# Revenue Recognition: A Whole New World

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1. Background

In May 2014, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) issued substantially converged final standards on revenue recognition. These final standards were the culmination of a joint project between the Boards that spanned many years. The FASB's Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606), was issued in three parts: (a) Section A, “Summary and Amendments That Create Revenue from Contracts with Customers (Topic 606) and Other Assets and Deferred Costs—Contracts with Customers (Subtopic 340-40);” (b) Section B, “Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables;” and (c) Section C, “Background Information and Basis for Conclusions.”

ASU 2014-09 provides a robust framework for addressing revenue recognition issues and, upon its effective date, will replace almost all pre-existing revenue recognition guidance in current U.S. generally accepted accounting principles (GAAP) (i.e., legacy GAAP), including industry-specific guidance and the Securities and Exchange Commission’s (SEC) Staff Accounting Bulletin (SAB) Topic 13, Revenue Recognition (which is also part of legacy GAAP for public entities). Implementation of the robust framework provided by ASU 2014-09 should result in improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. Except for the limited circumstances discussed in Section 11.2, implementation must occur no later than the quarter and year beginning January 1, 2018, for public entities (i.e., public business entities and certain not-for-profit entities and employee benefit plans) with a calendar year end. For all other entities with a calendar year end, implementation must occur no later than the year ending December 31, 2019.

2. Status

To help address issues identified by entities as they implement the new guidance, the FASB and IASB established the Joint Transition Resource Group (TRG). The TRG discusses implementation issues submitted by constituents and their primary purpose is to help inform the FASB and (or) IASB as to whether additional standard setting may be necessary to resolve a particular issue. While the TRG does not issue guidance, a summary of their discussions to-date and a summary of the issues discussed and next steps for each TRG meeting are available on the FASB’s website. If the TRG discussions on an issue lead the FASB and (or) IASB to believe additional standard setting is necessary, they add the issue to their respective agendas. While the FASB and IASB have moved in lockstep when addressing several of the TRG issues, there are also several issues where that has not been the case. For many TRG issues, the FASB has decided to undertake additional standard setting (e.g., provide clarifications or additional guidance), while the IASB has decided not to do so. In addition, while the FASB held TRG meetings in 2016, the IASB did not hold any TRG meetings in 2016 and has no plans to schedule any further TRG meetings. As of August 11, 2017, the FASB has not held or scheduled any TRG meetings in 2017. While the FASB’s and IASB’s new guidance on revenue recognition (as amended) continues to be converged in many important respects, the extent of that convergence is less than it was when ASU 2014-09 and International Financial Reporting Standard (IFRS) 15, Revenue from Contracts with Customers, were originally issued given the different approaches each Board has taken to addressing implementation issues.

As of August 11, 2017, the FASB has issued the following ASUs to revise the guidance originally included in ASU 2014-09 and clarify its applicability:

- 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 2016-12, *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 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*

• ASU 2017-10, *Service Concession Arrangements (Topic 853): Determining the Customer of the Operation Services*

Additional, but much less pervasive, revisions to the guidance originally included in ASU 2014-09 are pending as a result of: (a) the FASB’s proposed ASU, *Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made* (which was issued on August 3, 2017), and (b) the FASB’s project, *Collaborative Arrangements: Targeted Improvements* (which was in the initial deliberations stage as of August 11, 2017).

For information about all of the FASB’s pending and finalized clarifications and revisions to the guidance originally included in ASU 2014-09, refer to our summary, *Revenue recognition: In motion.*

The American Institute of Certified Public Accountants (AICPA) has organized several industry-specific task forces, which meet regularly to identify and provide guidance on implementation issues. The AICPA’s ultimate objective is to develop a comprehensive nonauthoritative revenue recognition guide that provides helpful discussion and illustrative examples on how to apply the new guidance to contracts in various industries. The AICPA decided to publish content for the guide as it is completed, instead of waiting until all of the content is completed. As a result, the AICPA Audit and Accounting Guide, *Revenue Recognition* (the Revenue Recognition AAG), has been published and includes discussion of the following: (a) the general accounting and auditing considerations related to the new guidance and (b) various implementation issues in several industries. The AICPA will be updating the guide with additional industry-specific implementation issues as they are completed. Additional information about the AICPA’s industry-specific task forces and its Revenue Recognition AAG can be found on its [website](#).

Virtually all entities will be affected to some extent by the new guidance added to the FASB’s Accounting Standards Codification (ASC) by ASU 2014-09, as subsequently amended by the ASUs listed earlier, which includes the guidance in:

• ASC 606, “Revenue from Contracts with Customers”

• ASC 340-40, “Other Assets and Deferred Costs – Contracts with Customers”

• ASC 610-20, “Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets”

The new guidance provides the basis for this white paper, which should be used to gain an initial understanding of the new guidance and whether this guidance could result in significant changes to the timing and amount of revenue recognized by an entity. Discussion is provided on the scope of the new guidance, its core principle and key steps, presentation and disclosure requirements and effective date and transition provisions. In addition, application of the principles in the new guidance to specific terms in a customer contract or specific types of transactions is also discussed.

### 3. Significant changes expected

While the policies used by almost all entities to account for revenue and certain related costs will be affected by the new guidance, the degree of change to a specific entity’s revenue recognition policies and the effects the changes have on the entity’s financial statements will vary depending on the nature and terms of the entity’s revenue-generating transactions. In addition, entities in some industries will likely be
affected by the new guidance more than entities in other industries. For example, while the revenue recognition policies for the normal course transactions of a traditional retailer will need to change so that they are aligned with the principles and guidance in ASC 606, those changes may not have a significant effect on the timing and amount of revenue recognized by the retailer. Conversely, the effects of the changes to a technology entity’s revenue recognition policies to align them with the principles and guidance in ASC 606 may result in significant changes to the timing and amount of revenue recognized by that entity (refer to our white paper, Changes to revenue recognition in the technology industry, for additional information). However, it is important to note that entities in virtually all industries will be significantly affected by the disclosure requirements in the new guidance.

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

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

- **Variable consideration.** Use of a model that may result in estimates of variable consideration being included in the transaction price (and recognized as revenue) sooner than they would be under legacy GAAP

- **Significant financing component.** Incorporation of a significant financing component (caused by either advance payment or deferred payment terms with the customer) into the measurement of revenue (with certain exceptions), which is only done today under legacy GAAP in the context of accounting for long-term receivables

- **Licenses.** Use of one comprehensive approach to account for all licenses and rights to use intellectual property (IP) instead of the limited-scope industry-specific models in legacy GAAP

- **Multiple-element arrangements.** Use of one comprehensive approach to account for multiple-element arrangements instead of the general model (i.e., ASC 605-25, “Revenue Recognition – Multiple-Element Arrangements”) and industry-specific models in legacy GAAP

- **Costs related to customer contracts.** Requirement to capitalize certain costs related to a contract with the customer (e.g., sales commissions, setup costs) under certain circumstances instead of having the option to do so in certain cases under legacy GAAP

In addition, the disclosure requirements in the new guidance will cause the volume of revenue-related information disclosed in the financial statements to significantly increase, particularly for public entities. These and other changes are highlighted throughout the remainder of this white paper. Whether, and the degree to which, any of the changes introduced by the new guidance affect an entity can only be determined after performing a comprehensive analysis of customer contracts in the context of that guidance.

### 4. Scope

ASC 606 addresses revenue from contracts with customers. Revenue is defined in the Master Glossary of the ASC as “Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.” While the scope of ASC 606 is limited to revenue, as discussed in Section 4.3, many aspects of the guidance in ASC 606 are also applicable to certain transfers of nonfinancial (and in substance nonfinancial) assets to counterparties other than customers.
4.1. General scope requirements

All customer contracts fall within the scope of ASC 606 except for the following: (a) lease contracts, (b) all contracts within the scope of ASC 944, “Financial Services—Insurance,” (c) various contractual rights or obligations related to financial instruments, (d) guarantees (including the related fees) within the scope of ASC 460, “Guarantees,” other than warranties and (e) certain nonmonetary exchanges. Other applicable guidance exists in the ASC related to the accounting for these types of contracts.

Pending changes

As mentioned earlier in this white paper, changes have been proposed by the FASB with respect to when a transfer of assets from a resource provider (e.g., a government) to a not-for-profit entity should be accounted for as: (a) a contribution received in accordance with the relevant guidance in ASC 958-605, “Not-for-Profit Entities – Revenue Recognition,” or (b) an exchange transaction in accordance with ASC 606. Under the proposed ASU, an exchange transaction would be defined as a reciprocal transfer in which what is transferred by each party in the transaction is of approximately commensurate value to what is received by each party in the transaction. In addition, the proposed ASU would clarify that transfers of assets by a resource provider (e.g., government) to a recipient (e.g., hospital) in connection with an existing transaction between the recipient and an identified customer (e.g., patient insured under the Medicare program) are not contributions and should instead be accounted for in accordance with other applicable guidance (e.g., ASC 606). The proposed ASU also includes additional implementation guidance (including several new examples) to help determine: (a) whether a transfer is an exchange transaction or contribution and (b) whether contributions are conditional or unconditional for purposes of applying ASC 958-605. For information about these pending changes and other pending and finalized changes, refer to our summary, Revenue recognition: In motion.

There are no other scope exceptions in ASC 606 for certain industries that have had their own customer contract-based revenue recognition guidance in legacy GAAP. Examples of industries that are subject to ASC 606 and that no longer have their own separate industry-specific revenue recognition guidance include the construction, real estate, software and franchising industries.

Spotlight on change

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

4.2. Definition of a customer

Customer is defined in ASC 606-10-15-3 as “a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.” In most cases, applying this definition to determine whether the counterparty to a contract is a customer will not require much analysis. In other cases, such as contracts with a collaborator or partner (e.g., two companies agree to collaborate on the development of a new drug), more analysis will be required to determine whether the collaborator or partner meets the definition of a customer. For service concession arrangements within the scope of ASC 853, “Service Concession Arrangements,” the grantor is considered the customer of the operation services provided by the operating entity.
Pending changes

Changes are being considered with respect to when transactions between entities in a collaborative arrangement are within the scope of ASC 606.

For information about these pending changes and other pending and finalized changes, refer to our summary, Revenue recognition: In motion.

In certain circumstances, revenue can be generated by contracts with counterparties that are not customers (e.g., income replacement and subsidy programs in the agriculture industry, alternative revenue programs of utilities and contributions received by not-for-profit entities). Because this revenue does not come from contracts with customers, the guidance in ASC 606 does not apply and the guidance in legacy GAAP remains applicable.

4.3. Sales of nonfinancial (and in substance nonfinancial) assets to counterparties other than customers

An entity may transfer (i.e., sell) nonfinancial assets that are not an output of its ordinary activities. For example, a bakery may sell its used delivery trucks to a third party, or a manufacturer may sell some of its used manufacturing equipment to a third party. In general, these types of transfers are accounted for under ASC 610-20. Provided in this section of the white paper is an overview of the scope of and guidance in ASC 610-20.

4.3.1. Scope of ASC 610-20

In general, ASC 610-20 applies to transfers (i.e., sales) of nonfinancial assets and in substance nonfinancial assets to counterparties other than customers. However, certain transfers of nonfinancial (and in substance nonfinancial) assets to counterparties other than customers are excluded from the scope of ASC 610-20, including, for example, sales of subsidiaries or groups of assets that meet the definition of a business used in ASC 805, “Business Combinations,” sale-leaseback transactions, conveyances of oil and gas mineral rights and nonmonetary transactions. For a complete list of the transfers of nonfinancial (and in substance nonfinancial) assets that are excluded from the scope of ASC 610-20, refer to ASC 610-20-15-4.

4.3.1.1. Nonfinancial assets

Nonfinancial assets include tangible assets (e.g., delivery trucks, equipment) and intangible assets (e.g., a trademark, patented technology). It is important to note that ASC 610-20 addresses the transfer of intangible assets, not the license of intangible assets. In addition, whether there is a carrying amount on the entity’s books for the intangible assets transferred depends in large part on whether the intangible assets were internally generated or acquired by the entity.

4.3.1.2. In substance nonfinancial assets

ASC 610-20-15-5 defines an in substance nonfinancial asset as “a financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets.” Consider a situation in which a bakery transfers its used delivery trucks and certain financial assets to a counterparty. If the delivery trucks make up substantially all of the fair value of the assets transferred, the financial assets that are being transferred with the delivery trucks would be considered in substance nonfinancial assets for purposes of applying ASC 610-20.

To determine whether the sale of an ownership interest in a consolidated subsidiary that is not a business falls within the scope of ASC 610-20, the entity must look through to the nature of the assets held by the subsidiary. Consider a situation in which a consolidated subsidiary holds real estate assets and does not meet the definition of a business used in ASC 805. If substantially all of the fair value of the consolidated
If the subsidiary’s assets are real estate (i.e., nonfinancial) assets, then the sale of an ownership interest in that consolidated subsidiary would be considered the sale of an in substance nonfinancial asset within the scope of ASC 610-20. Conversely, if less than substantially all of the fair value of the consolidated subsidiary’s assets are nonfinancial assets, then the sale of an ownership interest in that consolidated subsidiary would be within the scope of the derecognition or deconsolidation (as applicable) guidance in ASC 810-10-40.

ASC 610-20-15-5 to 15-10 provides additional information about the definition of an in substance nonfinancial asset.

4.3.1.3. Counterparty

A key differentiator between the types of transactions that fall within the scope of ASC 610-20 vs. ASC 606 is the counterparty to the transactions. Under ASC 610-20, the counterparty is not a customer, while under ASC 606, the counterparty is a customer. As discussed earlier, customers obtain goods or services that are an output of the entity’s ordinary activities. As such, when the output of an entity’s ordinary activities is delivery trucks, the counterparties to which the entity sells its delivery trucks are customers, and the accounting for those sales falls within the scope of ASC 606. Conversely, when the output of an entity’s ordinary activities is baked goods, the counterparties to which the entity transfers its used delivery trucks are not customers, and the accounting for those transfers falls within the scope of ASC 610-20.

4.3.1.4. Contracts only partially in the scope of ASC 610-20

To the extent the promises in a contract include more than transferring nonfinancial (and in substance nonfinancial) assets within the scope of ASC 610-20 (e.g., the contract also includes a guarantee), the promises within the scope of ASC 610-20 and the promises outside the scope of ASC 610-20 should be separated and measured based on the same guidance used to separate and measure portions of a contract that are partially within the scope of ASC 606 and partially within the scope of other guidance in the ASC, which is discussed in Section 4.4.

4.3.2. Accounting model

ASC 610-20 requires an entity to apply certain guidance in ASC 810, “Consolidation,” and ASC 606 when accounting for the transfer of nonfinancial (and in substance nonfinancial) assets within its scope.

4.3.2.1. Determining if the entity has a controlling financial interest in the transferred nonfinancial (and in substance nonfinancial) assets

The guidance in ASC 810 is applied first to determine whether the entity retains a controlling financial interest in the transferred nonfinancial (and in substance nonfinancial) assets. Determining whether that is the case depends on whether those assets were transferred directly to the counterparty or indirectly through the transfer of ownership interests in a consolidated subsidiary that is not a business:

- **Directly to the counterparty.** The entity determines whether it has a controlling financial interest in the counterparty.
- **Indirectly through the transfer of ownership interests in a consolidated subsidiary.** The entity determines whether it continues to have a controlling financial interest in the consolidated subsidiary.

If the entity retains a controlling financial interest in the transferred nonfinancial (and in substance nonfinancial) assets, those assets are not derecognized and a gain or loss is not recognized. Instead, the effects of the transfer are accounted for in equity similar to the accounting for other transactions in which the parent’s controlling financial interest in a subsidiary decreases, but remains a controlling financial interest (i.e., transactions in which the parent does not lose its controlling financial interest in a subsidiary).
4.3.2.2. Recognizing, measuring, presenting and disclosing the transfer of nonfinancial (and in substance nonfinancial) assets in which the entity did not retain a controlling financial interest

If the entity does not retain a controlling financial interest in the transferred nonfinancial (and in substance nonfinancial) assets, it takes the following steps (which are mirrored after those in ASC 606) to account for the transfer:

- **Identify the contract with the counterparty.** To identify the contract with the counterparty, the entity applies the guidance discussed in Sections 5.1.1 and 5.1.2. A key element of that guidance is whether the contract existence criteria are met. If they are not met, the transferred nonfinancial (and in substance nonfinancial) assets are not derecognized and the entity continues to amortize or depreciate the assets as otherwise appropriate and apply the impairment guidance otherwise applicable to the assets. Any consideration received by the entity is recognized as a liability until either: (a) the contract existence criteria are met and a gain or loss should otherwise be recognized under ASC 610-20 or (b) one of the circumstances discussed in Section 5.1.2 arises (e.g., the consideration received is nonrefundable and the contract has been terminated).

- **Identify each distinct nonfinancial (and in substance nonfinancial) asset.** If the transfer involves multiple nonfinancial (and in substance nonfinancial) assets that will be transferred to the counterparty at different points in time, the entity applies the guidance discussed in Section 5.2.2 related to identifying distinct promised goods or services to identify each distinct nonfinancial (and in substance nonfinancial) asset that is part of the transfer. To the extent a nonfinancial (or in substance nonfinancial) asset is not distinct, it is combined with one or more other nonfinancial (or in substance nonfinancial) assets in the transfer until the group of assets would be considered distinct.

- **Determine the consideration promised.** The consideration promised in a transfer of nonfinancial (and in substance nonfinancial) assets includes its transaction price and the carrying amount of any liabilities assumed or relieved by the counterparty in the transfer.
  - **Transaction price.** The transaction price includes fixed cash consideration, noncash consideration, variable consideration (subject to an overall constraint) and consideration payable to the counterparty. It may also need to reflect a significant financing component, depending on the facts and circumstances. The guidance discussed in Section 5.3 is used to determine the transaction price. A type of noncash consideration that may be promised in a transfer of nonfinancial (and in substance nonfinancial) assets is a noncontrolling interest in an entity (e.g., an equity method investment). In addition, when the transfer of nonfinancial (and in substance nonfinancial) assets results in the entity indirectly losing control of those assets through the transfer of ownership interests in a consolidated subsidiary, any noncontrolling interest retained in that subsidiary should be treated as noncash consideration for purposes of determining the transaction price.
  - **Liabilities assumed or relieved.** In general, the carrying amount of any liabilities assumed or relieved by the counterparty in the transfer of nonfinancial (and in substance nonfinancial) assets should be included in the consideration promised. However, if the gain or loss on the transfer is recognized before the liabilities assumed or relieved should be derecognized, the entity applies the variable consideration constraint discussed in Section 5.3.3 to determine how much (if any) of the carrying amount of the liabilities should be included in the consideration promised for purposes of calculating the gain or loss on the transfer.

- **Allocate the consideration promised to the distinct nonfinancial (and in substance nonfinancial) assets.** If the transfer involves multiple distinct nonfinancial (and in substance nonfinancial) assets that will be transferred to the counterparty at different points in time, the consideration promised for the transfer, as well as any subsequent changes in the amount of the consideration promised, should be allocated to the distinct nonfinancial (and in substance nonfinancial) assets using the guidance discussed in Section 5.4. This guidance results in using the standalone selling prices of the distinct
nonfinancial (and in substance nonfinancial) assets to allocate the consideration promised on a relative standalone selling price basis to each of those assets, with limited exceptions.

- **Derecognize each distinct nonfinancial (and in substance nonfinancial) asset and recognize a gain or loss upon transfer of control.** The guidance discussed in Section 5.5.1 should be used to determine the point in time that control of the distinct nonfinancial (and in substance nonfinancial) assets has transferred to either the counterparty or the legal entity, depending on the facts and circumstances. The gain or loss is measured as the difference between the consideration promised that was allocated to the distinct nonfinancial (and in substance nonfinancial) assets transferred and the carrying amount of those assets.

- **Derecognize any liabilities assumed or relieved by the counterparty when they are extinguished.** While the gain or loss that is recognized upon transfer of control may reflect the carrying amount of any liabilities assumed or relieved by the counterparty in the transfer, those liabilities are only derecognized when either: (a) the counterparty pays off the liabilities and the entity is relieved of its obligations or (b) the entity is legally released as the primary obligor for the liabilities.

- **Presenting contract assets and contract liabilities on the balance sheet.** As discussed in Section 9, the entity should recognize a contract asset or contract liability for the difference between its performance (transferring the nonfinancial [and in substance nonfinancial] assets) and the counterparty’s performance (transferring the consideration promised, including assuming or relieving any liabilities included in the transfer). For example, if the gain or loss on the transfer is recognized before the liabilities are derecognized, the entity should recognize a contract asset for the excess of the allocated consideration promised over the carrying amount of the transferred assets. Conversely, if the gain or loss is recognized after the liabilities are derecognized, the entity should recognize a contract liability for the excess of the carrying amount of the transferred assets over the allocated consideration promised.

- **Presenting the gain or loss on the income statement.** The gain or loss on a transfer of nonfinancial (and in substance nonfinancial) assets that is not a discontinued operation should be included in income from continuing operations before income taxes. In addition, if an entity presents an operating income (or similar) subtotal, the gain or loss should be reflected in that subtotal.

- **Disclosing the transfer.** Information about the transfer should be disclosed in accordance with ASC 360-10-50-3 to 50-3A.

**Spotlight on change**

In general, legacy GAAP related to revenue recognition is only applied to revenue-generating transactions. Key aspects of ASC 606 should be applied to more than just revenue-generating transactions. This creates the potential for significant changes in how an entity recognizes gains or losses on the sale of a nonfinancial (or in substance nonfinancial) asset to a counterparty other than a customer.

**4.3.3. Effective date and transition**

The effective date of the guidance in ASC 610-20 is the same as the effective date for ASC 606 and ASC 340-40, which is discussed in Section 11. In addition, the clarified definition of a business provided in ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business, should be adopted at the same time the guidance in ASC 610-20 is adopted.

As discussed in Section 12, an entity may apply one of two transition methods upon its initial application of ASC 606 and ASC 340-40. Upon its initial application of ASC 610-20, an entity may apply the same transition method used in adopting ASC 606 and ASC 340-40 or the other transition method. If different transition methods are used, the entity should disclose that fact.
Also as discussed in Section 12, to the extent the entity elects any of the practical expedients available under the transition methods, it must consistently apply the elected practical expedient(s) to all contracts in all periods presented. However, an entity may elect different practical expedients in its adoption of ASC 610-20 than it elected in its adoption of ASC 606 and ASC 340-40.

4.4. Customer contracts only partially in the scope of ASC 606

A contract may be partially within the scope of ASC 606 and partially within the scope of other guidance in the ASC. In this situation, the entity is required to separate and measure portions of a contract within the scope of other guidance in accordance with that guidance. If the other guidance does not state how to separate and (or) measure portions of a contract within its scope, the guidance in ASC 606 is applied. The amount allocated to the portion of a contract within the scope of other guidance is recognized based on that other guidance, and the amount allocated to the remaining portion is recognized in accordance with ASC 606.

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

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

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

5. Core principle and key steps

The core principle underlying the guidance in ASC 606, which is included in ASC 606-10-10-2, is to “recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or
services.” ASC 606-10-05-4 sets out the following steps for an entity to follow when applying the core principle to its revenue-generating transactions:

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

5.1. **Identify the contract with a customer (Step 1)**

5.1.1. **General requirements of identifying the customer contract**

Because ASC 606 provides guidance on how an entity should account for contracts with its customers, it is important to determine whether a customer contract exists. A contract is defined in ASC 606-10-25-2 as “an agreement between two or more parties that creates enforceable rights and obligations.”

By definition, an agreement (whether written, oral or implied based on the entity’s usual business practices) must be enforceable for it to be considered a contract. The enforceability of a right or obligation is a legal determination. An entity’s enforceable rights and obligations in a revenue-generating transaction typically include its obligation to provide specific goods or services to the customer and its right to receive payment for the specific goods or services provided.

An additional consideration in evaluating whether there is a customer contract for accounting purposes relates to whether the agreement provides the unilateral, enforceable right to each party to terminate the agreement with no compensation to the other party if it is wholly unperformed. If both parties have such a right, a contract does not exist for accounting purposes. Wholly unperformed means that the entity has not satisfied any part of its performance obligations and the customer has not paid, or is not obligated to pay, any of the related consideration.

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

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

These criteria are first evaluated at contract inception and, if all of the criteria are met, they only need to be reassessed if there is a significant change in circumstances. While the reassessment should not result in the reversal of any revenue already recognized, an entity should consider whether any receivables or contract assets recognized before the significant change in circumstances are impaired.
In situations in which one or more of the contract existence criteria is not met at contract inception, the entity should reassess the criteria each reporting period (as necessary) to determine whether all of the criteria subsequently are met. At the point in time that all of the criteria are met, the remaining steps in the revenue recognition model in ASC 606 are applied. Until that point in time, the entity recognizes a liability for any consideration received and only recognizes that liability as revenue when the amounts paid by the customer are nonrefundable and one of the following is true:

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

**Spotlight on change**

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

**5.1.2. Collection is probable**

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

- The purpose of assessing whether collection is probable is solely to determine whether there is a substantive transaction between the entity and its customer. In other words, once the determination is made that a contract exists for purposes of applying ASC 606, collectibility generally does not affect the subsequent measurement or recognition of revenue except, for example, when a significant financing component exists.
- The collectibility assessment is focused on the customer’s ability and intention to pay substantially all, and not all, of the consideration to which the entity otherwise expects to be entitled.
- The amount evaluated for collectibility is based on the goods or services that will be transferred to the customer, which may not be all of the promised goods or services in the contract.
Before evaluating the likelihood of collection, the entity must determine the amount that should be evaluated for collectibility. To do so, there are two primary considerations:

- **Transaction price.** The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to its customer. An entity considers a number of factors in estimating the transaction price, including: (a) whether the entity intends to offer the customer a price concession and (b) whether the customer has a valid expectation of receiving a price concession based on the entity’s customary business practices, published policies or specific statements. In general, the entity does not take the customer’s credit risk into consideration when estimating the transaction price except, for example, when the customer contract includes a significant financing component (which requires use of a discount rate that reflects the customer’s credit risk when estimating the transaction price).

- **Ability to mitigate credit risk.** An entity may be able to mitigate its credit risk through its ability to stop transferring promised goods or services upon nonpayment by the customer and its practice of doing so. Taking into consideration the entity’s ability to mitigate its credit risk could, depending on the facts and circumstances, result in the amount evaluated for collectibility being an amount less than the transaction price. This is consistent with the focus of the collectibility criterion on the amount the entity expects to be entitled to for the goods or services that will be transferred to the customer, which may not be all of the promised goods or services in the contract. Another way an entity may be able to mitigate its credit risk is by requiring its customers to pay in advance. While the entity has mitigated some of its credit risk in this situation, the amount evaluated for collectibility would still include the portion of the transaction price prepaid by the customer. However, collection of at least the amount prepaid would be considered probable if the customer’s prepayment is nonrefundable. The right to repossess transferred goods or services should not be considered in assessing the entity’s ability to mitigate its credit risk.

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

Determining whether the customer has the ability and intention to pay substantially all of the consideration to which the entity will be entitled in exchange for the promised goods or services that will be transferred to the customer requires a significant amount of judgment to be exercised and the consideration of all the relevant facts and circumstances, which includes contractual terms as well as the entity’s customary business practices and knowledge of the customer.

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

- **Is the change in circumstances significant?** If so, the entity needs to reassess all of the contract existence criteria, including whether the likelihood of collecting substantially all of the amount to which it will be entitled in exchange for the goods or services that will be transferred to the customer is still probable. An example of a significant change in circumstances related to whether collectibility continues to be probable is a significant deterioration in a customer’s credit risk and ability to access credit due to the loss of major customers.

- **Does the change in circumstances affect any receivable or contract asset recorded for the customer contract?** After a receivable (which is an unconditional right to receive consideration) is recognized in conjunction with the accounting for a customer contract in accordance with ASC 606, the subsequent
accounting for that receivable is based on the guidance in ASC 310, "Receivables" (or the recently issued ASC 326, “Financial Instruments—Credit Losses,” once it is adopted). Any credit losses recognized in accordance with ASC 310 (or ASC 326) are presented as bad debt expense (and not a reduction of revenue). In addition, any contract asset recognized in conjunction with the accounting for a customer contract in accordance with ASC 606 should be evaluated for impairment in accordance with ASC 310 (or ASC 326).

To illustrate application of this guidance, consider a situation in which the entity’s stated price for a product or service is $5,000. However, the entity intends to offer a price concession of $1,000 because establishing a positive relationship with this customer could help forge relationships with other potential customers. Assuming no other factors exist that could affect the transaction price, the entity concludes that the amount it expects to be entitled to (i.e., the transaction price) is $4,000. Next the entity evaluates whether it can mitigate its credit risk such that an amount less than $4,000 should be evaluated for collectibility. The evaluation indicates that $4,000 is the amount that should be evaluated for collectibility. As a result, the entity evaluates whether collection of the $4,000 is probable. If it is probable (and all the other contract existence criteria are met), the entity would recognize revenue of $4,000 when it satisfies the related performance obligation(s). If collection is not probable (either in whole or in part), the entity would not recognize any revenue until collection is probable and ASC 606 is applied or until the amounts paid by the customer are nonrefundable and one of the following is true: (a) the entity has no remaining performance obligations and it has received all, or substantially all, of the $4,000, (b) termination of the contract has occurred or (c) the entity has: (i) transferred control of the goods or services to which any nonrefundable consideration relates and (ii) stopped transferring additional goods or services to the customer and is under no obligation to transfer any additional goods or services. Assume the entity concludes that collection of $4,000 is probable and the entity recognizes accounts receivable and revenue in the amount of $4,000 based on the appropriate application of ASC 606. Subsequently, if there is a change in circumstances that affects the customer’s ability to pay, the entity should recognize the effects of a credit loss in accordance with ASC 310 (or ASC 326) and present it as bad debt expense. Alternatively, if the subsequent change in circumstances causes an entity to change the amount of the price concession given to the customer, that change is reflected in the transaction price and, ultimately, the amount of revenue recognized.

5.1.3. Combining contracts

While ASC 606 generally applies to individual contracts, criteria are provided to assess whether individual contracts with the same customer (or parties related to the customer) that are entered into at or near the same time should be combined for accounting purposes. If one or more of the following criteria are met, individual contracts with the same customer (or parties related to the customer) that are entered into at or near the same time are combined for accounting purposes:

- The contracts were negotiated as a package and share the same commercial objective.
- The consideration to be paid under one contract is tied to the other contract’s price or performance.
- The contracts include goods and (or) services that represent a single performance obligation.

**Practical expedient**

ASC 606 may be applied to a portfolio of similar contracts if doing so is not reasonably expected to result in materially different outcomes compared to individually accounting for the contracts.

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

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

The accounting model applied to a contract modification under ASC 606 depends on a number of factors, including the pricing of the modification, whether any new products or services added by the modification are distinct and whether any of the remaining goods or services are part of a partially satisfied single performance obligation. As shown in the flowchart on the next page, a contract modification could be accounted for as any of the following depending on the facts and circumstances: (a) a separate contract, (b) the termination of one contract and execution of a new contract (which results in prospective treatment) or (c) part of the original contract (which could result in recognition of a cumulative catch-up adjustment).
5.2. **Identify the performance obligations in the contract (Step 2)**

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

### 5.2.1. Identifying promises to transfer goods or services

Promises to transfer goods or services come in a variety of shapes and sizes. Some are obvious, such as the goods sold by a manufacturer or retailer, the cleaning services provided by a professional cleaner and the software license provided by a software company. Others are less obvious, such as a when-and-if-
available software upgrade right and the option to purchase an additional good or service in the future at a discount. The key is for an entity to scrutinize its customer contracts and identify all of the promises to transfer goods or services to the customer.

**Promised goods or services immaterial in the context of the contract**

An entity may decide not to identify promised goods or services that are immaterial in the context of the contract for further evaluation under ASC 606. However, if the entity makes this decision, the costs related to the goods or services that are immaterial in the context of the contract should be accrued if revenue related to the contract is recognized before those promised goods or services are transferred to the customer.

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

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

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

**Accounting policy election**

Shipping and handling activities that occur before the customer obtains control of the promised goods (e.g., FOB destination) should be considered fulfillment activities and not promised services that have to be further evaluated under ASC 606. An entity may elect an accounting policy under which shipping and handling activities that occur after the customer obtains control of the promised goods (e.g., FOB shipping point) are treated as fulfillment activities and not promised services that have to be further evaluated under ASC 606. However, under this accounting policy election, the costs related to the shipping and handling activities should be accrued when the entity recognizes revenue for the related promised goods. If this accounting policy is not elected, the entity would have to further evaluate the shipping and handling activities as a promised service under ASC 606.

**Spotlight on change**

While legacy GAAP includes various multiple-element arrangement models, there is very little discussion in those models with respect to what constitutes an element or deliverable. As a result, the introduction of guidance on the subject of identifying promises to transfer goods or services could ultimately affect the units of account identified by an entity for revenue recognition purposes.

**5.2.2. Separating promises to transfer goods or services into performance obligations**

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

- **Capable of being distinct.** If a customer can benefit from the promised good or service on its own or by combining it with other resources readily available to the customer, then the good or service is capable of being distinct.

- **Separately identifiable from other promises in the contract.** If the promised good or service is distinct within the context of the contract, it is separately identifiable from the contract’s other promised goods or services.

Additional information about each criterion is provided in the remainder of this section. The evaluation of whether a promised good or service is distinct should be performed at contract inception for each promised good or service in the contract.

5.2.2.1. Capable of being distinct

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

5.2.2.2. Separately identifiable from other promises in the contract

To determine whether a promised good or service is separately identifiable from other promised goods or services in the contract, the entity must ascertain which of the following best describes its promise within the context of the specific contract:

- **The promise within the context of the specific contract is to transfer the promised good or service individually.** If this best describes the entity’s promise within the context of the specific contract, then the promised good or service is separately identifiable from the other promises in the contract.

- **The promise within the context of the specific contract is to transfer a combined item or items to which the promised good or service is an input.** If this best describes the entity’s promise within the context of the specific contract, then the promised good or service is not separately identifiable from the other promises in the contract.

Indicators are provided to assist in determining whether a promised good or service is separately identifiable from one or more other promised goods or services in the contract. Answering yes to any of the following questions is an indication that the promised good or service is *not* separately identifiable from one or more other promised goods or services in the contract:

- Is the entity providing a significant service of integrating the promised good or service with one or more of the other promised goods or services in the contract, with the result of that integration being one or more of the combined outputs contracted for by the customer?
Does the promised good or service significantly modify or customize one or more of the other promised goods or services in the contract, or is the promised good or service significantly modified or customized by one or more of the other promised goods or services in the contract?

Is the promised good or service highly interdependent or highly interrelated with one or more of the other promised goods or services in the contract, such that each of the promised goods or services is significantly affected by one or more of the other promised goods or services?

To appreciate the effects these indicators can have on determining whether a promised good or service is separately identifiable from the other promised goods or services in the contract, consider the following examples:

- **Construction of a building.** Most, if not all, of the promised goods and services involved in the entity's construction of a building for a customer would likely not be considered separately identifiable from each other because of the level of integration required to transform those goods and services into the building for which the customer contracted. In this situation, the entity's promise within the context of the contract would likely be to transfer a building (i.e., a combined item) to which most, if not all, of the promised goods or services are inputs.

- **Software license and installation services.** If a customer contract includes a license for the entity's software as well as installation services that require substantial customization of the software, the software and installation services would likely not be considered separately identifiable from each other because of the level of customization required to make the software work in the customer's environment. In this situation, the entity's promise within the context of the contract would be to transfer installed software (i.e., a combined item) to which both the software and installation services are inputs.

### 5.2.2.3. Accounting consequences

If a promised good or service is distinct, it is considered a performance obligation and accounted for separately. However, a series of distinct promised goods or services that are substantially the same should be considered a single performance obligation and accounted for as one unit of account if each of the goods or services has the same pattern of transfer to the customer as a result of: (a) each of the goods or services otherwise being considered satisfied over time and (b) the entity otherwise having to use the same method of measuring progress toward completion for each of the goods or services.

Examples of the types of customer contracts that may, depending on the facts and circumstances, include a series of distinct promised goods or services that should be accounted for as a single performance obligation are long-term contracts for hotel management services and transaction processing services.

**Practical expedient**

ASC 606 may be applied to a portfolio of similar performance obligations across multiple customer contracts for accounting purposes if doing so is not reasonably expected to result in materially different outcomes compared to individually accounting for the performance obligations.

Promised goods or services that are not distinct are combined until the group of promised goods or services is considered distinct, at which point that group is considered a performance obligation and accounted for separately. It is possible that all of the promised goods or services in the contract might have to be accounted for as a single performance obligation. This happens when none of the promised goods or services are considered distinct on their own or together with less than all of the other promised goods or services in the customer contract.
Spotlight on change
In legacy GAAP, there is a general multiple-element arrangement model as well as models that focus on specific industries (e.g., software, construction). The criteria used to determine whether an element should be treated separately for accounting purposes under these models are different from the criteria in ASC 606. For example, under the general multiple-element arrangement model in legacy GAAP, a delivered element must have standalone value to the customer to be accounted for separately. If the element is sold separately by the entity or another party, it is considered to have standalone value to the customer. The analysis of whether a promised good or service is distinct under ASC 606 requires consideration of more factors than just whether the promised good or service is sold separately. This difference could lead to the identification of different units of account for revenue recognition purposes (e.g., goods and services accounted for separately under ASC 605-25 may need to be bundled together under ASC 606).

5.3. Determine the transaction price (Step 3)

5.3.1. General requirements of determining the transaction price
Transaction price is defined in ASC 606-10-32-2 as “the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes).” In addition to the contract terms, the entity’s customary business practices should also be taken into consideration in determining the transaction price. The entity should assume that the contract will be fulfilled in accordance with its terms and customary business practices for purposes of determining the transaction price. In other words, the entity should not assume or consider cancellation, renewal or modification of the contract.

Accounting policy election
An entity may elect an accounting policy under which it excludes from the transaction price all sales and similar taxes collected from customers. If this accounting policy is not elected, the entity must determine whether it is a principal or an agent with respect to the sales or similar tax. If it is a principal, the sales or similar tax is included in the transaction price. If it is an agent, the sales or similar tax is not included in the transaction price.

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

5.3.2. Noncash consideration
If the fair value of the noncash consideration can be reasonably estimated at contract inception, then that fair value is included in the transaction price. Otherwise, the entity should indirectly determine its fair value using the standalone selling prices of the goods or services being provided to the customer. After contract inception, the fair value of the noncash consideration may vary due to its form (e.g., a share of the customer’s stock) or for other reasons (e.g., the entity’s performance). Variations in fair value after contract inception that are due to the form of the noncash consideration are not reflected in the transaction price. Variations in fair value after contract inception that are not due to the form of the noncash consideration should be accounted for using the variable consideration guidance in ASC 606. If variations in the fair value after contract inception are caused by both the form of the noncash consideration and other factors not related to the form of the noncash consideration, then only the portion
of the variability attributable to factors not related to the form of the noncash consideration should be accounted for using the variable consideration guidance in ASC 606. The portion of the variability attributable to the form of the noncash consideration is excluded from the transaction price.

A customer may provide noncash consideration to the entity in the form of contributed goods or services that the entity will use in fulfilling its obligations to the customer. In that situation, the question arises as to whether the entity should reflect the fair value of those contributed goods or services in the transaction price. The answer to that question depends on whether the entity obtains control of those goods or services. If it does, then their fair value is included in the transaction price.

### 5.3.3. Variable consideration

Variable consideration can take many forms – refunds, returns, discounts, rebates, performance bonuses, milestone payments, penalties, contract claims and price concessions, just to name a few. The variability in the amount of consideration payable by the customer may be stated in the contract, or it may be caused by an implicit price concession that the entity intends to offer the customer or that the customer has a valid expectation of receiving based on the entity’s customary business practices, published policies or specific statements (e.g., the discount from standard rates that a hospital intends to offer a self-pay patient). The variability in the consideration could affect whether the entity is entitled to the consideration (e.g., occurrence or nonoccurrence of meeting a deadline to which a performance bonus is tied) and (or) the specific amount of consideration the customer will ultimately have to pay (e.g., the performance bonus an entity will obtain depending on how early it is able to complete the project).

With one exception, an estimate of the variable consideration that the entity expects to be entitled to should be included in the transaction price to the extent it is probable that its inclusion will not result in a significant reversal of cumulative revenue recognized when the uncertainty giving rise to the variability is resolved. The exception relates to a sales and (or) usage-based royalty when the only, or predominant, item to which the royalty relates is the license of IP. The royalties subject to this exception should not be included in the transaction price until the later of: (a) the resolution of the related uncertainty (i.e., sales and [or] usage occur) or (b) the satisfaction of the related performance obligation in whole or in part. It is important to note the following about this exception:

- It does not apply to outright sales of IP.
- It should not be applied to part of a royalty stream (i.e., it is applied on an all-or-nothing basis).
- It should not be applied by analogy to account for other types of variable consideration or other types of promised goods or services.

Sales and (or) usage-based royalties that are not subject to this exception (e.g., a usage-based royalty that is not related to IP) should be accounted for using the overall variable consideration guidance in ASC 606.

To determine the amount of variable consideration that should be included in the transaction price, the entity first needs to estimate the amount to which it expects to be entitled using one of two methods, which are the expected value method and the most likely amount method. The method an entity should use depends on which method better predicts the amount of variable consideration in the particular set of facts and circumstances. One method should be used consistently when accounting for a contract’s variable payment stream. However, to the extent a customer contract includes two different variable payment streams based on the resolution of different uncertainties, the facts and circumstances may support using different methods to estimate the variable consideration expected upon the resolution of each uncertainty.

Once the entity has estimated the amount of variable consideration to which it expects to be entitled, it then needs to apply the constraint focused on whether it is probable that the inclusion of the estimated variable consideration in the transaction price will not result in a significant reversal of cumulative revenue.
recognized for the contract when the uncertainty giving rise to the variability is resolved. Only estimated variable consideration for which it is probable that its inclusion in the transaction price will not result in a significant reversal of cumulative revenue recognized should be included in the transaction price. If it is probable that a significant reversal of cumulative revenue recognized will not occur with respect to just a portion of the estimated variable consideration to which the entity expects to be entitled, that portion would be included in the transaction price. ASC 606 provides indicators to help in assessing whether it is probable that a significant reversal of cumulative revenue recognized will not occur. Some of these indicators consider: (a) whether the variability is caused by factors outside the entity’s influence, (b) the length of time until resolution of the uncertainty, (c) the nature and extent of the entity’s experience with similar contracts, (d) the entity’s past practices with respect to offering price concessions or changing payment terms and (e) the number and range of possible outcomes.

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

**Spotlight on change**

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

### 5.3.4. Significant financing component

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

All of the relevant facts and circumstances related to the customer contract need to be considered in determining whether it includes a significant financing component. For example, an entity should consider whether there is a difference between the amount the customer would have had to (i.e., hypothetically) pay for the promised goods or services in cash upon their transfer and the amount the customer is paying for those goods or services based on the payment terms in the contract. An entity should also consider the amount of time that will pass between when the promised goods or services are transferred to the customer and when the customer pays for those goods or services along with the relevant prevailing interest rates.

ASC 606 specifically indicates that a significant financing component does not exist in any of the following situations:

- The customer makes an advance payment and the timing of transferring the promised goods or services to the customer is at the customer’s discretion (e.g., prepaid phone cards).
- There is substantial variable consideration and payment of that consideration is contingent on the resolution of an uncertainty that is not substantially in the entity’s or customer’s control (e.g., sales-based royalty).
• There are reasons not related to financing that justify the nature and amount of the difference between the cash selling prices of the promised goods or services and the promised consideration (e.g., deferred payment terms or contract holdbacks may protect the customer if the entity fails to satisfy some or all of its contractual obligations).

**Practical expedient**

If a customer contract has a significant financing component, a practical expedient to ignore that financing component when estimating the transaction price can be applied if the entity expects the difference between the following two events to be one year or less at contract inception: (a) the entity’s transfer of the promised goods or services to the customer and (b) customer payment for those goods or services. When assessing whether the practical expedient can be applied, it is important to focus on these two events and not the duration of the contract in its totality.

If an entity chooses not to consider the practical expedient or concludes that the practical expedient cannot be applied in its facts and circumstances, then the significant financing component must be taken into consideration in estimating the transaction price. The objective of doing so is to recognize revenue in an amount consistent with what the customer would have paid in cash upon the transfer of the promised good or service. To adjust the promised consideration for the significant financing component, the entity should use a discount rate consistent with the rate that would be present in a separate financing transaction between the entity and the customer at contract inception. Such discount rate should take into consideration: (a) the credit risk of the entity (when advance payments are involved) or the customer (when deferred payments are involved) and (b) any collateral or other security provided by either the entity or the customer. The discount rate is not adjusted after contract inception.

Interest income or expense should only be recognized to the extent an accounts receivable, contract asset or contract liability has been recognized for the customer contract. The relevant guidance in ASC 835-30, “Interest – Imputation of Interest,” should be used to: (a) present any discount or premium in the financial statements and (b) apply the interest method. The income statement effects of reflecting a significant financing component in the transaction price should be presented separate from the revenue for the portion of the transaction price attributed to the performance obligations. The income statement effects when a significant financing component results in a cost (e.g., advance payments) should be reflected as interest expense.

**Spotlight on change**

Under legacy GAAP, receivables for which the payment is not due for more than one year are generally discounted. However, the same is not true for advance payments, which ASC 606 requires to be adjusted for a significant financing component under certain circumstances. This could represent a significant change for entities that regularly receive long-term advance payments from their customers.

### 5.3.5. Consideration payable to the customer

Customer contracts may include provisions in which the entity is explicitly required to pay consideration to its customer (e.g., manufacturer’s payment of slotting fees to a retailer customer) or its customers’ customers (e.g., manufacturer’s payment of rebates to consumers). In addition, future payments to customers may be implied based on an entity’s past practices. In these situations, an entity may or may not receive something in return from its customer for these payments (e.g., manufacturer pays retailer customer for cooperative advertising or product placement at eye level).

Consideration paid by the entity to its customers or its customers’ customers is reflected as a reduction of the transaction price (and, as a result, a reduction of revenue) unless the entity receives something in
return for that consideration that is distinct. If consideration payable to a customer is variable, it should be measured consistent with the variable consideration guidance in ASC 606.

For purposes of determining whether the good or service received by the entity is distinct, the entity uses the guidance in Step 2 to determine whether a promised good or service should be treated separately as a performance obligation. If the entity receives a good or service that is distinct, it has to determine if its fair value can be reasonably estimated. If the entity cannot reasonably estimate the fair value of the distinct good or service it receives from the customer, then the payment made to the customer is treated as a reduction of the transaction price. Otherwise, the cost of the good or service received by the entity is the lesser of the fair value of the good or service provided to the entity and the amount payable to the customer by the entity. This cost is accounted for in the same manner as if the entity had bought the good or service from a party other than its customer. Any excess of the amount payable to the customer over the fair value of the good or service the entity receives from its customer is treated as a reduction of the transaction price.

When the consideration payable by the entity to its customers or customers’ customers is not variable and should be treated as a reduction in the transaction price, that reduction should be reflected upon the later of: (a) when the revenue for the related goods or services is recognized and (b) when consideration is paid or promised (which includes payments made only upon the occurrence of a future event).

The approach to accounting for consideration payable to the customer in ASC 606 is largely consistent with the approach in legacy GAAP.

**5.4. Allocate the transaction price to the performance obligations (Step 4)**

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

**Spotlight on change**

While there are some similarities between the guidance in ASC 606 related to allocating the transaction price to performance obligations and the guidance in the multiple-element arrangement models in legacy GAAP related to allocating the arrangement consideration, there are also many differences that could result in a different amount being allocated to a unit of account for revenue recognition purposes. For example, while today’s general multiple-element arrangement model requires allocation of arrangement consideration using a relative selling price model, it does not provide exceptions related to allocating discounts or variable consideration. For another example, under the general multiple-element arrangement model in legacy GAAP, any arrangement consideration allocated to a delivered element (e.g., equipment) that is contingent on delivery of the undelivered elements (e.g., installation services) in the arrangement must be deferred until delivery of those undelivered elements occurs (e.g., the installation services are provided). Under ASC 606, when some or all of the transaction price is contingent upon the delivery of undelivered promised goods or services, the effects of that contingency are addressed by applying the variable consideration guidance. While ASC 606 includes a variable consideration constraint, that constraint is not expected to limit the transaction price to the amount that is not contingent upon delivery of the undelivered promised goods or services in many cases because resolution of the contingency is typically within the entity’s control (i.e., the entity typically controls whether it delivers the undelivered promised goods or services). As a result, the change in how amounts contingent upon the delivery of undelivered promised goods or services are
treated from an accounting perspective is expected to result in recognizing those contingent amounts as revenue sooner in many cases under ASC 606.

5.4.1. Standalone selling prices

The standalone selling price of a performance obligation is the amount the entity charges (or would charge) when the distinct goods or services that make up the performance obligation (i.e., the underlying distinct goods or services) are sold on their own to a customer. Standalone selling prices are determined at contract inception and are not subsequently adjusted for changes in facts and circumstances.

The best evidence of the standalone selling price of the underlying goods or services is the observable price charged by the entity for those goods or services when they are sold separately in similar circumstances to similar customers. Absent evidence of a directly observable standalone selling price, the entity is required to estimate a standalone selling price. In making this estimate, the entity should maximize observable inputs and consider all reasonably available and relevant information, which includes both entity-specific and market-specific information. While there are any number of approaches to estimating a standalone selling price that are consistent with the overall objective of allocating the transaction price, ASC 606 discusses the following three approaches:

- **Adjusted market assessment approach.** This approach identifies the price at which customers would be willing to buy the underlying goods or services on a standalone basis, which might include looking at prices charged by competitors for similar goods or services and making the appropriate entity-specific adjustments.

- **Expected cost plus a margin approach.** This approach builds up a standalone selling price for the underlying goods or services using the costs the entity expects to incur to provide the goods or services and adding an appropriate margin to those costs.

- **Residual approach.** This approach may only be used when one of the following criteria is met: (a) the price at which the entity has sold the goods or services underlying a performance obligation on a standalone basis at or near the same time represent a broad range of prices within which a representative standalone selling price cannot be identified (i.e., the selling price is highly variable) or (b) the goods or services underlying a performance obligation have not previously been sold on a standalone basis and the entity has not yet established a price for those goods or services (i.e., the selling price is uncertain). The difference (or residual) between the total transaction price and the observable standalone selling prices of those performance obligations with observable standalone selling prices is considered to be the estimated standalone selling price of the goods or services underlying the performance obligation.

Other approaches to estimating the standalone selling price of a performance obligation in the absence of an observable standalone selling price may be appropriate if the objective of those approaches is to identify the amount the entity would charge if it sold the underlying goods or services on their own. In addition, it may be appropriate or necessary to use more than one approach to estimate a standalone selling price when an observable standalone selling price does not exist provided doing so results in identifying the amount the entity would charge if it sold the underlying goods or services on their own. The approach(es) used should be consistently applied in similar circumstances.

**Spotlight on change**

Under the general multiple-element arrangement model in legacy GAAP, a three-level hierarchy is used to identify selling prices compared to what is essentially a two-level hierarchy in ASC 606. As a result, the manner in which an entity identifies the selling prices to be used for purposes of allocating the transaction price to performance obligations, and the standalone selling prices themselves, could change. In turn, this would affect the amount of revenue allocated to each unit of account. In addition,
while ASC 606 permits the use of a residual method to estimate the standalone selling price of a performance obligation under certain circumstances, the general multiple-element arrangement model in legacy GAAP does not permit the use of residual methods.

The legacy GAAP for software transactions requires use of vendor-specific objective evidence (VSOE) of fair value for purposes of allocating arrangement consideration in a multiple-element arrangement. If VSOE of fair value does not exist for an undelivered element, the elements in an arrangement are not treated separately for accounting purposes. ASC 606 does not require VSOE of fair value for allocation purposes and requires estimation of standalone selling prices for all performance obligations in the absence of an observable price charged for performance obligations when they are sold separately in similar circumstances to similar customers. In addition, legacy GAAP for software transactions requires use of a residual method when VSOE of fair value only exists for the undelivered elements. However, this circumstance and the way in which the residual method is applied are different from the circumstances and the way in which a residual method may be used under ASC 606.

5.4.2. Changes to the transaction price

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

Changes in the transaction price, other than those resulting from contract modifications, are caused by changes in one or more of the numerous factors that are taken into consideration when estimating the transaction price, such as an entity’s expectations about the likelihood of it being entitled to variable consideration. In these situations, any necessary adjustment to the transaction price should generally be allocated to the performance obligations on the same basis that was used to allocate the transaction price at contract inception. However, an exception to this allocation approach exists if the change in transaction price is due to a change in the amount of variable consideration after contract inception that can be shown to be specifically related to one or more (but less than all) performance obligations or distinct goods or services in a series of distinct goods or services that is appropriately accounted for as a single performance obligation. If some or all of the transaction price adjustment is allocated to a performance obligation that has already been satisfied (i.e., for which revenue has already been recognized), the allocated adjustment amount should be reflected as an increase or decrease to revenue, as appropriate, in the period of the adjustment.

Additional considerations apply if the change in transaction price occurs after a contract modification. Depending on the facts and circumstances, these additional considerations could result in allocating the change in transaction price only to those performance obligations that existed before the contract modification or only those performance obligations that were not fully satisfied immediately after the modification date.

5.5. Recognize revenue when (or as) each performance obligation is satisfied (Step 5)

Revenue is recognized when (or as) a performance obligation is satisfied, which is when control of the underlying distinct goods or services is transferred to the customer. The amount of revenue recognized when the performance obligation is satisfied is the amount of the transaction price allocated to it.

5.5.1. Transfer of control

Control has been transferred to a customer when the customer has the ability to direct the use of the good or service and receive substantially all of the related remaining benefits, which includes the customer being able to stop others from directing the use of the good or service and receiving substantially all of the related remaining benefits. For this purpose, benefits are considered in terms of the potential cash flows the customer can obtain (directly or indirectly) as a result of having control of the good or service. ASC 606 provides a number of indicators that should be considered in assessing whether control has transferred, including indicators focused on the customer’s obligation to pay,
customer acceptance and the transfer of legal title, physical possession and the significant risks and rewards of ownership.

**Spotlight on change**

Recognizing revenue based on when control of the underlying good(s) or service(s) is transferred to the customer is fundamentally different than most of the models found throughout legacy GAAP, which are predominantly focused on the transfer of the risks and rewards of owning the related goods or services by requiring consideration of whether revenue is earned and realized or realizable. This fundamental difference could affect the timing of when many entities recognize revenue.

### 5.5.2. Satisfaction of performance obligation over time or at a point in time

To identify the appropriate timing and pattern of revenue recognition, an entity must perform an evaluation at contract inception focused on whether the performance obligation is satisfied (and control of the underlying good or service is transferred) over time or at a point in time. If a performance obligation meets one or more of the following criteria, it is considered satisfied over time:

- **Customer simultaneously receives and consumes benefits as entity performs.** A performance obligation is satisfied over time if the customer consumes the benefits of the entity’s performance at the same time as: (a) the customer receives those benefits and (b) the entity performs and creates those benefits. If it is not readily apparent whether this is the case in a particular set of facts and circumstances, then a performance obligation is satisfied over time if another entity could step in and fulfill the remaining performance obligation without having to substantially reperform the work already performed by the entity. Examples of performance obligations for which it may be readily apparent that simultaneous receipt and consumption of the benefits occur as the entity performs include routine or recurring services, such as monthly payroll processing services or a one-year health club membership.

- **Control passes as the entity performs.** A performance obligation is satisfied over time if the customer controls the asset (which encompasses the underlying goods and [or] services) as it is created or enhanced by the entity’s performance. An entity will need to carefully consider the indicators of control discussed previously in assessing whether control of the asset passes to the customer as the entity performs. An example of a performance obligation that might meet this criterion, depending on all of the facts and circumstances, is a construction contract in which the entity is building a manufacturing facility on land owned by the customer.

- **No alternative use and an enforceable right to payment.** A performance obligation is satisfied over time if: (a) the asset created by the entity’s performance does not have an alternative use to the entity upon its completion and (b) the entity’s right to payment for its performance to date is enforceable. In making the alternative use assessment, an entity needs to determine the nature and substance of any legal or practical limitations on its ability to redirect (e.g., sell to another customer) the completed asset created by its performance. This assessment is only reperformed after contract inception if the performance obligation is substantively changed by a subsequent contract modification. In making the assessment as to whether an enforceable right to payment for performance to date exists, an entity is not required to conclude that it has a present unconditional right to payment. However, the entity must be able to conclude, based on the terms of the contract and applicable laws, that it is entitled to sufficient compensation for its performance to date at all times during the contract if the contract were to be terminated by the customer or another party for reasons other than the entity’s nonperformance. Additional guidance is provided with respect to making this determination, including how to evaluate whether the compensation the entity would be entitled to is sufficient and whether the entity’s rights under the contract are enforceable. An example of a performance obligation that might meet this criterion, depending on all of the facts and circumstances, is a consulting service in which the entity is
obligated to issue a customer-specific report and, in return, is entitled to payment for costs incurred to date plus a reasonable profit margin.

If a performance obligation does not meet any of these three criteria, then it is considered satisfied at a point in time and revenue is recognized at the point in time that the customer obtains control over the underlying good or service.

If the performance obligation is considered satisfied over time, the related revenue is recognized over time. In these situations, the entity must identify a single method by which to measure the progress toward complete satisfaction of the performance obligation. Important considerations in identifying that single method include the following:

- The nature of the underlying promised good or service should be taken into consideration in identifying an appropriate measure of progress toward complete satisfaction of the performance obligation.
- The method identified should provide a reasonable and reliable estimate of the measure of progress toward complete satisfaction of the performance obligation.
- The method identified should be consistent with how control of the underlying goods or services is transferred to the customer.
- The method of measuring progress toward the complete satisfaction of a performance obligation should be applied consistently to similar performance obligations in similar circumstances.

If an entity is unable to reasonably and reliably measure the progress toward complete satisfaction of the performance obligation, it should recognize revenue to the extent of the costs incurred to satisfy the performance obligation, but only if it expects to recover those costs. This approach is used only until the entity is able to reasonably and reliably measure the outcome of a performance obligation.

Output methods or input methods can be used to measure progress toward complete satisfaction of performance obligations. Output methods rely on the value of the underlying goods or services transferred to the customer (e.g., appraisals of results achieved, units produced). Input methods rely on the efforts put forth by the entity to satisfy the performance obligation (e.g., labor hours, costs incurred). In applying either an output or input method, measurement of progress towards complete satisfaction of a performance obligation should only reflect the underlying goods or services for which control transfers to the customer. In addition, an input method should not reflect inputs that relate to activities that are not themselves performance obligations (e.g., setup activities). Discussion is provided in ASC 606 regarding the circumstances under which it may or may not make sense to use a particular method. In addition, guidance is provided on how to apply a cost-based input method in situations in which a cost incurred by the entity is not proportionate to the progress it has made in satisfying the related performance obligation. One such situation involves what is commonly referred to as uninstalled materials, which are goods that have been transferred to the customer, but have not yet been used in satisfying the related performance obligation. In these situations, it might be appropriate, depending on the facts and circumstances, to take the costs of these goods out of the input method used to measure the entity’s progress in satisfying the performance obligation and recognize revenue equal to those costs. This approach may represent a faithful depiction of the entity’s performance if, at contract inception, the entity expects all of the following conditions to be met with respect to the transferred goods:

- The goods are not distinct (i.e., they do not represent their own performance obligation[s]).
- A significant period of time will elapse between when the customer obtains control of the goods and when the entity subsequently provides the services related to those goods.
• The cost of the goods is significant in comparison to the total costs expected to be incurred to satisfy the performance obligation.
• The goods are provided by a third party and the entity is not significantly involved in their design or manufacture; however, the entity is acting as a principal under ASC 606 with respect to providing those goods to the customer.

Significant judgment will be involved in determining whether it is a faithful depiction of the entity’s performance to adjust a cost-based input method and recognize revenue to the extent of certain costs incurred.

Progress toward complete satisfaction of a performance obligation is based on the amount of outputs or inputs to date and the estimated total amount of outputs or inputs necessary to satisfy the performance obligation. Progress towards completion is calculated at the end of each reporting period and used in determining the appropriate amount of revenue to recognize.

Practical expedient

An entity may recognize revenue for the amount it has a right to invoice the customer if its right to consideration from that customer directly corresponds to the value of the entity’s performance completed to date. For example, if the customer contract requires the entity to provide cleaning services to a customer over a period of time, and the customer is obligated to pay the same hourly rate regardless of the nature or timing of the cleaning services provided, the entity could elect this practical expedient.

Spotlight on change

The general revenue recognition guidance in legacy GAAP does not provide a model for determining whether revenue should be recognized at a point in time or over time. Entities essentially have to make this determination when they apply the general revenue recognition criteria to a transaction. Having specific guidance in ASC 606 related to making this determination could change an entity’s conclusion as to whether revenue for a particular customer contract should be recognized over time or at a point in time. This is particularly true with respect to service transactions given the lack of guidance on this subject in legacy GAAP. In addition, having more broadly applicable guidance on how to measure progress towards completion could change the timing of when an entity recognizes its revenue. Again, this is particularly true with respect to service transactions given the lack of guidance on this subject in legacy GAAP.

Unlike ASC 606, the guidance in legacy GAAP applicable to the accounting for construction-type and production-type contracts does not provide for revenue to be recognized to the extent of costs incurred by the entity when: (a) those costs are not proportionate to the progress it has made in satisfying the related performance obligation (e.g., the costs of uninstalled materials) and (b) certain criteria are met.

6. Onerous contracts

Existing guidance in legacy GAAP that addresses onerous contracts (which is limited in scope) was retained. Examples of the types of contracts or situations for which the onerous contract guidance was retained include separately priced extended warranty and product maintenance contracts, construction-type and production-type contracts, continuing care contracts of continuing care retirement communities, prepaid health care services contracts and long-term power sales contracts. While this guidance was retained, in some cases, it was amended to reflect the fact that ASC 606 and ASC 340-40 will factor into the determination as to whether a contract is onerous and, if so, the amount of loss that is recognized.
7. Contract costs

ASC 340-40 addresses the circumstances under which certain costs that arise in conjunction with customer contracts (i.e., costs to fulfill a customer contract and the incremental costs of obtaining a customer contract) should be capitalized.

**Spotlight on change**

Capitalization of fulfillment costs and customer acquisition costs for which there is no specific guidance in legacy GAAP generally depends on whether those costs meet the definition of an asset and whether the entity has made an accounting policy election to capitalize such costs. In other words, an entity is generally not required to capitalize such costs. Under ASC 340-40, an entity may be required to capitalize these costs depending on the facts and circumstances. This could result in a significant change if the entity does not already have an accounting policy that results in the capitalization of these costs.

7.1. Costs to fulfill a customer contract

If there is other guidance in the ASC that applies to the costs incurred to fulfill a customer contract, that other guidance should be applied. Examples of topics and subtopics in the ASC that provide guidance on how to account for costs that may be involved in the fulfillment of a customer contract include:

- ASC 330, “Inventory”
- ASC 340-10, “Other Assets and Deferred Costs – Overall” (specifically, the guidance applicable to preproduction costs related to long-term supply contracts [see Section 7.1.1 for additional information])
- ASC 360, “Property, Plant, and Equipment”
- ASC 720, “Other Expenses” (specifically, the guidance requiring the recognition of an accrual and expense for the obligation to make certain advertising expenditures at the point in time revenue is recognized when the recognition of such revenue is what creates the obligation to make those expenditures [e.g., cooperative advertising])
- ASC 946-720, “Financial Services—Investment Companies – Other Expenses” (specifically, the cost capitalization guidance applicable to offering costs, which is applicable to both advisors of public and private funds)
- ASC 985-20, “Software – Costs of Software to Be Sold, Leased, or Marketed”

If there is no specific guidance in the ASC that applies to costs incurred to fulfill a customer contract, ASC 340-40 should be applied, which requires capitalization of those costs if all of the following criteria are met:

- The costs incurred by the entity are directly related to a specific contract or anticipated contract (e.g., direct labor related to setup activities).
- The costs generate or enhance resources that the entity will use in satisfying its future performance obligations under the customer contract (e.g., the activities giving rise to the costs are not a performance obligation in and of themselves).
- The entity expects to recover the costs (e.g., based on net future cash flows from the contract and expected contract renewals).

If these criteria are met, the fulfillment costs must be capitalized. In other words, the option does not exist to expense fulfillment costs for which these criteria are met.
7.1.1. Preproduction costs related to long-term supply contracts

In the proposed ASU, *Technical Corrections and Improvements to Update 2014-09, Revenue from Contracts with Customers (Topic 606)*, which was issued in May 2016, the FASB proposed: (a) eliminating the specific guidance on how to account for preproduction costs related to long-term supply contracts (the preproduction costs guidance) from ASC 340-10 and (b) requiring such costs to be accounted for in the same manner as other costs incurred to fulfill a customer contract (e.g., ASC 340-40).

Based on the feedback received on this proposal, particularly as it relates to the capitalization of molds, tools and dies, the FASB performed additional outreach. Based on its outreach, the FASB decided not to move forward with eliminating the preproduction costs guidance at the same time it finalized the other technical corrections and improvements in the proposed ASU. The basis for this decision and the FASB’s views on how the preproduction costs guidance interacts with ASC 340-40 are provided in paragraphs BC43-BC45 of *ASU 2016-20*. In paragraph BC45, the FASB indicates that it does not expect more entities to apply the preproduction costs guidance upon the adoption of ASC 606 and ASC 340-40 than applied that guidance before the adoption of ASC 606 and ASC 340-40. In other words, if an entity was appropriately not following the preproduction costs guidance before the adoption of ASC 606 and ASC 340-40, the entity should not need to start applying that guidance upon the adoption of ASC 606 and ASC 340-40.

While the FASB discussed the preproduction costs guidance at its meeting on February 15, 2017, it did not: (a) make any technical decisions, (b) request any additional research be performed before the effective date of the new guidance or (c) add a separate project to its agenda on the topic. However, the board meeting handout discussed by the FASB at this meeting was added to the TRG materials for the TRG’s November 2015 meeting because the FASB believed it provided a good summary of the TRG’s discussions at that meeting as far as how the preproduction costs guidance interacts with ASC 340-40.

7.2. Incremental costs of obtaining a contract

The incremental costs of obtaining a customer contract (i.e., those costs related to obtaining the customer contract that would not have been incurred if the customer contract was not obtained), such as a sales commission, should be capitalized if the entity expects to recover those costs (e.g., based on net future cash flows from the contract and expected contract renewals).

**Practical expedient**

An entity may expense the incremental costs of obtaining a contract if the amortization period would otherwise be one year or less.

Costs of obtaining a customer contract that are not incremental (i.e., costs related to obtaining the customer contract that would have been incurred regardless of whether the customer contract had been obtained), such as travel costs incurred to present the customer proposal, should only be capitalized if those costs are explicitly chargeable to the customer regardless of whether the entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

7.3. Amortization

Capitalized costs related to obtaining a customer contract or fulfilling a customer contract (including an anticipated contract) should be amortized in a manner that is consistent with how the related goods or services are transferred to the customer. For example, if the related services are transferred to the customer continuously and evenly over the amortization period, then straight-line amortization of the capitalized costs would typically be appropriate.
Depending on the facts and circumstances, it may be appropriate to use an amortization period that is longer than the initial contract period. For example, the amortization period should include contractual renewals when those renewals are anticipated and there are no incremental costs related to obtaining the renewal of the customer contract. It is important to note, however, that the threshold for including contractual renewals in the amortization period for capitalized costs related to obtaining or fulfilling a customer contract is different than the threshold for reflecting contract renewals in the accounting for the revenue related to that contract (which is discussed in Section 8.4). As a result of this difference, the amortization period for the capitalized costs could be longer than the period over which the revenue related to the initial contract is recognized.

7.4. Impairment

Costs capitalized in accordance with ASC 340-40 are tested for impairment by comparing the carrying amount of the capitalized costs to an amount that considers all of the following: (a) the contract consideration an entity expects to receive in the future, (b) the contract consideration the entity has already received but not yet recognized as revenue and (c) the costs that remain to be recognized under the contract. The time period reflected in the impairment test should take into consideration expected contract renewals and extensions with the same customer.

Before recognizing an impairment loss, the entity should first evaluate whether any impairment losses exist on certain other assets related to the contract, such as inventory. In addition, an entity should recognize any impairment loss on costs capitalized in accordance with ASC 340-40 before it tests property, plant and equipment or goodwill for impairment.

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

8. Application and implementation guidance

ASC 606 provides a significant amount of application and implementation guidance focused on explaining and illustrating how the concepts and model in ASC 606 should be applied to specific terms in a customer contract or specific types of transactions. This application and implementation guidance is discussed in the remainder of this section.

8.1. Right of return

A customer’s right to return a product or receive a refund of fees for services is not considered a performance obligation. Instead, it is treated as variable consideration. As a result, when the entity recognizes revenue, it does so for the amount of the transaction price that it expects to be entitled to, limited to the amount for which it is probable that a significant reversal of cumulative revenue recognized will not occur (i.e., the transaction price reflects expected returns and refunds). In assessing the probability of a significant reversal in the cumulative revenue recognized, an entity should take many factors into consideration, including its history with the same or similar return rights.

The entity recognizes a refund liability for the amount it ultimately does not expect to be entitled to as a result of the return or refund right (i.e., the amount it is expected to refund). In addition, with product sales, the entity also separately recognizes an asset representing the right to returned inventory and an adjustment to cost of sales for estimated returns. The asset for the right to returned inventory is measured by using the former carrying amount of the product reduced for the costs expected to be incurred to recover the product, which includes any decrease in value of the returned product.

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

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

If the customer has the option to purchase the warranty, it represents a performance obligation and is accounted for separately. If such an option does not exist, the entity must consider a number of factors to determine whether the warranty provides the customer with a service (e.g., maintenance) that goes beyond the promise that the product complies with agreed-upon specifications. Some of those factors are focused on whether the warranty is required by law, the length of time covered by the warranty and the tasks the entity may perform under the warranty. If the warranty goes beyond the promise that the product complies with agreed-upon specifications, then the entity must determine whether it can reasonably account for the promise that the product complies with agreed-upon specifications (i.e., the assurance-type warranty) separate from the promise that goes beyond the assurance-type warranty (i.e., the service-type warranty). If the entity can reasonably account for the two warranties separate from each other, the assurance-type warranty is accounted for under ASC 460 and the service-type warranty is accounted for as a performance obligation under ASC 606. If the entity cannot reasonably account for the two warranties separate from each other, both warranties are accounted for together as a single performance obligation under ASC 606.

The flowchart on the next page illustrates the considerations involved in accounting for a warranty included in a customer contract.
The warranty is a performance obligation that should be accounted for under ASC 606.

Yes

No

The warranty is not a performance obligation and should be accounted for under ASC 460.

Does the customer have the option to purchase the warranty separately?

Does the warranty (or part of the warranty) provide the customer with a service (i.e., service-type warranty) in addition to the assurance that the product complies with agreed-upon specifications (i.e., assurance type warranty)?

Yes

No

Both warranties should be accounted for together as a single performance obligation under ASC 606.

Is the entity able to reasonably account for the assurance-type and service-type warranties separately?

Yes

No

The assurance-type warranty is not a performance obligation and should be accounted for under ASC 460. The service-type warranty is a performance obligation that should be accounted for under ASC 606.

Spotlight on change

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

The principal vs. agent guidance in ASC 606 is only applied when another party is involved with the entity in providing the specified goods or services to the customer. When that is the case, there are two key steps in the principal vs. agent guidance in ASC 606:

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

Additional information about each of these steps is provided in the remainder of this section.

8.3.1. Identifying the specified goods or services

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

8.3.2. Determining whether control of a specified good or service is obtained

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

When another party is involved with the entity in providing the goods or services that make up a specified good or service to the customer, the entity is a principal with respect to the specified good or service in the following situations:

- The entity obtains control of a good or another asset from the other party and then transfers that good or other asset to the customer.
- The entity obtains control of a right to a service from the other party and has the ability to direct the other party in providing the service to the customer on the entity’s behalf.
- The entity obtains control of a good or service from the other party that the entity then combines with other goods or services to provide the specified good or service to the customer.

For purposes of assessing whether the entity obtains control of the good, other asset, service and (or) right to a service that make up the specified good or service, the entity should consider whether it has the ability to direct the use of the specified good or service and receive substantially all of the related remaining benefits (which includes the entity being able to stop others from directing the use of the specified good or service and receiving substantially all of the related remaining benefits). This approach to determining whether the entity has control of the specified good or service before it is transferred to the customer is the same approach used to determine whether control of the goods or services underlying a performance obligation has transferred to the customer for purposes of recognizing revenue.

In some cases, an analysis of the facts and circumstances will conclusively show that the entity has the ability to direct the use of the specified good or service and receive substantially all of the remaining benefits. In other situations in which the analysis of the facts and circumstances does not conclusively show that the entity has the ability to direct the use of the specified good or service and receive substantially all of the remaining benefits, the entity may consider indicators focused on whether
the entity: (a) is primarily responsible for fulfillment, (b) has inventory risk and (c) has discretion in setting prices. With respect to using these indicators in the overall evaluation of whether the entity obtains control of a specified good or service, it is important to keep in mind that they contribute to that overall evaluation and do not override it.

For additional information about determining whether the entity has obtained control of a specified good or service when another party is involved in providing the good or service to the customer, refer to our white paper, Revenue recognition: FASB revises new principal vs. agent guidance.

8.3.3. Difference between performance obligations and specified goods or services

As mentioned earlier, the same analysis used to identify the performance obligations in a customer contract is also used to identify the specified goods or services to which the principal vs. agent guidance is applied when another party is involved in providing those goods or services to the customer. The difference between performance obligations and specified goods or services arises from the incremental control analysis an entity must perform when another party is involved in providing the specified goods or services to the customer. If this analysis results in the entity concluding that it has obtained control of the specified goods or services before transferring control to the customer, then the performance obligations are to transfer the specified goods or services. Conversely, if this analysis results in the entity concluding that it has not obtained control of the specified goods or services before transferring control to the customer, then the performance obligation is to arrange for those specified goods or services to be provided to the customer by the other party rather than to transfer the specified goods or services to the customer.

Spotlight on change

The approaches used in the principal vs. agent guidance in legacy GAAP and ASC 606 are fundamentally different. Legacy GAAP focuses solely on an analysis of eight indicators to determine whether the entity was acting as a principal or an agent. While ASC 606 incorporates consideration of three indicators, its overall focus is on whether the entity obtains control of the promised good or service before it is transferred to the customer. The three indicators included in ASC 606 are only considered if the control analysis is inconclusive. While we do not expect this fundamental change to result in a different outcome in most situations, an entity will still need to apply the principal vs. agent guidance in ASC 606 to its facts and circumstances to determine if a different outcome is warranted.

8.4. Customer options for additional goods or services (e.g., customer loyalty programs)

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

The question that arises when an entity includes an option for additional goods or services in a customer contract is whether that option represents a performance obligation. The answer to this question hinges on whether the option provides a material right to the customer that it would not have received without entering into the contract with the entity. An example of an option that provides a material right is a discount that is incremental to the range of discounts typically given by the entity on the same goods or services to the same class of customer in the same geographical area or market. If the option provides a material right to the customer that it would not have received without entering into the contract with the entity, it represents a performance obligation and part of the transaction price is allocated to it based on its standalone selling price. Otherwise, the option does not represent a performance obligation and is not accounted for separately.
Practical alternative
Instead of estimating the standalone selling price of an option for additional goods or services, the entity may allocate a portion of the transaction price to the optional goods or services based on the goods or services expected to be provided in connection with the option and the related expected consideration. However, this alternative may only be elected if the optional goods or services are:

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

An option for additional goods or services that would most likely qualify for this practical alternative, depending on the facts and circumstances, is a contract renewal option.

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

In addition, legacy GAAP does not explicitly address how to account for customer loyalty programs. As a result, some entities may have an accounting policy for customer loyalty programs that uses a cost accrual approach, while others may have an accounting policy for customer loyalty programs that uses the general multiple-element arrangement model in legacy GAAP. In either case, those accounting policies will need to change to reflect the guidance on customer options for additional goods or services provided in ASC 606.

8.5. Nonrefundable upfront fees
A nonrefundable upfront fee is part of the transaction price for the customer contract. Whether some or all of a nonrefundable upfront fee is recognized as revenue upfront from a timing perspective depends on the nature of the performance obligations in the customer contract and whether control of any of the related underlying goods or services is transferred to the customer upfront. While a nonrefundable upfront fee might be related to an activity undertaken upfront by the entity in connection with the customer contract (e.g., service activation, setup activities), that activity may not represent a performance obligation. The nonrefundable upfront fee (as part of the overall transaction price) is only recognized when or as the performance obligations in the customer contract are satisfied.

To the extent a nonrefundable upfront fee should not be recognized upfront, in determining when it should be recognized, consideration must be given to whether the period over which the performance obligations are satisfied extends beyond the initial contract period, such as when the customer contract provides a renewal option that represents a material right to the customer.

Depending on the facts and circumstances, costs incurred by the entity to perform activities that do not represent performance obligations may need to be capitalized and amortized under ASC 340-40. However, if applying ASC 606 results in recognizing a nonrefundable upfront fee over time, the period...
over which that fee is recognized may not, depending on the facts and circumstances, be the same as the period over which any costs capitalized under ASC 340-40 are amortized.

**Spotlight on change**

Under SAB Topic 13 in legacy GAAP, nonrefundable upfront fees that do not relate to goods or services transferred to a customer upfront (e.g., initiation or setup fees) are generally recognized as revenue on a straight-line basis over the longer of the contract term or expected customer life. Under ASC 606, nonrefundable upfront fees that do not relate to goods or services transferred to a customer upfront are considered part of the transaction price, similar to any other fees due from a customer. These fees (as part of the overall transaction price) are allocated to each unit of account in the contract and recognized as revenue as control of the goods or services underlying each unit of account is transferred to the customer. The timing of revenue recognition extends beyond the initial contract term under ASC 606 only when there is a contract renewal option that provides the customer with a material right. Otherwise, the period over which the nonrefundable upfront fee is recognized under ASC 606 could be limited to the contract term (depending on the facts and circumstances), which may be shorter than the period over which the fee is recognized under SAB Topic 13. If that is the case, the nonrefundable upfront fee would be recognized quicker under ASC 606 than SAB Topic 13.

8.6. **Customer’s unexercised rights (i.e., breakage)**

The contract with a customer may provide the customer with contractual rights it can exercise in the future. Those rights might entitle the customer to goods and (or) services, which obligates the entity to provide or stand ready to provide those goods or services. Customers do not always exercise all of their contractual rights. Those rights that go unexercised are referred to as breakage. One of the most common forms of breakage occurs when gift cards go unredeemed. However, breakage occurs in a number of other situations as well, including nonrefundable upfront fees, rights for free or discounted products and certain consideration payable to the customer.

To the extent an entity expects to be entitled to an amount of breakage, that amount should be recognized as revenue as the other performance obligations in the contract (i.e., those contractual rights expected to be exercised by the customer) are satisfied. However, the entity will need to apply the variable consideration constraint and conclude it is probable that a significant reversal in cumulative revenue recognized will not occur as a result. When the entity does not expect to be entitled to an amount of breakage based on applying the variable consideration constraint, the transaction price related to that breakage should not be recognized as revenue until it becomes remote that the customer will exercise those rights. When the entity does not expect to be entitled to an amount of breakage because it is required to remit amounts received related to a customer’s unexercised rights to another party (e.g., a governmental authority), it should recognize a liability for those amounts.

8.7. **Licensing and rights to use**

Licensing involves an entity (i.e., licensor) providing a customer (i.e., licensee) with a right to use its IP, which comes in many different shapes and sizes. Examples of IP include software, movies, trademarks, patented drug formulas, franchises, manuscripts and songs, just to name a few. It is important to note that the licensor still owns the IP subject to the license (i.e., ownership of the IP does not transfer to the licensee). The same five steps are applied to a customer contract that includes a license of IP as are applied to other customer contracts. However, given the unique nature of IP, additional implementation guidance was provided in ASC 606 with respect to applying the following steps to customer contracts that include a license of IP:
• Identifying the performance obligations in the contract (Step 2)
• Determining the transaction price (Step 3)
• Recognizing revenue when (or as) each performance obligation is satisfied (Step 5)

The implementation guidance related to Steps 2 and 5 is discussed in the remainder of this section. The implementation guidance related to Step 3 addresses the recognition of sales and (or) usage-based royalties related to a license of IP, which is discussed in Section 5.3.3.

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

In some situations, a customer contract may only include a license of IP. In other situations, a customer contract may include a license of IP in addition to other promised goods or services (e.g., a software license and installation services). In these situations, the licensor must consider whether the license of IP is distinct from the other promised goods or services in the customer contract. If the license of IP is distinct, it is a performance obligation. If the license is not distinct, it is combined with other promised goods or services in the contract until a performance obligation exists.

Questions that may arise in identifying the performance obligations in a contract that includes a license of IP include the following:

• How should restrictions in time, geographical region or use be evaluated? The licensor must determine which of the following restrictions of time, geographical region or use represent:
  -- Attributes of the license that define its scope. If the restrictions represent attributes of the license that define its scope, they do not give rise to additional promised goods or services and do not affect whether the license of IP is a performance obligation that is satisfied over time or at a point in time.
  -- Additional rights that will be transferred to the licensee in the future. If the restrictions represent additional rights that will be transferred to the licensee in the future, those additional rights are promised goods or services that must be reflected in the identification of the performance obligations.

Making the determination as to whether a restriction of time, geographical region or use represents an attribute of the license that defines its scope or additional rights that will be transferred to the licensee in the future will require exercising a significant amount of judgment. The implementation guidance in ASC 606 includes examples illustrating how this determination should be made in different facts and circumstances.

• Does a customer contract that includes hosted software include a license of software for purposes of applying ASC 606? A customer contract for hosted software includes a license of software for purposes of applying ASC 606 if both of the following criteria are met:
  -- The customer has a contractual right to take possession of the software during the hosting period without a significant penalty.
  -- If the customer were to take possession of the software during the hosting period, at least one of the following would be feasible: (a) running the software on its own hardware or (b) contracting with a third party to host the software.

For purposes of determining whether the customer can take possession of the software without significant penalty, consideration must be given to whether the customer can do so without incurring significant cost and without experiencing a significant decline in the software’s utility or value. If a customer contract for hosted software includes a license of software, the license and hosting services are treated as promised goods or services for purposes of applying ASC 606. If a customer contract includes both a license of software and hosted services, the licensor must determine whether the license of software is a distinct performance obligation.
for hosted software does not include a license of software, the hosting of the software is one promised service for purposes of applying ASC 606.

- Are guarantees or promises provided by the licensor that it has a valid patent to the IP or that it will defend the patent against unauthorized use promised goods or services? No. Such guarantees and promises are not promised goods or services for purposes of applying ASC 606 and do not affect whether revenue should be recognized over time or at a point in time.

8.7.2. Determining when a performance obligation that includes a license of IP is satisfied

The licensor must determine whether the transaction price allocated to the performance obligation that includes a license should be recognized over time or at a point in time.

When the performance obligation only includes a license of IP, the key question in determining whether the related revenue should be recognized over time or at a point in time is whether the license of the IP represents: (a) a right to use the IP, in which case the allocated transaction price would be recognized at a point time, or (b) a right to access the IP, in which case the allocated transaction price would be recognized over time. Determining whether the license of IP represents a right to use the IP or a right to access the IP is based on whether the IP has significant standalone functionality. To have significant standalone functionality, the IP must derive a substantial portion of its utility (i.e., its ability to provide benefit or value to the licensee) from its significant standalone functionality. IP with significant standalone functionality includes IP that provides benefits to the licensee through its ability to process a transaction, perform a function or task or be played or aired. When the IP has significant standalone functionality, the license of the IP is considered a right to use the IP unless both of the following criteria are met:

- Substantive changes to the functionality of the IP are expected to result during the license period from activities of the entity that do not transfer a promised good or service to the licensee.
- The licensee is contractually or practically required to use the substantively changed IP.

If both of these criteria are met, what would otherwise be considered a right to use the IP would be considered a right to access the IP. The FASB indicated in paragraph B59 of ASU 2016-10 that they would expect both of these criteria to be met “only infrequently, if at all.”

When the IP does not have significant standalone functionality, it is considered symbolic IP. The utility derived from symbolic IP is its association with the licensor’s past or ongoing activities, including its ordinary business activities. A license of symbolic IP is considered a right to access the IP.

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

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

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

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

**Spotlight on change**

While there are some industry-specific revenue recognition models in legacy GAAP that provide guidance on how to account for licenses and rights to use specific types of IP (e.g., software, motion pictures, franchisors), these models are very different from the model in ASC 606. In addition, ASC 606 fills a deep void for licenses and rights to use other types of IP not specifically covered in legacy GAAP. For these reasons, the accounting for licenses and rights to use IP will change significantly under ASC 606.

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

Forwards and call and put options are all considered repurchase agreements for accounting purposes. A forward exists when the entity sells an asset to the customer and is obligated to repurchase the asset at some point in the future. A call option exists when the entity sells an asset to the customer and has the option to repurchase the asset at some point in the future. A put option exists when the entity sells an asset to the customer and the customer has the option to require the entity to repurchase the asset at some point in the future. For these purposes, the asset that the entity repurchases or may repurchase can either be the same asset it sold to the customer, a different asset that is substantially the same as the asset it sold to the customer or a different asset that includes the asset it sold to the customer as a component.

The accounting model applied to a repurchase agreement under ASC 606 depends on its nature. For a forward or call option, the entity’s initial transfer of the asset subject to the forward or call option is not considered a sale for accounting purposes because control of the asset is not considered to have transferred to the customer. Instead, the accounting for the customer contract depends on whether the repurchase price is less than the original selling price. If so, it is accounted for as a lease or, if it is part of a sale-leaseback transaction, as a financing arrangement. If not (i.e., the repurchase price is equal to or more than the original selling price), it is accounted for as a financing arrangement. If a forward or call option that is accounted for as a financing arrangement expires unexercised, revenue would be recognized at that time.

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

**Spotlight on change**

Under legacy GAAP, when an entity sells equipment subject to a guaranteed minimum resale value, the entity accounts for the transaction as a lease. Under ASC 606, the accounting for these arrangements could change significantly depending on the facts and circumstances. If the terms of the arrangement could result in the entity reacquiring the equipment, it would be accounted for as a repurchase agreement, which could, depending on the facts and circumstances, lead to accounting for the arrangement as a lease, financing arrangement or sale subject to the right of return. If the arrangement only requires the entity to make its customer whole for the difference between the customer’s sale proceeds and the guaranteed minimum resale value, the arrangement would consist of two performance obligations that would be accounted for separately: (1) the sale of equipment, which would be accounted for under ASC 606 and (2) a guarantee, which would be accounted for under ASC 460.
8.9. Consignment arrangements

When an entity ships product to a third party (e.g., a dealer or distributor) and that third party sells the products to consumers, the entity needs to consider whether the third-party seller obtains control over the products received from the entity prior to selling them to the consumer. In some cases, inventory shipped to third-party sellers is held on consignment, which means the third-party seller has not obtained control of the products received. Indicators that the third-party seller is holding the inventory on consignment include the following: (a) the entity retains control over the inventory until it is sold through to the consumer or until another specific point in time, (b) the third-party seller is not obligated to pay for the products until they are sold through to the consumer or (c) the entity can redirect the products to itself or other parties.

When products shipped to a third-party seller are considered to be held on consignment, a performance obligation has not been satisfied (and no revenue is recognized), despite the fact the products have been delivered to the third-party seller. In these situations, the consumer, and not the third-party seller, is often the entity’s customer for accounting purposes.

The implementation guidance that explains how to account for consignment arrangements in the context of ASC 606 is largely consistent with legacy GAAP.

8.10. Bill-and-hold arrangements

A bill-and-hold arrangement refers to a customer contract in which the customer purchases products and is billed for the products, but the entity retains physical possession of the products for a period of time. The key question in a bill-and-hold arrangement is whether control of the goods has transferred to the customer, despite the fact the goods are not in the customer’s physical possession. Given the difficulty in answering this question, ASC 606 requires an entity to evaluate whether control has transferred to the customer using: (a) the general concept of control and indicators of control transfer (other than physical possession) provided in ASC 606 and (b) criteria specifically related to bill-and-hold arrangements, which include: (i) the reason for the bill-and-hold arrangement must be substantive (e.g., the customer initiated the arrangement), (ii) the products must be separately identified as the customer’s products, (iii) the products must be ready for physical transfer to the customer and (iv) the products must not be able to be used by the entity or be redirected to another customer. Revenue is recognized in a bill-and-hold arrangement prior to shipment only if this evaluation results in a conclusion that control of the products has transferred to the customer.

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

**Spotlight on change**

With limited exceptions, the criteria in legacy GAAP that must be met to recognize revenue for a bill-and-hold arrangement prior to the customer taking possession of the products are similar to those in ASC 606. One exception arises from legacy GAAP (and not ASC 606) including a criterion that requires there to be a fixed schedule for delivery of the goods that is reasonable and consistent with the customer’s business purpose. As a result, if a bill-and-hold transaction failed only this criterion under legacy GAAP, revenue for that transaction would likely be recognized earlier under ASC 606.
8.11. Customer acceptance

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

If the entity can objectively determine that the goods or services meet the agreed-upon specifications before the customer accepts the goods or services, then acceptance by the customer is not necessary to conclude that control has transferred to the customer. Conversely, the inability to objectively determine whether the goods or services meet the agreed-upon specifications before the customer accepts the goods or services precludes the entity from concluding that control has transferred to the customer until acceptance is provided. As a result, if customer acceptance is based on subjective criteria (e.g., customer satisfaction), then the entity cannot conclude that control has transferred to the customer until the customer provides acceptance.

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

The implementation guidance that explains how to account for customer acceptance provisions in the context of ASC 606 is largely consistent with legacy GAAP.

9. Presentation

Application of the guidance in ASC 606 may result in the recognition and presentation on the balance sheet of a contract asset or liability for the difference between the entity’s performance (i.e., the goods or services transferred to the customer) and the customer’s performance (i.e., the consideration paid by, or unconditionally due from, the customer).

When determining the amount of the contract asset or liability to be recognized (if any), an entity should first determine whether it has an unconditional and noncancellable right to any consideration from the customer. An unconditional right exists when only the passage of time is required before customer payment. If the entity has an unconditional and noncancellable right to consideration from the customer, it should recognize a receivable. If the contract is cancellable by the customer and the entity has not yet performed, it cannot have an unconditional right to payment from the customer.

A contract liability arises if the customer’s performance is greater than that of the entity (i.e., the consideration paid or recognized as a receivable is greater than the revenue recognized). This liability represents the entity’s obligation to perform with respect to the customer contract. Conversely, a contract asset arises if the entity’s performance is greater than that of the customer (i.e., the revenue recognized is greater than the consideration paid or recognized as a receivable). This asset represents the entity’s conditional right to consideration for its performance.

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

Contract liability and contract asset are not prescribed descriptors for the related asset or liability in the balance sheet. However, if a descriptor other than contract asset is used, it needs to clearly indicate that the asset represents something other than a receivable.

Once recognized: (a) a receivable is accounted for in accordance with ASC 310 (or ASC 326) and (b) a contract asset is evaluated for impairment in accordance with ASC 310 (or ASC 326).
10. Disclosure

10.1. Disclosures required by the new guidance

Many new qualitative and quantitative disclosure requirements are included in ASC 606-10-50, ASC 340-40-50 and ASC 270-10-50. The objective of the disclosure requirements is to help financial statement users understand the nature, amount, timing and uncertainty of revenue and related cash flows. In general, entities are required to disclose a variety of information about the contracts they have with customers and significant judgments used in the application of the guidance in ASC 606 and ASC 340-40.

While the most disclosures are required of public entities (which includes public business entities and certain not-for-profit entities and employee benefit plans), many disclosures are also required of nonpublic entities. In addition, while more disclosures are required of public entities on an annual basis than an interim basis, many of the disclosures required on an interim basis are quantitative in nature.

The disclosure requirements themselves focus on providing a variety of revenue-related information. Some of the information that must be disclosed is high-level, such as the amount of revenue recognized from customer contracts and the amount of any impairment (or credit) losses recognized on receivables or contract assets related to customer contracts. But, there is also a significant amount of detailed information that must be disclosed annually related to customer contracts, including information about:

- Disaggregated revenue
- Contract assets, contract liabilities and receivables
- Performance obligations in general and the transaction price allocated to the remaining performance obligations at the end of the reporting period
- Significant judgments involved in determining when performance obligations are satisfied and in estimating the transaction price and the amounts allocated to performance obligations
- Capitalized costs related to obtaining or fulfilling a customer contract

**Spotlight on change**

While there are some areas in legacy GAAP for which substantive revenue-related disclosures are required (e.g., accounting for multiple-element arrangements), for most areas in legacy GAAP, the revenue-related disclosures are relatively limited, particularly in comparison to the disclosures required under ASC 606. Significant effort will be required to capture, track and aggregate the information that must be disclosed annually related to customer contracts, including information about:

10.2. SAB 74 disclosures

SAB Topic 11M, *Miscellaneous Disclosure – Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period* (which is also referred to as SAB 74), requires SEC registrants to disclose the impact that recently issued accounting standards will have on the registrant’s balance sheet and income statement when those standards are adopted in a future period. While not required of entities that are not SEC registrants, such entities are strongly encouraged to provide similar disclosures.

The nature of the information that should be provided in an entity’s SAB 74 disclosures includes the following:

- A brief description of the new guidance, its effective date and when the entity expects to adopt it.
- A discussion of the transition methods allowed and the method the entity expects to use (if known).
• Information related to how adoption of the new guidance is expected to affect the financial statements:
  – If the expected effects are known and reasonably estimable, this information should include a discussion of those expected effects
  – If the expected effects are not known or reasonably estimable, a statement to that effect

• A discussion of the potential effects that adopting the new guidance will have on other significant matters, such as whether adopting the new guidance will cause technical violations of debt covenants or planned or intended changes to business practices

At the Emerging Issues Task Force (EITF) meeting held in September 2016, the SEC Observer emphasized the need to provide SAB 74 disclosures related to the new guidance. In doing so, the SEC Observer indicated that certain qualitative disclosures should be provided to the extent a registrant indicates that the expected effects on the financial statements of adopting that guidance are not known or reasonably estimable. In addition, the SEC Observer indicated that the status of a registrant’s implementation efforts should be disclosed, including aspects of those efforts that have not yet been completed. The topic of SAB 74 disclosures was also discussed by Sylvia E. Alicea, a professional accounting fellow in the SEC’s Office of the Chief Accountant, at the 2016 AICPA National Conference on Current SEC and PCAOB Developments in December 2016. Some of the observations made by Ms. Alicea included the following:

• If the expected financial-statement effects of adopting the new guidance are not known or reasonably estimable, in addition to making a statement to that effect, the entity should also provide a qualitative discussion that will assist the users of its financial statements in assessing the potential significance of the new guidance on the financial statements. If known, this qualitative discussion should describe how (and why) the entity expects the new guidance to affect the timing of its revenue recognition. For example, if the entity expects the new guidance to accelerate when it recognizes revenue for a particular revenue stream, it should describe that expectation and explain the basis for it.

• An entity should not wait to provide users of the financial statements with quantitative information related to its adoption of the new guidance until it knows the financial-statement effects with absolute certainty. The threshold for providing quantitative information is that it be reasonably estimable, not certain. In addition, if an entity has multiple revenue streams and can reasonably estimate the financial-statement effects of the new guidance on some, but not yet all, of those revenue streams, it should provide the reasonably estimable quantitative information for those revenue streams for which such information is available.

• An entity should ensure that its SAB 74 disclosures are consistent with information provided to the audit committee and investors.

• An entity should ensure that its SAB 74 disclosures are subject to its internal controls over financial reporting.

SEC registrants should be providing (and others are strongly encouraged to provide) SAB 74 disclosures pertaining to their adoption of the new guidance. Given the SEC staff’s focus on the topic of SAB 74 disclosures, entities should re-evaluate such disclosures every reporting period to determine whether additional qualitative or quantitative information should be provided. As an entity progresses in its adoption of the new guidance, the content of the SAB 74 disclosures is expected to change, as necessary, to reflect that progress.
11. Effective date

Except for the limited circumstances noted in Sections 11.1 and 11.2, the new guidance is effective for public entities in annual reporting periods beginning after December 15, 2017 and the interim periods within that year. Public entities include: (a) public business entities, (b) not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC. As such, for a public business entity with a calendar year end, the new guidance is effective on January 1, 2018 for both its interim and annual reporting periods (except for the limited circumstances noted in Section 11.2). For all other entities (e.g., private companies), the new guidance is effective in annual reporting periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019. As such, for a private company with a calendar year end, the new guidance is effective for the year ending December 31, 2019 and for interim periods in the year ending December 31, 2020. The earliest any entity is permitted to adopt the new guidance is its annual reporting period beginning after December 15, 2016, and the interim periods within that year. As such, the earliest any entity with a calendar year end may adopt the new guidance is its annual and interim period (as applicable) beginning January 1, 2017.

11.1. Effective date and transition guidance for ASUs revising and clarifying the guidance originally included in ASU 2014-09

As discussed in Section 2, the FASB has issued several ASUs to revise and clarify the guidance originally included in ASU 2014-09. In most cases, the effective dates and transition guidance provided in those ASUs are the same as the effective dates and transition guidance provided for the new guidance. Those ASUs with incremental effective date and transition guidance include the following:

- ASU 2017-05 (see Section 4.3.3 for additional information)
- ASU 2017-10 (see ASC 853-10-65-2 for additional information)

11.2. Optional effective date deferral for certain public business entities

The definition of a public business entity includes entities whose financial statements or financial information is included in a filing with the SEC pursuant to SEC rules and regulations, which include (but are not limited to) the following:

- Regulation S-X, Rule 3-09, Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons
- Regulation S-X, Rule 3-05, Financial Statements of Businesses Acquired or to Be Acquired
- Regulation S-X, Rule 4-08(g), Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons

These entities are only considered public business entities for purposes of the financial statements included in the SEC filing. In other words, these entities are not considered public business entities for purposes of their standalone financial statements when they are not filed with or furnished to the SEC.

As public business entities, the new guidance is effective for these entities in annual reporting periods beginning after December 15, 2017 and the interim periods within that year. However, at the EITF meeting held on July 20, 2017, the SEC Observer made an announcement that the SEC staff would not object to these entities choosing to adopt the new guidance in accordance with the effective date provided for private companies. In other words, these entities may adopt the new guidance in annual reporting periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019. These entities also still have the option to adopt the new guidance in accordance with the effective date provided for public business entities. Refer to our article, Some PBEs
may use private company effective dates for ASC 606 and 842, for additional information about the announcement.

The optional deferral is only available to those entities that are public business entities solely because their financial statements or financial information is included in a filing with the SEC pursuant to SEC rules and regulations. The optional deferral is not available to any other public business entities.

12. Transition

The transition alternatives that an entity must choose between when initially applying the new guidance include the full retrospective transition method and the modified retrospective transition method. For purposes of both transition methods, a completed contract is one for which all or substantially all of the revenue has already been recognized under legacy U.S. GAAP. In addition, the date of initial application is the beginning of the reporting period in which the new guidance is first applied by the entity. For additional information related to the transition guidance provided in the ASUs issued to revise and clarify the guidance originally included in ASU 2014-09, refer to Section 11.1.

The full retrospective transition method involves retrospective application to all periods presented. In addition, an entity may elect one or more of the four practical expedients included in the table later in this section. If an entity elects this method, it must provide the disclosures required for accounting changes in ASC 250, “Accounting Changes and Error Corrections,” with certain exceptions, such as how the accounting change affects certain amounts in the current period income statement. This exception eliminates the need for an entity to determine the amounts that would have been reflected on the income statement if legacy GAAP had been applied in the current period.

The modified retrospective transition method involves application of the new guidance to either: (a) all contracts at the date of initial application or (b) only contracts that are not completed at the date of initial application. Prior periods are not adjusted to reflect application of the new guidance. Under this method, a cumulative effect adjustment is recognized as of the date of initial application (which is January 1, 2018 for a public business entity with a calendar year end that adopts the new guidance as of the applicable effective date). The only practical expedient that may be elected under the modified retrospective transition method is included in the table later in this section. If an entity elects the modified retrospective transition method, a variety of information must be disclosed, including the effects of applying the new guidance in the period of adoption. In other words, an entity must determine the amount of revenue and related costs it would have recognized in the period of adoption if it had continued to apply legacy GAAP in that period, disclose the change for each financial statement item affected and explain the reasons for those changes that are significant.

The following table captures the practical expedients that may be elected under either the full retrospective or modified retrospective transition methods:

<table>
<thead>
<tr>
<th>Practical expedients</th>
<th>Full retrospective</th>
<th>Modified retrospective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer contracts that begin and are completed within the same annual reporting period are not restated. (If this practical expedient is not elected, the entity restates interim periods for contracts that begin and are completed within the same annual reporting period.)</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>The transaction price at completion of the contract is used to retrospectively apply the new guidance to completed customer contracts that included variable consideration. (If this practical expedient is not elected, the entity must estimate variable)</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>
Practical expedients

<table>
<thead>
<tr>
<th>Practical expedients</th>
<th>Full retrospective</th>
<th>Modified retrospective</th>
</tr>
</thead>
<tbody>
<tr>
<td>consideration included in the comparative reporting periods for those contracts.)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The following information is not disclosed about remaining performance obligations for reporting periods presented before the date of initial application: (a) the portion of the transaction price allocated to the remaining performance obligations and (b) when that portion of the transaction price is expected to be recognized as revenue (i.e., when the remaining performance obligation is expected to be satisfied). (If this practical expedient is not elected, the entity must provide the disclosures about remaining performance obligations for all reporting periods presented.)</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>For contracts modified before the beginning of the earliest period presented using the new guidance, the entity applies Steps 2 through 4 of ASC 606 to the contract as modified as of the beginning of the earliest period presented using the new guidance. (If this practical expedient is not elected, the entity applies the contract modification guidance in Step 1 of ASC 606 before applying Steps 2 through 4.)</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

To the extent an entity elects one or more of these practical expedients, they must be applied consistently to all contracts in all periods presented. In addition, the entity must disclose that the expedients have been applied and, if reasonably possible, provide a qualitative assessment of the effects of applying each elected practical expedient.

13. What’s next

The information about the new guidance provided in this white paper should facilitate understanding the degree to which the timing and amount of revenue recognized by an entity will change. It should also provide some indication of the degree to which an entity’s financial reporting processes and systems will need to change to implement the new guidance and satisfy the new disclosure requirements. While the FASB provided delayed effective dates for the new guidance, it was with the understanding that implementation of that guidance would be a significant undertaking for many (if not most) entities. With over three years having passed since initial issuance of the new guidance, entities should be well on their way to assessing how it will affect their revenue recognition policies and disclosures, developing an implementation plan and completing that implementation plan. This is particularly true for public entities, companies that plan on electing the full retrospective transition method and companies that have multi-year contract terms with their customers. If you have questions about the new guidance or need implementation assistance, don’t hesitate to contact your RSM representative.
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