ASC 340-40-55-2 THROUGH 55-4): INCREMENTAL COSTS OF OBTAINING A CONTRACT**

A consulting services provider 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	\$ 30,000
Travel costs to deliver proposal	50,000
Sales commissions	20,000
<b>Total costs incurred</b>	<b>\$ 100,000</b>

The entity recognizes an asset for the \$20,000 incremental costs of obtaining the contract arising from the sales commissions 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. The entity does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. Rather, the amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. In other words, the bonuses are not directly attributable to identifiable contracts.

Additionally, the entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, those costs are expensed when incurred, unless they are within the scope of other U.S. GAAP, in which case, that guidance applies.

#### **EXAMPLE 7-41: INCREMENTAL COSTS OF OBTAINING A CONTRACT**

An engineering entity enters a contract with Customer Z to design a water treatment plant. The design project is expected to take two years to complete. Assume that the entity will transfer the services to Customer Z over time.

To win the project, the entity incurred the following costs as part of developing the bid:

- ▶ External marketing consultant fee of \$100,000
- ▶ Other internal labor costs totaling \$350,000

After being selected as the winning bid, the entity incurred the following costs:

- ▶ Commission of \$120,000 to a PR agent after the contract was signed relating specifically to this contract.
- ▶ After the contract is signed, the PR agent is paid an additional \$50,000 bonus due to exceeding a threshold on total value of contracts executed year-to-date.

The \$100,000 fee paid to the external marketing entity and the \$350,000 of internal labor costs were incurred as part of the bid process to win the contract and would have been incurred by the entity even if it had not been selected. Therefore, these costs would not be considered an incremental cost of obtaining the contract. The entity must therefore expense the \$100,000 marketing fee and the labor costs as incurred.

The PR agent's commission and bonus are considered incremental costs of obtaining the contract because these amounts would not have been paid unless the contract has been signed. Although the bonus is paid based on the total value of contracts obtained rather than only the current contract, it is still considered an incremental cost to obtain a contract, consistent with the TRG discussions on identifying incremental costs to obtain a contract with a customer in Section 7.7.1. The entity must capitalize the PR agent's commission and bonus as a 'costs to obtain a contract' asset and amortize it over the project period (that is, to reflect the pattern of transfer of the design service to Customer Z).

#### **EXAMPLE 7-42: INCREMENTAL COSTS OF OBTAINING A CONTRACT – CHANGES TO SALES COMMISSIONS BECAUSE OF A CONTRACT MODIFICATION**

A sales agent receives an initial sales commission based on the contract price when a contract with the customer is obtained. Assume that the sales commission is appropriately capitalized under ASC 340-40.

Subsequently, the customer modifies the contract to purchase additional goods and the modification does not result in the entity accounting for the modification as a separate contract (see ASC 606-10-25-12 and 25-13). The sales agent is paid an additional commission based on the increase in the contract price arising from the modification.

Even though the contract modification is not accounted for as a separate contract, the increase in the contract price results in additional commission that is incremental to obtaining the modified contract. Therefore, the additional commission paid is an incremental cost of obtaining a contract and should be capitalized and amortized (with any unamortized amount relating to the initial commission) on a systematic basis that is consistent with the transfer to the customer of the remaining goods or services provided over the remaining contractual period.

### 7.7.2 Costs to Fulfill a Contract



#### FASB REFERENCES

ASC 340-40-25-5 through 25-8

The guidance in ASC 340-40 is applicable to costs incurred to fulfill a contract with a customer only if the costs are not within the scope of other U.S. GAAP including:

- ▶ ASC 330
- ▶ ASC 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements (see Section 7.7.1 for discussion on that guidance)
- ▶ ASC 350-40, *Intangibles – Goodwill and Other – Internal Use Software*
- ▶ ASC 360
- ▶ ASC 985-20, *Software – Costs of Software to be Sold, Leased, or Marketed*

An entity must account for the costs incurred in fulfilling a contract in accordance with other applicable GAAP, if those costs are within the scope of other U.S. GAAP.

#### 7.7.2.1 Recognition of Costs to Fulfill a Contract

An entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet all the following criteria:

- ▶ The costs relate directly to a contract or an anticipated contract that the entity can specifically identify. For example, costs relating to services provided under renewal of an existing contract or costs of designing an asset transferred under a specific contract that has not yet been approved but is expected to be approved would be considered costs to fulfill a contract.
- ▶ The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.
- ▶ The costs are expected to be recovered.

Costs that relate directly to a contract or a specific anticipated contract include:

- ▶ Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer)
- ▶ Direct materials (for example, supplies used in providing the promised services to a customer)
- ▶ 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)
- ▶ Costs that are explicitly chargeable to the customer under the contract
- ▶ Other costs that are incurred only because an entity entered into the contract such as payments to subcontractors

An entity must expense the following costs when incurred:

- ▶ General and administrative costs unless those costs are explicitly chargeable to the customer under the contract, in which case an entity must evaluate whether those costs relate directly to a contract or a specific anticipated contract

- ▶ Costs of wasted materials, labor, or other resources not reflected in the price of the contract
- ▶ Costs that relate to partially or fully satisfied performance obligations in the contract (that is, costs that relate to past performance)
- ▶ 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)

#### **BDO INSIGHTS – FULFILLMENT COSTS THAT RELATE TO PARTIALLY SATISFIED PERFORMANCE OBLIGATIONS**

Because fulfillment costs that relate to partially satisfied performance obligations cannot be capitalized, we generally do not expect any costs to fulfill an over-time contract to be capitalized under ASC 340-40 once control of the goods or services start transferring to the customer, that is, revenue recognition begins.

BC45 of ASU 2016-20 provides the FASB's expectations that:

- ▶ Costs historically accounted for within the scope of ASC 605-35 for long-term construction- and production-type contracts will be accounted for in accordance with ASC 340-40
- ▶ Adoption of ASC 606 and ASC 340-40 will not require more entities to apply the guidance in ASC 340-10 as compared with the historical practice.

#### **BDO INSIGHTS – PRE-PRODUCTION COSTS ASSOCIATED WITH LONG-TERM SUPPLY CONTRACTS**

Historically there has been diversity in practice in accounting for pre-production costs associated with long-term supply contracts. ASC 340-10 provides guidance on accounting for the costs of designing and developing “molds, dies, and other tools that will be used in producing” products under a long-term supply agreement. ASC 606 did not amend or supersede the guidance provided on pre-production costs in ASC 340-10. Entities that conclude that their pre-production costs are within the scope of ASC 340-10 should continue to follow that guidance. Entities that conclude that the guidance in ASC 340-10 is not directly applicable should apply the guidance in ASC 340-40 instead.

#### **EXAMPLE 7-43: CONTRACT COSTS – MANUFACTURING ENTITY**

Entity A, a manufacturer of solar panels, enters a contract to sell 10,000 units at \$500 per unit to a new customer. Once the contract was signed, Entity A purchased tooling for \$25,000 and incurred engineering costs of \$100,000 to facilitate production of the solar panels. The tooling and engineering activities do not represent a good or service, which is transferred to the customer (Entity A retains title and control of the tooling and owns and controls of all IP arising from the activities).

Entity A first determines if any of the costs are within the scope of other U.S. GAAP.

- ▶ The tooling is an equipment accounted for in accordance with ASC 360.
- ▶ Entity A determines that the engineering activities are within the scope of ASC 730, *Research and Development*, and the costs must be expensed as incurred. This is because the costs meet the definition of development activities and are not specific to the customer contract. That is, the IP resulting from the engineering efforts can be used by Entity A to fulfill other future customer orders.

Because all costs incurred to begin delivering under the contract are subject to other U.S. GAAP, the guidance in ASC 340-40 is not applicable.

### 7.7.3 Amortization and Impairment of Capitalized Costs



#### FASB REFERENCES

ASC 340-40-35-1 through 35-5

An entity considers the following guidance for the subsequent measurement of an asset resulting from the deferred costs to obtain or fulfill a contract with a customer.

#### 7.7.3.1 Amortization of Capitalized Costs

An asset is 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 solely to the current contract, or it may also relate to future anticipated contracts. An entity must update the amortization to reflect a significant change in the entity's expected timing of transfer of the goods or services to which the asset relates to the customer. Such a change is accounted for as a change in accounting estimate in accordance with ASC 250.

#### 7.7.3.2 Impairment of Capitalized Costs

An entity recognizes an impairment charge in profit or loss to the extent that the carrying amount of a recognized asset exceeds:

<p><b>Consideration</b></p> <p>The amount that the entity expects to receive in the future and has received but has not recognized as revenue, in exchange for the goods or services to which the asset relates</p>	<p><b>Less</b></p>	<p><b>Costs</b></p> <p>The costs that directly relate to providing those goods or services and that have not been recognized as expenses (see Section 7.7.1 and Section 7.7.2)</p>
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For the purposes of determining the consideration, an entity must:

- ▶ Consider expected contract renewals and extensions (with the same customer)
- ▶ Use the principles for determining the transaction price except for the guidance on constraining estimates of variable consideration (see Chapter 4) and adjust that amount to reflect the effects of the customer's credit risk

Subsequent reversal of a previously recognized impairment loss is not allowed.

Before an entity recognizes an impairment loss for an asset recognized under ASC 340-40, it must recognize any impairment loss for assets related to the contract that are recognized in accordance with other U.S. GAAP, including ASC 330 and ASC 985-20. After applying the impairment test in ASC 340-40-35-3, an entity must include the resulting carrying amount of the asset recognized under ASC 340-40 in the carrying amount of the asset group or reporting unit to which it belongs for the purpose of applying the guidance in ASC 350 and ASC 360.



#### TRG DISCUSSIONS – IMPAIRMENT TESTING OF CAPITALIZED CONTRACT ACQUISITION COSTS

In July 2014, the TRG considered whether entities should factor in cash flows that are expected to arise in any period covered by customer options to extend or renew the contracts when testing capitalized contract assets for impairment. TRG members concluded that extension and renewal periods are considered if:

- ▶ It is expected that the customer will extend or renew the contract.
- ▶ The contract costs capitalized relate to goods or services that would be transferred to the customer during such extension or renewal periods.



## TRG DISCUSSIONS — COMMISSIONS PAID TO OBTAIN A RENEWABLE CONTRACT WITH A CUSTOMER

In certain instances, commissions paid at inception of a customer contract exceed those paid upon contract renewal, if any. In these situations, careful consideration should be given to the amortization period, including whether the entity may apply the practical expedient of immediately recording the incremental payments as a period expense. Specifically, the amortization period for the initial commissions would relate only to the current contract if the commissions paid at contract renewal are commensurate with the commissions paid at contract signing.

For example, assume an entity enters a one-year, \$100,000 renewable maintenance contract with a customer. The entity pays a 5% commission on contract signing to its sales agent and will pay that same individual a smaller 1% commission upon contract renewal. The difference in the renewal rates stems from the entity's belief that the level of effort necessary to obtain a renewal is far less than initially entering into a new contract.

The TRG considered this issue and indicated that the level of effort to obtain a contract or renewal should not factor into determining whether the commission paid on a contract renewal is commensurate with the initial commission. Instead, a renewal commission is commensurate with an initial commission if the two commissions are reasonably proportionate to the respective contract values (for example, both are 2% of the amounts invoiced to customers). Therefore, if a contract does not contain commensurate commissions, the initial commission may relate to an expected future contract beyond the initial term.

Returning to the example, the initial and renewal commissions are not commensurate. Accordingly, the entity would not qualify for the practical expedient and instead would defer and amortize the initial commissions over a period that considers both the initial contract term and any expected renewals. Determining how the initial commission and subsequent commissions should be amortized may require judgment; multiple approaches may be acceptable as illustrated in Example 7-44.

### EXAMPLE 7-44: INCREMENTAL COSTS OF OBTAINING A CONTRACT — SALES COMMISSIONS PAID FOR A NEW CONTRACT AND SUBSEQUENT RENEWALS

A sales agent is paid a commission for each contract obtained with a customer as follows:

- ▶ \$100 is paid for a new customer contract.
- ▶ \$60 is paid each time that same customer renews the contract.

The entity concludes that the \$60 renewal commission is not considered commensurate with the \$100 commission paid on the initial contract.

The \$100 paid for the new customer contract is capitalized at contract inception (unless the practical expedient in ASC 340-40-25-4 is available and the entity elects it).

The \$60 for each renewal is capitalized upon renewal because it is also an incremental cost that would not have been incurred if the renewal contract was not obtained.

For the \$100 capitalized when the new customer contract is obtained, alternative amortization approaches include:

- ▶ **Approach 1:** Amortizing the initial \$100 over the contract period that includes the specific anticipated renewals (that in this case is assumed to equal the expected customer relationship life) and amortizing each capitalized renewal amount over the respective renewal period.
- ▶ **Approach 2:** Separating the initial \$100 commission into two components: \$60 that is amortized over the original contract term and \$40 that is amortized over the period of the initial contract and the specific anticipated renewals. Upon renewal, the \$60 renewal commission is capitalized and amortized over the renewal period.

**EXAMPLE 7-45: (ADAPTED FROM ASC 340-40-55-5 THROUGH 55-9) – COSTS THAT GIVE RISE TO AN ASSET**

An entity enters a contract with a customer to manage the 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 incurs the following costs:

- ▶ Paid an employee a \$10,000 sales commission upon the customer signing the contract.
- ▶ Before providing the services, designed and built 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**

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 when providing the services. The entity amortizes the asset over seven years because the asset relates to the services transferred to the customer during the initial contract term of five years and the anticipated two one-year renewal periods thereafter.

**Costs to Fulfill a Contract**

The entity incurred the following initial costs to set up the technology platform:

Design services	\$ 20,000
Hardware	60,000
Software	45,000
Data migration and testing	50,000
<b>Total costs incurred</b>	<b>\$ 175,000</b>

The initial set-up 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:

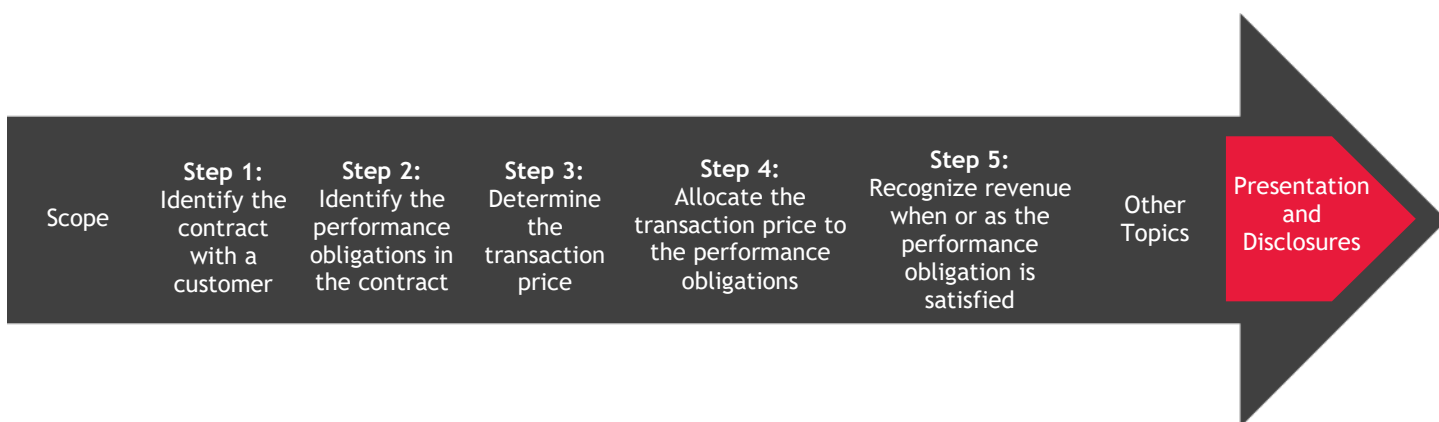
- ▶ Hardware costs – accounted for in accordance with ASC 360
- ▶ Software costs – accounted for in accordance with ASC 350-40
- ▶ Design services, data migration, and testing – assessed to determine whether an asset can be recognized for the costs to fulfill the contract. Any resulting asset would be 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.

Assume that 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 the 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. Therefore, the costs do not meet the criteria to be recognized as an asset under ASC 340-40 and the entity recognizes the payroll expense for the two employees when incurred.





# CHAPTER 8 – PRESENTATION AND DISCLOSURES



## 8.1 OVERVIEW

The presentation and disclosure requirements in ASC 606 are significant and detailed. For each contract with a customer, an entity is required to present any contract asset, contract liability and receivable, as applicable, on its balance sheet. Additionally, an entity is required to provide comprehensive qualitative and quantitative disclosures to meet the disclosure objective specified in ASC 606. The disclosure objective of ASC 606 is to provide users of financial statements with sufficient information to understand the nature, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Relief from certain disclosure requirements is available for nonpublic entities. This chapter provides a discussion on the presentation and disclosure requirements and highlights any relief available for nonpublic entities.

## 8.2 PRESENTATION

### 8.2.1 Balance Sheet



#### FASB REFERENCES

ASC 606-10-45-1 through 45-5

When either party to a contract has performed, an entity presents the contract with a customer in the balance sheet as either a contract asset or a contract liability on a net basis, depending on the relationship between the entity's performance and the customer's payment. An entity presents any unconditional rights to consideration separately as a receivable.

The net presentation of remaining rights and performance obligations in a contract with a customer is based on the notion that an entity's obligation to perform and the entity's right to receive consideration from a customer is interdependent – the right to receive consideration from a customer depends on the entity's performance and, similarly, the entity performs only as long as the customer continues to pay. An entity's net position in a contract is generally recognized as a contract asset, contract liability, or receivable.

While the guidance uses the terms contract asset and contract liability, an entity is not prohibited from using alternative descriptions in the balance sheet for those items. If an entity uses an alternative description for a contract asset, the entity must provide sufficient information to enable a user of the financial statements to distinguish

between contract assets (rights to consideration that are conditional) and receivables (rights to consideration that are unconditional).

### **BDO INSIGHTS – PRESENTATION OF CONTRACT ASSETS AND CONTRACT LIABILITIES**

For a contract that has multiple performance obligations, the contract assets and contract liabilities must be netted together at the contract level. That is, an entity presents either a contract asset or a contract liability for each contract (or group of contracts that are required to be combined – see Section 2.6) rather than multiple contract assets or contract liabilities for the same contract based on individual performance obligations in the contract.

#### **8.2.1.1 Contract Liability**

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. If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (that is, a receivable – see Section 8.2.1.3), before the entity transfers a good or service to the customer, the entity is required to present the contract as a contract liability when the payment is made or the payment is due, whichever is earlier.

#### **8.2.1.2 Contract Asset**

A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity is required to present the contract as a contract asset, excluding any amounts presented as a receivable (see Section 8.2.1.3 for discussion on receivables).

Additionally, certain upfront payments to a customer (or potential customer) may be accounted for as a contract asset. See Section 4.6 for a summary of TRG discussions on upfront payment to a customer or potential customer.

A contract asset is assessed for impairment, and any impairment is measured, presented, and disclosed in accordance with ASC 326.

#### **8.2.1.3 Receivable**

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 is required to account for a receivable in accordance with ASC 310, with impairments assessed, measured, presented, and disclosed in accordance with ASC 326.

### **BDO INSIGHTS – PRESENTATION OF CONTRACT ASSETS, CONTRACT LIABILITIES, AND RECEIVABLES**

- ▶ Current and non-current portions of contract assets, contract liabilities, and receivables must be separately presented in a classified balance sheet.
- ▶ Contract assets and liabilities must be disclosed separately from other balances related to revenues outside the scope of ASC 606. For example, receivables from contract revenues must be disclosed separately from receivables that arise from leasing contracts.
- ▶ Contract assets, contract liabilities, and receivables must be presented separately on the balance sheet or in the footnotes. Entities must consider other U.S. GAAP (for example, ASC 210-20, *Balance Sheet – Offsetting*) to assess whether it is appropriate to net contract assets and contract liabilities that arise from different contracts (for example, multiple contracts with the same customer) that are not required to be combined in accordance with ASC 606.

#### **8.2.1.4 Distinguishing Between a Contract Asset and a Receivable**

A receivable is distinguished from a contract asset if the receipt of the consideration is unconditional, that is consideration is solely based on the passage of time. The standard requires that receivables be presented separately from contract assets because, as stated in BC323 of ASU 2014-09, receivables and contract assets are subject to different levels of risk. Although both are subject to credit risk, contract assets are also subject to other risks,

including performance risk. Once an entity's right to consideration becomes unconditional, the contract asset must be reclassified as a receivable, even if the entity has not generated an invoice (that is, as an unbilled receivable).

### **BDO INSIGHTS – DETERMINATION OF AN UNCONDITIONAL RIGHT**

In some situations, an entity has an unconditional right to consideration in advance of performance. In such situations, it would be appropriate to record both a receivable and a contract liability. However, an entity must exercise care in determining whether there is an unconditional right to payment when it has not transferred a good or service, because this might be difficult to assert. Entities must carefully consider whether the contract terms and specific facts and circumstances support the existence of unconditional rights to payment.

The following example illustrates the journal entries that are recorded when an entity has an unconditional right to consideration in advance of performance.

#### **EXAMPLE 8-1 (ADAPTED FROM ASC 606-10-55-284): CONTRACT LIABILITY AND RECEIVABLE – CANCELLABLE CONTRACT**

On March 1, 20X2, a manufacturing entity enters a cancellable contract with a retail customer to sell products, which the retail customer will resell to end consumers. The contract with the customer has the following terms:

- ▶ The retail customer is required to pay to the entity \$10,000 in advance at the start of the contract before the receipt of any products.
- ▶ The retail customer pays \$10,000 to the entity on April 1, 20X2.
- ▶ Each product is determined to have a sales price of \$500, and revenue is to be recognized at the point the retail customer has control of the goods.
- ▶ The manufacturing entity transfers control of the 100 products on April 30, 20X2 to retail customer. The manufacturing entity has no further obligations to perform in the contract once transfer of control for the products has occurred.

On April 1, 20X2, the entity recorded the following journal entry to recognize a contract liability for the cash received in advance of performance:

Debit	Cash	\$ 10,000	
Credit	Contract Liability		\$ 10,000

On April 30, 20X2, the entity recorded the following journal entry to recognize revenue for the 100 products transferred to the customer:

Debit	Contract Liability	\$ 10,000	
Debit	Receivable	\$ 40,000	
Credit	Revenue		\$ 50,000

On April 30, 20X2, the manufacturing entity satisfied its performance obligations to transfer control to its customer of 100 products with a purchase price of \$500 each (100 X \$500 = \$50,000). The manufacturing entity had previously recognized the advance of \$10,000 on its balance sheet as a contract liability. The entity now derecognizes that contract liability and recognizes \$10,000 in revenue because it has satisfied the related performance obligation. Additionally, the entity recognizes a receivable for the difference, which is calculated as \$50,000 revenue less the \$10,000 contract liability (cash collected) = \$40,000.

**EXAMPLE 8-2 (ADAPTED FROM ASC 606-10-55-285 AND 55-286): CONTRACT LIABILITY AND RECEIVABLE - NONCANCELLABLE CONTRACT**

On March 1, 20X2, an entity enters into a contract with a customer to sell products on April 30, 20X2 for consideration of \$10,000, paid in advance (that is, before the receipt of any products) on March 30, 20X2. The customer pays \$10,000 to the entity on April 1, 20X2. The entity transfers the product on April 30, 20X2.

The contract becomes noncancellable on March 30, 20X2. Because the contract is now noncancellable, the entity has an unconditional right to payment for the \$10,000. Thus, a receivable is recognized.

On March 30, 20X2, the entity recorded the following journal entry to recognize a receivable and a contract liability for the noncancellable contract:

Debit	Receivable	\$ 10,000	
Credit	Contract Liability		\$ 10,000

On April 1, 20X2, the entity recorded the following journal entry to recognize the receipt of cash from the customer and the reversal of the receivable:

Debit	Cash	\$ 10,000	
Credit	Receivable		\$ 10,000

On April 30, 20X2, the entity recorded the following journal entry to recognize revenue for the product transferred to the customer:

Debit	Contract Liability	\$ 10,000	
Credit	Revenue		\$ 10,000

**EXAMPLE 8-3 (ADAPTED FROM ASC 606-10-55-287 THROUGH 55-290): CONTRACT ASSET RECOGNIZED FOR THE ENTITY'S PERFORMANCE**

On January 1, 20X2, a retail entity enters a contract to transfer Products X and Y to a customer in exchange for \$10,000. The contract with the customer specifies that:

- ▶ Product X must be provided first if the entity cannot provide both products at the same time.
- ▶ Payment for Product X will not be due until both products have been transferred to the customer.

Assume that the retail entity has determined the following:

- ▶ Product X has a standalone selling price of \$3,000 and Product Y has a standalone selling price of \$7,000.
- ▶ Revenue must be recognized at the point in time control of each product transfers to the customer.

The retail entity transfers control of Product X on March 14, 20X2. After resolving supply chain issues, the retail entity is finally able to transfer control of Product Y on July 1, 20X2.

On March 14, 20X2, the retail entity transfers control of Product X but the entity does not have an unconditional right to consideration until both products are delivered due to terms and conditions in the contract. Therefore, on March 14, 20X2, the retail entity recorded the following journal entry to recognize revenue for Product X:

Debit	Contract Asset	\$ 3,000	
Credit	Revenue		\$ 3,000

On July 1, 20X2, the retail entity satisfied its performance obligations to transfer control to its customer of Product Y. Per the terms of the contract, the retail entity now has an unconditional right to consideration for both products, and records the following journal entry to recognize revenue for Product Y and a receivable for both products:

Debit	Receivable	\$ 10,000	
Credit	Contract Asset		\$ 3,000
Credit	Revenue		7,000

**8.2.1.5 Distinguishing Between a Contract Liability and a Refund Liability**

When a customer pays consideration (or consideration is unconditionally due) and the entity has an obligation to transfer goods or services to the customer, the entity records a contract liability. However, when an entity expects to refund some or all of the amounts received to the customer, it records a refund liability. As such, a refund liability does not constitute an obligation to transfer goods or services to the customer in the future. Therefore, we believe that such liability must be presented separately (if material) from the contract liability.

A customer's right to exchange one product for another of the same type, quality, condition, and price is not considered a right to return and hence does not result in a potential refund liability for an entity – see Section 4.3.8 for a discussion of sales with a right of return.

**EXAMPLE 8-4 (ADAPTED FROM ASC 606-10-55-291 THROUGH 55-294): RECEIVABLE AND REFUND LIABILITY RECOGNIZED FOR ENTITY'S PERFORMANCE**

An entity enters a contract with a new customer on January 1, 20X2, to sell widgets at \$15 each. The price per widget decreases retrospectively to \$13 each if the customer buys over 1 million widgets in a calendar year. Below are some key facts:

- ▶ There are no other performance obligations in the contract.
- ▶ Payment is due when the customer receives control of the widget.
- ▶ When initially assessing the transaction price, the entity determined that the customer would meet the 1 million purchase threshold and as such, estimated that the transaction price for each widget was \$13.
- ▶ On February 1, 20X2, the entity transferred control of 100,000 widgets to the customer.

The journal entry to record the revenue recognized for the first shipment is:

Debit	Receivable	\$ 1,500,000 <sup>a</sup>	
Credit	Revenue		\$ 1,300,000 <sup>b</sup>
Credit	Refund Liability		\$ 200,000

a) Contractual Price of \$15 each multiplied by 100,000 products

b) Transaction price of \$13 multiplied by 100,000 products

The refund liability represents \$2 per widget, which the entity expects to provide the customer for the volume-based rebate. A receivable is recognized for the contractual amount owed by the customer, as control of the widgets has passed to the customer and the entity has an unconditional right to payment for these widgets.

### 8.2.1.6 Presentation of Other Assets

ASC 606 provides guidance for the capitalization of incremental costs of obtaining a contract and costs to fulfill a contract. Such capitalized costs should be presented separately from contract assets and contract liabilities.

### 8.2.2 Income Statement

ASC 606 requires entities to present or disclose revenue recognized from contracts with customers separately from revenues from other sources of revenue (that is, revenues outside the scope of ASC 606) either on the face of the income statement or in the footnotes. For example, if not already presented separately on the income statement, an entity that earns income from contracts from customers and leases could disclose in its footnotes:

Revenues from contracts with customers	\$ 10,000,000
Lease income	1,300,000
Total revenue	<u>\$ 11,300,000</u>

Entities must also present the effects of financing (interest income or interest expense) separately from revenue from contracts with customers in the income statement. BC247 of ASU 2014-09 states that entities may present interest income as revenue only when interest income represents income from their ordinary activities.

### BDO INSIGHTS – PRESENTATION OF AMORTIZATION OF CONTRACT COSTS

While neither ASC 606 nor ASC 340-40 specify the presentation of amortization of contract costs in the income statement, we believe it is appropriate for an entity to present:

- ▶ Amortization of costs to obtain a contract with a customer in the same caption as other selling and marketing costs
- ▶ Amortization of costs incurred to fulfil a contract in the same caption as cost of sales

We generally do not believe that amortization of capitalized contract costs should be presented as depreciation and amortization.

## 8.3 DISCLOSURES

### 8.3.1 Disclosure Objective



#### FASB REFERENCES

ASC 606-10-45-1, ASC 606-10-50-1 through 50-23, and ASC 340-40-50-1 through 50-6

The objective of the disclosure requirements in ASC 606 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.” Additionally, an entity is required to 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 aggregates or disaggregates 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.

To help entities achieve this objective, ASC 606 requires quantitative and qualitative disclosures about:

- ▶ Contracts with customers
- ▶ Significant judgments, and changes in judgments, made in applying the guidance to those contracts
- ▶ Assets recognized from the costs to obtain or fulfill a contract with a customer

Judgment is required to determine the appropriate level of aggregation or disaggregation of information needed to satisfy the overall disclosure objective.

The disclosure requirements in ASC 606 are applicable to each reporting period for which an income statement is presented and as of each reporting period for which a balance sheet is presented. An entity does not need to disclose information in accordance with ASC 606 if it has provided the information in accordance with other U.S. GAAP.

#### BDO INSIGHTS – DISCLOSURES

In BC331 of ASU 2014-09, the FASB acknowledged that the disclosures described in the standard must not be viewed as a checklist of minimum disclosures. Accordingly, entities do not need to include disclosures that are immaterial or not relevant; however, entities must include disclosures that are needed to meet the overall disclosure objective. Entities must make appropriate disclosures for each reporting period for which income statements are presented and as of each balance sheet date. Entities are not required to repeat disclosures if the information is already presented in the financial statements as required by other accounting standards.

The following table summarizes the annual and interim disclosures requirements for public and nonpublic entities under ASC 606:

	PUBLIC ENTITIES – ANNUAL DISCLOSURES	NONPUBLIC ENTITIES – ANNUAL DISCLOSURES	INTERIM – DISCLOSURES REQUIRED?
<b>Presentation</b>	<ul style="list-style-type: none"> <li>▶ Present or disclose contract assets separately from contract liabilities</li> <li>▶ Present or disclose unconditional rights to consideration separately as a receivable</li> </ul>	▶ Same requirements	▶ Same requirements



	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED?
<b>Overall</b>	<ul style="list-style-type: none"> <li>▶ Present or disclose revenue from contracts with customers separately from other sources of revenue (that is, revenues outside the scope of ASC 606)</li> <li>▶ Present or disclose impairment or credit losses on any receivables or contract assets arising from contracts with customers separately from impairment or credit losses from other contracts</li> </ul>	<ul style="list-style-type: none"> <li>▶ Same requirements</li> </ul>	<ul style="list-style-type: none"> <li>▶ Same requirements</li> </ul>
<b>Disaggregated Revenue</b>	<ul style="list-style-type: none"> <li>▶ Disaggregate revenue into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors</li> <li>▶ Disclose sufficient information to enable users to understand the relationship of disaggregated revenue presented in accordance with ASC 606 and revenue information disclosed for each reportable segment</li> </ul>	<p>Nonpublic entities may elect to omit the quantitative disaggregation disclosure guidance in ASC 606-10-50-5 through 50-6 and ASC 606-10-55-89 through 55-91; however, if this election is made, the entity must disclose at a minimum:</p> <ul style="list-style-type: none"> <li>▶ Revenue disaggregated according to the timing of transfer of goods or services (for example, at a point in time or over time)</li> <li>▶ Qualitative information about how economic factors (for example, type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows</li> </ul>	<ul style="list-style-type: none"> <li>▶ Public entities — Yes</li> <li>▶ Nonpublic entities — Optional</li> </ul>

	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED?
<b>Contract Balances</b>	<ul style="list-style-type: none"> <li>▶ Disclose opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers</li> <li>▶ Disclose revenue recognized in the period that was included in the contract liability balance at the beginning of the period</li> <li>▶ Explain how timing of satisfaction of performance obligations relates to the typical timing of payment and the effect those factors have on the contract asset and contract liability balances</li> <li>▶ Provide an explanation of the significant changes in the contract asset and contract liability balances during the reporting period, including qualitative and quantitative information such as: <ul style="list-style-type: none"> <li>• Changes due to business combinations</li> <li>• Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or liability</li> <li>• Impairment of a contract asset</li> <li>• 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)</li> <li>• 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)</li> </ul> </li> </ul>	<p>Nonpublic entities can elect to disclose only the opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers. The other disclosures in ASC 606-10-50-8 through 50-10 are optional.</p>	<ul style="list-style-type: none"> <li>▶ Public entities — Disclose opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers and revenue recognized in the period that was included in contract liability balance at the beginning of the period</li> <li>▶ Nonpublic entities — Optional</li> </ul>

	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED?
<b>Performance Obligations</b>	<p>Provide descriptive information about performance obligations, including:</p> <ul style="list-style-type: none"> <li>▶ 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</li> <li>▶ Significant payment terms (for example, when payment is typically 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)</li> <li>▶ The nature of the goods and 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)</li> <li>▶ Obligations for returns, refunds, and other similar obligations</li> <li>▶ Types of warranties and related obligations</li> </ul> <p>Disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).</p>	<ul style="list-style-type: none"> <li>▶ Nonpublic entities can elect to disclose only the descriptive information about performance obligations required by ASC 606-10-50-12. The other disclosures in ASC 606-10-50-12A and ASC 606-10-50-13 through 50-15 are optional.</li> </ul>	<ul style="list-style-type: none"> <li>▶ Public — Disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example changes in transaction price) and disclose information about remaining performance obligations.</li> <li>▶ Nonpublic — Optional</li> </ul>

PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED?
<p>Disclose information about remaining performance obligations:</p> <ul style="list-style-type: none"> <li>▶ Aggregate amount of transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) at the end of the reporting period</li> <li>▶ An explanation of when the entity expects to recognize revenue from remaining performance obligations either on a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations or by using qualitative information</li> <li>▶ Optional exemptions - ASC 606 includes several optional exemptions from the remaining performance obligations disclosure requirements. See discussion in Section 8.3.4.2.1.</li> </ul>		

	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED?
<b>Significant Judgments</b>	<p>Disclose the judgments and changes in judgments that significantly affect the determination of amount and timing of revenue in regard to:</p> <ul style="list-style-type: none"> <li>▶ Timing of satisfaction of performance obligations <ul style="list-style-type: none"> <li>• For performance obligations satisfied over time, disclose the methods used to recognize revenue and why the method is appropriate</li> <li>• For performance obligations satisfied at a point in time, disclose significant judgments made in evaluating when a customer obtains control of promised goods or services</li> </ul> </li> <li>▶ Transaction price and amounts allocated to performance obligations. Disclose information about methods, inputs and assumptions used for: <ul style="list-style-type: none"> <li>• 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</li> <li>• Assessing whether an estimate of variable consideration is constrained</li> <li>• 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)</li> <li>• Measuring obligations for returns, refunds, and other similar obligations</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▶ Nonpublic entities can elect to disclose only the information required by ASC 606-10-50-17 on significant judgments that affect the determination of the amount and timing of revenue recognized and ASC 606-10-50-18(a) on the method used to recognize revenue for a performance obligation satisfied over time. The other disclosures in ASC 606-10-50-18(b) through 50-20 are optional.</li> </ul>	<ul style="list-style-type: none"> <li>▶ Not required</li> </ul>

	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED?
<b>Costs to obtain or fulfill a contract</b>	<ul style="list-style-type: none"> <li>▶ Describe judgments made in determining the amount of costs incurred to obtain or fulfill a contract with a customer</li> <li>▶ Describe method of amortization</li> <li>▶ Disclose closing balances of assets recognized from costs incurred to obtain or fulfill a contract with a customer by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs)</li> <li>▶ Disclose amount of amortization and any impairment losses recognized in the reporting period</li> </ul>	▶ Not required	▶ Not required
<b>Practical Expedients</b>	▶ Disclose if an entity elects to use the practical expedient in either ASC 606-10-32-18 (about the existence of a significant financing component) or ASC 340-40-25-4 (about expensing the incremental costs of obtaining a contract).	▶ Not required	▶ Not required

### 8.3.2 Disaggregated Revenue



#### FASB REFERENCES

ASC 606-10-55-91

Although the standard requires entities to provide disaggregated revenue information, it does not prescribe specific categories to disclose. The extent to which revenues are disaggregated depends on the facts and circumstances that pertain to an entity's contracts with customers. While some entities might need to use more than one type of revenue category, others might use only one type of revenue category and still meet the requirements of the standard.

When selecting the type of category (or categories) to comply with the requirement to disclose disaggregated revenue information, an entity must consider how its revenue information has been presented for other purposes, including all of the following:

- ▶ Disclosures presented outside the financial statements (for example, earnings releases, annual reports, or investor presentations)
- ▶ Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments

- ▶ Other information that is similar to the types of information identified above 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

Following are examples of categories that might be appropriate:

- ▶ Type of good or service (for example, major product lines)
- ▶ Geographical region (for example, country or region)
- ▶ Market or type of customer (for example, government and nongovernment customers)
- ▶ Type of contract (for example, fixed-price and time-and-materials contracts)
- ▶ Contract duration (for example, short- and long-term contracts)
- ▶ 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)
- ▶ Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries)



#### DISAGGREGATED REVENUE DISCLOSURES FOR NONPUBLIC ENTITIES

While nonpublic entities are not required to provide full quantitative disaggregated revenue disclosures, those entities must at a minimum disclose disaggregated revenue according to the timing of transfer of goods or services (for example, revenue recognized over time and revenue recognized at a point of time).

Additionally, nonpublic entities must disclose qualitative information about how economic factors, such as the type of customer, geographical location of customers, and type of contract, affect the nature, amount, timing, and uncertainty of revenue and cash flows.

#### 8.3.2.1 Relationship to Segment Disclosures



#### FASB REFERENCES

ASC 606-10-55-296 and 55-297

Disclosures that satisfy the objectives of ASC 606 will often present revenues disaggregated at a different level or on a different basis than segment disclosures. Accordingly, ASC 606 requires entities to disclose sufficient information to enable financial statement users to understand the relationship between disaggregated revenue disclosures and revenue information presented for each reportable segment. There is no prescribed format for these disclosures, but ASC 606 provides an example of such disclosures as follows:

**EXAMPLE 8-5 (ADAPTED FROM ASC 606-10-55-296 AND 55-297): DISAGGREGATION OF REVENUE**

An entity reports the following segments in accordance with ASC 280: consumer products, transportation, and energy. The entity disaggregates revenue into primary geographical markets, major product lines, and timing of revenue recognition for investor presentations.

The entity analyzes the requirements in ASC 606-10-50-5 and concludes that the categories in the investor presentations can be used to meet the objective of the disaggregation disclosure requirements.

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 ASC 606-10-50-6.

Segments	Consumer Products	Transportation	Energy	Total
<b>Primary Geographical Markets</b>				
North America	\$ 900	\$ 2,000	\$ 5,000	\$ 7,900
Europe	250	700	1,100	2,050
Asia	750	300	-	1,050
	<u>\$ 1,900</u>	<u>\$ 3,000</u>	<u>\$ 6,100</u>	<u>\$11,000</u>
<b>Major Goods/Service Lines</b>				
Office Supplies	\$ 550	\$ -	\$ -	\$ 550
Appliances	900	-	-	900
Clothing	450	-	-	450
Motorcycles	-	500	-	500
Automobiles	-	2,500	-	2,500
Solar panels	-	-	1,000	1,000
Power plant	-	-	5,100	5,100
	<u>\$ 1,900</u>	<u>\$ 3,000</u>	<u>\$ 6,100</u>	<u>\$11,000</u>
<b>Timing of Revenue Recognition</b>				
Goods transferred at a point of time	\$ 1,900	\$ 3,000	\$ 1,000	\$ 5,900
Services transferred over time	-	-	5,100	5,100
	<u>\$ 1,900</u>	<u>\$ 3,000</u>	<u>\$ 6,100</u>	<u>\$11,000</u>



### BDO INSIGHTS – DISAGGREGATED REVENUES

ASC 606 requires entities to disaggregate revenues into categories that reflect how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows. Entities must review other publicly available information, including other portions of filings such as management’s discussion and analysis, investor presentations and earnings calls, and consider the revenue information in those other public communications when determining how to disaggregate revenue in the financial statement disclosures.

### 8.3.3 Contract Balances

ASC 606 requires specific disclosures regarding contract balances. The purpose of these disclosures is to provide information about the amount of revenue that is recognized in the current period that is not the result of current period performance. ASC 606 does not prescribe a specific format for these disclosures – they could be presented in a tabular or narrative format. Following is an example of potential disclosures using a combination of tabular and narrative formats:

#### EXAMPLE 8-6: CONTRACT ASSET AND LIABILITY DISCLOSURES

Entity A discloses receivables from contracts with customers separately in the balance sheet. To satisfy the other disclosure requirements for contract assets and liabilities, Entity A includes the following information in the notes to the financial statements:

	20X9	20X8	20X7
Contract asset	\$ 500	\$ 700	\$ 400
Contract liability (deferred revenue)	\$ (200)	\$ (300)	\$ (100)
Revenue recognized in the period from amounts included in the contract liability at the beginning of the period	\$ 250	\$ 100	\$ 200

The timing of revenue recognition, billings, and cash collections results in receivables, contract assets and contract liabilities. Generally, billing occurs subsequent to revenue recognition, resulting in contract assets. However, we sometimes receive advances or deposits from our customers before revenue is recognized, resulting in contract liabilities. Accounts receivable are recorded when the right to consideration becomes unconditional and are presented separately in the balance sheet. Contract assets and contract liabilities are included in other assets and deferred revenue, respectively, in the balance sheet.

In 20X9, contract assets and liabilities increased by \$20 and \$10, respectively, as a result of cumulative catch-up adjustments due to changes in transaction price. In 20X8, contract assets and liabilities increased by \$10 and \$30, respectively, as a result of cumulative catch-up adjustments due to changes in transaction price. In 20X8, contract assets and liabilities also increased by \$300 and \$70, respectively, as a result of business combinations.

Although not required, an entity could elect to meet the disclosure requirements related to contract assets and liabilities by providing a full rollforward of those balances and the applicable activity for each period presented.

### 8.3.4 Performance Obligations

#### 8.3.4.1 Qualitative Disclosures

ASC 606 requires disclosures that provide descriptive information about an entity’s performance obligations to help financial statement users understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. These disclosures must be entity-specific and complement the entity’s accounting policy disclosures. Entities must avoid boilerplate language and tailor these disclosures to their specific facts and circumstances.

ASC 606 also requires entities to disclose the amount of revenue recognized in the current period that relates to performance obligations satisfied (or partially satisfied) in previous periods. For example, if an entity changes its estimate of transaction price, the resulting amounts recognized as revenue that relate to performance obligations satisfied in previous periods must be disclosed.

#### 8.3.4.2 Remaining Performance Obligations

ASC 606 requires entities to disclose information about the transaction price allocated to remaining performance obligations, as well as when revenue will be recognized related to these obligations. This type of disclosure is sometimes referred to as a backlog disclosure as it requires disclosure of future revenue to be recorded on partially completed contracts, but may be different than other backlog disclosures that are sometimes included in filings with the SEC.

This quantitative disclosure of remaining performance obligations must only include amounts related to performance obligations in current contracts, that is, excluding renewals that have not been executed and that do not represent material rights accounted for as performance obligations under current contracts. Additionally, this disclosure does not include amounts of consideration that have been excluded from the transaction price. Entities must, however, explain whether any amounts have been excluded from the transaction prices (and therefore excluded from the disclosures), such as variable consideration that has been constrained.

Explanations of when entities expect to recognize amounts as revenue can be provided either qualitatively or quantitatively using time bands that are most appropriate for the duration of the remaining performance obligations. Judgment is required to determine which type of disclosure will be most meaningful to financial statement users.

##### 8.3.4.2.1 Optional Exemptions



#### OPTIONAL EXEMPTIONS RELATED TO THE DISCLOSURE OF TRANSACTION PRICE ALLOCATED TO REMAINING PERFORMANCE OBLIGATIONS

The standard includes four optional exemptions related to the disclosure of transaction price allocated to the remaining performance obligations, which may be applied if any of the following conditions are met:

- ▶ The performance obligation is part of a contract that has an original expected duration of one year or less.
- ▶ The entity applies the as-invoiced practical expedient.
- ▶ The variable consideration is a sales- or usage-based royalty promised in exchange for a license of IP.
- ▶ The variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied distinct good or service that forms part of a single performance obligation.

The standard includes these optional exemptions to avoid instances in which an entity would be required to estimate variable consideration for disclosure purposes, despite not being required to estimate it for recognition in the financial statements.

If an entity uses the optional exemptions, it must disclose the nature of the performance obligations, the remaining duration, and a description of the variable consideration that has been excluded from its disclosures, as well as whether any consideration is not included in the transaction price.

Following are examples of disclosures on remaining performance obligations and application of optional exemptions.

#### EXAMPLE 8-7 (ADAPTED FROM ASC 606-10-55-298 THROUGH 55-305): DISCLOSURE OF THE TRANSACTION PRICE ALLOCATED TO THE REMAINING PERFORMANCE OBLIGATIONS

On March 31, 20X1, an entity enters three contracts with separate customers to provide certain services. Each contract has a two-year noncancellable term. The description of each contract and the entity's disclosures of its remaining performance obligations for those contracts at December 31, 20X1, is included in the following:

### Contract 1: Cleaning Services – Fixed Fee – As-invoiced Practical Expedient and Related Exemption from Disclosing Remaining Performance Obligations

The entity is required to provide cleaning services to the customer over the two-year contract term. The services are typically provided at least once per month. The customer is required to pay an hourly rate of \$15.

The entity observes that it bills the customer a fixed fee for each hour of service provided and the fee corresponds directly with the value of the entity's performance completed to date. The entity elects to apply the as-invoiced practical expedient for revenue recognition. As a result, the entity elects to utilize the optional disclosure exemption and does not provide disclosures on its remaining performance obligations. The entity discloses the following:

- ▶ Election of the optional disclosure exemption
- ▶ The nature of its performance obligation
- ▶ The remaining contract duration
- ▶ Description of the variable consideration that has been excluded from the disclosure of remaining performance obligations

### Contract 2: Cleaning and Common Area Maintenance Services – Fixed Fee

The entity is required to provide cleaning and common area maintenance services to the customer as and when needed over the two-year contract term. However, the entity will provide a maximum of four visits per month. The customer is required to pay a fixed monthly fee of \$200 for both services.

Assume that the services represent an over-time performance obligation. The entity measures its progress toward satisfaction of the performance obligation using a time-based measure (see Chapters 3 and 6 on identification of performance obligation and measure of progress for revenue recognition).

Unlike in contract 1, the entity determines that the fixed fee does not correspond directly with the value of the entity's performance completed to date. Therefore, the entity concludes that the as-invoiced practical expedient for revenue recognition cannot be elected, and the related optional disclosure relief cannot be used.

The entity provides the following quantitative information in a tabular format with time bands to disclose the amount of the transaction price that has not yet been recognized as revenue and to illustrate when the entity expects to recognize that amount as revenue.

	20X2	20X3	Total
Revenue expected to be recognized as of December 31, 20X1	\$ 2,400 <sup>(a)</sup>	\$ 600 <sup>(b)</sup>	\$ 3,000
(a) \$2,400 = \$200 x 12 months			
(b) \$600 = \$200 x 3 months			

### Contract 3: Cleaning Services – Fixed Fee and Variable Performance Bonus

The entity is required to provide cleaning services to the customer as and when needed over the two-year contract term. The customer is required to pay a fixed monthly fee of \$100 and a one-time performance bonus related to a one-time regulatory review and certification of the customer's facility, which could range between \$0 and \$1,000.

Assume the following:

- ▶ The entity applies the guidance on estimating and constraining variable consideration (see Chapter 4) and estimates that it will be entitled to \$600 of the variable consideration.
- ▶ The service represents an over-time stand-ready performance obligation; each day represents a distinct service that forms part of a single performance obligation (see Chapter 3 on identification of performance obligations).
- ▶ The entity measures its progress toward satisfaction of the performance obligation using a time-based measure (see Chapter 6 on measure of progress for revenue recognition).

The entity considers the optional exemption from disclosing the information on remaining performance obligations for variable consideration and determines that the performance bonus does not qualify for that exemption. This is because:

- ▶ The bonus does not represent a royalty in exchange for a license of IP.
- ▶ The bonus is not allocated to a wholly unsatisfied promise to transfer a distinct service that forms part of a single performance obligation. Rather, the bonus relates to both satisfied and unsatisfied distinct services that form part of a single performance obligation.

Therefore, the entity concludes that the optional exemption from disclosing remaining performance obligations is not applicable. The entity provides the following disclosures:

- ▶ Quantitative information in a tabular format with time bands to disclose the amount of the transaction price that has not yet been recognized as revenue and to illustrate when the entity expects to recognize that amount as revenue.

	20X2	20X3	Total
Revenue expected to be recognized as of December 31, 20X1	\$1,500 <sup>(a)</sup>	\$375 <sup>(b)</sup>	\$1,875

(a) Transaction price = \$3,000 (\$100 x 24 months + \$600 variable consideration) recognized ratably over 24 months at \$125 per month. Revenue for 12 months in 20X2 is \$1,500 derived as \$125 x 12 months.

(b) \$375 = \$125 (ratable monthly revenue) x 3 months

- ▶ Qualitative discussion about the part of the performance bonus that has been excluded from the tabular disclosure because it was not included in the transaction price in accordance with the guidance on constraining estimates of variable consideration.

#### EXAMPLE 8-8 (ADAPTED FROM ASC 606-10-55-306 AND 55-307): REMAINING PERFORMANCE OBLIGATIONS – QUALITATIVE DISCLOSURE

On June 1, 20X1, a construction entity enters a contract with a customer to construct a building for a fixed fee of \$5 million. Assume that the construction of the building is a single performance obligation that the entity satisfies over time. As of December 31, 20X1, the entity has recognized \$2 million of revenue. The entity estimates that construction will be completed in 20X2, but it is possible that the project will be completed in the first half of 20X3.

At December 31, 20X1, the entity is required to disclose the amount of the transaction price that has not yet been recognized as revenue and when the entity expects to recognize that amount as revenue. The entity observes that the disclosure can be provided either in a quantitative manner using time bands that are most appropriate for the duration of the remaining performance obligation or by a qualitative explanation. The entity makes the following qualitative disclosure because it is uncertain about the timing of revenue recognition:

*As of December 31, 20X1, the aggregate amount of the transaction price allocated to the remaining performance obligation is \$3 million, and the entity will recognize this revenue as the building is completed, which is expected to occur over the next 12-18 months.*

### 8.3.5 Significant Judgments

Financial statement users need information regarding the entity's critical judgments to understand the nature, amount, timing, and uncertainty of the entity's revenues. Accordingly, the standard requires that entities disclose their judgments (and changes in judgments) that affect the amount and timing of revenue recognition.

#### 8.3.5.1 Judgments Related to Timing

For performance obligations satisfied over time, entities must disclose the methods used to recognize revenue and why the methods used provide a faithful depiction of the transfer of goods or services. For performance obligations satisfied

at a point in time, entities must disclose significant judgments made in evaluating when customers obtain control of the goods or services.

#### 8.3.5.2 Judgments Related to Transaction Price

Entities must 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
- ▶ Measuring noncash consideration

An entity must also disclose the methods, inputs, and assumptions used when assessing whether an estimate of variable consideration is constrained.

#### 8.3.5.3 Judgments Related to Amounts Allocated to Performance Obligations

Entities must disclose the methods, inputs, and assumptions used for allocating the transaction price, including estimating standalone selling prices of goods or services, including any judgments made in allocating discounts and variable consideration to a specific part of the contract (if applicable).

Similarly, entities must disclose judgments made in measuring obligations for returns, refunds, and other similar obligations.

#### 8.3.6 Contract Costs

Consistent with the overall disclosure objective, entities must disclose the judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer as well as the method of amortization.

Additionally, entities must disclose the closing balances of contract costs by main category of asset (for example, costs to obtain contracts, precontract costs, and setup costs) and the amount of amortization and any impairment losses recognized in the period.

#### 8.3.7 Practical Expedients and Accounting Policy Elections

ASC 606 provides several practical expedients that are meant to simplify the application of the recognition and measurement principles of the standard. A public entity must disclose if it elects either of the following practical expedients:

- ▶ **Significant financing components** – An entity need not adjust the promised amount of consideration for the effects of a significant financing component if, at contract inception, 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 is expected to be one year or less.
- ▶ **Contract costs** – An entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that otherwise would have been recognized is one year or less.

ASC 606 also provides certain accounting policy elections, which must be disclosed if elected:

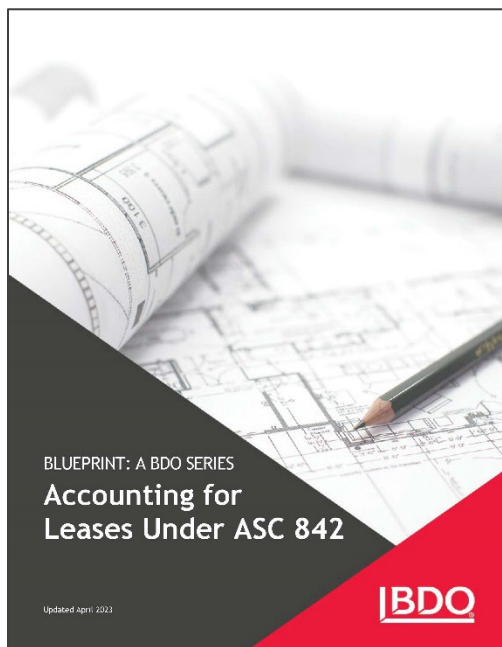
- ▶ **Shipping and handling** – Whether shipping and handling activities represent a promised service in a contract with a customer depends on when they are performed. The standard clarifies that if such activities are performed before the customer obtains control of the good, they are fulfillment activities and not a promised service. On the other hand, if shipping and handling activities occur after the customer obtains control of the good, such activities would typically be a separate service provided to the customer for which consideration would need to be allocated. However, the standard provides that an entity may elect to account for shipping and handling services provided after the customer obtains control of the good as fulfillment activities rather than as a separate service to the customer. Entities that make this election must accrue the costs of the shipping and handling if revenue is recognized for the related good before the fulfillment activities occur.
- ▶ **Sales (and similar) taxes** – An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes 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). This accounting policy election does not apply to taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process.

**8.3.7.1 Nonpublic Franchisor**

A nonpublic franchisor that elects the practical expedient in ASU 2021-02 regarding identification of performance obligations in Step 2 is required to disclose that fact. An additional disclosure is required if that entity makes the accounting policy election to recognize preopening services as a single performance obligation. See Section 3.6 for discussion on the practical expedient and policy election available to nonpublic franchisors.

# APPENDIX A – OTHER BDO BLUEPRINTS

Other publications in BDO's Blueprint series are available on the [BDO Center for Accounting Standards and Reporting Matters](#).



## [Accounting for Leases Under ASC 842](#)

This Blueprint, *Accounting for Leases Under ASC 842*, guides professionals through the application of ASC 842.

This Blueprint was updated in April 2023 for FASB amendments to ASC 842 and BDO Insights.

# CONTACTS

BOBBI S. GWINN

Professional Practice Director - Accounting  
214-665-0749 / bgwinn@bdo.com

ANGELA NEWELL

Professional Practice Partner - Accounting  
214-689-5669 / ajnewell@bdo.com

ADAM BROWN

National Managing Partner - Accounting  
214-665-0673 / abrown@bdo.com

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