

Changes to revenue recognition in the industrial products industry

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August 2018

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A. Background

In May 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), collectively, the Boards, issued substantially converged final standards on revenue recognition. These final standards were the culmination of a joint project between the Boards that spanned many years. The FASB's Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, provides a robust framework for addressing revenue recognition issues, and upon its effective date, replaces almost all pre-existing revenue recognition guidance in current U.S. generally accepted accounting principles (GAAP) (i.e., legacy GAAP), including industry-specific guidance and guidance issued by the staff of the Securities and Exchange Commission (e.g., Staff Accounting Bulletin Topic 13, *Revenue Recognition*). The new guidance added to the FASB's Accounting Standards Codification (ASC) by ASU 2014-09 primarily included or affected:

- ASC 606, "Revenue from Contracts with Customers"
- ASC 340-40, "Other Assets and Deferred Costs – Contracts with Customers"
- ASC 610-20, "Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets"

To help address issues identified by entities as they implement the new guidance, the FASB and IASB established the Joint Transition Resource Group (TRG). In addition, the American Institute of Certified Public Accountants (AICPA) organized several task forces to identify and provide guidance on industry-specific implementation issues in a comprehensive nonauthoritative revenue recognition audit and accounting guide. For additional information about the TRG's and AICPA's activities, see Sections 2.2.1 and 2.2.2 of our publication, [A guide to revenue recognition](#) (our revenue recognition guide). Based on the TRG's and AICPA industry-specific task forces' activities and other sources of feedback, the FASB has made several revisions to the new guidance since its issuance. The FASB's [Summary of Amendments After the Issuance of Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers \(Topic 606\)](#) highlights the nature of the revisions made to the new guidance by the FASB. This white paper discusses the new guidance as amended through August 31, 2018.

While virtually all aspects of the new guidance are relevant to entities in the industrial products industry (IP entities), this white paper highlights aspects of the new guidance particularly relevant to IP entities. For additional information about all of the new guidance, including those aspects discussed in this white paper, as well as numerous examples illustrating how to apply the new guidance, refer to [our revenue recognition guide](#).

B. Core principle and key steps

To put the specific aspects of the new guidance discussed in this white paper into proper context, it is important to know that the core principle included in the new guidance 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 new guidance sets forth the following five steps for purposes of applying the core principle to revenue-generating transactions:



Comprehensive discussion about each of these steps, and numerous examples illustrating their application, is provided in [our revenue recognition guide](#).

C. 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 new guidance, the following five criteria (the contract existence criteria) must be met:

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

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. Additional discussion and examples related to Step 1 are provided in Chapter 5 of [our revenue recognition guide](#).

D. Step 2: Identifying performance obligations in the contract

After contract identification (Step 1), an IP 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.

D.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 an IP entity’s contracts is relatively straightforward, with examples of such promised goods or services being manufacturing equipment, installation of manufacturing equipment, agricultural machinery and components for construction vehicles. However, in other cases, identifying the promised goods or services in an IP entity’s contracts may not be as straightforward:

- Some activities performed by an IP 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. While performing these activities is necessary to provide the promised goods or services in the contract, the activities themselves do not give rise to a promised good or service. Determining whether nonrecurring engineering and preproduction activities represent promised goods or services or setup activities is discussed in Section D.3 of this white paper.
- While promised goods and services are most often explicitly stated in the contract, consideration also needs to be given to whether an IP 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 an IP entity's customary business practice creates a valid expectation on the customer's part to receive training on how to use a piece of complex manufacturing equipment, an implicit promise to transfer services exists that should be accounted for like an explicit promise to transfer services.

D.1.1. Shipping and handling activities

IP 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 an IP entity should consider in determining when control of promised goods has transferred to the customer. If, after considering all control indicators (which are discussed in Section G.1 of this white paper), the IP entity concludes that control transfers to the customer based on transfer of title, the following guidance applies:

- When promised goods are shipped FOB destination, title to those goods passes to the customer when the goods reach their destination (e.g., the customer's warehouse). 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 IP 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 IP 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 IP entity elects this accounting policy, the costs related to the shipping and handling activities should be accrued when the IP entity recognizes revenue for the related promised goods. If elected, the accounting policy must be applied consistently to similar transactions. In addition, an IP entity that elects the accounting policy must provide the accounting policy disclosures required by ASC 235, "Notes to Financial Statements."

D.1.2. Promised goods or services that are immaterial in the context of the contract

An IP 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 IP 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, the IP entity 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 be both quantitative and qualitative in nature. In addition, because the guidance indicates that to not be identified for further evaluation under ASC 606 the promised good or service must be immaterial in the context of the contract, the IP 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.

D.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](#).

D.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 IP 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 IP entity or another party, or it must be a good or service that the customer already has obtained as a result of either a contract with the IP entity (including the contract under evaluation) or another transaction or event.

D.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 IP 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 IP 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 IP 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 IP entity providing a significant service of integrating the promised good or service with one or more of the other promised goods or services in the contract, with the result of that integration being one or more of the combined outputs contracted for by the customer?
- Does the promised good or service significantly modify or customize one or more of the other promised goods or services in the contract, or is the promised good or service significantly modified or customized by one or more of the other promised goods or services in the contract?
- Is the promised good or service highly interdependent or highly interrelated with one or more of the other promised goods or services in the contract, such that each of the promised goods or services is significantly affected by one or more of the other promised goods or services? Another way to think of this question is can the IP entity satisfy each of the promises in the contract independent of its efforts to satisfy the other promises?

Sections D.2.3 to D.2.5 in this white paper discuss identifying the performance obligations in contracts that include installation services, warranties and contract manufacturing services, respectively.

D.2.3. Installation services

When an IP entity sells equipment or machinery to a customer, it is not uncommon for it to also sell the customer services to install the equipment or machinery in the customer's own environment. The following example: (a) illustrates a situation in which equipment and installation services are distinct from each other and (b) discusses how the facts and circumstances would need to change to arrive at a conclusion that the equipment and installation are not distinct from each other.

Example 1: Identifying the performance obligations in a contract including equipment and installation services

The following example includes *Example 11—Determining Whether Goods or Services Are Distinct, Case C—Promises Are Separately Identifiable (Installation)*, from ASC 606-10-55-150A to 55-150D:

An entity contracts with a customer to sell a piece of equipment and installation services. The equipment is operational without any customization or modification. The installation required is not complex and is capable of being performed by several alternative service providers.

The entity identifies two promised goods and services in the contract: (a) equipment and (b) installation. The entity assesses the criteria in paragraph 606-10-25-19 to determine whether each promised good or service is distinct. The entity determines that the equipment and the installation each meet the criterion in paragraph 606-10-25-19(a). The customer can benefit from the equipment on its own, by using it or reselling it for an amount greater than scrap value, or together with other readily available resources (for example, installation services available from alternative providers). The customer also can benefit from the installation services together with other resources that the customer will already have obtained from the entity (that is, the equipment).

The entity further determines that its promises to transfer the equipment and to provide the installation services are each separately identifiable (in accordance with paragraph 606-10-25-19(b)). The entity considers the principle and the factors in paragraph 606-10-25-21 in determining that the equipment and the installation services are not inputs to a combined item in this contract. In this Case, each of the factors in paragraph 606-10-25-21 contributes to, but is not individually determinative of, the conclusion that the equipment and the installation services are separately identifiable as follows:

- a. The entity is not providing a significant integration service. That is, the entity has promised to deliver the equipment and then install it; the entity would be able to fulfill its promise to transfer the equipment separately from its promise to subsequently install it. The entity has not promised to combine the equipment and the installation services in a way that would transform them into a combined output.
- b. The entity's installation services will not significantly customize or significantly modify the equipment.
- c. Although the customer can benefit from the installation services only after it has obtained control of the equipment, the installation services do not significantly affect the equipment because the entity would be able to fulfill its promise to transfer the equipment independently of its promise to provide the installation services. Because the equipment and the installation services do not each significantly affect the other, they are not highly interdependent or highly interrelated.

On the basis of this assessment, the entity identifies two performance obligations (the equipment and installation services) in the contract.

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

RSM commentary: If the facts were such that the entity is the only party that could perform the installation and the entity never sells the equipment without the installation services, the entity would have to carefully consider how the customer could benefit from the equipment on its own or by combining it with other resources readily available to it for purposes of determining whether the equipment is capable of being distinct. If the customer could sell the equipment on a secondary market for more than scrap value, it is likely that the customer could benefit from the equipment on its own, which means it is likely that the equipment is capable of being distinct. Conversely, if the equipment had no alternative use to the customer (even for resale on a secondary market), the customer could not benefit from the equipment on its own, which means the equipment is not capable of being distinct.

Determining whether equipment and installation are distinct from each other often will require significant judgment to be exercised and careful consideration of an IP entity's own relevant facts and circumstances.

D.2.4. Warranties

IP entities often provide a warranty to the customer when the customer purchases promised goods or services, such as equipment, machinery and installation services, among many others. In addition, some IP 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 IP 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 an IP 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 IP 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 an IP 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 IP 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 is accounted for in accordance with ASC 460. However, determining whether an IP 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 IP entity must determine whether it can reasonably account for the assurance-type warranty separate from the service-type warranty. If the IP 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 IP 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. An IP 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 IP entity account for the warranties as a single performance obligation under ASC 606. It is worth noting that accounting for the warranties as a single performance obligation will result in the deferral of more revenue under ASC 606.

D.2.5. Contract manufacturing

In the most basic sense, contract manufacturing is an IP entity outsourcing the manufacture of a product or a product component to another entity. For example, an IP entity and its customer may enter into a contract under which the IP entity manufactures 20 complex pieces of equipment in accordance with the customer's specifications. Under legacy GAAP, the IP entity's accounting for this contract could result in the identification of multiple elements—one for each device to be produced—that should be accounted for separately. However, as illustrated in the following example, the IP entity's accounting for this contract under ASC 606 could result in the identification of one performance obligation, depending on the specific facts and circumstances.

Example 2: Identifying the performance obligations in a contract to manufacture multiple units of a specialized complex device

The following example is *Example 10—Goods and Services Are Not Distinct, Case B—Significant Integration Service*, from paragraphs ASC 606-10-55-140A to 55-140C:

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

The entity assesses the promises in the contract and determines that each of the promised devices is capable of being distinct in accordance with paragraph 606-10-25-19(a) because the customer can benefit from each device on its own. This is because each unit can function independently of the other units.

The entity observes that the nature of its promise is to establish and provide a service of producing the full complement of devices for which the customer has contracted in accordance with the customer's specifications. The entity considers that it is responsible for overall management of the contract and for providing a significant service of integrating various goods and services (the inputs) into its overall service and the resulting devices (the combined output) and, therefore, the devices and the various promised goods and services inherent in producing those devices are not separately identifiable in accordance with paragraphs 606-10-25-19(b) and 606-10-25-21. In this Case, the manufacturing process provided by the entity is specific to its contract with the customer. In addition, the nature of the entity's performance and, in particular, the significant integration service of the various activities mean that a change in one of the entity's activities to produce the devices has a significant effect on the other activities required to produce the highly complex specialized devices such that the entity's activities are highly interdependent and highly interrelated. Because the criterion in paragraph 606-10-25-19(b) is not met, the goods and services that will be provided by the entity are not separately identifiable, and, therefore, are not distinct. The entity

accounts for all of the goods and services promised in the contract as a single performance obligation.

RSM commentary: IP entities that provide contract manufacturing services should carefully consider their own facts and circumstances in the context of ASC 606 to ensure they have obtained an appropriate understanding of the nature of the promised goods or services included in the contract and identified the appropriate performance obligation(s). If that were not done in this example, the entity might have inappropriately concluded that each highly complex and specialized device was a performance obligation. Arrangements for contract manufacturing services are often unique and complex. As a result, identifying the performance obligations when such services are being provided to the customer will require significant judgment to be exercised and careful consideration of the IP entity's own relevant facts and circumstances.

Whether the entity in this example should recognize revenue for its single performance obligation over time or at a point in time is discussed in Section G.2.1 of this white paper.

D.3. Nonrecurring engineering and preproduction (NE&P) activities

It is not uncommon for an IP entity to undertake NE&P activities for a customer, oftentimes in connection with fulfilling a long-term supply contract or in anticipation of entering into such a contract. For example, an IP entity may enter into a contract with its customer to produce a component that its customer will use in the production of a vehicle. In connection with that contract, the IP entity may be involved in the design and development of the component. In addition, the IP entity may need to design and develop molds, dies and other tools to facilitate its production of the component. The IP entity may or may not be explicitly paid or reimbursed for these NE&P activities.

D.3.1. Determining whether amounts paid for NE&P activities generate revenue

Under legacy GAAP, diversity in practice exists with respect to whether reimbursements from the customer for NE&P activities should be accounted for as revenue. In some cases, IP entities have concluded that the NE&P activities do not generate revenue and should be accounted for as cost reimbursements under other applicable legacy GAAP. In other cases, IP entities have concluded that the NE&P activities generate revenue and any related reimbursements should be accounted for as such. Presumably, these conclusions were based on analyzing the NE&P activities in the context of the following definition of revenue in paragraph 78 of FASB Concepts Statement 6, *Elements of Financial Statements*: "Revenues are inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."

We believe this diversity in practice will likely continue to exist after the adoption of ASC 606 because: (a) the definition of revenue has not changed and (b) we understand that the SEC staff would generally expect there to be consistency in the conclusion reached by an IP entity with respect to whether NE&P activities related to a particular contract generate revenue under legacy GAAP and ASC 606. Simply put, if the definition of revenue did not change as a result of ASC 606, then the previous conclusions reached with respect to whether NE&P activities generate revenue under legacy GAAP generally are not expected to change as a result of ASC 606. For example, if an IP entity concluded that NE&P activities did not generate revenue when applying legacy GAAP, the SEC staff would generally expect the IP entity to conclude that such activities do not generate revenue when applying ASC 606. We also understand that if an IP entity believes its conclusion with respect to whether NE&P activities generate revenue when applying ASC 606 will be different than it was when applying legacy GAAP, it should consider consulting on the matter with subject matter experts (including, for public entities, the SEC staff). In other words, consultation with subject matter experts should be considered if an IP entity finds itself in either of the following positions with respect to accounting for NE&P activities: (a) it believed such activities did not generate revenue when applying legacy GAAP, but do generate revenue when applying ASC 606 or (b) it

believed such activities generated revenue when applying legacy GAAP, but do not generate revenue when applying ASC 606.

Sections D.3.2 and D.3.3 in this white paper discuss the following two topics, respectively: (a) the accounting under ASC 606 for NE&P activities that generate revenue and (b) the accounting for NE&P activities that do not generate revenue. The accounting for costs incurred in performing NE&P activities is discussed in Section H.2.1 of this white paper.

D.3.2. Accounting under ASC 606 for NE&P activities that generate revenue

The FASB, its staff and the TRG discussed the application of ASC 606 to NE&P activities. The [board meeting handout](#) used by the FASB for these discussions includes a flowchart that captures the major decision points and accounting implications of applying ASC 606 to such activities, including:

- To the extent an IP entity concludes that NE&P activities generate revenue that should be accounted for under ASC 606, any payments or cost reimbursements from the customer for such activities should be considered part of the transaction price for the contract.
- The IP entity must determine whether the NE&P activities: (a) transfer a promised good or service to the customer or (b) are setup activities that do not transfer a promised good or service to the customer.

Determining whether NE&P activities should be considered promised goods or services or setup activities was discussed by the FASB staff and TRG. The basis for these discussions was Question 1 in [TRG 46](#), “Pre-Production Activities,” and a summary of the discussions is provided in [TRG 49](#), “November 2015 Meeting – Summary of Issues Discussed and Next Steps.” Paragraphs 9 and 10 in TRG 46 provide examples of NE&P activities that would be considered a promised good or service. For additional information about determining whether NE&P activities should be considered promised goods or services or setup activities, refer to the flowchart and corresponding discussion in the board meeting handout and the relevant discussion in TRG 46 and 49.

If the IP entity determines that the NE&P activities transfer one or more promised goods or services to the customer, the IP entity must determine whether the promised goods or services are distinct:

- If so, each distinct promised good or service is accounted for as a performance obligation and the transaction price allocated to the performance obligation is recognized as revenue when or as it is satisfied (i.e., when or as control of the promised good or service transfers to the customer).
- If not, each promised good or service is bundled with other promised goods or services until there is a bundle of promised goods or services that is distinct, in which case that bundle of promised goods or services is accounted for as a performance obligation, and the transaction price allocated to the performance obligation is recognized as revenue when or as it is satisfied (i.e., when or as control of the bundle of promised goods or services transfers to the customer).

Determining whether a promised good or service is distinct is discussed in detail in Section D of this white paper. In addition, determining whether the transaction price allocated to a performance obligation should be recognized when (at a point in time) or as (over time) it is satisfied is discussed in Section G of this white paper.

If the IP entity determines that the NE&P activities are setup activities that do not transfer a promised good or service to the customer, it does not recognize revenue when or as it performs those activities. For example, if the IP entity determines that the NE&P activities are performed to set up the entity to produce vehicle components for the customer under a long-term supply arrangement, revenue is not recognized as the entity performs the NE&P activities, but instead when or as it satisfies its performance obligation(s) related to producing and delivering the vehicle components. Determining when revenue should be recognized for a performance obligation is discussed in Section G of this white paper, along with specific considerations relevant to contract manufacturing arrangements in Section G.2.1.

D.3.3. Accounting for NE&P activities that do not generate revenue

To the extent an IP entity concludes that NE&P activities do not generate revenue that should be accounted for under ASC 606, it should account for such activities in accordance with other applicable GAAP. Consideration should be given to whether the guidance in ASC 610-20 related to transfers of nonfinancial assets applies. While much of the recognition and measurement guidance in ASC 606 may ultimately be applied to certain transfers of nonfinancial assets under ASC 610-20, the proceeds related (or allocated) to such transfers are not reflected as revenue in the income statement.

E. Step 3: Determining the transaction price when there is variable consideration

E.1. Accounting for variable consideration

Step 3 of the five-step revenue recognition model in ASC 606 requires an IP entity to determine the transaction price, which often includes variable consideration. In the IP industry, common forms of variable consideration include early payment discounts, volume discounts, rebates, price concessions and rights of return. Variability in the amount of consideration for which the IP 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 IP entity intends to offer the customer or that the customer has a valid expectation of receiving based on the IP entity's customary business practices, published policies or specific statements.

With one exception related to sales- and (or) usage-based royalties (see Section 7.3.5 of [our revenue recognition guide](#)), an estimate of the variable consideration to which an IP 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 an IP entity should include in the transaction price suggests the following two steps should be performed:

1. Estimate the amount of variable consideration to which the IP 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 (in whole or in part) 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](#), an IP 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 IP 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.

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 6.6 of [our revenue recognition guide](#).

Application of the variable consideration guidance in ASC 606 to volume and early payment discounts rebates, and rights of return are discussed further in Sections E.2 and E.3 of this white paper, respectively. Section 7.3 of [our revenue recognition guide](#) provides additional information and examples related to accounting for variable consideration.

E.2. 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 five percent 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 five percent discount off list price if the customer pays the amount owed within 30 days (early payment discount).
- The customer will receive a ten percent discount off list price if the customer buys more than ten units of equipment (volume discount).
- The customer receives a rebate of \$10,000 if it purchases four machines.

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

The following example illustrates application of the variable consideration guidance to a common volume discount scenario, and also considers how the accounting effects would differ if there was an early payment discount or rebate instead of a volume discount.

Example 3: Applying the variable consideration constraint to a volume discount

The following example is *Example 24—Volume Discount Incentive* from 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 ended March 31, 20X8 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 ended June 30, 20X8, 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 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 $\left(\frac{[(1,200 \text{ units} \times \$100 \text{ per unit}) - \$10,000 \text{ rebate}]}{1,200 \text{ units}} \right)$ 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.

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

E.3. Rights of return

If a contract allows a customer the right to return a product and receive a refund, the consideration received from the customer is variable, which means the variable consideration guidance in ASC 606 should be applied. In applying that guidance, the IP entity estimates the transaction price to which it expects to be entitled (which reflects expected returns and refunds), limited to the amount for which it is probable that a significant reversal of cumulative revenue recognized will not occur. As a result, for contracts with a right of return, revenue is not recognized for products expected to be returned.

If an IP entity has received (or recognized a receivable for) amounts to which it does not expect to be entitled due to expected returns, it should recognize a refund liability for those amounts instead of recognizing revenue. An IP entity should also recognize an asset (and reduce cost of sales) for the right

to recover the products expected to be returned by the customer. The asset recognized should be measured by reference to the former carrying amount of the product (e.g., inventory cost) less any expected costs to recover the product (which includes any decline in the product's value). For presentation purposes, the asset representing the right to recover products and the refund liability should not be netted against each other. In addition, the refund liability to the customer typically should not be included with contract liabilities for presentation purposes.

At the end of each reporting period, an IP entity should review its estimated returns and refunds compared to actual and determine whether there are any changes in expectations about products to be returned. If so, adjustments to the refund liability, revenue, asset for inventory expected to be returned and (or) cost of goods sold should be recorded, as appropriate.

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).

F. Step 4: Allocating the transaction price to the performance obligations

F.1. Overall allocation model

Step 4 of the five-step revenue recognition model in ASC 606 requires an IP 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 IP 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., equipment and installation 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 and (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 Sections F.3 and F.4 of this white paper.

F.2. Standalone selling price

The standalone selling price of a performance obligation is the amount the IP 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 IP 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 IP entity is required to estimate a standalone selling price. In making this estimate, the IP entity should maximize observable inputs and consider all reasonably available and relevant information, which includes information specific to the IP entity, the market, the customer and the customer class. In addition, an IP 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

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 IP 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 IP 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 an IP 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 an IP entity when an observable standalone selling price does not exist.

F.3. Allocating variable consideration

To the extent there is more than one performance obligation in a contract, variable consideration included in the transaction price should be allocated on a proportionate basis to each of the performance obligations, except when the following two criteria are met:

- The terms of the variable payment are specifically related to the IP 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 IP 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 F.4 of this white paper]). For example, consider a situation in which an IP entity is providing its customer with engineering and design services and contract manufacturing services, and based on the facts and circumstances, each set of services represents its own performance obligation. The IP entity will receive a bonus if it completes the contract manufacturing services by a certain date. If the facts and circumstances indicate that the bonus relates to only the contract manufacturing services because the criteria discussed earlier are met, then the bonus is allocated to only the performance obligation for those services. Conversely, if the facts and circumstances indicate that the bonus relates to both the design and engineering services and the contract manufacturing services because the criteria discussed earlier are not met, then the bonus is allocated to both performance obligations for each set of services. 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.

F.4. Allocating a discount

If the sum of the standalone selling prices for the performance obligations in a contract is more than the transaction price for the contract, the IP entity has provided the customer with a discount. For example, if an IP entity is selling three pieces of equipment that are each a performance obligation for \$1 million, but the sum of the standalone selling prices for those three pieces of equipment is \$1.2 million, the contract

includes a discount. A discount should be allocated on a proportionate basis to each of the performance obligations, which happens automatically when allocating the (discounted) transaction price on the relative standalone selling price basis, unless there is observable evidence indicating that the entire discount should be allocated to less than all the performance obligations in a contract. The following criteria must be met to conclude that observable evidence exists in support of the whole discount being allocated to one or more (but less than all) performance obligations:

- Each distinct good or service (or each bundle of distinct goods or services) in the contract is regularly sold by the IP entity on a standalone basis.
- A bundle (or bundles) of some of the distinct goods or services in the contract are regularly sold by the IP entity on a standalone basis at a discount to the sum of their standalone selling prices.
- The discount at which the IP entity sells each bundle of distinct goods or services is substantially the same as the discount the IP entity provided on the contract as a whole, and an analysis of the distinct goods or services in each bundle sold at a discount provides observable evidence of the performance obligation(s) to which the whole contract discount should be allocated.

Implicit in these criteria is that the distinct goods or services in the contract that are not part of the bundle of distinct goods or services regularly sold at a discount are not themselves regularly sold at a discount. For these criteria to be met, there typically must be at least three performance obligations: (a) a bundle of at least two performance obligations that is regularly sold by the IP entity at a discount that matches the entire discount in the contract and (b) one performance obligation to which it can be shown that none of the discount relates.

If all of the criteria are met, the IP entity allocates the whole discount in the contract to the performance obligation (or bundle of performance obligations) sold at a discount. If less than all of these criteria are met, the IP entity allocates the discount on a proportionate basis to all performance obligations in the contract on a relative standalone selling price basis. Continuing with the example introduced earlier, if the facts and circumstances indicate that the \$200,000 discount relates to only two of the three pieces of equipment being sold to the customer because the criteria discussed earlier are met, then the discount is allocated to just those two pieces of equipment using their standalone selling prices. Conversely, if the facts and circumstances indicate that the \$200,000 discount relates to all three pieces of equipment being sold to the customer because the criteria discussed earlier are not met, then the discount is allocated to all three pieces of equipment. Example 8-3 in [our revenue recognition guide](#) provides a detailed numerical example illustrating how to allocate the transaction price when the contract includes a discount.

G. Step 5: Recognizing revenue when (or as) each performance obligation is satisfied

To properly assess when revenue should be recognized, an IP entity must perform an evaluation at contract inception 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*.

G.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, which includes 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 IP 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 IP 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, an IP entity might enter into a bill-and-hold transaction that results in it holding the machinery bought by the customer for a period of time before the customer takes physical possession. If the IP entity is able to demonstrate that the other indicators of control transfer are present and that the incremental bill-and-hold criteria in ASC 606 have been met (see Section 9.9 of [our revenue recognition guide](#)), the IP entity would conclude that control of the machinery has transferred to the customer while the IP entity holds the machinery for the customer (i.e., control of the machine transfers to the customer prior to the customer obtaining physical possession of the machinery).

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

G.2. Determining whether a performance obligation is satisfied over time or at a point in time

As indicated earlier, an IP entity must perform an evaluation at contract inception focused on whether a performance obligation is satisfied over time or at a point in time. Under ASC 606, a performance obligation is considered satisfied over time if it meets one or more of the following criteria:

- *The customer simultaneously receives and consumes benefits as the IP entity performs.* A performance obligation is satisfied over time if the customer consumes the benefits of the IP entity's performance at the same time as: (a) the customer receives those benefits and (b) the IP entity performs and creates those benefits.
- *The customer controls the asset as the IP 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 IP entity's performance.
- *The asset has no alternative use and the right to payment is enforceable.* A performance obligation is satisfied over time if: (a) the asset created by the IP entity's performance does not have an alternative use to the IP entity upon its completion and (b) the IP 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 the three criteria to determine whether revenue related to each performance obligation 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 IP entity is able to identify a single method by which 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 methods or input methods can be used to measure progress toward complete satisfaction of performance obligations. Output methods rely on the value of the underlying goods or services included in the performance obligation. Input methods rely on the efforts put forth by the IP 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 entity is recognizing revenue over time because the asset has no alternative use and the right to payment is enforceable. In these situations, the entity should consider whether there being no alternative use and (or) an enforceable right to payment for performance completed to date *effectively* results in control of the 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.

G.2.1. Contract manufacturing considerations

As discussed in Section D.2.5 of this white paper, IP entities that provide contract manufacturing services should carefully consider their own facts and circumstances in the context of ASC 606 to determine whether their contracts for contract manufacturing services include one or more performance obligations. Example 2 in Section D.2.5 of this white paper illustrates a situation in which an entity identifies the performance obligations in a contract to manufacture multiple units of a highly complex and specialized device. For the reasons described in that example, the entity concludes that there is only a single performance obligation in the contract. In other words, the entity did not conclude that each highly complex and specialized device that it will manufacture under the contract is a performance obligation.

As a result of having identified a single performance obligation, the entity in Example 2 must determine whether the revenue for that single performance obligation should be recognized over time or at a point in time. In evaluating the criteria that are used to make that determination, the entity would consider the following:

- *The customer simultaneously receives and consumes the benefits of the entity's performance as it performs.* Given the nature of the promised goods and services included in the single performance obligation in Example 2, this criterion would not be met.
- *The customer controls the asset as the entity creates or enhances the asset.* Given the nature of the promised goods and services included in the single performance obligation in Example 2, it is unlikely that this criterion would be met. For example, it is unlikely that the customer obtains control of the manufacturing process, specialized devices and other promised goods or services as the related asset is created. However, the entity should consider whether there are any contract terms or other facts and circumstances that affect when the customer obtains control of the asset created by the entity's performance.

- *The asset has no alternative use to the entity and the entity's right to payment is enforceable.* There are not enough facts and circumstances provided in Example 2 to determine whether this criterion is met.

Of the three criteria, the last criterion has the most potential to be met in Example 2, and perhaps in most contract manufacturing scenarios in which there is a single performance obligation. ASC 606 provides a significant amount of supplemental guidance on what it takes to meet the last criterion, which is discussed and illustrated in Section 9.2.3 of [our revenue recognition guide](#).

If none of the three criteria are met in Example 2, the entity recognizes revenue for the single performance obligation at a point in time. While additional facts and circumstances would be needed to reach a final conclusion, that point in time would likely be when the contract is complete, which would likely be when control of the last device to be manufactured by the entity transfers to the customer. Conversely, if one or more of the three criteria are met in Example 2, the entity recognizes revenue for the single performance obligation over time using a method to measure its progress toward complete satisfaction of that performance obligation that is consistent with how control of the promised goods or services in the performance obligation transfers to the customer. If the entity in Example 2 were to decide to use a units-produced or units-delivered method, it should ensure the method takes into consideration any work in process at the beginning of the reporting period for which control transferred to the customer in the previous reporting period and any work in process at the end of the reporting period for which control transferred to the customer in the current reporting period. Section 9.3 of [our revenue recognition guide](#) discusses and illustrates how to recognize revenue over time under ASC 606.

G.3. Sales involving distributors and consignment sales

When an IP entity ships products to a third party (e.g., a dealer or distributor) and that third party sells the products to consumers, the IP entity needs to consider whether the third-party seller obtains control over the products received from the IP 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 IP 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 IP entity can redirect the products to itself (i.e., require the third-party seller to return the products to the IP 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-through basis) is not appropriate under ASC 606 if control of the product has transferred to the third-party seller.

H. Contract costs

H.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.

H.2. Costs to fulfill a contract

When other guidance exists that applies to the costs incurred to fulfill a contract within the scope of ASC 606, that other guidance should be applied. Examples of this other accounting guidance include: (a) ASC 330, "Inventory," (b) ASC 350-40, "Intangibles—Goodwill and Other – Internal-Use Software," (c) ASC 360, "Property, Plant, and Equipment," and (d) the guidance for preproduction costs related to long-term supply contracts in ASC 340-10, "Other Assets and Deferred Costs – Overall" (which is discussed further in Section H.2.1 of this white paper). ASC 340-40 is applied to costs to fulfill a contract when there is no other applicable guidance in the ASC. For example, if there are setup costs that do not fall within the scope of the preproduction cost guidance in ASC 340-10 or other guidance in the ASC, then such costs would be accounted for in accordance with ASC 340-40.

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

H.2.1. Preproduction costs related to long-term supply contracts

It is not uncommon for an IP entity to undertake NE&P activities for a customer, oftentimes in connection with fulfilling a long-term supply contract or in anticipation of entering into such a contract. Whether revenue should be recognized related to those activities (and, if so, how that revenue should be recognized) is discussed in detail in Section D.3 of this white paper. With respect to accounting for the costs of NE&P activities, ASC 340-10 provides guidance on how to account for preproduction costs related to long-term supply arrangements, which include: (a) the costs to design and develop the products that will be sold under a long-term supply arrangement and (b) the costs to design and develop molds, dies and other tools that will be used in manufacturing the products that will be sold under the long-term supply arrangement.

IP entities that have historically applied the preproduction costs guidance in ASC 340-10 because they incurred costs within its scope should continue to apply that guidance. IP entities that have historically applied the preproduction costs guidance in ASC 340-10 by analogy should carefully consider the scope provisions of both that guidance and ASC 340-40, as well as how those scope provisions should be applied to its facts and circumstances. In doing so, reference should be made to a [board meeting handout](#) discussed by the FASB, which provides a summary of how the preproduction costs guidance in ASC 340-10 interacts with ASC 340-40. IP entities that have historically applied the preproduction costs guidance in ASC 340-10 by analogy also should consider whether any changes to their accounting policy disclosures are warranted.

In addition, it is worth noting that if the IP entity concludes that NE&P activities do not generate revenue that should be accounted for under ASC 606, the related costs cannot be within the scope of ASC 340-40.

H.3. Costs to obtain a contract

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 IP 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 IP entity expects to recover those costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). However, an IP 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 IP entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

H.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](#).

I. Disclosures

Many new 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. But, there is also a significant amount of detailed information that must be disclosed annually related to customer contracts, including information about:

- Disaggregated revenue
- Contract assets, contract liabilities and receivables
- Performance obligations
- Transaction price allocated to remaining performance obligations at the end of the reporting period (public entities only)
- Significant judgments about the timing of satisfying performance obligations
- Significant judgments about the transaction price and the amounts allocated to performance obligations
- Practical expedients (public entities only)
- Capitalized costs related to obtaining or fulfilling a customer contract (public entities only)

The nature and extent of the required disclosures in each of the preceding categories depends on whether the IP entity is a public entity (more required disclosures) or nonpublic entity (less required disclosures). In addition, while more disclosures are required for annual periods, some disclosures also are required for interim periods. However, when an IP 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 IP 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](#).

J. Summary

All IP entities' revenue recognition policies will be affected by ASC 606. The degree to which the timing and amount of revenue recognized in any given reporting period by a particular IP entity will change

depends on its own facts and circumstances. To understand the nature and amount of the change, an IP entity must perform a comprehensive review and assessment of its relevant customer contracts (both domestic and international). Performing this review and assessment will require the IP entity to evaluate whether any changes are needed to its current revenue and financial reporting processes, internal controls and systems. Contact your RSM professional to discuss this review and assessment process further.

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