Financial Reporting Insights

REVENUE RECOGNITION IN THE CONSUMER PRODUCTS INDUSTRY

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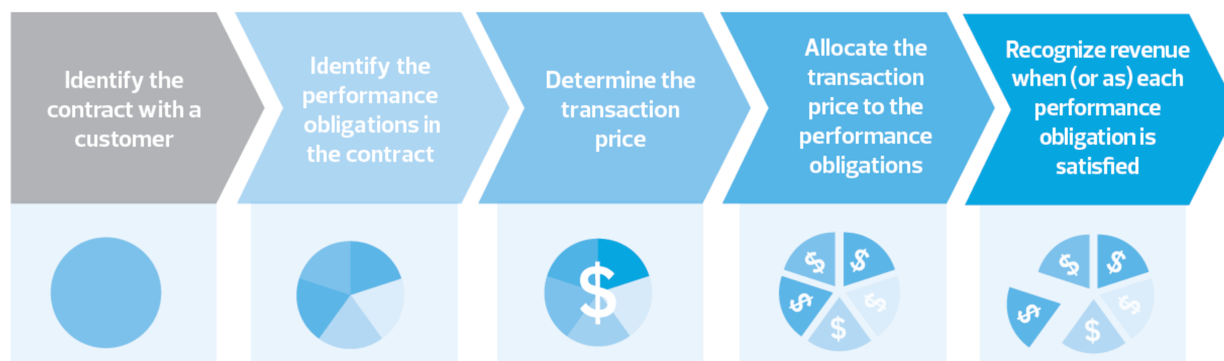
1. Introduction

In 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606*) to provide a robust framework and comprehensive principles for addressing revenue recognition issues. Additionally, the guidance on accounting for certain costs related to a contract with a customer in the scope of ASC 606 was codified in ASC 340-40, "Other Assets and Deferred Costs – Contracts with Customers."

While virtually all aspects of ASC 606 and ASC 340-40 are relevant to consumer products entities (CP entities), this white paper highlights aspects of the guidance that are particularly pertinent for these entities. For additional information about all of the revenue recognition guidance, including those aspects discussed in this white paper, as well as numerous examples illustrating how to apply the guidance, refer to our revenue recognition guide.

2. Core Principle and Key Steps

To put the specific aspects of the revenue recognition guidance discussed in this white paper into proper context, it is important to know that the core principle included in the guidance (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." In addition, the guidance sets out the following steps for an entity to follow when applying the core principle to its revenue-generating transactions:



3. Step 1: Identifying the Contract With a Customer

A contract is defined in ASC 606-10-25-2 as "an agreement between two or more parties that creates enforceable rights and obligations." To account for a contract in accordance with the guidance, the following contract existence criteria must be met:

- 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
- Commercial substance exists
- 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)

Many CP entities enter into written contracts in which significant judgement is not required to determine whether the contract existence criteria are met. These written contracts may consist of a Master Service

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Agreement combined with a purchase order (for a distributor) or be as simple as a receipt (for retailers and restaurants). One criterion which may require additional judgement is whether 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. This determination is partly forward-looking and requires consideration of all the relevant facts and circumstances, including contractual terms as well as the entity's customary business practices and knowledge of the customer.

When all of the contract existence criteria are met, the remaining steps in the five-step revenue recognition model are applied to the contract. When all of the contract existence criteria are not met, revenue is deferred and the contract existence criteria continue to be evaluated to determine whether they are subsequently met. Absent meeting the contract existence criteria, revenue is only recognized under very limited circumstances, which could result in the initial deferral of revenue for what may be a significant period of time, even if nonrefundable cash has been received.

4. Step 2: Identifying Performance Obligations in the Contract

After contract identification (Step 1), a CP entity needs to identify the performance obligations in the contract (Step 2). Identifying performance obligations in a contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized.

4.1 Identifying promises to transfer goods or services

The first step in identifying the performance obligations in the contract is to identify all promises to provide goods or services. In many cases, identifying the promised goods or services in a CP entity's contracts is relatively straightforward. Examples of promised goods or services include travel services, cleaning products, leisure and fitness services, toys, apparel, accessories and sporting goods. However, in other cases, identifying the promised goods or services in a CP entity's contracts may not be as straightforward:

- Some activities performed by a CP entity in fulfilling a contract (e.g., setup activities) do not transfer goods or services to the customer, and thus are not accounted for as a performance obligation. For example, when a fitness center enters into a contract with a new member, it provides the member with a membership kit and access card, and it collects key member data that will be used in tracking the member's progress against established goals. While performing these activities is necessary for the member to start receiving the benefits made available by the fitness center (e.g., access to the fitness center, group classes and progress reports), the activities themselves do not give rise to a promised good or service.
- While promised goods and services are most often explicitly stated in the contract, consideration also needs to be given to whether a CP entity's customary business practices, published policies or specific statements give rise to a promise to transfer a good or service to the customer. For example, if a CP entity's customary business practice creates a valid expectation on the customer's part to receive assistance on optimizing product placement in the customer's retail locations, an implicit promise to transfer services exists that should be accounted for like an explicit promise to transfer services.

4.1.1. Shipping and handling activities

CP entities are commonly faced with accounting for shipping and handling activities arising from delivering promised goods to their customers. The accounting for shipping and handling activities depends on whether the activities are performed before or after a customer obtains control of the promised goods. Passage of legal title is one of several indicators a CP entity should consider in determining when control of promised goods has transferred to the customer. If, after considering all

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control indicators (which are discussed in Section 7.1), the CP entity concludes that control transfers to the customer based on transfer of title, the following guidance applies:

- *When promised goods are shipped free-on-board (FOB) destination*, title to those goods passes to the customer when the goods reach their destination (e.g., the customer's warehouse, retail location or home). In these situations, the shipping and handling activities occur *before* the customer obtains control of those goods. As a result, the shipping and handling activities should be considered fulfillment activities and not a promised service that should be further evaluated under ASC 606.
- *When promised goods are shipped FOB shipping point*, title to those goods passes to the customer when the shipping company picks up the goods from the shipping point (e.g., the CP entity's facilities). In these situations, the shipping and handling activities occur *after* the customer obtains control of those goods. As a result, the shipping and handling activities should be considered a promised service and further evaluated under ASC 606. However, the CP entity may elect an accounting policy under which shipping and handling activities are accounted for as fulfillment activities and not promised services requiring further evaluation under ASC 606. If the CP entity elects this accounting policy, the costs related to the shipping and handling activities should be accrued when the CP entity recognizes revenue for the related promised goods. If elected, the accounting policy must be applied consistently to similar transactions. In addition, a CP entity that elects the accounting policy must provide the accounting policy disclosures required by ASC 235, "Notes to Financial Statements."

Additional practices and terms may need to be taken into consideration in determining the effects of shipping terms on the identification of promised goods or services and when control of the promised goods transfers to the customer. For example, consider situations in which a CP entity ships promised goods using FOB shipping point terms, but either insures the promised goods during shipment or has a practice of replacing promised goods that are lost or stolen while in transit (which may be referred to as synthetic FOB destination). In all situations, the CP entity should determine when control of promised goods transfers to a customer by performing a thorough analysis of its facts and circumstances in the context of all five indicators of control transfer, two of which are passage of title and transfer of risk of loss. A CP entity shipping promised goods using FOB shipping point terms but insuring the promised goods during shipment or having a practice of replacing promised goods that are lost or stolen while in transit results in title to the promised goods transferring to the customer (when the shipping company picks up the goods at the shipping point) before the risk of loss associated with the promised goods transfers to the customer (when the customer receives the goods). As a result, determining when control transfers in these situations hinges on the analysis of the three additional indicators of control transfer discussed in Section 7.1. If, based on the analysis of all five indicators of control transfer, the CP entity concludes that control of the promised goods transfers to the customer at the shipping point, then the insurance or service of replacing promised goods lost or stolen in transit should be treated as a promised service the CP entity is providing to the customer. Conversely, if the CP entity concludes that control of the promised goods transfers to the customer upon receipt of the goods by the customer, then the costs associated with the insurance or replacing the promised goods lost or stolen in transit should be treated as a fulfillment cost related to those promised goods.

4.1.2. Promised goods or services that are immaterial in the context of the contract

A CP entity may choose not to identify for further evaluation under ASC 606 those promised goods or services that are immaterial in the context of the contract. However, if the CP entity chooses not to identify such promised goods or services for further evaluation, 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 performance obligation in which those goods or services are included is recognized before those goods or services are transferred to the customer. In addition, a CP entity should consistently apply this election to contracts with similar promised goods or services in similar circumstances.

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A CP 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 (see Section 4.3).

If a CP entity elects to treat a promised good or service as immaterial in the context of the contract, it should document the evaluation performed in arriving at a conclusion that the promised good or service is immaterial in the context of the contract. This evaluation should consider whether the promises are either quantitatively or qualitatively material to the customer. Because the guidance indicates that the promised good or service must be immaterial in the context of the contract to not be identified for further evaluation under ASC 606, the CP entity is not required to aggregate the promised goods or services that are immaterial in the context of the related contracts for purposes of evaluating whether those promised goods or services are material as a whole to the financial statements.

4.2 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 accounted for separately. 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: (a) it is capable of being distinct and (b) it is distinct within the context of the contract. A promised good or service that is considered distinct is accounted for separately as a performance obligation unless the series exception applies. For additional information about the series exception, refer to Section 6.3 of our revenue recognition guide.

4.2.1. 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, the good or service is capable of being distinct. A promised good or service is capable of being distinct when the CP entity regularly sells that good or service separately or when the customer could generate an economic benefit from using, consuming, selling or otherwise holding the good or service for economic benefit either on its own or when combined with other readily available resources. For a resource to be readily available to the customer, it must be sold separately either by the CP entity or another party, or it must be a good or service that the customer already has obtained.

4.2.2. Distinct within the context of the contract

To determine whether a promised good or service is distinct within the context of the contract, the CP entity must ascertain which of the following best describes its promise within the context of the specific contract:

- *The promise in the contract is to transfer the promised good or service individually*. If this best describes the CP entity's promise within the context of the specific contract, the promised good or service is distinct within the context of the contract.
- *The promise in the contract is to transfer a combined item or items to which the promised good or service is an input.* If this best describes the CP entity's promise within the context of the specific contract, the promised good or service is not distinct within the context of the contract.

Indicators are provided to assist in determining whether a promised good or service is distinct within the context of the contract. Answering yes to any of the following questions is an indication that the promised good or service is *not* distinct within the context of the contract:

- Is the CP 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?

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- 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? Another way to think of this question is: can the CP entity satisfy each of the promises in the contract independent of its efforts to satisfy the other promises?

If a promised good or service is capable of being distinct (see Section 4.2.1) and distinct within the context of the contract, it is considered a performance obligation and accounted for separately unless the series exception applies (which is explained and illustrated in detail in Section 6.3 of our revenue recognition guide). A contract having more than one performance obligation results in the CP entity allocating the transaction price to each performance obligation using the relative standalone selling price method (Step 4, which is discussed in Section 6) and determining whether the transaction price allocated to each performance obligation should be recognized over time (and if so, the method of measuring progress toward complete satisfaction of the performance obligation) or at a point in time (and if so, the point in time control of the underlying goods or services transfers to the customer) (Step 5, which is discussed in Section 7).

If a promised good or service is not distinct, it is combined with other promised goods or services 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.

4.2.3. Warranties

CP entities often provide a warranty to the customer when the customer purchases certain types promised goods or services (e.g., electronics, household appliances). In addition, some CP entities will sell the customer an extended warranty that includes maintenance services. 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 control of the warranty services is transferred to the customer. If a warranty does not represent or include a performance obligation, no part of the transaction price is allocated to it. Instead, the warranty is accounted for in accordance with the product warranty guidance included in ASC 460, “Guarantees,” which requires accrual of expected warranty costs.

If a customer has the option to purchase a warranty, the warranty represents a performance obligation and is accounted for separately. If such an option does not exist, the CP entity must determine whether it is providing: (a) only a warranty that the product complies with agreed-upon specifications (i.e., an assurance-type warranty) or (b) a service (e.g., maintenance) in addition to the assurance-type warranty (i.e., a service-type warranty). Some factors a CP entity should consider in determining whether it is providing a service-type warranty in addition to an assurance-type warranty include the following:

- A warranty required by law is indicative of an assurance-type warranty
- The longer the warranty is in effect, the more likely it is that the warranty includes a service-type warranty
- If the CP entity has to perform certain steps to provide assurance that agreed-upon specifications are met, those steps are likely not performance obligations

In many cases, determining whether a CP entity is providing a service-type warranty in addition to an assurance-type warranty will be clear. For example, if the warranty only results in the CP entity replacing a product during the warranty period as required by law because the product does not comply with agreed-upon specifications (i.e., the product is defective), the warranty is an assurance-type warranty that

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is accounted for in accordance with ASC 460. However, determining whether a CP entity is providing a service-type warranty in addition to an assurance-type warranty in other cases may not be as clear, and as a result, will require the exercise of significant judgment and careful consideration of all the facts and circumstances.

If the warranty goes beyond the promise that the product complies with agreed-upon specifications, the CP entity must determine whether it can reasonably account for the assurance-type warranty separate from the service-type warranty. If the CP 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 CP 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. A CP entity should put forth reasonable effort to determine whether it can reasonably account for the two warranties separate from each other. Only after putting forth that effort and drawing the conclusion that it cannot reasonably account for the two warranties separate from each other should the CP entity account for the warranties as a single performance obligation under ASC 606.

When applying ASC 606 to a service-type warranty accounted for as a performance obligation, consideration should be given to whether the warranty represents a stand-ready obligation, which is discussed in detail in Section 6.1.3 of our revenue recognition guide.

4.3 Customer options for additional goods or services

As part of a contract, a CP entity may provide its customer with options for additional goods or services, such as: (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.

As discussed in more detail later in this section, if an option provides a material right to the customer that the customer would not have received without entering into the contract with the CP entity, the option itself is a performance obligation. In other words: (a) the goods or services that would be provided to the customer if the option were exercised are not identified as promised goods or services or performance obligations and (b) the transaction price does not include the amounts to which the CP entity would expect to be entitled in exchange for transferring control of any promised goods or services the customer elects to purchase upon exercising the option.

4.3.1. Determining whether a contract includes a customer option for additional goods or services or variable consideration

In many cases, determining whether a contract includes a customer option for additional goods or services will be relatively straightforward. However, in other cases, such as those in which the contract has variable attributes, it may not initially be clear whether those variable attributes give rise to an option for additional goods or services or variable consideration.

Understanding the CP entity's and the customer's rights and obligations is critical to determining whether the variable attributes in a contract should be accounted for as an option or variable consideration. The following table captures the rights and obligations of the CP entity and the customer that point to the variable attributes in a contract being either an option or variable consideration for accounting purposes:

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Points to variable attributes in a contract being…	
An option	**Variable consideration**
The CP entity is not obligated to transfer additional promised goods or services unless and until the customer exercises its right to purchase those additional goods or services.	The CP entity is obligated to provide the promised goods or services without the customer exercising an incremental right.
The customer becomes obligated to transfer additional consideration to the CP entity only after it both exercises its right to purchase additional promised goods or services and takes control of those goods or services.	The customer becomes obligated to transfer additional consideration to the CP entity *after (or as)* it obtains control of the promised goods or services transferred by the CP entity.
Actions taken by the customer obligate the CP entity to provide additional promised goods or services.	Actions taken by the customer serve to resolve the uncertainty related to the amount of consideration it is obligated to pay.

While in some situations there will be minimal differences between accounting for the variable attributes in a contract as an option instead of variable consideration (or vice versa), it remains important in those situations to reach the appropriate conclusion, given the disclosure requirements in ASC 606. For example, if the contract includes an option that is accounted for as a performance obligation, the CP entity would be required to include the option in its disclosure requirements about its performance obligations. Conversely, if the contract includes variable consideration, the CP entity's disclosures about the transaction price allocated to the remaining performance obligations would be affected (unless the CP entity is eligible for and elects an available practical expedient).

Example 4-1: Determining whether the variability in the quantity of widgets a customer might purchase is an option or variable consideration (Question 23 of FASB's Revenue Recognition Implementation Q&As)

Optional Purchases (Example 2)

Entity B enters into a contract to provide 100 widgets to Customer Y at CU 10 per widget. Each widget is a distinct good transferred at a point in time. The contract also provides Customer Y the right to purchase additional widgets at the standalone selling price of CU 10 per widget. Therefore, the quantity that may be purchased by Customer Y is variable.

Although the quantity that may be purchased is variable, the transaction price for the existing contract is fixed at CU 1,000. That is, the transaction price includes only the consideration for the 100 widgets specified in the contract and any exercise of an option is accounted for as an independent contract (because there is no material right given the pricing of the option to acquire additional widgets in this contract). The contract provides a right that allows the customer to choose the number of additional widgets which are distinct goods. In addition, while Entity B may have an obligation to stand ready to deliver additional widgets, Entity B is not legally obligated to provide the widgets until Customer Y exercises the option.

RSM COMMENTARY: In this example, the variability in the quantity of widgets the customer may buy (over the fixed contractual quantity of 100 widgets) should be accounted for as an option because the entity is not obligated to transfer (and the customer is not obligated to pay for) the widgets until the customer exercises its option (and the entity transfers control of the widgets to the customer).

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In addition, the option does not provide a material right to the customer that it would not have obtained without entering into the contract because the widgets that can be purchased by the customer under the option are priced at their standalone selling price. As a result, the option represents a marketing offer that is not accounted for until the option is exercised.

Example 4-2: Determining whether the variable attribute in a contract gives rise to an option or variable consideration (Question 23 of FASB's Revenue Recognition Implementation Q&As)

Goods (Example 3)

Entity A enters into a contract to provide equipment to Customer X. The equipment is a single performance obligation transferred at a point in time. Entity A charges the customer based upon usage of the equipment at a fixed rate per unit of consumption. The contract has no minimum payment guarantees. The customer is not contractually obligated to use the equipment; however, Entity A is contractually obligated to transfer the equipment to Customer X. The usage of the equipment by the customer is a variable quantity that affects the amount of consideration owed to the entity. It does not affect the entity's performance obligation, which is to transfer the piece of equipment. In other words, the vendor has previously performed by transferring the distinct good, and the customer's actions that result in additional payment occur after the goods have been transferred and do not require the vendor to provide additional goods or services.

RSM COMMENTARY: In this example, the entity is obligated to transfer control of the equipment to the customer. The customer does not have an option to buy the equipment; it has committed to buying the equipment. The entity has no further obligations to the customer beyond transferring control of the equipment. The customer does not have an option to buy additional goods or services from the entity. The customer's obligation to pay the entity arises after it obtains control of the equipment (i.e., as it uses the equipment). The action taken by the customer is using the equipment (not exercising an option to buy additional goods or services), which is resolving the uncertainty related to the amount of consideration it is obligated to pay. Based on the nature of the parties' rights and obligations, the variability in how much the equipment is used gives rise to variable consideration (and not an option).

4.3.1.1. Contract renewal and contract termination rights

A contract renewal right is an option that should be evaluated under ASC 606 to determine whether it provides the customer with a material right that should be accounted for as a performance obligation. Depending on the facts and circumstances, contract termination rights may provide a customer with what is essentially a contract renewal right that also should be evaluated under ASC 606 to determine whether it provides the customer with a material right that should be accounted for as a performance obligation.

As discussed in Section 5.3.2 of our revenue recognition guide, the contract term for purposes of ASC 606 should include the period subject to an enforceable termination right if exercising that right results in a substantive termination penalty or other substantive required payment. When a termination penalty or other required payment upon termination of the contract is not substantive (or is nonexistent), the period subject to the enforceable termination right is not included in the contract term for purposes of ASC 606. Instead, the CP entity should evaluate the contract as one with a contract renewal right. In essence, requiring no or a nonsubstantive termination penalty or payment upon exercising a termination right turns that termination right into a renewal right for accounting purposes.

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Consider a situation in which a CP entity enters into a three-year contract that provides the customer with the option to terminate the contract after two years without having to pay any termination penalty. This situation is economically the same as the CP entity entering into a two-year contract that provides the customer with an option to renew the contract for an additional year. To reflect this economic substance in the accounting for the contract, the CP entity's accounting for the contract should reflect a two-year term and a renewal option for a third year, which should be evaluated to determine whether it provides the customer with a material right that should be accounted for as a performance obligation.

4.3.2. Determining whether customer options for additional goods or services are performance obligations

The question that arises when a CP entity includes an option for additional goods or services in a contract is whether that option is a performance obligation that should be accounted for separately. 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 CP entity. In general, if an option included in a contract gives the customer the right to a discount that is incremental to the range of discounts typically given by the CP entity on the same goods or services to the same class of customer in the same geographical area or market, the option provides a material right to the customer that it would not have received without entering into the contract. Conversely, if an option included in a contract gives the customer the right to purchase products or services at their standalone selling prices in the future, the option does not provide a material right to the customer that it would not have received without entering into the contract. This type of option is essentially a marketing offer that is not accounted for until the customer exercises the option.

When evaluating whether an option provides a material right, the CP entity should take into consideration all transactions, which include current, past and future transactions with the customer that are relevant to the evaluation. Consider the following example.

Example 4-3: Evaluating whether a "Buy three and get one free" program includes an option that provides the customer with a material right (Example 12 of FASB's Revenue Recognition Implementation Q&As)

Entity A offers a program in which customers who have purchased three products over a given period of time may receive a fourth product free. Based on its historical data, Entity A determines that it is likely that its customers will receive a free product.

After a customer purchases the first of the three products, the customer has obtained an option (that is, an escalating right) that allows the customer to receive a free product if the customer chooses to purchase two additional products. Similarly, after the customer purchases the second of the three products, it receives an option that allows the customer to receive a free product if the customer chooses to purchase one additional product. After completion of the third product purchase, the customer has an option to obtain a free product. As a result, the standalone selling price of each option may be different.

Assume that in the current transaction, which is the customer's first of the three required purchases, Customer Y purchases a product from Entity A at its observable standalone selling price of $6. Entity A concludes that the standalone selling price of the customer option in this transaction is $0.30.

Entity A would consider that Customer Y has in-substance earned one-third of a free product in the current transaction (or in other words, has earned the right to receive one free product if the customer purchases two additional products). Entity A also would consider whether Customer Y is likely to purchase two additional products that will entitle it to a free product.

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RSM COMMENTARY: This example illustrates that the entity should take into consideration more than just the option the customer received in the current transaction when evaluating whether the entity is providing the customer with a material right. In other words, it should consider more than just whether the estimated standalone selling price of the customer option resulting from its first purchase ($0.30) provides the customer with a material right in relation to its first purchase. While the entity would consider this information, it also would consider other information, such as the likelihood of the customer buying two additional products in the future to be entitled to the free product.

Example 4-4: Evaluating whether a discount voucher includes an option that provides the customer with a material right (Question 13 of FASB's Revenue Recognition Implementation Q&As)

Entity A provides its customers who purchase goods on a particular day with a voucher for 25 percent off their next purchase (of any size). The voucher may be applied against the purchase of any product and expires after 60 days. Based on its historical data for similar offerings, Entity A determines that customers typically use the voucher to make an additional purchase that is, on average, more expensive than what a customer would typically purchase without a voucher. Entity A does not offer its customers any other discounts throughout the year.

On the day that Entity A offers its customers vouchers, Customer Y purchases a product for $200 and Customer Z purchases a product for $10.

Entity A would consider the quantitative nature of the rights received by each customer based on the standalone selling price of the voucher in relation to the transaction with the customer. Entity A also would consider that the voucher has given both Customers Y and Z the qualitative nature of the rights in that both customers have the opportunity to receive a 25 percent discount on a future purchase, including purchases for products that may have an observable standalone selling price that is significantly higher than the selling prices of the products purchased by Customers Y and Z in the current transactions.

RSM COMMENTARY: This example illustrates that the entity should take into consideration more than just quantitative information about the option it received in the current transaction when evaluating whether the entity is providing the customer with a material right. In other words, it also should consider qualitative information related to the types of purchases the customers may make in the future to maximize the benefit they receive from the discount voucher. Example 4-5 in Section 4.3.3.1 illustrates how to account for a discount voucher that includes an option that provides the customer with a material right.

4.3.3. Accounting for an option that is a performance obligation

When an option is a performance obligation, a CP entity must determine the standalone selling price for the option for purposes of allocating a portion of the transaction price to the option (see Section 4.3.3.1). In addition, the transaction price does not include any additional consideration that would result from the customer exercising the option because the option is a material right that the customer is implicitly obligated to pay for as part of the contract in which it is included. The transaction price allocated to the option is recognized as revenue when or as the option is exercised (see Section 4.3.3.2 and Example 4-4), or, if it is not exercised, when the option expires unused. This accounting model essentially reflects the customer partially paying in advance for goods and services it will purchase when it exercises the option.

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4.3.3.1. Estimating the standalone selling price of an option that is a performance obligation

While unlikely to be the case, if there is a directly observable standalone selling price for the option, it should be used for allocation purposes. For the more likely scenario in which a directly observable standalone selling price for the option is not available, the CP entity must estimate the standalone selling price (which is discussed in detail in Section 8.2 of our revenue recognition guide). In doing so, the CP entity should ensure that the estimate reflects both of the following:

- *If the customer could get a discount without exercising the option, that discount should be taken into consideration in the standalone selling price of the option.* For example, consider a situation in which a customer has an option to purchase product from the CP entity in the future at a 30% discount. If the customer could get a 10% discount on future purchases of the product without the option because, for example, the CP entity is offering a 10% discount on future purchases of any product to all customers, that should be taken into consideration in estimating the standalone selling price of the option. In this situation, the discount that should be evaluated to determine whether it provides the customer with a material right is the incremental 20% discount on future purchases that CP entity is offering to only this customer. This is important to keep in mind because the effects of the customer only getting an incremental discount of 20% (compared to 30%) decreases the value of the option, all other things being equal.
- *How likely it is that the customer will exercise the option.* For example, consider a situation in which a customer has an option to purchase up to $1,000 of product from the CP entity in the future at a 30% discount. If the customer is only expected to use the discount to purchase $800 of product, the standalone selling price of the option should reflect the expected purchases of $800 and not the maximum possible purchases of $1,000. Conceptually, this is a form of breakage (i.e., unexercised customer rights), which is discussed in Section 5.1.4.

Given the difficulties that may arise in estimating the standalone selling price of an option for additional goods or services, a CP entity may instead 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 practical alternative may only be elected if the optional goods or services are:

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

While the type of option for additional goods or services that most likely would qualify for this practical alternative is a contract renewal option, other types of options also may qualify.

Example 4-5: Determining whether a discount voucher is a performance obligation, estimating its standalone selling price and accounting for its redemption (ASC 606-10-55-336 to 55-339)

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

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

To estimate the standalone selling price of the discount voucher in accordance with paragraph 606-10-55-44, the entity estimates an 80 percent likelihood that a customer will redeem the voucher and that a

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customer will, on average, purchase $50 of additional products. Consequently, the entity's estimated standalone selling price of the discount voucher is $12 ($50 average purchase price of additional products × 30 percent incremental discount × 80 percent likelihood of exercising the option). The standalone selling prices of Product A and the discount voucher and the resulting allocation of the $100 transaction price are as follows:

Performance Obligation	Standalone Selling Price	
Product A	$100	
Discount voucher	12	
Total	$112	
Performance Obligation	**Allocated Transaction Price**	
Product A	$89	($100 ÷ $112 × $100)
Discount voucher	11	($12 ÷ $112 × $100)
Total	$100	

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

RSM COMMENTARY: While not explicitly stated, the entity concludes that it should account for the promise to provide the incremental discount of 30% as a performance obligation because it represents a material right the customer would not have received if it had not entered into the contract with the entity to purchase Product A for $100.

Assuming the inventory cost of the $100 product purchased by the customer is $40, the entity records the following journal entry when it transfers control of Product A to the customer.

	Debit	Credit
Cash	$100	
Cost of goods sold	40	
Revenue		$89
Discount voucher liability		11
Inventory		40

The following journal entry summarizes how the entity would recognize revenue if the customer used the voucher to purchase products totaling $30, $50 or $70 over the 30-day period, respectively:

	$30		$50		$70	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash (Note 1)	$18		$30		$42	
Discount voucher liability	11		11		11	
Revenue (Note 2)		$29		$41		$53

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Note 1: The cash reflected for each purchase was calculated by reducing the purchase price ($30, $50 or $70) by the 40% discount. For example, if the discount voucher were used to purchase an item with a price of $30, the cash received on that purchase would be $18 ($30 × [1 – 40%]).

Note 2: The revenue reflected for each purchase is the amount the customer pays for the current purchase plus the discount voucher liability recorded when the customer made the purchase that entitled it to the discount voucher.

The entity should take its experience with the redemption of this discount voucher into consideration when estimating the standalone selling prices of similar discount vouchers in the future.

4.3.3.2. Accounting for the customer's exercise of an option that provides a material right

The FASB staff and TRG discussed how an entity should account for the customer's exercise of an option that provides a material right. For this purpose, the FASB staff and TRG concluded that two models are supportable under ASC 606. One of the models is based on continuing to account for the performance obligations previously identified in the contract as they otherwise would have been accounted for absent exercise of the option, and separately accounting for the performance obligations created by the customer's exercise of the option. The other model is based on the change in scope or price resulting from exercise of the option being evaluated as a contract modification. A CP entity must elect an accounting policy related to which model it will use to account for the customer's exercise of an option that provides a material right, disclose that accounting policy and consistently apply it in similar facts and circumstances. It is worth noting that the TRG and FASB staff considered and rejected a view that the customer's exercise of an option that provides a material right should (or may) be accounted for as variable consideration. They did not believe this view was supportable under ASC 606.

Additional information about (and an example illustrating) each of the supportable models is provided in Section 6.6.3.2 of our revenue recognition guide.

4.3.4. Accounting for customer loyalty programs

A customer loyalty program is an example of a customer option for additional goods or services and should be evaluated as such. In other words, a CP entity should determine whether the option for additional goods or services provided in a customer loyalty program is a material right that the customer would not have received had it not entered into the contract with the CP entity. As discussed earlier, when evaluating whether an option provides a material right, the CP entity should consider: (a) both quantitative and qualitative information about the customer loyalty program and (b) all relevant transactions related to the customer loyalty program, which includes current, past and future transactions. Consider the following example.

Example 4-6: Evaluating whether a specific loyalty program includes an option that provides the customer with a material right (Question 12 of FASB's Revenue Recognition Implementation Q&As)

Loyalty Program (Example 1)

Entity A has a loyalty program in which its customers accumulate one point for every dollar spent. Points may be exchanged for free products when the customer accumulates enough points. Based on its historical data, Entity A determines that it is likely that its customers will accumulate enough loyalty points to receive a free product.

In the current transaction, Customer Y purchases a product from Entity A for $50 and receives 50 loyalty points. Entity A concludes that each loyalty point has a standalone selling price of $0.01.

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Entity A would consider whether the loyalty points earned from the current transaction are expected to contribute to a material right that the customer has (or will) accumulate. The evaluation would consider that an element of the right granted to Customer Y in the current transaction is the customer's ability to accumulate loyalty points that will entitle the customer to a free product.

RSM COMMENTARY: By tying whether a material right exists in this example to the customer's ability to accumulate loyalty points on future transactions, the TRG and FASB staff rejected the position that if the loyalty points earned in the current transaction are not enough to entitle the customer to a benefit (e.g., free hotel room stay, $100 discount), they do not provide the customer with a material right.

While the AICPA did not have an industry-specific revenue recognition task force focused on the CP industry, other industries in which customer loyalty programs are prevalent and for which the AICPA had industry-specific revenue recognition task forces are the gaming, airline and hospitality industries. Chapters 6, 10 and 17, respectively, of the AICPA's Audit and Accounting Guide, *Revenue Recognition*, provide guidance on issues having to do with customer loyalty programs in those industries. Determining whether a customer loyalty program includes an option that provides the customer with a material right will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

Determining that a customer loyalty program includes an option that provides the customer with a material right results in the CP entity accounting for that option as a performance obligation. To account for that performance obligation, the CP entity must estimate its standalone selling price and allocate a portion of the transaction price to the performance obligation. The transaction price allocated to the performance obligation is recognized as revenue when or as the underlying option is exercised (see Section 4.3.3.2), or, if it is not exercised, when the option expires unused. Consider the following example.

Example 4-7: Accounting for a customer loyalty program (ASC 606-10-55-353 to 55-356)

An entity has a customer loyalty program that rewards a customer with 1 customer loyalty point for every $10 of purchases. Each point is redeemable for a $1 discount on any future purchases of the entity's products. During a reporting period, customers purchase products for $100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed, and the standalone selling price of the purchased products is $100,000. The entity expects 9,500 points to be redeemed. The entity estimates a standalone selling price of $0.95 per point (totalling $9,500) on the basis of the likelihood of redemption in accordance with paragraph 606-10-55-44.

The points provide a material right to customers that they would not receive without entering into a contract. Consequently, the entity concludes that the promise to provide points to the customer is a performance obligation. The entity allocates the transaction price ($100,000) to the product and the points on a relative standalone selling price basis as follows:

Product	$91,324 [$100,000 × ($100,000 standalone selling price ÷ $109,500)]
Points	$8,676 [$100,000 × ($9,500 standalone selling price ÷ $109,500)]

At the end of the first reporting period, 4,500 points have been redeemed, and the entity continues to expect 9,500 points to be redeemed in total. The entity recognizes revenue for the loyalty points of $4,110

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[(4,500 points ÷ 9,500 points) × $8,676] and recognizes a contract liability of $4,566 ($8,676 – $ 4,110) for the unredeemed points at the end of the first reporting period.

At the end of the second reporting period, 8,500 points have been redeemed cumulatively. The entity updates its estimate of the points that will be redeemed and now expects that 9,700 points will be redeemed. The entity recognizes revenue for the loyalty points of $3,493 {[(8,500 total points redeemed ÷ 9,700 total points expected to be redeemed) × $8,676 initial allocation] – $4,110 recognized in the first reporting period}. The contract liability balance is $1,073 ($8,676 initial allocation – $7,603 of cumulative revenue recognized).

RSM COMMENTARY: The entity is accounting for the customer loyalty program on a portfolio basis. Doing so is only appropriate if it will not provide a materially different result compared to accounting for the customer loyalty program on a customer-by-customer basis. The entity should have documentation supporting its ability to account for the program on a portfolio basis.

5. Step 3: Determining the Transaction Price

5.1 General requirements for 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).” A CP entity may elect an accounting policy under which it excludes from the transaction price taxes it collects from its customers that were assessed by a government authority on (or contemporaneous with) the CP entity’s revenue-generating transactions with its customers. Examples of taxes to which this accounting policy would apply if elected are sales taxes, use taxes, value-added taxes, excise taxes and other similar taxes. Examples of taxes to which this accounting policy would not apply if elected are gross receipts taxes and taxes imposed during the inventory procurement process.

If a CP entity elects this accounting policy, it must apply the policy to all sales and similar taxes. In other words, the CP entity cannot choose to apply the policy to some sales and similar taxes and not apply the policy to other sales and similar taxes. In addition, if the CP entity elects the accounting policy, the accounting policy disclosure requirements in ASC 235 apply.

If a CP entity does not elect the accounting policy, it must determine whether it is a principal or an agent with respect to each sale or similar tax assessed on its revenue-generating transactions. 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. Making the determination as to whether the entity is a principal or an agent with respect to each sale or similar tax in every tax jurisdiction in which its revenue-generating transactions are subject to such taxes could be a very onerous exercise. It is for this reason that the FASB provided the alternative accounting policy that an entity may elect.

5.2 Accounting for variable consideration

Variable consideration can take many forms. In the CP industry, common examples include early payment discounts, volume discounts, rebates, price concessions and rights of return. The variability in the amount of consideration to which the CP entity is entitled may be caused by explicit terms in the contract or it may be caused by an implicit price concession, discount, refund or credit that the CP entity intends to offer the customer or that the customer has a valid expectation of receiving based on the CP entity’s customary business practices, published policies or specific statements.

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There are certain scenarios in which an entity may not be required to estimate variable consideration:

- An entity provides a series of distinct good or services for which the variable payments relate specifically to the entity's efforts to transfer each distinct good or service within the series (see Section 8.3.2.1 5 of our revenue recognition guide)
- An entity is entitled to sales- or usage-based royalties and the only, or predominant, item(s) to which the royalty relates is the license of IP (see Section 7.3.5 of our revenue recognition guide)
- An entity elects to apply the practical expedient that allows revenue to be recognized for the amount the entity has a right to invoice (see Section 9.3.1.1 of our revenue recognition guide)

Outside of these exceptions, an estimate of the variable consideration to which a CP entity expects to be entitled 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. This approach to determining the amount of variable consideration that a CP entity should include in the transaction price suggests the following two steps should be performed:

1. Estimate the amount of variable consideration to which a CP entity expects to be entitled using either the expected value method or the most likely amount method (the specific method used depends on which will better predict the amount of variable consideration in a particular set of facts and circumstances).
2. Constrain the estimated amount of variable consideration such that it is probable that the inclusion of the estimate 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.

While these appear to be two discrete steps, as discussed in Question 7Q.3.3.1 of our revenue recognition guide, a CP entity's use of the expected value method to estimate the variable consideration to which it expects to be entitled may reduce, depending on the facts and circumstances, the probability of a revenue reversal such that the CP entity does not have to separately constrain its estimate of variable consideration.

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 used to initially estimate the variable consideration included in the transaction price also should be used when the estimate is reassessed each reporting period.

As discussed in Section 4.3.1, when a contract has variable attributes, it may not initially be clear whether those variable attributes give rise to an option for additional goods or services or variable consideration. Additional discussion and examples are provided in Section 4.3.

Application of the variable consideration guidance in ASC 606 to volume and early payment discounts and rebates, rights of return or refund and price concessions is discussed further and illustrated in Sections 5.2.1, 5.2.2 and 5.2.3, respectively. Section 7.3 of our revenue recognition guide provides additional information and examples related to accounting for variable consideration.

5.2.1. Volume and early payment discounts and rebates

Discounts and other contract terms that are fixed at contract inception do not give rise to variable consideration. For example, if the contract terms indicate that the customer is receiving a 5% discount off list price for the equipment purchased, that discount is fixed. In contrast, if the contract terms indicate any of the following, the consideration is variable:

- The customer will receive a 5% discount off list price *if* the customer pays the amount owed within 30 days (early payment discount)

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- The customer will receive a 10% discount off list price *if* the customer buys more than a specified amount of consumer products (retrospective volume discount)
- The customer will receive a rebate of $10,000 *if* the customer purchases a certain quantity of consumer products (volume rebate)

The consideration is variable in these situations because it is uncertain whether the CP entity will have to provide the discount or rebate, given that it is contingent on an action (or inaction) by the customer.

The following examples illustrates application of the variable consideration guidance to common retrospective volume discount and rebate scenarios.

Example 5-1: Applying the variable consideration constraint to a retrospective volume discount (ASC 606-10-55-216 to 55-220)

An entity enters into a contract with a customer on January 1, 20X8, to sell Product A for $100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to $90 per unit. Consequently, the consideration in the contract is variable.

For the first quarter ended March 31, 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

The entity considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $100 per unit) will not occur when the uncertainty is resolved (that is, when the total amount of purchases is known). Consequently, the entity recognizes revenue of $7,500 (75 units × $100 per unit) for the quarter ended March 31, 20X8.

In May 20X8, the entity's customer acquires another company and in the second quarter ended June 30, 20X8, the entity sells an additional 500 units of Product A to the customer. In light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and, therefore, it will be required to retrospectively reduce the price per unit to $90.

Consequently, the entity recognizes revenue of $44,250 for the quarter ended June 30, 20X8. That amount is calculated from $45,000 for the sale of 500 units (500 units × $90 per unit) less the change in transaction price of $750 (75 units × $10 price reduction) for the reduction of revenue relating to units sold for the quarter ended March 31, 20X8 (see paragraphs 606-10-32-42 through 32-43).

RSM COMMENTARY: The fixed price of Product A is $90 per unit, and there is variable consideration of $10 per unit. The uncertainty related to the variable consideration is whether the customer will buy more than 1,000 units of Product A. The entity determined that the transaction price per unit for the customer's purchases in the first quarter was $100 per unit (i.e., the variable consideration of $10 per unit was not constrained based on the entity's analysis of the facts and circumstances at that point in time). In the second quarter, the entity reassesses the variable consideration and concludes it should be constrained because of a change in the facts and circumstances (i.e., the customer's acquisition of another company and the increase in the relative quantity of Product A purchased by the customer in that quarter). Accounting for the change in the transaction price results in the entity making an adjustment to reduce revenue by $750 (75 units sold in the first quarter × $10 per unit) in the second quarter for the units of Product A transferred to the customer in the first quarter for which revenue was

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recognized at $100 per unit. Also in the second quarter, the entity recognizes revenue of $45,000 (500 units sold in the second quarter × $90 per unit).

Consider a change to the fact pattern in this example that would result in a reduction to the unit price for Product A from $100 to $90 if the customer paid for all shipments of Product A under the contract within 25 days of receipt. In this revised fact pattern, the entity would need to assess the likelihood of the customer making all payments for Product A over the contract term within the 25-day discount period (instead of assessing whether the customer would buy more than 1,000 units of Product A over the contract term). If the entity concluded in the first quarter that the customer would not make all payments for Product A within the 25-day discount period, but reassessed its conclusion in the second quarter and concluded that the customer would make all payments for Product A within the 25-day discount period, the accounting for the early payment discount would produce the same accounting results as the volume discount in the preceding example. If the early payment discount applied to each shipment of Product A (instead of all shipments of Product A), the accounting results may differ depending on the entity's assessment of the likelihood of the customer paying for some shipments of Product A within the 25-day discount period and others outside the 25-day discount period.

Consider a different change to the fact pattern in this example that would result in the entity receiving a $10,000 rebate if the customer purchases more than 1,000 units. While the entity's accounting in the first quarter would remain the same in this revised fact pattern, its accounting in the second quarter would depend, at least in part, on how many units it expects the customer to purchase. For example, if the entity believes it is probable that the customer will purchase 1,200 units over the contract term, then the per unit price of $91.68 ([(1,200 units × $100 per unit) – $10,000 rebate] ÷ 1,200 units) would be used to calculate the adjustment to the revenue recognized in the first quarter and to calculate the revenue that would be recognized in the second quarter, provided the variable consideration of $1.68 included in that per unit price would not otherwise need to be constrained.

Accounting for variable consideration often will require significant judgment and careful consideration of a CP entity's own relevant facts and circumstances. It is critically important for a CP entity to exercise consistent judgment in similar facts and circumstances.

Example 5-2: Estimating variable consideration when rebates are provided based on volume of customer purchases

CP Company (CPCo) enters into a master services agreement (MSA) with Retailer (CPCo's customer) to supply up to 50,000 dress shirts made out of a new stain-resistant fabric for $20 per shirt. To provide an incentive for Retailer to purchase a significant number of the new shirts, CPCo notifies Retailer that if sales volumes under the MSA exceed 40,000 dress shirts, CPCo will credit an agreed-upon percentage of gross sales (not to exceed 50,000 shirts) back to Retailer via a rebate.

CPCo decides to estimate the variable consideration that should be included in the transaction price for each dress shirt sold under the MSA using the expected value method. Provided in the following table are the rebate thresholds in the MSA, which are based on a 40,000-dress shirt benchmark, and the rebate earned on gross sales by Retailer if it reaches a specific rebate threshold. Also provided is CPCo's expectation with respect to the probability of Retailer meeting a particular rebate threshold. These probabilities are based on CPCo's analysis of a variety of factors, including Retailer's historical purchasing patterns and market expectations in Retailer's operating territory.

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Rebate threshold with a 40,000-shirt benchmark	Rebate earned on gross sales when rebate threshold is met	Probability of meeting rebate threshold	Expected value of the rebate
40,000 or less	0.0%	10%	0.00%
40,001 to 45,000	1.0%	50%	0.50%
45,001 to 50,000	2.0%	40%	0.80%
			1.30% (or $0.26 per shirt)

Based on this information, CPCo will never be entitled to less than $19.60 ($20 × [1 – 2.0%]) per dress shirt sold to Retailer. As a result, the amount of variable consideration per dress shirt is $0.40 ($20 – $19.60). Based on applying the expected value method to estimate the rebate CPCo expects Retailer to be entitled to, CPCo estimates that it expects to be entitled to approximately $0.14 of the variable consideration per dress shirt ($0.40 – [$0.40 × (1.3% ÷ 2.0%)]), for a net sales price per shirt of $19.74 ([$19.60 + $0.14] or [$20 × (1 – 1.3%)]).

If CPCo concludes that its use of the expected value method to estimate the variable consideration to which it expects to be entitled reduces the probability of a revenue reversal such that CPCo does not have to separately constrain its estimate of variable consideration, then the transaction price per dress shirt is $19.74. Otherwise, CPCo must consider whether it is probable that including $0.14 per dress shirt 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. If it is probable, the transaction price per dress shirt is $19.74. If it is not probable, CPCo must determine the amount by which it should constrain the variable consideration of $0.14 for purposes of estimating the transaction price.

After Retailer issues its first purchase order for the dress shirts, CPCo must determine whether Retailer's option to buy additional shirts subject to the rebate represents a material right that Retailer would not have received had it not entered into the MSA with CPCo. Making this determination and the related accounting effects are discussed in Section 4.3.2 and Section 4.3.3, respectively.

5.2.2. Rights of return or refund

A customer's right to return a product and 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 CP entity recognizes revenue, it does so for the amount of the transaction price to which it expects to be entitled, 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, a CP entity should take many factors into consideration, including its history with the same or similar return rights, relevant industry information and economic trends.

A CP entity recognizes a refund liability for the amount received or receivable to which it ultimately does not expect to be entitled as a result of the return or refund right (i.e., the amount it is expected to refund). In addition, a CP 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 include any decrease in value of the returned product. The refund liability and asset for the right to returned inventory should be separately recognized (i.e., they should not be netted against each other). In addition, the refund liability to the customer typically is not considered a contract liability and should not be included with the contract liability for presentation purposes.

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At the end of each reporting period, a CP entity should review its estimated returns and refunds compared to actual and determine whether any adjustments are needed to the refund liability, revenue, asset for the right to returned inventory and cost of goods sold related to products sold subject to a right of return or refund.

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 [see Section 4.2.3]).

5.2.2.1. Restocking fees and costs related to returned products

When a product is returned, a CP entity may charge the customer a restocking fee or incur restocking costs, such as the costs to repackage the returned product. The FASB staff and TRG discussed how to account for such fees and costs, given that they were not explicitly addressed by ASC 606. A summary of these discussions is provided in Question 42 of FASB's Revenue Recognition Implementation Q&As. The FASB staff and TRG concluded that: (a) restocking fees related to the products expected to be returned should be included in the transaction price and recognized when control of the product is transferred to the customer and (b) restocking costs related to the products expected to be returned should be accrued and used to reduce the asset for returned inventory when control of the product is transferred to the customer. Consider the following example.

Example 5-3: Accounting for restocking fees and costs (Question 42 of FASB's Revenue Recognition Implementation Q&As)

Entity enters into a contract with Customer to sell 10 widgets for $100 each. The cost of each widget is $75. Customer has the right to return a widget, but will be charged a restocking fee of 10% (that is, $10 per widget). Entity expects to incur restocking costs of 5% (that is, $5 per widget). Entity concludes that, due to the existence of a return right, the consideration promised in its contract with Customer includes a variable amount. Entity uses the expected value method for estimating the variable consideration and estimates that 10% of widgets will be returned and that it is probable that returns will not exceed 10%. Entity expects that the returned widgets can be resold at a profit.

In this case, Entity would recognize revenue of $910 [(9 widgets expected not to be returned * $100 selling price) + (1 widget expected to be returned * $10 restocking fee)] and a refund liability of $90 [1 widget expected to be returned * ($100 selling price – $10 restocking fee)] when control of the widgets transfers to Customer.

RSM COMMENTARY: Entity records the following journal entry when control of the widgets transfers to Customer:

	Debit	Credit
Accounts receivable (Note 1)	$1,000	
Cost of goods sold (Note 2)	680	
Asset for returned inventory (Note 3)	70	
Revenue (Note 4)		$910
Refund liability (Note 5)		90
Inventory (Note 6)		750

Note 1: $100 price per widget × 10 widgets for which control transferred to the customer

Note 2: ($75 cost per widget × 10) – $70 asset for returned inventory (Note 3)

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Note 3: $75 cost of the one widget expected to be returned – $5 restocking costs

Note 4: ($100 price per widget × 9 widgets expected to be sold and not returned) + $10 restocking fee for the one widget expected to be returned

Note 5: $100 price of the one widget expected to be returned – $10 restocking fee for the one widget expected to be returned

Note 6: $675 cost of the nine widgets sold and not expected to be returned + $75 cost of the one widget expected to be returned

5.2.3. Price concessions

Price concessions arise when a CP entity provides its customer with a reduction in the price for some or all of the promised goods or services included in the customer contract. Because it is not uncommon for price concessions to be implicit at contract inception and only explicitly granted to a customer after contract inception, CP entities should ensure they have appropriate processes in place to identify the implicit price concessions the CP entity intends to offer the customer, as well as those price concessions the customer has a valid expectation of receiving based on the CP entity's customary business practices, published policies or specific statements.

From an accounting perspective, price concessions are another form of variable consideration to which the variable consideration accounting model should be applied. Consider the following example.

Example 5-4: Applying the variable consideration constraint to price concessions (ASC 606-10-55-208 to 55-215)

An entity enters into a contract with a customer, a distributor, on December 1, 20X7. The entity transfers 1,000 products at contract inception for a price stated in the contract of $100 per product (total consideration is $100,000). Payment from the customer is due when the customer sells the products to the end customers. The entity's customer generally sells the products within 90 days of obtaining them. Control of the products transfers to the customer on December 1, 20X7.

On the basis of its past practices and to maintain its relationship with the customer, the entity anticipates granting a price concession to its customer because this will enable the customer to discount the product and thereby move the product through the distribution chain. Consequently, the consideration in the contract is variable.

Case A—Estimate of Variable Consideration Is Not Constrained

The entity has significant experience selling this and similar products. The observable data indicate that historically the entity grants a price concession of approximately 20 percent of the sales price for these products. Current market information suggests that a 20 percent reduction in price will be sufficient to move the products through the distribution chain. The entity has not granted a price concession significantly greater than 20 percent in many years.

To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates the transaction price to be $80,000 ($80 × 1,000 products).

The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of $80,000 can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and determines that it has significant previous experience with this product and current market information that supports its estimate. In addition, despite some uncertainty resulting from factors outside

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its influence, based on its current market estimates, the entity expects the price to be resolved within a short time frame. Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $80,000) will not occur when the uncertainty is resolved (that is, when the total amount of price concessions is determined). Consequently, the entity recognizes $80,000 as revenue when the products are transferred on December 1, 20X7.

Case B—Estimate of Variable Consideration Is Constrained

The entity has experience selling similar products. However, the entity's products have a high risk of obsolescence, and the entity is experiencing high volatility in the pricing of its products. The observable data indicate that historically the entity grants a broad range of price concessions ranging from 20 to 60 percent of the sales price for similar products. Current market information also suggests that a 15 to 50 percent reduction in price may be necessary to move the products through the distribution chain.

To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that a discount of 40 percent will be provided and, therefore, the estimate of the variable consideration is $60,000 ($60 × 1,000 products).

The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether some or all of the estimated amount of variable consideration of $60,000 can be included in the transaction price. The entity considers the factors in paragraph 606-10-32-12 and observes that the amount of consideration is highly susceptible to factors outside the entity's influence (that is, risk of obsolescence) and it is likely that the entity may be required to provide a broad range of price concessions to move the products through the distribution chain. Consequently, the entity cannot include its estimate of $60,000 (that is, a discount of 40 percent) in the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Although the entity's historical price concessions have ranged from 20 to 60 percent, market information currently suggests that a price concession of 15 to 50 percent will be necessary. The entity's actual results have been consistent with then-current market information in previous, similar transactions. Consequently, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur if the entity includes $50,000 in the transaction price ($100 sales price and a 50 percent price concession) and, therefore, recognizes revenue at that amount. Therefore, the entity recognizes revenue of $50,000 when the products are transferred and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved in accordance with paragraph 606-10-32-14.

RSM COMMENTARY: The following are additional assumptions related to the fact pattern in Case A and the corresponding journal entries:

- The inventory cost of the 1,000 products transferred by the entity to its customer is $55,000 and control of the products transfers to the entity's customer on December 1, 20X7. Based on these assumptions, the entity records the following journal entry:

	Case A	
	Debit	**Credit**
Contract asset	$80,000	
Cost of goods sold	55,000	
Revenue		$80,000
Inventory		55,000

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- The entity's customer sells 600 products to end customers in the first 30 days after having obtained control of the products. Based on this assumption, the entity records the following journal entry:

	Case A	
	Debit	**Credit**
Accounts receivable	$48,000	
Contract asset		$48,000

- Shortly after the end customers obtained control of the 600 products sold to them by the entity's customer, the entity explicitly grants a 20% discount to its customer on all 1,000 products transferred. It does not expect to offer any additional discount. Based on this assumption, the entity does not record any further journal entries related to the 600 products over which the customer already has control because the 20% discount explicitly granted to the customer is the same as the concession used for purposes of measuring variable consideration and determining the transaction price.

  The entity's customer sells the remaining 400 products to end customers in the second 30 days after having obtained control of the products. Based on this assumption, the entity records the following journal entry.

	Case A	
	Debit	**Credit**
Accounts receivable	$32,000	
Contract asset		$32,000

The following are additional assumptions related to the fact pattern in Case B and the corresponding journal entries:

- The inventory cost of the 1,000 products transferred by the entity to its customer is $55,000 and control of the products transfers to the entity's customer on December 1, 20X7. Based on these assumptions, the entity records the following journal entry:

	Case B	
	Debit	**Credit**
Contract asset	$50,000	
Cost of goods sold	55,000	
Revenue		$50,000
Inventory		55,000

- The entity's customer sells 900 products to end customers by January 31, 20X8. Based on this assumption, the entity records the following journal entry:

	Case B	
	Debit	**Credit**
Accounts receivable	$45,000	
Contract asset		$45,000

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- The entity receives a payment of $30,000 from its customer on January 31, 20X8. Based on this assumption, the entity records the following journal entry:

	Case B	
	Debit	**Credit**
Cash	$30,000	
Accounts receivable		$30,000

- The entity determines on January 31, 20X8 that it will grant a 40% discount to its customer in January 20X8 on all 1,000 products transferred. It does not expect to offer any additional discount. Based on this assumption, the entity records the following journal entry:

	Case B	
	Debit	**Credit**
Accounts receivable (Note 1)	$9,000	
Contract asset (Note 2)	1,000	
Revenue (Note 3)		$10,000

Note 1: ([900 products sold to end customers × ($100 per product × [1 – 40%])] – $30,000) = $24,000, which is what the balance in Accounts receivable should be at January 31, 20X8. Compared to the actual balance of $15,000 ($45,000 – $30,000), Accounts receivable should be increased by $9,000 ($24,000 – $15,000).

Note 2: (100 products not yet sold to end customers x [$100 per product × (1 – 40%)]) = $6,000, which is what the balance in the Contract asset should be at January 31, 20X8. Compared to the actual balance of $5,000 ($50,000 – $45,000), the Contract asset should be increased by $1,000.

Note 3: ([1,000 products transferred to customer × ($100 per product × [1 – 40%])] – $50,000) = $10,000, which is the amount of additional revenue that should be recorded based on the actual discount of 40% compared to the constrained discount of 50%.

- In February 20X8, the entity explicitly grants the 40% discount to its customers, and the entity's customer sells the remaining 100 products to end customers. Based on these assumptions, the entity records the following journal entry:

	Case B	
	Debit	**Credit**
Accounts receivable	$6,000	

5.3 Consideration payable to the customer

5.3.1. Identifying consideration payable to the customer

Consideration payable to the customer includes amounts the CP entity is explicitly required to pay to its customer (e.g., CP goods manufacturer paying a slotting fee to a retailer customer) or its customer's customers (e.g., CP goods manufacturer granting a rebate to a consumer [which is its customer's customer]). The consideration payable could be labeled a credit, coupon, voucher, rebate, cooperative advertising or slotting fee, etc. In addition, consideration payable to the customer may be implied based on a CP entity's past practices or the customer's expectations. A CP entity may or may not receive something in return for the consideration payable to the customer (e.g., CP goods manufacturer pays a retailer customer for cooperative advertising or product placement at eye level).

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As discussed in detail in Questions 7Q.5.1.1 and 7Q.5.1.2 of our revenue recognition guide, consideration payable to the customer should include those payments to a customer that are either explicitly or implicitly part of the contract or a group of contracts combined based on the guidance in Section 5.4 of our revenue recognition guide, as well as those payments that are otherwise linked to a contract. In addition, payments to the customer's customers in the distribution chain, as well as payments to the customer's customers outside the distribution chain in certain facts and circumstances, should be treated as consideration payable to a customer for purposes of ASC 606. CPE entities should approach identifying payments to their customers that should be treated as consideration payable to a customer in the spirit of the core principle in ASC 606-10-10-2, which 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."

5.3.2. Accounting for consideration payable to a customer

Consideration payable to a customer is reflected as a reduction of the transaction price (and, as a result, a reduction of revenue) unless the CP entity receives something distinct in return for that consideration. If consideration payable to a customer is variable, it should be accounted for consistent with the variable consideration guidance in ASC 606 (see Section 5.2). Section 5.3.3 provides additional discussion about the interaction of the variable consideration and consideration payable to a customer guidance in ASC 606.

For purposes of determining whether the good or service received by the CP entity is distinct, the CP entity follows the guidance in Section 4.2 (which is used to determine whether a promised good or service is distinct and should be accounted for separately as a performance obligation). If the CP entity receives a good or service that is distinct, it must determine if its fair value can be reasonably estimated. If the CP entity cannot reasonably estimate the fair value of the distinct good or service it receives from the customer, 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 CP entity is the lesser of the fair value of the good or service provided to the CP entity and the amount payable to the customer by the CP entity. This cost is accounted for in the same manner as if the CP 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 CP entity receives from its customer is treated as a reduction of the transaction price.

When some or all of the consideration payable to a customer 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 transferred to the customer is recognized or (b) when the consideration is paid or promised to the customer (which includes payments made only upon the occurrence of a future event).

5.3.2.1. Slotting fees

Slotting fees (or allowances) are payments a CP entity may make to its distributors or retailers to carry its product and, in some cases, to provide specific product placement within a retail location (e.g., a specific shelf or endcap within a grocery store). Because it is not uncommon for slotting fees to be implicit at contract inception and only explicitly granted to a customer (or a customer's customer) after contract inception, CP entities should ensure they have appropriate processes in place to identify the implicit slotting fees the CP entity intends to offer the customer (or the customer's customer), as well as those price concessions the customer has a valid expectation of receiving based on the CP entity's customary business practices, published policies or specific statements.

Given that consideration payable to a customer that is variable is accounted for as variable consideration (and not consideration payable to a customer), a variable slotting fee should be accounted for as variable consideration. Nonvariable slotting fees should be accounted for as consideration payable to the customer. Consider the following example of how to account for a nonvariable slotting fee.

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Example 5-6: Accounting for a slotting fee paid to a customer (ASC 606-10-55-252 to 55-254)

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

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

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

RSM COMMENTARY: There is no presumption about how to treat cash paid to customers under ASC 606. Instead, ASC 606 indicates that such payments should be treated as a revenue reduction unless the CP entity receives a distinct good or service whose fair value can be reasonably estimated.

Slotting fees received by a CP entity are outside the scope of ASC 606 and would not be recorded as revenue unless received in exchange for a distinct good or services transferred by the CP entity. See the guidance in ASC Subtopic 705-20 for further discussion on the accounting for consideration received from a vendor.

5.3.2.2. Cooperative advertising

Cooperative advertising typically refers to situations in which a manufacturer and retailer (or others in the distribution chain, such as a distributor) jointly advertise a product. The terms of a cooperative advertising arrangement will vary depending on the parties and products involved and the nature of the cooperative advertising that will be undertaken. In the context of consideration payable to a customer, cooperative advertising typically arises when a retailer requires payment from the manufacturer to advertise the manufacturer's product in a retailer-specific advertisement. In this situation, the retailer is either the manufacturer's customer or a customer of the manufacturer's customer (e.g., the retailer is a customer of a distributor that is a customer of the manufacturer).

Applying the consideration payable to a customer guidance in ASC 606 to cooperative advertising requires a CP entity to consider whether it receives advertising that is distinct, and if so, the fair value of the advertising. Consider the following example.

Example 5-7: Accounting for cooperative advertising

Company A, a manufacturer of breakfast cereal, enters into a contract to sell Customer B, a grocery retailer, 100,000 boxes of its breakfast cereals at $2 per box. The inventory cost of the cereal is $1.25 per

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box. In addition, Company A agrees to pay Customer B $25,000 for cooperative advertising in a future edition of Customer B's weekly circular in the Sunday newspaper, which features certain products and special offers at Customer B's retail locations in the coming week. Company A concludes that the cooperative advertising provides it with a distinct service.

Consider the following three cases:

1. The fair value of the cooperative advertising is $15,000, which is less than Company A's payment to Customer B.
2. The fair value of the cooperative advertising is $30,000, which is more than Company A's payment to Customer B.
3. The fair value of the cooperative advertising is not reasonably estimable.

Company A would record the following journal entry for each case upon transferring control of the breakfast cereal to Customer B:

	Case 1		Case 2		Case 3	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Accounts receivable (Notes 1, 2)	$200,000		$200,000		$200,000	
Cost of goods sold (Note 3)	125,000		125,000		125,000	
Prepaid advertising (Note 4)	15,000		25,000			
Revenue (Note 5)		$190,000		$200,000		$175,000
Inventory (Note 3)		125,000		125,000		125,000
Accounts payable (Note 2)		25,000		25,000		25,000

Note 1: In all three scenarios, 100,000 boxes of breakfast cereal × $2 per box

Note 2: Depending on the facts and circumstances, the accounts receivable from Customer B and the accounts payable to Customer B may have to be presented net.

Note 3: In all three scenarios, 100,000 boxes of breakfast cereal × $1.25 per box.

Note 4: In Cases 1 and 2, Company A recognizes prepaid advertising for the lesser of the fair value of the cooperative advertising and the amount Company A pays Customer B. In Case 3, Company A does not recognize prepaid advertising because the fair value of the cooperative advertising is not reasonably estimable. Company A will recognize advertising expense when its ad runs in Customer B's Sunday circular in the future.

Note 5: In Case 1, (100,000 boxes of breakfast cereal × $2 per box) – ($25,000 payment to Customer B – $15,000 fair value of cooperative advertising). In Case 2, 100,000 boxes of breakfast cereal × $2 per box. In Case 3, (100,000 boxes of breakfast cereal × $2 per box) – $25,000 payment to Customer B

5.3.3. Interaction of the variable consideration and consideration payable to a customer guidance

If consideration payable to a customer is variable, the question arises as to whether the variable consideration or the consideration payable to the customer guidance in ASC 606 should be used to determine when the consideration payable to the customer should be recognized as a reduction to the transaction price (or otherwise, if the CP entity receives a distinct good or service in return). The question arises because the variable consideration guidance requires a CP entity to include an estimate of the variable consideration subject to a constraint in the transaction price (which is then recognized when or as the performance obligations are satisfied), while the consideration payable to the customer guidance

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requires a CP entity to recognize the consideration payable to the customer at the later of two points in time (only one of which is when the related performance obligations are satisfied).

The FASB staff and TRG discussed whether the variable consideration or the consideration payable to the customer guidance in ASC 606 should be used to determine when consideration payable to the customer should be recognized. A summary of these discussions in Question 29 of FASB's Revenue Recognition Implementation Q&As. The FASB staff and TRG concluded that if the CP entity is required to make a payment to its customer and that payment is variable, the variable consideration guidance should be applied. In addition, the CP entity should consider whether it intends to make a variable payment to its customer or whether the customer expects to receive a variable payment from the CP entity because of the CP entity's customary business practices. In either case, the variable consideration guidance should be applied.

5.3.3.1. Coupons

In some cases, determining whether the variable consideration or consideration payable to a customer guidance should be applied to variable consideration payable to a customer will require significant judgment to be exercised and careful consideration of all the facts and circumstances. Consider the following example.

Example 5-8: Accounting for Coupons (Question 29 of FASB's Revenue Recognition Implementation Q&As)

An entity that manufactures consumer goods enters into a contract to sell a new product to a customer (a retail store chain) on December 15th. Before delivering any of the new products to the retail store chain, the entity's marketing department assesses whether the entity should offer CU1-off coupons in newspapers to encourage consumers to buy the new product at the retail store chain. The entity will reimburse the retail store chain for any coupons that are redeemed by consumers. The entity has not historically entered into similar coupon offerings in the past. The entity delivers the new consumer goods (1,000 units at CU10/unit) to the retail store chain on December 28th. On December 31st, the entity decides to make the coupon offering. On January 2nd, the entity communicates to its customer that it will reimburse the retail store chain on March 30th for any coupons redeemed by the retail store's customers. Assume the entity prepares its financial statements based on a calendar year end.

RSM COMMENTARY: Based on the FASB staff's and TRG conclusions, the coupon is not variable consideration because on December 15 (a) the entity is not contractually required to make a payment to its customer and (b) the customer has no basis to expect a payment from the entity, given that the entity has not entered into similar coupon offerings in the past. Applying the consideration payable to a customer guidance to this example results in the entity reducing revenue on January 2 (the date the consideration is paid or promised) for the payment it expects to make to the customer for the coupons it expects to be redeemed because that is later than December 28 (when the revenue for the related goods or services was recognized).

Consider the following two alternative fact patterns: (a) the entity communicates to its customer during contract negotiations that it will be making a coupon offering upon introduction of the new product in the market or (b) the customer's customers expect the entity to make a coupon offering upon introduction of the new product in the market because it is the entity's customary business practice to do so. In either case, the consideration payable to the customer in connection with the coupon offering should be considered variable consideration at contract inception because the entity is either contractually required to make the coupon offering or the customer's customers have a reasonable basis to expect the entity to make the coupon offering, given the entity's customary business practice in similar situations. As a result, the entity reduces the transaction price for the payment it expects to make to the customer for the

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coupons it expects to be redeemed (subject to the variable consideration constraint). The transaction price is then recognized on December 28 when the entity's performance obligation related to the new consumer goods is satisfied.

The difference in the timing of when the revenue reduction is recognized under the variable consideration guidance compared to the consideration payable to a customer guidance (the revenue reduction is recognized sooner under the variable consideration guidance in this example) underscores the importance of carefully analyzing all the facts and circumstances when determining the accounting model that should be applied to variable consideration payable to a customer.

6. Step 4: Allocating the Transaction Price to the Performance Obligations

6.1 Overall allocation model

Step 4 of the five-step revenue recognition model in ASC 606 requires a CP entity to allocate the transaction price (determined in Step 3) to each performance obligation in the contract (identified in Step 2).

The overall objective of the guidance on allocating the transaction price is to allocate an amount to each performance obligation (or distinct good or service in a single performance obligation resulting from the series exception [refer to Section 6.3 of our revenue recognition guide]) that represents the consideration to which the CP entity expects to be entitled as a result of transferring control of the underlying goods or services to the customer.

If a contract has more than one performance obligation (e.g., two consumer products that are distinct from each other), the transaction price generally should 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 are provided for certain situations involving discounts or variable consideration that can be shown (by meeting certain criteria) to be related to one or more (but less than all) performance obligations. Those exceptions are discussed in Section 6.3 of this whitepaper and Section 8.3.1 of our revenue recognition guide.

6.2 Standalone selling prices

The standalone selling price of a performance obligation is the amount the CP 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 CP 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 CP entity is required to estimate a standalone selling price. In making this estimate, the CP entity should maximize observable inputs and consider all reasonably available and relevant information, which includes information specific to the CP entity, the market, the customer and the customer class. In addition, a CP entity should be consistent in how it applies an estimation method and the situations in which it applies an estimation method.

Whether the contract price or list price for a good or service represents the good's or service's standalone selling price depends on the facts and circumstances. There is no presumption that the contract price or

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list price for a good or service represents its standalone selling price, nor is there a presumption that the contract price or list price for the good or service does not represent its standalone selling price.

If the contract price or list price for a good or service is different from the observable price charged by the CP entity for that good or service when it is sold separately in similar circumstances to similar customers, the contract price or list price does not represent the good's or service's standalone selling price because the observable price (to the extent one exists) should be used as the standalone selling price.

When an observable standalone selling price does not exist, the contract price or list price for a good or service is one data point that should be considered by the CP entity in addition to other data points (such as the standalone selling price for the good or service estimated using the adjusted market assessment approach or the expected cost plus a margin approach). Only after considering all reasonably available and relevant data points will a CP entity know if the contract price or list price for a good or service represents the good's or service's standalone selling price. Question 8Q.2.3 in our revenue recognition guide discusses other data points that may be considered by a CP entity when an observable standalone selling price does not exist.

6.3 Allocating variable consideration

Variable consideration included in the transaction price should be allocated on a proportionate basis to each of the performance obligations in a contract, except when the following two criteria are met:

- The terms of the variable payment are specifically related to the CP entity's efforts to (a) satisfy, or achieve a specific outcome from satisfying, a specific performance obligation or (b) transfer, or achieve a specific outcome from transferring, a distinct good or service in a single performance obligation resulting from application of the series exception.
- Allocating the variable payment to the specific performance obligation, or distinct good or service in a single performance obligation resulting from the series exception, depicts the amount of consideration to which the CP entity expects to be entitled in exchange for transferring that good or service to the customer when considering all of the performance obligations and payment terms in the contract.

When these criteria are met, the variable payment included in the transaction price that meets these criteria, and any change in the estimate of that payment, should be allocated in their entirety to the specific performance obligation or distinct good or service to which the variable payment relates.

The remaining transaction price is allocated as it otherwise would be under ASC 606 (i.e., allocated on a relative standalone selling price basis unless the discount exception applies [which is discussed in Section 8.3.1 of our revenue recognition guide]). For example, consider a situation in which a CP entity is providing its customer with jackets and boots, and based on the facts and circumstances, each represents its own performance obligation. The CP entity will receive a bonus if it ships the boots by a certain date. If the facts and circumstances indicate that the bonus relates only to the boots because the criteria discussed earlier are met, then the bonus is allocated to only the performance obligation for those boots. Conversely, if the facts and circumstances indicate that the bonus relates to both the jackets and boots because the criteria discussed earlier are not met, then the bonus is allocated to both performance obligations. Example 8-5 in our revenue recognition guide provides a detailed numerical example illustrating how to allocate the transaction price when the contract includes variable consideration.

7. Step 5: Recognizing Revenue When (or As) Each Performance Obligation is Satisfied

To properly assess when revenue should be recognized, a CP entity must perform at contract inception an evaluation focused on whether a performance obligation is satisfied over time or at a point in time. Central to this evaluation is understanding what constitutes *control having transferred to the customer*.

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7.1 Transfer of control

Control of an asset has transferred to a customer when the customer has the ability to direct the use of the asset and receive substantially all of the related remaining benefits, including the customer being able to stop others from directing the use of the asset 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 or save (directly or indirectly) as a result of having control of the asset.

ASC 606 provides several indicators that should be considered in assessing whether control of an asset has transferred to the customer. When present, the following indicators may signal that the customer has the ability to direct the use of the asset (and restrict others' use of the asset) and receive substantially all of the asset's remaining benefits:

- The customer is presently obligated to pay the CP entity for the transferred asset
- The customer has legal title to the transferred asset
- The customer has physical possession of the transferred asset
- The customer has the significant risks and rewards of owning the asset
- The customer has accepted the asset

It is important to note the following about the presence or absence of an indicator:

- *The presence of an indicator is not determinative evidence that control has transferred to the customer*. For example, the customer may have legal title and physical possession of equipment transferred subject to a call option, but the CP entity concludes the customer does not have the ability to direct the use of the equipment and receive substantially all of the equipment's remaining benefits because of that call option (see Section 9.7.1 of our revenue recognition guide). As a result, control has not transferred to the customer even though at least two of the indicators are present.
- *The absence of an indicator is not determinative evidence that control has not transferred to the customer*. For example, a CP entity might retain legal title to product transferred to the customer to protect itself in case of nonpayment. If other indicators are present in this situation that cause the CP entity to conclude that the customer still has the ability to direct the use of the product and receive substantially all of the product's remaining benefits prior to obtaining legal title, then control has transferred to the customer despite one of the indicators not being present.

Determining whether control of an asset has transferred to a customer often will require significant judgment and careful consideration of all the facts and circumstances.

7.2 Determining whether a performance obligation is satisfied over time or at a point in time

As indicated earlier, a CP entity must perform an evaluation at contract inception focused on whether a performance obligation is satisfied 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 the CP entity performs*. A performance obligation is satisfied over time if the customer consumes the benefits of the CP entity's performance at the same time as the customer receives those benefits and the CP entity performs and creates those benefits.
- *Customer controls the asset as the CP entity creates or enhances the asset.* A performance obligation is satisfied over time if the customer controls the asset (which could be tangible or intangible) as it is created or enhanced by the CP entity's performance.

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- *No alternative use and an enforceable right to payment for performance to date.* A performance obligation is satisfied over time if (a) the asset created by the CP entity's performance does not have an alternative use to the CP entity upon its completion and (b) the CP entity's right to payment for its performance to date is enforceable.

The same criteria are evaluated regardless of whether the performance obligation includes one or more promised goods or services. In addition, these criteria include no predispositions that will result in a performance obligation that includes a promised good being satisfied at a point in time or a performance obligation that includes a promised service being satisfied over time. Each performance obligation should be evaluated against these criteria to determine whether revenue should be recognized over time or at a point in time.

If the performance obligation is considered satisfied over time because one of the criteria discussed earlier is met, the related revenue is recognized over time if the CP entity is able to reasonably measure its progress toward complete satisfaction of the performance obligation using reliable information. The objective of this method should be to measure the progress made in transferring control of the underlying goods or services to the customer. Output 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 included in the performance obligation. Input methods rely on the efforts put forth by the CP entity to satisfy the performance obligation.

Regardless of whether an output or input method is used, the measurement of progress toward complete satisfaction of a performance obligation should only reflect the underlying goods or services for which control has transferred to the customer and should not reflect (a) any underlying goods or services for which control has not transferred to the customer or (b) any activities that are not themselves promised goods or services (e.g., setup activities). Identifying an appropriate measurement of progress toward complete satisfaction of a performance obligation could be complex when the CP entity is recognizing revenue over time because the asset has no alternative use and the right to payment is enforceable. In these situations, the CP entity should consider whether there being no alternative use or an enforceable right to payment for performance completed to date *effectively* results in control of the CP entity's performance to date transferring to the customer.

If a performance obligation does not meet any of the three criteria discussed earlier, it is considered satisfied at a point in time, and the control transfer criteria discussed earlier are used to determine the point in time that control transfers to the customer.

7.3 Sales involving resellers and consignment sales

When a CP entity ships products to a third party (e.g., a reseller or distributor) and that third party sells the products to consumers, the CP entity needs to consider whether the third-party seller obtains control over the products received from the CP 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: (a) the CP 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 CP entity can redirect the products to itself (i.e., require the third-party seller to return the products to the CP entity) or other parties (e.g., a different third-party seller). A performance obligation has not been satisfied (and no revenue is recognized) if a product shipped to a third-party seller is held on consignment because the third-party seller has not obtained control of the products.

When products sold and shipped to a third-party seller are not held on consignment, and each product is a performance obligation satisfied at a point in time, revenue should be recognized when control of each product transfers to the third-party seller. Deferring revenue recognition until each product is sold by the third-party seller to the end consumer (which is commonly referred to as recognizing revenue on a sell-

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through basis) is not appropriate under ASC 606 if control of the product has transferred to the third-party seller.

7.4 Bill-and-hold arrangements

A bill-and-hold arrangement refers to a contract in which the customer purchases products and is billed for the products, but the CP 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 a CP 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) (see Section 7.1) and (b) the following criteria specifically related to bill-and-hold arrangements, all of which must be met:

- *There is a substantive reason for the bill-and-hold arrangement.* An example of a substantive reason is the customer requesting to purchase the product on a bill-and-hold basis.
- *The products are separately identified as belonging to the customer.* This would be the case if the CP entity has segregated the products and labeled them as belonging to the customer.
- *The products are ready to be physically transferred to the customer.* This would be the case if the products are complete and ready for shipment. Further, to meet this criterion there should be no other costs to be incurred to satisfy the performance obligation other than standard shipping costs that would be incurred in other than bill-and-hold arrangements
- *The CP entity is unable to use the products or redirect them to other customers.* To meet this criterion, the industrial entity should not be able to use the specific products set aside for the customer in the bill-and-hold arrangement to fulfill orders from other customers. Further, if the CP entity has ever used or redirected product in the past that was set aside for a customer in connection with a bill-and-hold arrangement, its ability to meet this criterion and recognize revenue prior to shipment of the product in future bill-and-hold arrangements is tainted.

Revenue is recognized in a bill-and-hold arrangement prior to the customer taking physical possession of the product only if: (a) the CP entity's evaluation of the general concept of control transfer and the general indicators of control transfer results in a conclusion that control of the product has transferred to the customer and (b) the specific bill-and-hold criteria have been met.

If a CP 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 CP entity's obligation to hold the products for a period of time after it transferred control to the customer represents a performance obligation that should be accounted for separately.

7.5 Customer's unexercised rights (i.e., breakage)

The contract may provide for the customer to prepay for contractual rights it can exercise in the future. Those rights might entitle the customer to goods or services, which obligates the CP entity to provide or stand ready to provide those goods or services. The prepayment should be recognized as a contract liability. Revenue is recognized by derecognizing the contract liability when the customer exercises its rights in the future. However, customers do not always exercise all of the rights for which they prepaid. Those rights that go unexercised are referred to as breakage. While one of the most common forms of breakage occurs when gift cards go unredeemed, breakage might occur 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 a CP entity expects to be entitled to an amount of breakage, that amount should be proportionately 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 CP entity will

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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 of proportionately recognizing breakage as revenue as the other performance obligations in the contract are satisfied. When the CP entity does not proportionately recognize all breakage as revenue as the other performance obligations in the contract are satisfied (perhaps because of the variable consideration constraint), the transaction price related to that breakage should not be recognized as revenue until the likelihood that the customer will exercise those rights becomes remote. However, when the CP 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.

Example 5-5: Accounting for breakage related to gift cards when it can be reasonably estimated, and there is no escheatment law

While this example addresses the accounting for a single gift card (for ease of illustration), the same approach should be used if a CP entity elects to account for a portfolio that includes a large volume of similar gift cards (see Section 6.4.1 of our revenue recognition guide).

Customer B buys a $50 gift card from Company A. The gift card expires in one year, and Company A enforces the expiration date.

Based on its historical data, Company A estimates that Customer B will only use $45 of the gift card and that $5 will go unused. Company A concludes it is probable that recognizing $1.11 of revenue ($50 gift card ÷ $45 expected to be redeemed) per $1 of gift card value redeemed will not result in a significant reversal of cumulative revenue recognized when the uncertainty related to how much of the gift card is used before its expiration is resolved. There are no escheatment laws in the state in which the gift card was sold or used that require Company A to pay the state proceeds from the sale of gift cards that go unused.

When Company A sells the gift card to Customer B, it records the following journal entry:

	Debit	Credit
Cash	$50	
Contract liability		$50

When Customer B uses the gift card six months later to purchase shoes for $30, Company A records the following revenue-related journal entry:

	Debit	Credit
Contract liability (Note 1)	$33	
Revenue (Note 1)		$33

Note 1: $30 gift card value redeemed × $1.11 of revenue per $1 gift card value redeemed

Company A still expects $15 of the remaining value on the gift card to be redeemed and the other $5 of the remaining value to expire unused.

8. Principal vs. Agent (i.e., Gross vs. Net)

The principal vs. agent guidance is only applied when another party is involved with the CP 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:

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- Identifying the specified goods or services being provided to the customer, which requires identifying all of the promises to provide goods or services in the contract and then determining whether those promised goods or services are distinct
- Determining whether the CP entity obtains control of the specified goods or services before transferring control of those goods or services to the customer, which requires performance of a control analysis and may require consideration of three indicators

Chapter 11 of our revenue recognition guide discusses each of these steps in detail and provides numerous examples of their application.

While ASC 606 incorporates consideration of three indicators for determining whether a CP entity is acting as a principal or an agent, its overall focus is on whether the CP entity obtains control of the promised good or service before it is transferred to the customer. The three indicators included in ASC 606, as stated below, are only considered along with all relevant facts and circumstances if the control analysis is inconclusive.

- Is the CP entity primarily responsible?
- Does the CP entity have inventory risk?
- Does the CP entity have pricing discretion?

9. Contract Costs

9.1 Scope

ASC 340-40 addresses the circumstances under which certain costs that arise in conjunction with performing under contracts within the scope of ASC 606 should be capitalized. The two categories of costs addressed in ASC 340-40 include: (a) costs to fulfill a contract and (b) costs to obtain a contract.

9.2 Costs to fulfill a contract

If there is other guidance in the ASC that applies to the costs incurred to fulfill a contract within the scope of ASC 606, that other guidance should be applied. Examples of other guidance on how to account for costs that may be involved in the fulfillment of a contract are listed in the following table:

ASC	Type of fulfillment cost
330	Inventory
340-10-25-1 to 25-4	Preproduction costs related to long-term supply contracts
350-40	Costs of internal-use software
360	Costs related to property, plant and equipment
720-35-25-1A	Certain advertising expenditures incurred after revenue is recognized (e.g., cooperative advertising)
946-720-25-3	Offering costs of advisors of both public and private funds
985-20	Costs of software to be sold, leased or marketed

Note 1: Prior to applying the guidance noted, it is important to understand the specific scope provisions of the guidance to ensure it is applicable to an entity or the specific cost being evaluated.

If the guidance in the table or other specific guidance is applicable to a fulfillment cost incurred by the entity, it must be applied. ASC 340-40 is only applicable to costs to fulfill a contract when there is no other applicable guidance.

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If certain criteria are met, fulfillment costs within the scope of ASC 340-40 must be capitalized. A CP entity may not choose to expense such costs when the criteria are met.

9.3 Costs to obtain a contract

The incremental costs to obtain a specific contract within the scope of ASC 606 are those costs that would not have been incurred if the contract was not obtained, such as a sales commission. For a cost to be considered an incremental cost of obtaining a contract, the CP entity must be obligated to make a payment only as a result of entering into the contract. The incremental costs to obtain a contract should be capitalized if the CP entity expects to recover those costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). However, a CP entity may elect a practical expedient that allows it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less.

Costs to obtain a contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the contract that would have been incurred even if the contract was not obtained (e.g., travel costs incurred to present a proposal to the customer). These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the CP entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

Direct response advertising costs should be recognized as an expense in accordance with other applicable GAAP and are not subject to the provisions of ASC 606.

9.4 Amortization and impairment of capitalized costs

ASC 340-40 provides guidance on amortizing costs capitalized in accordance with its provisions as well as testing those capitalized costs for impairment. This guidance is summarized and illustrated in Sections 13.3 and 13.4 in our revenue recognition guide.

10. Disclosures

Many qualitative and quantitative disclosure requirements are included in ASC 606-10-50 and ASC 340-40-50. ASC 606-10-50-1 states the following as the overall disclosure objective of ASC 606 (which is also the overall disclosure objective of ASC 340-40): “The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.”

The disclosures required to achieve this objective 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. However, 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
- Transaction price allocated to remaining performance obligations at the end of the reporting period (disclosures required for public entities and elective for nonpublic entities)
- Significant judgments about the timing of satisfying performance obligations

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- Significant judgments about the transaction price and the amounts allocated to performance obligations
- Practical expedients (disclosures required for public entities and elective for nonpublic entities)
- Capitalized costs related to obtaining or fulfilling a customer contract (disclosure required for public entities and elective for nonpublic entities)

The nature and extent of the required disclosures in each of the preceding categories depends on whether the CP entity is a public entity (more required disclosures) or nonpublic entity (fewer required disclosures). In addition, while more disclosures are required for annual periods, some disclosures also are required of public entities for interim periods. However, when a CP entity applies ASC 606 and 340-40 in its interim financial statements for one or more interim periods before it applies ASC 606 and 340-40 in its annual financial statements, the CP entity must provide all the required annual disclosures in those interim financial statements.

Detailed discussion and illustrations of the disclosure requirements for both public and nonpublic entities are included in Chapter 15 of our revenue recognition guide.

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