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Revenue from contracts with customers

Navigating the guidance in ASC 606 and ASC 340-40

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1. Overview

This edition of this publication has been updated to reflect technical accounting amendments issued after January 2022 and features new illustrative examples and additional Grant Thornton insights. See Appendix B for a summary of all changes in the 2025 edition compared to the 2022 version of this publication.

In May 2014 the FASB and the IASB published their largely converged standards on revenue recognition—ASU 2014-09 and IFRS 15, both titled *Revenue from Contracts with Customers*—which superseded and replaced virtually all existing U.S. GAAP and IFRS revenue recognition guidance, affecting almost every revenue-generating entity.

While the standards were largely converged between U.S. GAAP and IFRS when they were originally issued, several amendments have been made subsequent to their release by both standard setters, resulting in several areas of difference between U.S. GAAP and IFRS. These differences are outlined in Section 14 of this guide.

ASC 606-10-10-1

The objective of the guidance in this Topic is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer.

ASC 606-10-10-2

To meet the objective in paragraph 606-10-10-1, the core principle of the guidance in this Topic is that an entity shall 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.

The FASB codified the amendments in ASU 2014-09 in Topic 606, *Revenue from Contracts with Customers,* which, unlike the voluminous and often industry-specific revenue recognition rules it replaced, calls for a single, principle-based model for recognizing revenue. The core principle requires an entity to recognize revenue in a way that depicts the transfer of goods and/or services to a customer in an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods and/or services.

To achieve the core principle, an entity is required to apply the following five-step model:

Step 1: Identify the contract with the customer.

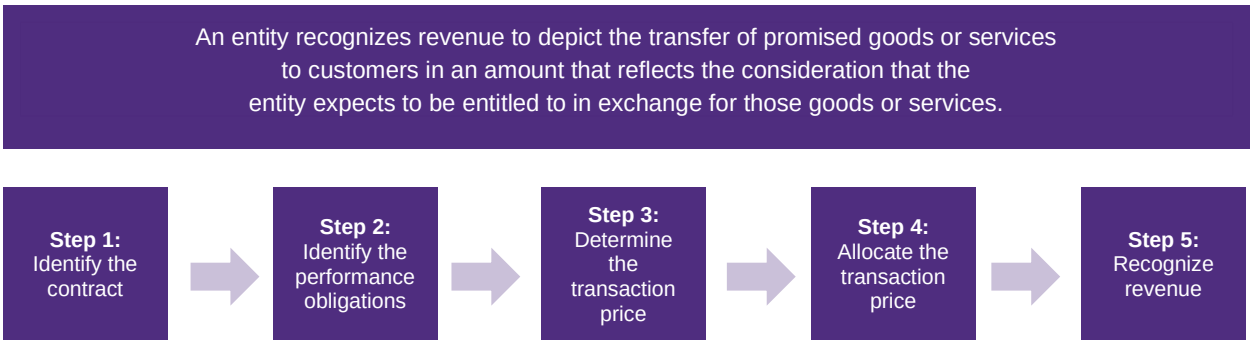
Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract.

Step 5: Recognize revenue when (or as) the entity satisfies its performance obligations.

Figure 1.1: The five-step model



To assist entities in applying the five-step model, the standard provides implementation guidance on a number of topics, including warranties, customer options, licensing, and other topics as outlined in ASC 606-10-55-3.

ASC 606-10-55-3

This implementation guidance is organized into the following categories:

a. Assessing collectability (paragraphs 606-10-55-3A through 55-3C)

aa. Performance obligations satisfied over time (paragraphs 606-10-55-4 through 55-15)

b. Methods for measuring progress toward complete satisfaction of a performance obligation (paragraphs 606-10-55-16 through 55-21)

c. Sale with a right of return (paragraphs 606-10-55-22 through 55-29)

d. Warranties (paragraphs 606-10-55-30 through 55-35)

e. Principal versus agent considerations (paragraphs 606-10-55-36 through 55-40)

f. Customer options for additional goods or services (paragraphs 606-10-55-41 through 55-45)

g. Customers' unexercised rights (paragraphs 606-10-55-46 through 55-49)

h. Nonrefundable upfront fees (and some related costs) (paragraphs 606-10-55-50 through 55-53)

i. Licensing (paragraphs 606-10-55-54 through 55-60 and 606-10-55-62 through 55-65B)

j. Repurchase agreements (paragraphs 606-10-55-66 through 55-78)

k. Consignment arrangements (paragraphs 606-10-55-79 through 55-80)

l. Bill-and-hold arrangements (paragraphs 606-10-55-81 through 55-84)

m. Customer acceptance (paragraphs 606-10-55-85 through 55-88)

n. Disclosure of disaggregated revenue (paragraphs 606-10-55-89 through 55-91)

The amendments in ASU 2014-09 also created guidance on accounting for contract costs associated with revenue contracts, codified in ASC 340-40, *Other Assets and Deferred Costs: Contracts with Customers*, as well as new guidance for the sale of nonfinancial assets to an entity other than a customer, codified in ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*. Contract assets are discussed in Section 12.1. For a discussion of the sale of nonfinancial assets under ASC 610-20, refer to Grant Thornton's *Sales and transfers of nonfinancial assets: ASC 610-20*.

The remainder of this guide

- Summarizes the revenue guidance and certain FASB examples, including the amendments in subsequent ASUs
- Incorporates discussions, insights, and examples from the Joint Transition Resource Group for Revenue Recognition (TRG) meetings and the FASB's Revenue Recognition Implementation Q&As
- Includes Grant Thornton insights on various topics
- Includes illustrative examples to demonstrate how to apply the guidance

Grant Thornton insight: Principle-based revenue recognition model

ASC 606 is based on a single core principle of revenue recognition: that is, revenue is recognized in a way that depicts 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 and services. The guidance in ASC 606 requires an entity to apply significant judgment and estimations, while keeping in mind the underlying core revenue recognition principle. For example, the principle-based model requires entities to make estimates to reflect the amount of consideration to which an entity "expects to be entitled" when transactions have variable consideration. Entities are required to make detailed disclosures describing these judgments, including a discussion of estimation methods, inputs, and assumptions.

1.1 Joint Transition Resource Group for Revenue Recognition

Shortly after the standard was issued in 2014, the FASB and IASB formed the TRG to help entities implement the new revenue guidance. The purpose of the group was to

- Solicit and discuss stakeholder questions arising from implementing the new revenue guidance
- Inform the Boards about implementation issues and recommend action as needed
- Provide a forum for stakeholders to learn about the new guidance

The TRG did not issue authoritative guidance, but the meeting papers (hereinafter referred to as "TRG Paper XX, *Title"*) and meeting summaries provide stakeholders with additional insight as to how to apply the revenue guidance, especially for those areas where TRG members reached general agreement.

In 2016, then Deputy Chief Accountant for the U.S. Securities and Exchange Commission (SEC) Wesley R. Bricker advised[1] SEC registrants to follow the TRG discussions, even though they are not authoritative guidance. In other words, when an entity has a fact pattern similar to one that is included in a FASB or IASB staff paper or discussed at a TRG meeting, the entity is advised to consult with the SEC staff if it reaches a different conclusion on applying the guidance than the conclusion reached by the TRG.

Following the conclusion of the activities of the TRG, the FASB staff issued "The Revenue Recognition Implementation Q&As" (the Revenue or Implementation Q&As), which incorporates previously issued TRG papers and other educational materials into a single document containing 81 questions that cover a wide range of related topics.

1.2 AICPA Revenue Recognition Task Forces

Before ASC 606 became effective, the AICPA formed 16 industry task forces to address industry-specific implementation questions and to help develop a new accounting and auditing guide on revenue recognition. The industries involved with this project included aerospace and defense, airlines, asset management, broker-dealers, construction contractors, depository institutions, gaming, health care, hospitality, insurance, not-for-profit, oil and gas, power and utility, software, telecommunications, and timeshare.

As a result of this effort, the AICPA issued the *Audit and Accounting Guide: Revenue Recognition,* which contains accounting and auditing overviews as well as industry-specific considerations for 16 industries. While the guide contains interpretive guidance, it does not create new U.S. GAAP and is not authoritative.

1.3 Private Company Council

The Private Company Council (PCC) is the primary advisory body to the FASB on private company accounting issues. The PCC asked the FASB staff to prepare certain educational memos to assist with private companies' implementation of ASC 606. These memos, which are not authoritative, can be found on the Implementation Q&A section of the FASB website.

[1] Remarks before the 2016 Baruch College Financial Reporting Conference, May 5, 2016.

2. Scope

ASC 606 applies to all contracts with customers to provide goods or services that are outputs of the entity's ordinary course of business in exchange for consideration, with the few exceptions noted in the remainder of this section. An important element of the definition of a "customer" under ASC 606 is that the goods or services under contract must be an output of the entity's *ordinary activities.* However, the FASB and the IASB decided not to further define "ordinary activities," in part, because the Boards used different definitions of *revenue* in their respective Concept Statements preceding the final standard. Therefore, some judgment may be required in determining what goods or services constitute an output of the entity's ordinary activities when determining if the counterparty to a transaction qualifies as a customer.

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

Revenue

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

ASC 606 is often referred to as a "residual standard," because it applies only after an entity determines that no other guidance takes precedence. To evaluate whether a contract with a customer is within the scope of ASC 606, an entity must first determine whether another accounting standard applies. If no other standard applies, then the contract would fall under the scope of ASC 606.

Below is a list of other areas of U.S. GAAP that an entity would apply prior to determining that an arrangement is within the scope of ASC 606:

- Lease contracts within the scope of ASC 842
- Insurance contracts within the scope of ASC 944
- Guarantees (other than product or service warranties) within the scope of ASC 460
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers, such as purchases and sales of inventory with the same counterparty within the scope of ASC 845
- Financial instruments and other contractual rights and obligations within the scope of one of the following Codification Topics: ASC 310, ASC 320, ASC 323, ASC 325, ASC 405, ASC 470, ASC 815, ASC 825, and ASC 860

Fixed-odds wagering contracts should be accounted for in accordance with the guidance in ASC 606, as the industry specific guidance for casinos in ASC 924-815 specifically excludes fixed-odds wagering contracts from the scope of the derivatives guidance in ASC 815.

In some cases, a contract with a customer that is within the scope of ASC 606 may contain an option either allowing or requiring the entity to repurchase the asset that was exchanged under that contract. Depending on the specific facts and circumstances, such a feature may result in that contract being accounted for in accordance with other guidance, such as ASC 842 or ASC 460. See Section 7.4, "Repurchase Agreements," for more discussion on determining the appropriate accounting treatment for revenue contracts that contain repurchase features.

In addition to the exclusions discussed explicitly in ASC 606, the TRG discussed several types of agreements and whether or not they should be accounted for under the revenue guidance.

TRG area of general agreement: In or out of scope of ASC 606?

The TRG discussed the following types of arrangements and reached general agreement on the applicability of the scope of ASC 606 as follows:

- **Credit card fees**: At its July 2015 meeting,[2] the TRG reached general agreement that credit card fees accounted for under ASC 310 are not within the scope of ASC 606. In other words, TRG members expect the conclusion under both legacy guidance and ASC 606 to be the same when evaluating various revenue streams from credit card programs. An SEC observer to the meeting cautioned, however, that entities should not assume that any fee connected to a credit card or any arrangement labeled as a credit card lending arrangement would automatically fall within the scope of ASC 310. In other words, the entity must assess whether the nature of the overall arrangement is a credit card lending arrangement and, if not, the entity should not presume that the arrangement is entirely within the scope of ASC 310.
- **Credit card reward programs**: At its July 2015 meeting,[3] the TRG also generally agreed that an entity must apply judgment and consider all facts and circumstances of the specific credit cardholder award program in question to determine whether the reward program is within the scope of ASC 606. If an entity determines that all fees related to the program, including the credit card fees, are within the scope of ASC 310, the program would not be within the scope of ASC 606.
- **Servicing and sub-servicing fees**: At its April 2016 meeting,[4] the TRG generally agreed that servicing and sub-servicing fees are in the scope of ASC 860 and therefore are excluded from the scope of ASC 606.
- **Deposit-related fees**: At its April 2016 meeting,[5] the TRG generally agreed that deposit-related fees are within the scope of ASC 606. While the deposit-related liability is within the scope of ASC 405 and is excluded from the scope of ASC 606, ASC 405 lacks accounting guidance for deposit-related fees. Therefore, it is appropriate to apply the guidance in ASC 606 to deposit-related fees.
- **Carried interest**: At its April 2016 meeting,[6] the TRG members generally agreed that incentive-based performance fees in the form of an allocation of capital from an investment fund under

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[2] TRG Paper 36, *Scope: Credit Cards.*
[3] Ibid
[4] TRG Paper 52, *Scoping Considerations for Financial Institutions.*
[5] Ibid.
[6] TRG Paper 50, *Scoping Considerations for Incentive-based Capital Allocations, Such as Carried Interest*.

management, referred to as a "carried interest," are within the scope of ASC 606. Some TRG members indicated that a reasonable alternative view could be that the carried interest is an equity arrangement, because it is, in form, an interest in the entity. Some TRG members noted this alternative view may lead to questions regarding whether an asset manager should consolidate the fund. The SEC staff observer stated that the SEC staff would most likely accept the application of ASC 606 to carried interest arrangements but also noted that there could be a basis for following an ownership model. The SEC staff would expect entities that apply an ownership model to include an analysis of the consolidation model under ASC 810, *Consolidation*, the equity method of accounting under ASC 323, *Investments – Equity Method and Joint Ventures*, or other relevant guidance.

- **Preproduction activities**: At its November 2015 meeting,[7] the TRG discussed whether certain pre-production costs fall within the scope of ASC 340-10 or ASC 340-40. See additional discussion at Section 11.3.

2.1 Sales of nonfinancial assets

ASC 610-20, which was added to the Codification at the same time as ASC 606, provides guidance on accounting for sales of nonfinancial assets to parties other than customers. ASC 610-20 requires entities to apply portions of the guidance in ASC 606 on contract existence, control, and measurement to transfers of nonfinancial assets that are not an output of the entity's ordinary activities. For more discussion of ASC 610-20, refer to Grant Thornton's *Sales and transfers of nonfinancial assets: ASC 610-20*.

Sales of nonfinancial assets

Quality Paper (QP) is a manufacturer of paper goods that operates in seven locations across the United States. QP builds a new facility in Omaha and sells its existing facility in Lincoln to a third party. The sale of manufacturing facilities is not an output of QP's ordinary activities; however, QP will still apply the contract existence, control, and measurement provisions in ASC 606 to the sale of its Lincoln facility. Applying those provisions, however, will not affect QP's income statement presentation of any resulting gain or loss from the facility sale.

2.2 Interaction with other guidance

A contract with a customer may be partially within the scope of ASC 606 and partially within the scope of other ASC Topics. If the other Topics specify how to separate and/or measure a portion of the contract, then that guidance should be applied first. The amounts measured under other Topics should be excluded from the transaction price that is allocated to performance obligations under ASC 606. If the other Topics do not stipulate how to separate and/or measure a portion of the contract, then ASC 606 should be used to separate and/or measure that portion of the contract.

[7] TRG Paper 46, *Pre-production costs*.

ASC 606-10-15-4

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

a. If the other Topics specify how to separate and/or initially measure one or more parts of the contract, then an entity shall first apply the separation and/or measurement guidance in those Topics. An entity shall exclude from the transaction price the amount of the part (or parts) of the contract that are initially measured in accordance with other Topics and shall apply paragraphs 606-10-32-28 through 32-41 to allocate the amount of the transaction price that remains (if any) to each performance obligation within the scope of this Topic and to any other parts of the contract identified by paragraph 606-10-15-4(b).

b. If the other Topics do not specify how to separate and/or initially measure one or more parts of the contract, then the entity shall apply the guidance in this Topic to separate and/or initially measure the part (or parts) of the contract.

2.2.1 Collaborative arrangements

A collaborative arrangement is defined as a contractual arrangement under which two or more parties actively participate in a joint operating activity and are exposed to significant risks and rewards that depend on the activity's commercial success. Therefore, an entity that enters into arrangements such as those for collaborative research and development activities will need to evaluate the particular facts and circumstances of each contract to determine if the collaborative arrangement participant is a customer. Collaborative arrangements are accounted for under ASC 808; however, that Topic does not provide comprehensive recognition and measurement guidance for these transactions. As a result, an entity may need to analogize to other U.S. GAAP, including ASC 606, to account for an arrangement that is within the scope of ASC 808.

Certain transactions between collaborative arrangement participants should be accounted for as revenue under ASC 606 if the collaborative arrangement participant is a customer with respect to the "unit of account" (identified as a promised good or service, or a bundle of goods or services, that is distinct within the collaborative arrangement under the related guidance in ASC 606). An entity that accounts for this type of transaction under ASC 606 should apply all of the guidance in ASC 606, including the recognition, measurement, presentation, and disclosure requirements.

Also, a transaction with a collaborative arrangement participant that is not directly related to sales to third parties should not be presented together with revenue recognized under ASC 606 if the collaborative arrangement participant is not a customer.

2.2.2 Contributions received

One element of the definition of a customer in ASC 606 is that the counterparty to a contract obtains goods or services in exchange for consideration. ASC 958-605 provides a framework for determining whether (1) a particular transaction is an exchange transaction, a contribution transaction, or an other type of transaction, such as an agency transaction, and (2) a contribution is conditional or unconditional. Exchange transactions are a form of reciprocal transaction, which means that both parties give and receive something that has commensurate economic value. In contrast, contributions are a form of nonreciprocal transaction, meaning that the resource provider neither expects to receive, nor receives, economic value in return for what it provides. While ASC 958 is industry-specific guidance for not-for-

profit entities, the contribution revenues section of ASC 958-605 applies to all entities that receive or make contributions, including for-profit entities.

Exchange transactions are excluded from the scope of ASC 958-605 and instead are accounted for under other guidance, including ASC 606.

Distinguishing between exchange and nonexchange transactions

Case A

Brainpower University receives $40,000 in tuition from a student to attend a semester of college. The student receives the output of the university's ordinary activities (educational services) in exchange for consideration ($40,000). Therefore, the student is a customer of the university, and the transaction is accounted for under ASC 606 by the university.

Case B

Brainpower University receives a $1 million grant from Wellness Foundation to further its research on a new cancer treatment. The foundation will not receive the output of the research, nor any other good or service, aside from furthering its mission to eradicate cancer. The foundation is not receiving a good or service in exchange for the consideration (grant) it is providing. Therefore, the transaction is a nonexchange transaction, the foundation is not a customer of the university, and the transaction is accounted for as a contribution under ASC 958-605.

3. Identify the contract with a customer

Because the guidance in ASC 606 applies only to contracts with customers, the first step in the model is to identify those contracts.

A **contract** is an agreement between two or more parties that creates enforceable rights and obligations.

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

ASC 606-10-25-2

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

The guidance in ASC 606-10-25-2 makes it clear that the rights and obligations in a contract must be "enforceable" before an entity applies the five-step revenue model. Enforceability is a matter of law, so an entity needs to consider the local relevant legal environment to determine whether rights and obligations are enforceable. That said, while the contract must be legally enforceable, oral or implied promises may give rise to performance obligations in the contract under Step 2 (Section 4).

To assist entities in determining if an arrangement is within the scope of ASC 606, the guidance specifies five criteria that the arrangement must meet.

3.1 Criteria for recognizing a contract

Step 1 serves as a "gate" through which a contract must pass before an entity applies the later steps of the model to that contract. In other words, if at the inception of an arrangement, an entity concludes that the criteria below are not met, it should not apply Steps 2 through 5 of the model until it determines that the Step 1 criteria are subsequently met. Significant judgment may be required to conclude whether an accounting contract exists. When a contract meets the five criteria and "passes" Step 1, the entity will not reassess the Step 1 criteria unless there is an indication of a significant change in facts and circumstances (Section 3.2.1).

An accounting contract exists only when an arrangement with a customer meets the following five criteria:

- The parties have approved the contract and are committed to perform their contractual obligations.
- The entity can identify each party's rights.
- The entity can identify the payment terms.
- The contract has commercial substance.
- It is probable that the entity will collect substantially all of the consideration to which it expects to be entitled.

If the arrangement does not meet the five criteria, an accounting contract does not exist, even though a legal contract may exist, and the entity follows the guidance in ASC 606-10-25-7 as described in Section 3.2.

ASC 606-10-25-1

An entity shall account for a contract with a customer that is within the scope of this Topic only when all of the following criteria are met:

a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.

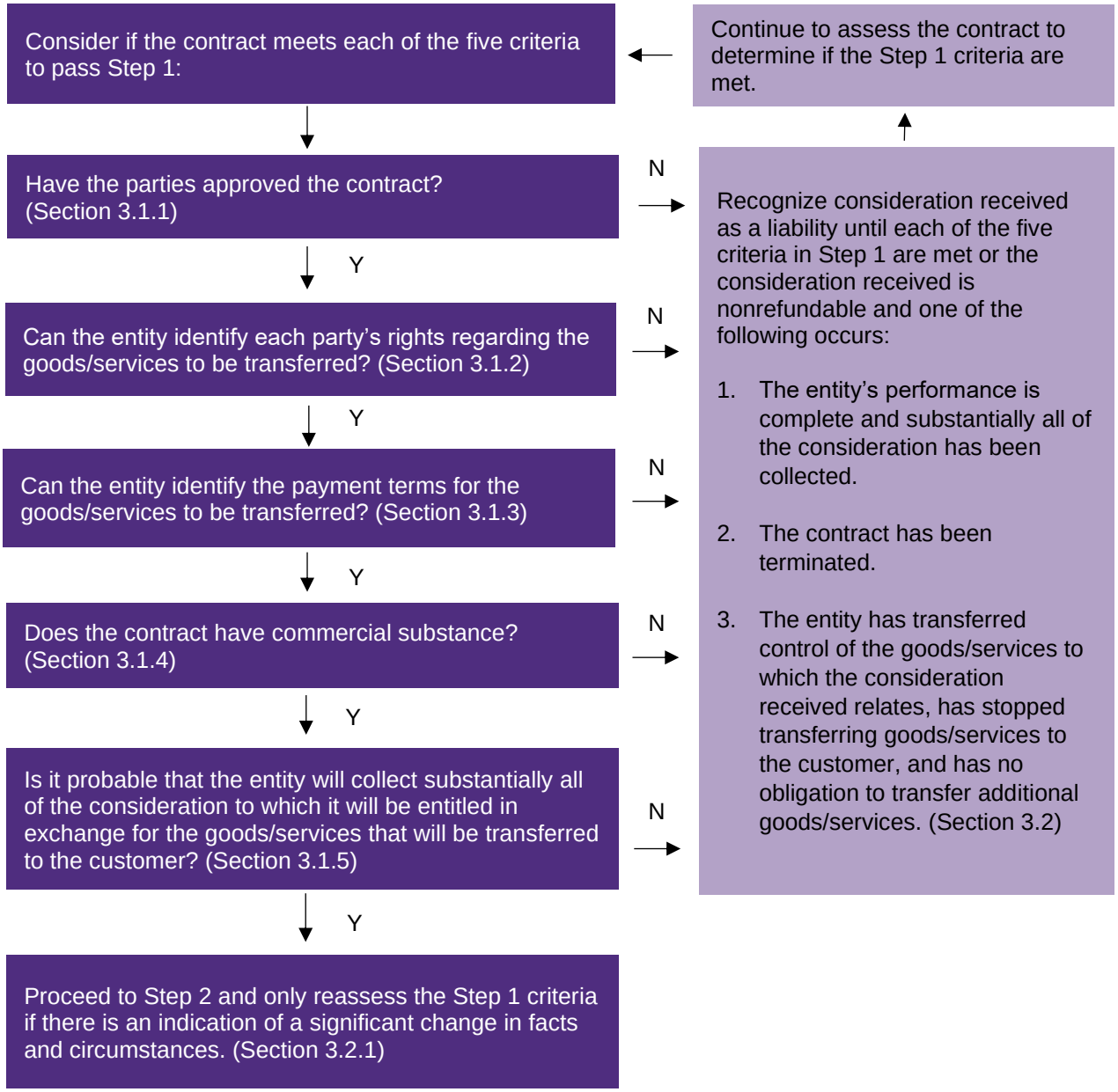
b. The entity can identify each party's rights regarding the goods or services to be transferred.

c. The entity can identify the payment terms for the goods or services to be transferred.

d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).

e. It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C). In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 606-10-32-7).

Figure 3.1: Criteria for recognizing a contract



3.1.1 The parties have approved the contract and are committed to perform

To pass Step 1, the parties must approve the contract. This approval may be written, oral, or implied, as long as the parties intend to be bound by the terms and conditions of the contract.

The parties should also be committed to performing their respective obligations under the contract. This does not mean that the parties need to be committed to fulfill *all* of their respective rights and obligations in order for this criterion to be met. For example, an entity may include a requirement in a contract for the customer to purchase a minimum quantity of goods each month, but the entity may have a history of not enforcing the requirement. In this example, the contract approval criterion can still be satisfied if evidence supports that the customer and the entity are both substantially committed to the contract. The FASB and IASB noted[8] that requiring all of the rights and obligations to be fulfilled would have inappropriately resulted in no recognition of revenue for some contracts in which the parties are substantially committed to the contract.

Trial periods

Some entities offer free trial periods to prospective customers to entice business. These trial periods must be carefully evaluated to determine if evidence exists to support that the customer has approved the contract and is committed to perform.

Evaluating trial periods

Members of a wine club receive a bottle of wine each month for 12 months for $20 per month. The wine vendor is offering a promotional trial period to prospective customers starting January 1, 20X8. Under the terms of the promotion, the vendor offers new participants up to a free two-month trial period. If participants wish to join the club, they must notify the vendor any time before the trial period lapses (February 28, 20X8). Participants that join the club receive an invoice for the 12-month membership period, which will end February 28, 20X9.

Until the customer gives notice to the wine vendor of its acceptance of the offer (either orally or written), the entity might not conclude that the customer has approved the contract and is committed to perform.

3.1.2 The entity can identify each party's rights

An entity must be able to identify its rights, as well as the rights of all other parties to the contract. An entity cannot assess the transfer of goods or services if it cannot identify each party's rights regarding those goods or services.

An entity may utilize a master service arrangement or master supply arrangement (MSA) with its customers. Each MSA must be evaluated to determine if the MSA alone establishes enforceable rights and obligations.

The MSA may establish only basic terms and conditions with customers and the entity may require its customers to also submit purchase orders specifying quantify and/or type of goods or services. In such cases, the MSA alone may not establish enforceable rights and obligations of the parties. Assuming all of the other criteria in ASC 606-10-25-1 are met, the MSA might not pass Step 1, and a contract might not

[8] BC36, ASU 2014-09.

exist, until a purchase order is submitted and approved. Often this will lead to each purchase order being a contract, depending on facts and circumstances.

An MSA that specifies minimum purchase quantities may create enforceable rights and obligations; however, if the entity has a past practice of waiving the minimum purchase requirement and such practice would render the term legally unenforceable, then the term is not considered when determining if the MSA alone creates legally enforceable rights and obligations.

3.1.3 The entity can identify the payment terms for the goods or services

An entity must also be able to identify the payment terms for the promised goods or services within the contract. The entity cannot determine how much it will receive in exchange for the promised goods or services (the "transaction price" in Step 3 of the model) if it cannot identify the contractual payment terms.

3.1.4 The contract has commercial substance

A contract has commercial substance if the risk, timing, or amount of the entity's cash flows is expected to change as a result of the contract. In other words, the contract must have economic consequences. This criterion was added to prevent entities from transferring goods or services back and forth to each other for little or no consideration to artificially inflate their revenue. This criterion is applicable for both monetary and nonmonetary transactions, because without commercial substance, it is questionable whether an entity has entered into a transaction that has economic consequences.

3.1.5 It is probable the entity will collect substantially all of the consideration

To pass Step 1, an entity must determine that it is probable that it will collect substantially all of the consideration to which it will be entitled under the contract in exchange for goods or services that it will transfer to the customer. This criterion is also referred to as the "collectibility assessment." In determining whether collection is probable, the entity considers the customer's ability and intention to pay when amounts are due.

Probable: The future event or events are likely to occur.

The objective of the collectibility assessment is to evaluate whether there is a substantive transaction between the entity and the customer. When evaluating collectibility, an entity bases its assessment on whether the customer has the ability and intention to pay the promised consideration in exchange for the goods or services that *will be transferred* under the contract, rather than assessing the collectibility of the consideration promised for *all* of the promised goods or services.

ASC 606-10-55-3A

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

substantive transaction between the entity and the customer, which is a necessary condition for the contract to be accounted for under the revenue model in this Topic.

ASC 606-10-55-3B

The collectibility assessment in paragraph 606-10-25-1(e) is partly a forward-looking assessment. It requires an entity to use judgment and consider all of the facts and circumstances, including the entity's customary business practices and its knowledge of the customer, in determining whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that the entity expects to transfer to the customer. The assessment is not necessarily based on the customer's ability and intention to pay the entire amount of promised consideration for the entire duration of the contract.

An entity should determine whether the contractual terms and its customary business practices indicate that it has the ability and intent to mitigate credit risk. For example, some contracts may require upfront payments before any goods or services are transferred to the customer. Any consideration received before the entity transfers the goods or services would not be subject to credit risk. In other cases, such as a telecom providing wireless network access to a building, the entity may be able to stop transferring goods or services under the contract upon a customer's failure to pay. In that situation, the entity would consider the likelihood of payment for only the promised goods or services that will be transferred to the customer.

An entity is precluded from considering its ability to repossess an asset transferred to a customer when assessing collectibility.

ASC 606-10-55-3C

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

a. Payment terms—In some contracts, payment terms limit an entity's exposure to credit risk. For example, a customer may be required to pay a portion of the consideration promised in the contract before the entity transfers promised goods or services to the customer. In those cases, any consideration that will be received before the entity transfers promised goods or services to the customer would not be subject to credit risk.

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

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

The following examples from ASC 606 illustrate the guidance on assessing credit risk and the collectibility criterion.

Example 1—Collectibility of the Consideration; Case B—Credit Risk is Mitigated

ASC 606-10-55-98A

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

ASC 606-10-55-98B

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

ASC 606-10-55-98C

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

ASC 606-10-55-98D

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

ASC 606-10-55-98E

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

indication of a significant change in facts or circumstances such as the customer not making its required payments.

Example 1—Collectibility of the Consideration; Case C—Credit Risk is Not Mitigated

ASC 606-10-55-98F

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

ASC 606-10-55-98G

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

ASC 606-10-55-98H

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

ASC 606-10-55-98I

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

Portfolio considerations when assessing collectibility

The TRG discussed stakeholder questions with respect to assessing collectibility when an entity elects to account for its contracts on a portfolio basis, as described in Section 3.4.

TRG area of general agreement: How should an entity assess collectibility for a portfolio of contracts?

At its January 2015 meeting,[9] the TRG discussed how an entity should assess collectibility at contract inception when the entity has historical experience that indicates it will not collect consideration from some customers in a portfolio of contracts.

For example, ABC Corp. has a large number of similar customer contracts for which it bills on a monthly basis in arrears. ABC Corp. performs credit assessment procedures before accepting a customer. When these procedures result in the conclusion that it is not probable the customer will pay the amounts owed, the entity does not accept the customer. Because these procedures are only designed to determine whether collection is probable (and thus not a certainty), the entity anticipates that it will have some customers that will not pay all amounts owed. Historical evidence, which is representative of its expectations for the future, indicates that the entity will only collect 98 percent of the amounts billed.

TRG members agreed that if an entity considers collectibility of the transaction price to be probable for a portfolio of contracts, then the entity should recognize revenue in full and perform a separate evaluation of the receivable for impairment. For example, if an entity bills $100 to its customers in a particular month and expects bad debt expense of $2, the entity should recognize revenue of $100 and a corresponding receivable representing its right to consideration that is unconditional when the entity satisfies its performance obligations. The guidance does not support the view that only $98 of revenue should be recognized in this example, because the entity evaluated collectibility for each customer and concluded that it is probable that each customer will pay the amount to which the entity will be entitled for a total of $100.

The resultant contract asset or receivable should be assessed for impairment under the receivable guidance in ASC 310. An entity would recognize the difference between the measurement of the receivable and the corresponding revenue as bad debt expense.

Price concessions

In determining the “consideration to which an entity will be entitled” for purposes of the collectibility assessment, an entity needs to evaluate at contract inception whether it expects to provide a price concession that will result in receiving less than the full contract price from the customer. Although price concessions are a form of variable consideration and are more fully evaluated when determining the transaction price under Step 3 (Section 5.1), when evaluating collectibility under Step 1, an entity should also assess at the onset of an arrangement whether it expects to provide a price concession.

When an entity expects to accept less than the contractual amount for goods and services that will be transferred to the customer, it should evaluate all relevant facts and circumstances, which may require significant judgment, to determine whether it has accepted a customer’s credit risk or has provided an implicit price concession.

[9] TRG Paper 13, *Collectibility.*

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

ASC 606-10-55-99

An entity sells 1,000 units of a prescription drug to a customer for promised consideration of $1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.

ASC 606-10-55-100

When assessing whether the criterion in paragraph 606-10-25-1(e) is met, the entity also considers paragraph 606-10-32-2 and 606-10-32-7(b). Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not $1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to $400,000.

ASC 606-10-55-101

The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty it is probable that it will collect $400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 606-10-25-1(e) is met based on an estimate of variable consideration of $400,000. In addition, based on an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1 are also met. Consequently, the entity accounts for the contract with the customer in accordance with the guidance in this Topic.

It can sometimes be difficult to distinguish between a price concession and a collectibility issue. The ramifications could impact the accounting because one path (a collectibility concern) might lead an entity to conclude that it does not pass Step 1 for a particular arrangement, while another path (a price concession) may result in variable consideration and allow the entity to proceed to Step 2 with a lower transaction price. Judgment will be required to determine which path is appropriate. Ultimately, as discussed by the TRG,[10] this is not a new area of judgment.

Grant Thornton insight: Price concession versus collectibility issue

ASC 606-10-32-7 provides guidance on factors an entity considers to determine if the promised consideration is variable because it has offered, or expects to offer, a price concession. It states, in part, that a price concession exists if either of the following conditions is met:

a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that

[10] TRG Paper 13, *Collectibility.*

is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession.

b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

Other possible indicators that suggest an entity is offering a price concession include

- A business practice of not performing a credit assessment prior to transferring promised goods or services (for example, a health care provider that is required by law to perform, as described in ASC 606-10-55-102 through 55-106, Example 3)
- A valid expectation of the customer that the entity will accept less than the contractually stated amount
- A business practice of continuing to perform despite historical experience suggesting that collection is not probable
- An arrangement where there is little to no incremental cost associated with fulfilling the performance obligations (for example, a software provider that incurs little to no reproduction cost when selling licenses for an existing software product)
- An expectation by the entity at the onset of the arrangement that despite pricing in the contract it later will offer a price concession (for example, the entity will accept less than the stated price in order to develop a strategic relationship with a new customer)

Factors that may indicate a customer or pool of customers presents collectibility issues include

- The customer's financial condition has deteriorated since contract inception.
- The entity has a pool (portfolio) of homogeneous customers with similar credit profiles, and while it expects that most will pay amounts when due, it expects that some will not.

There may be other relevant indicators, depending on the facts and circumstances.

See further guidance regarding price concessions, including estimating and reassessing the amount of variable consideration, at Section 5.1.

3.2 Contracts that do not 'pass' Step 1

If an entity determines at an arrangement's inception that one or more of the criteria in ASC 606-10-25-1 have not been met, an accounting contract, for purposes of applying ASC 606, does not exist. An entity that does not "pass" Step 1 should continue to reassess whether the five criteria are subsequently met.

A contract may not pass Step 1, but the entity may still transfer goods or services to the customer and receive nonrefundable consideration in exchange for those goods or services. In that circumstance, the entity cannot recognize revenue for the nonrefundable consideration received until either the Step 1 criteria are subsequently met, or one of the events outlined in ASC 606-10-25-7 has occurred, as discussed below.

ASC 606-10-25-7

When a contract with a customer does not meet the criteria in paragraph 606-10-25-1 and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when one or more of the following events have occurred:

a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.

b. The contract has been terminated, and the consideration received from the customer is nonrefundable.

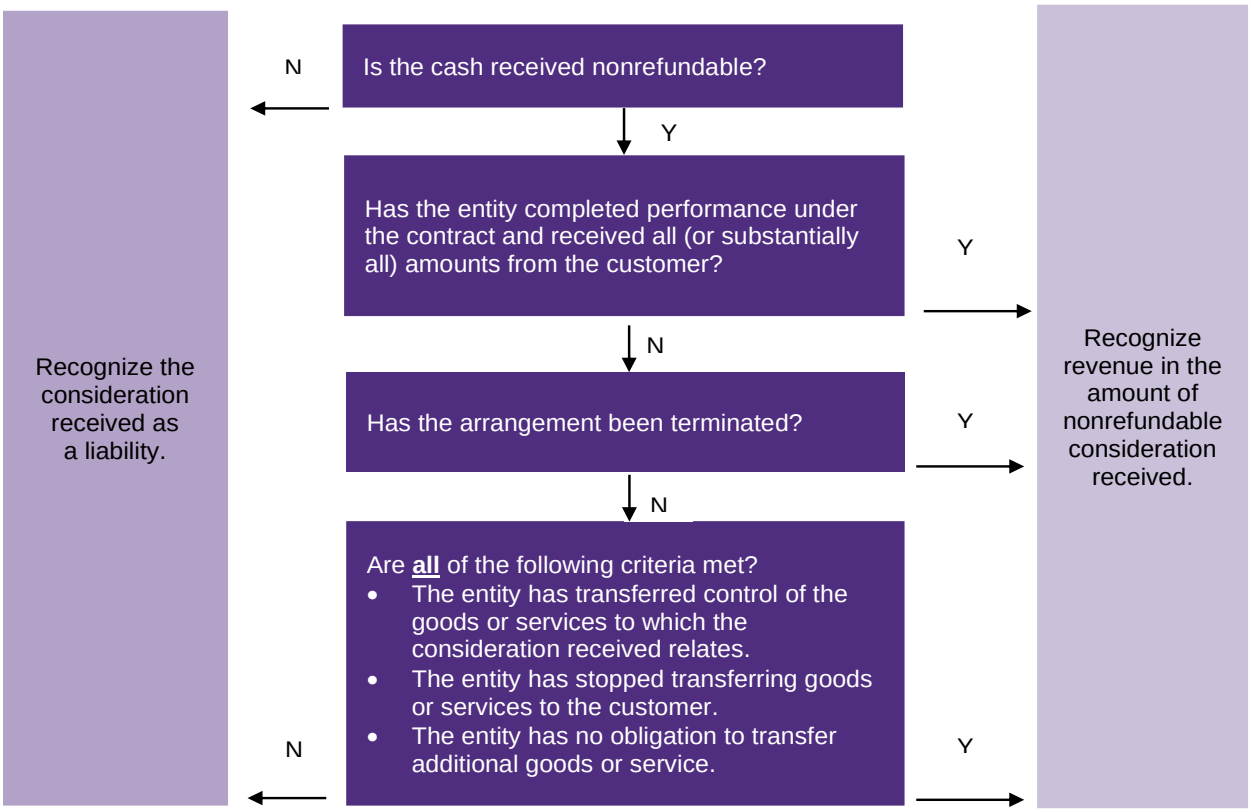
c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration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

The third criterion was added by the FASB[11] to accommodate situations in which an entity has not legally terminated the contract because it wants to continue to pursue collection or its other rights under the contract.

Until the contract passes Step 1 or one of the above criteria is met, an entity should recognize the consideration received from a customer as a liability that is measured at the amount of consideration received from the customer.

[11] BC23 and BC24, ASU 2016-12.

Figure 3.2: When cash is received for a contract that does not pass Step 1



Grant Thornton insight: ASC 606 is not cash basis accounting

The guidance outlined in ASC 606-10-25-7 does not equate to accounting for revenue using a cash basis (that is, recognizing revenue when cash is received). Further, a cash basis is not an acceptable approach to account for revenue prescribed in ASC 606. Under ASC 606, if a contract does not meet one of the criteria in ASC 606-10-25-7, an entity does not recognize revenue and instead is required to recognize a liability for nonrefundable amounts received in an arrangement representing its obligation to perform or refund the consideration received.

The FASB noted[12] that ASC 606-10-25-7(c) is not equivalent to a "cash basis" of accounting, because in order to meet this new criterion, the entity must either stop transferring goods or services to the customer with no obligation to transfer additional goods or services to the customer or must not have any additional promised goods or services to transfer.

[12] BC24, ASU 2016-12.

3.2.1 Reassessing the Step 1 criteria

When an entity determines that a contract passes Step 1, it should not reassess contract existence unless there is an indication of a significant change in facts and circumstances.

ASC 606-10-25-5

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

Grant Thornton insight: When a contract 'passes' Step 1, what constitutes a 'significant change in facts and circumstances' necessitating a reassessment in the Step 1 criteria?

The determination of what constitutes a "significant change in facts and circumstances" will often require judgment. Continuing with the example in ASC 606-10-25-5, if the entity determines that it is no longer probable that it will collect the consideration, the entity would not recognize revenue for the remaining goods and services as they are transferred to the customer, and would instead apply the guidance in ASC 606-10-25-7.

Example 4 in ASC 606 illustrates the guidance on reassessing the criteria for identifying a contract.

Example 4—Reassessing the Criteria for Identifying a Contract

ASC 606-10-55-106

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

ASC 606-10-55-107

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

ASC 606-10-55-108

During the second year of the contract, the customer continues to use the entity's patent, but the customer's financial condition declines. The customer's current access to credit and available cash on

hand are limited. The entity continues to recognize revenue on the basis of the customer's usage throughout the second year. The customer pays the first quarter's royalties but makes nominal payments for the usage of the patent in quarters 2–4. The entity accounts for any credit losses on the existing receivable in accordance with Subtopic 326-20 on financial instruments measured at amortized cost.

ASC 606-10-55-109

During the third year of the contract, the customer continues to use the entity's patent. However, the entity learns that the customer has lost access to credit and its major customers and thus the customer's ability to pay significantly deteriorates. The entity therefore concludes that it is unlikely that the customer will be able to make any further royalty payments for ongoing usage of the entity's patent. As a result of this significant change in facts and circumstances, in accordance with paragraph 606-10-25-5, the entity reassesses the criteria in paragraph 606-10-25-1 and determines that they are not met because it is no longer probable that the entity will collect the consideration to which it will be entitled. Accordingly, the entity does not recognize any further revenue associated with the customer's future usage of its patent. The entity accounts for additional credit losses on the existing receivable in accordance with Subtopic 326-20.

When the entity concludes that collectibility is no longer probable, only the revenue related to the remaining goods or services yet to be transferred is impacted. Other than impairment considerations, the reassessment has no impact on revenue recognized to date, receivables recorded, or assets recognized as a result of satisfied performance obligations.

TRG area of general agreement: Reassessing collectibility

The TRG discussed at its January 2015 meeting[13] when an entity should reassess collectibility for a customer after concluding that the customer passes Step 1 at the inception of a multi-year contract.

The TRG considered Example 4 above, whereby an entity licenses a patent to a customer in exchange for a usage-based royalty.

The TRG agreed that Example 4 demonstrates that

- The determination of whether there is a significant change in facts or circumstances will be situation-specific and will require judgment.
- The change in the customer's financial condition is so significant that it is an indication that the contract is no longer valid and fails Step 1 from that point forward.

[13] TRG Paper 13, *Collectibility.*

Grant Thornton insight: What constitutes a 'significant change in facts and circumstances necessitating a reassessment in the Step 1 criteria

We believe it is important to highlight what Example 4 in ASC 606 does and does *not* say.

Example 4 does say that despite the "customer's financial condition declin[ing]," the entity does *not* reevaluate its collectibility assessment in Year 2 of the contract. Even though the customer's access to credit and its available cash are limited, the entity does not reassess collectibility but instead continues to recognize revenue based on the customer's use of the patent throughout Year 2. The customer pays the first quarter's royalties but makes nominal payments for using the patent in the second and fourth quarters of Year 2. However, the example notes that the entity evaluates the receivables for impairment in Year 2.

In Year 3, the entity learns that the customer has lost access to credit and its major customers and that its ability to pay has significantly deteriorated. As a result of this significant change, the entity reassesses the criteria in paragraph 606-10-25-1 and determines they are not met, because it is no longer probable that the entity will collect the consideration to which it is entitled.

Example 4 does not actually say that a one-time missed payment by a customer calls for a Step 1 reassessment, but it can be inferred from this example that a customer's declining financial condition (as evidenced by short payments) does not necessarily constitute a significant change in the facts and circumstances that would result in a Step 1 reassessment. We believe, however, that the entity would be expected to evaluate whether (1) the amount of any variable consideration, or the amount of any fixed consideration that becomes variable consideration, requires applying a constraint, and (2) any receivable recognized must be evaluated for impairment.

3.3 Contract term

An entity applies ASC 606 to the contractual period over which the parties to the contract have present enforceable rights and obligations. Enforceability of the rights and obligations is a matter of law. Because practices and processes for establishing contracts with customers may vary across jurisdictions and entities, each entity should consider its established practices and processes when determining whether its agreements create enforceable rights and obligations.

3.3.1 Termination provisions

Some contracts can be terminated by either party at any time while others may only be terminated by one party. An accounting contract does not exist if each party to a contract has the unilateral enforceable right to terminate a wholly unperformed contract without paying a termination penalty. A "wholly unperformed" contract means that the entity hasn't yet performed and is not entitled to any consideration.

ASC 606-10-25-3 (excerpt)

Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations.

ASC 606-10-25-4

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

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

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

Contract cancellable for a full refund

On March 15, a customer orders a standard piece of furniture from a retailer and pays $1,000 for the furniture in advance of delivery, which typically occurs within 30 days. The contract indicates that the customer can cancel the order at any time prior to delivery and receive a full refund of the advance payment; however, the retailer has no cancellation rights.

The retailer considers whether it has a contract with a customer that passes Step 1 on March 15. When the customer paid for the furniture in advance, the contract was no longer wholly unperformed because the retailer had received consideration. Therefore, the guidance regarding wholly unperformed contracts in ASC 606-10-25-4 does not apply.

The retailer determines that a contract exists on March 15 because the contract meets the five criteria under Step 1 of the revenue recognition model:

- Both parties have approved the contract and are committed to performing their obligations as indicated by their signing the sales order and further supported by the $1,000 advance payment.
- Both parties' rights are identifiable in the contract terms.
- The payment terms are identified in the contract.
- The contract has commercial substance as the amount of the entity's future cash flow is expected to change as a result of the contract.
- Collectibility is probable since it has already occurred.

In some situations, only the customer has the ability to terminate the contract without penalty. In those situations, the contract term for accounting purposes may be shorter than the stated contract term.

Ability to terminate without penalty

A tennis club enters into a contract with a new member to provide access to its tennis courts for a 12-month period at $100 per month. The member can cancel his or her membership without penalty after six months. The enforceable rights and obligations of this contract are for six months, and therefore the contract term is six months.

The TRG has discussed how a termination penalty may impact the contract term, as summarized below.

TRG area of general agreement: How should termination clauses be evaluated in determining the duration of a contract?

The TRG discussed the accounting for termination clauses at its October 2014 meeting.[14] During this meeting, the TRG specifically discussed fact patterns when each party to the contract has the unilateral right to terminate the contract by paying a termination penalty. TRG members agreed the contract exists throughout the period covered by the termination penalties because the penalties are evidence of enforceable rights and obligations throughout the term of the contract. That said, the mere existence of a penalty by itself would not mean that the contract term includes the periods covered by the penalties. The penalties must be substantive.

At its November 2015 meeting,[15] the TRG also agreed that the discussion from October 2014 summarized above applies to contracts in which only the customer has a unilateral ability to terminate the contract. This is because the change in the fact pattern is not significant enough to warrant a different view. Therefore, in contracts where only the customer has a unilateral ability to terminate the contact, a contract exists throughout the period covered by the termination penalty as long as the penalty is substantive.

A common business model for some entities is to sell goods at a loss and to make money through sales of consumables that the customer has to purchase again and again (for example, a razor and razor blades, or a printer and printer cartridges). Sometimes these contracts are structured in such a way that if the customer does not purchase a minimum amount of consumables, it must pay a termination penalty. The TRG discussed how these contracts may effectively include a substantive termination penalty, which creates enforceable rights and obligations that may impact the contract term.

[14] TRG Paper 10, *Contract enforceability and termination clauses.*
[15] TRG Paper 48, *Customer options for additional goods and services.*

TRG area of general agreement: How should an entity evaluate the contract term when only the customer has the right to cancel without cause, and how do termination penalties affect that analysis?

At its November 2015 meeting,[16] the TRG discussed a scenario where only *one* party has the termination right. The TRG considered a contract for equipment and consumable parts in which the standalone selling price of the equipment and parts is $10,000 and $100, respectively. The entity sells the equipment for $6,000 and provides the customer with an option to purchase each part for $100. If the customer does not purchase at least 200 parts, it must pay a penalty that repays some or all of the $4,000 discount, and that penalty decreases as each part is purchased at a rate of $20 per part. The example assumes that the equipment and consumables are distinct goods, revenue is recognized at a point in time, and a discount of $10 would be a material right to the customer.

The TRG generally agreed that substantive termination penalties create enforceable rights and obligations, effectively creating a minimum purchase obligation for 200 parts in the example above. The TRG debated what constitutes a "substantive" penalty and acknowledged that significant judgment would be required to make that determination. One consideration in assessing whether a penalty is substantive would be to evaluate how many customers opt to pay the penalty. A significant number of customers opting to pay the penalty might indicate that the penalty is not substantive. If the penalty is not substantive, the entity must still evaluate whether the termination right (which is similar to an option for additional goods or services) gives rise to a material right. Said differently, if the existence of a contractual penalty does not create a longer contract term, it still could impact whether a material right is present for the optional goods or services.

Grant Thornton insight: Do contracts with the government automatically include substantive termination penalties?

Many contracts with the U.S. federal government include a "termination for convenience" provision that allows the government to terminate contracts when the government believes termination is in its best interest. Federal Acquisition Regulations (FAR) Section 49.201(a) states that if the government terminates a contract for reasons other than default, it should "compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit."

Questions often arise over whether the termination for convenience payment constitutes a substantive penalty for accounting purposes. The implications of this assessment can be significant for government contracting entities because the duration period for accounting purposes may be less than the duration period stated in the contract for payments deemed nonsubstantive (for example, the contract may be a month-to-month contract, depending upon the facts and circumstances). Further, the entity may be prohibited from including any payments after the accounting duration period in any disclosures that sum up the aggregate amount of transaction price allocated to performance obligations that are unsatisfied as of the end of the reporting period (often referred to the "remaining unperformed performance obligations" disclosure or "RUPO").

[16] Ibid.

Generally, the costs associated with terminating a contract for convenience for construction and manufacturing contracts may more likely be substantive, where there can be significant costs that would not have been incurred had the contract not been terminated, such as costs to shut down a production line or terminate long-term leases of heavy equipment. Costs associated with terminating a contract for convenience related to providing standard services to the government may be less likely to be substantive. Determining whether termination costs are substantive or nonsubstantive under government contracts is an area that may require significant judgment.

At a separate meeting, the TRG discussed whether an entity's past practice of waiving termination penalties would impact the assessment of the contract term and generally agreed that the answer depends on whether the past practice changes the legally enforceable rights and obligations, as explained below.

TRG area of general agreement: When an entity has a past practice of not enforcing the collection of termination penalties, does the past practice affect the assessment of the contract term?

At its October 2014 meeting,[17] the TRG discussed a fact pattern whereby an entity enters into a contract to provide services for 24 months. Either party can terminate the contract by compensating the other party. The entity has a past practice of not enforcing collection of the termination penalty when customers cancel after at least 12 months.

The TRG agreed that the determination of whether the contractual period is 24 months or 12 months depends on whether the past practice legally restricts the enforceable rights and obligations of the parties, which may vary by jurisdiction. The entity's past practice would affect the contract term only if that past practice changes the parties' legally enforceable rights and obligations. If that past practice does not change the parties' legally enforceable rights and obligations, then the contract term is 24 months.

3.4 Portfolio practical expedient

The guidance in ASC 606 applies to an individual contract with a customer but allows entities to apply the guidance to a portfolio of contracts or performance obligations with similar characteristics as a practical expedient. However, an entity may apply the practical expedient only if it expects that the effects of applying the guidance on a portfolio basis would not differ materially from applying the guidance on an individual contract-by-contract basis.

An entity will need to exercise judgment to determine how to group particular contracts or performance obligations for purposes of applying the portfolio practical expedient.

[17] TRG Paper 10, *Contract enforceability and termination clauses.*

ASC 606-10-10-4

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

TRG area of general agreement: Is an entity applying the portfolio practical expedient when it considers evidence from other, similar contracts to develop an estimate using the expected value method?

At its July 2015 meeting,[18] the TRG generally agreed that an entity can consider evidence from other, similar contracts to develop an estimate of variable consideration using the expected value method without applying the portfolio practical expedient. Said differently, considering historical experience does not necessarily mean that the entity is applying the portfolio practical expedient. This view is further supported by the guidance on estimating the standalone selling price of a good or service. ASC 606-10-32-34(a) states that a suitable method for estimating the standalone selling price of a good or service would include referring to prices of similar goods or services.

Stakeholders have questioned whether an entity needs to "prove" that the effects of applying the portfolio practical expedient do not differ materially from applying the guidance on an individual contract-by-contract basis. The Boards indicated in BC69 of ASU 2014-09 that they did not intend for entities to quantitatively evaluate each outcome and that entities should instead be able to determine a reasonable expectation that the portfolio approach would not differ materially and therefore determine the portfolios that would be appropriate for their types of contracts.

Grant Thornton insight: How should an entity evaluate whether contracts have similar characteristics?

ASC 606 does not include prescriptive guidance on how to determine if contracts may be grouped within the same portfolio.

An entity will need to exercise judgment to determine which contracts have similar characteristics when evaluating whether the contracts may be grouped within the same portfolio. One way to categorize contracts by portfolio may be by contract type. If an entity typically uses standard contract language, this may indicate that grouping the contracts into a single portfolio may be appropriate.

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[18] TRG Paper 38, *Portfolio Practical Expedient and Application of Variable Consideration Constraint.*

Another possible way to categorize contracts by portfolio would be by class of customer and the customer's behavior pattern. For example, a healthcare entity may have evidence that suggests that uninsured patients (customers) act similarly while insured patients (customers) act similarly and result in similar revenue recognition patterns. Additionally, insured patients might fall into different portfolios based on the terms of their insurance coverage.

Application of the portfolio practical expedient

A retailer sells clothing and shoes online and in brick-and-mortar stores. Based on historical experience, the retailer determines that online customers return 20 percent of items sold. However, the historical return rate for in-store sales is lower, at only 3 percent for shoes and 5 percent for clothing.

Because the historical pattern of behavior is different for online versus in-store customers, the retailer concludes that it would not be appropriate to include both of these classes of customers in the same portfolio of contracts.

The retailer considers whether in-store sales of clothing and shoes should be in the same portfolio of contracts because the return rates of 3 percent and 5 percent differ. The retailer determines that the historic weighted-average return rate for clothing and shoes is closer to 5 percent because more clothing is sold than shoes. As a result, the retailer includes all in-store sales in the same portfolio of contracts because the historical return activity from in-store sales is similar for both shoes and clothing and the use of 5 percent is reasonable.

The retailer enters into 1,000 in-store sales transactions, each for $100. Seven hundred contracts are for clothing and 300 are for shoes. The retailer applies the 5 percent return rate to the portfolio of in-store contracts and estimates a return liability of $5,000 (5% x 1,000 contracts x $100).

The retailer reasonably expects that the effect on the financial statements of applying the 5 percent return rate to the portfolio of in-store contracts would not differ materially from accounting for the clothing and shoe contracts individually. The retailer periodically estimates the potential difference to the return liability and revenue as though each in-store contract had been accounted for on an individual basis in order to ensure the effect on the financial statements of applying the portfolio approach would not differ materially from accounting for the contracts individually. In this example, the difference could reasonably be expected to approximate $600, calculated as $5,000 (the refund liability under the portfolio practical expedient) less $4,400 (the refund liability using the specific return percentages for clothing and shoes; $4,400 = $3,500 (5% x 700 x $100) + $900 (3% x 300 x $100)) and the retailer concludes this difference is not material.

The retailer monitors customer behavior, including return rates as well as sales channel and product mix, on an ongoing basis to continually evaluate whether it is appropriate to apply the portfolio practical expedient to all in-store sales.

3.5 Combining contracts

An entity should combine two or more contracts and account for them as a single contract in certain circumstances because the substance of the individual contracts cannot be understood without considering the entire arrangement. This evaluation takes place at contract inception.

In summary, two or more contracts may need to be accounted for as a single contract if they are entered into at or near the same time with the same customer (or with related parties), and if one of the following conditions exists:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration paid in one contract depends on the price or performance in the other contract.
- The goods or services promised in the contract are a single performance obligation.

The guidance does not specify what constitutes "at or near the same time," so an entity will need to exercise judgment to determine what constitutes this time frame as well as develop processes to evaluate whether the criteria are met.

ASC 606-10-25-9

An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

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

b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.

Grant Thornton insight: Combining contracts under ASC 606 may require significant judgment

ASC 606 requires an entity to combine contracts that were entered into at or near the same time with the same customer (or with related parties of the customer) if they meet any of the stated criteria in ASC 606-10-25-9. As a result, an entity should determine what constitutes "at or near the same time" and fully understand whether the parties involved are the same or "related parties," as defined in ASC 850. The contracts must be executed at or near the same time and with the same customer or related parties *in addition to* meeting one or more of the criteria outlined in ASC 606-10-25-9 in order to be combined and accounted for as a single combined contract. Furthermore, the entity should develop processes to evaluate whether the criteria in ASC 606-10-25-9 are met.

In many situations, the criteria related to whether the performance obligations or payments in multiple contracts are interdependent will be a straightforward evaluation; however, because ASC 606 is principle-based, many entities might find that significant judgment is required to determine whether multiple contracts are negotiated with a single commercial objective in mind or whether the goods and/or services under those contracts constitute a single performance obligation.

For example, if one contract with a party is for the construction of a building and another contract with the same party is for the installation of the elevators in that building, careful analysis of both contracts may lead to the conclusion that there is a single performance obligation for the building and that the contracts therefore should be combined. On the other hand, a contract with one party to construct a building and a second contract to install elevators at an adjacent property owned by the customer may require greater effort to determine whether the contracts should be combined.

4. Identify the performance obligations in the contract

Once a contract passes the Step 1 criteria (see Section 3.1), the entity may proceed to Step 2 in the revenue model. Step 2 is a critical step in the five-step revenue model. In this step, an entity identifies its performance obligations, which will serve as the unit of account throughout the rest of the model. If an entity fails to properly identify its performance obligations in Step 2, the subsequent accounting in Step 3 through Step 5 may not be appropriate.

Step 2 is a two-part process. Before an entity can identify its performance obligations, it must first identify all of the promised goods or services in the contract. Only after an entity identifies its promises can it then determine which of those promised goods or services constitute performance obligations.

Figure 4.1: Step 2 at a glance

4.1 Identifying promises

Promises are often explicitly specified in a contract but also may be implied by an entity's customary business practices, published policies, or specific statements that, at contract inception, create a reasonable expectation of the customer that the entity will transfer a good or service.

ASC 606-10-25-16

A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the promised goods or services identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in the contract. This is because a contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer.

ASC 606-10-25-18

Depending on the contract, promised goods or services may include, but are not limited to, the following:

a. Sale of goods produced by an entity (for example, inventory of a manufacturer)

b. Resale of goods purchased by an entity (for example, merchandise of a retailer)

c. Resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal, as described in paragraphs 606-10-55-36 through 55-40)

d. Performing a contractually agreed-upon task (or tasks) for a customer

e. Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides

f. Providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party, as described in paragraphs 606-10-55-36 through 55-40)

g. Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)

h. Constructing, manufacturing, or developing an asset on behalf of a customer

i. Granting licenses (see paragraphs 606-10-55-54 through 55-60 and paragraphs 606-10-55-62 through 55-65B)

j. Granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs 606-10-55-41 through 55-45)

When identifying promises, an entity should consider the customer's perspective because contractual promises are part of the negotiated exchange between the entity and the customer.

Further, implied promises do not need to be enforceable by law. If a customer has a reasonable expectation that the entity has made a promise, the customer would view the promise as part of the contract. Absent this guidance on implied promises,[19] an entity might incorrectly recognize all of the consideration received, despite having a remaining (implicit) promise to the customer.

[19] BC87, ASU 2014-09.

Figure 4.2: Examples of promises

Promise	Example
Sales of goods produced	A manufacturing entity sells inventory.
Resale of goods purchased	A retail entity sells purchased merchandise.
Resale of rights to goods or services purchased by an entity	A hospitality entity that purchased a concert ticket resells the ticket, acting as principal.
Performing tasks	A professional services entity provides consulting services.
Providing a service of standing ready to provide goods or services or of making goods or services available for a customer to use as and when the customer decides	A manufacturing entity provides maintenance services on machines sold to a customer when the customer decides it wants the services performed.
Providing the service of arranging for another party to transfer goods or services	A general maintenance entity acting as an agent provides a service of arranging for an unrelated party to provide specialized elevator maintenance to a customer.
Constructing, manufacturing, or developing an asset	A contractor builds a hospital.
Granting licenses	An entity grants a license to use its trade name.
Granting options to purchase additional goods or services that create a material right	A retailer grants a customer an option to buy three items and to receive 60 percent off of a fourth item at a later date.
Implicit promise of services	Although not explicitly stated in the contract or discussed in negotiations, a manufacturing entity has a customary business practice of providing maintenance services on machines sold to its customers. This practice creates a reasonable expectation on the part of the customer that the entity will perform periodic maintenance.

Administrative services

ASC 606 defines “promises” as those activities that transfer goods or services to the customer. In addition to the promised goods and services, an entity may be required to perform certain administrative services

in providing the promised goods and services in the contract. As these administrative services typically do not transfer a good or service to a customer, they are not considered promises in a contract with a customer, regardless of whether a payment from the customer is received when those administrative services are provided. If payment is received for administrative services that do not directly transfer a good or service to the customer, the payment should be accounted for as part of the transaction price, which is allocated to the identified performance obligations. When payments for related administrative services are nonrefundable, the guidance in Section 4.5 should be followed. Entities should also evaluate the costs incurred in providing the administrative services using the guidance on costs to fulfill a contract in ASC 340-40, which is further discussed in Section 11.2.

Exclusivity

A contract with a customer may include an exclusivity provision whereby either

- The entity promises to transfer a good or service to the customer and concurrently promises not to sell the same good or service to other customers; or
- The entity agrees to transfer an exclusive license to a customer but restricts the customer's ability to use the license to a specific geographic area.

Entities must evaluate exclusivity provisions to determine if they actually transfer a good or service to the customer, or if instead they restrict or define the scope of the other promises in the contract and, therefore, do not represent separate promises to a customer.

Grant Thornton insight: Is exclusivity a promise?

Contracts may include goods or services and assign a dollar amount for the exclusive use of a particular good or service. This "exclusivity" clause is common in contracts that convey a right to use a license or intellectual property to a customer for a period of time.

The Basis for Conclusions[20] in ASU 2014-09 notes that the FASB and IASB observed that exclusivity represents an attribute of a license or an asset that's been transferred, rather than the nature of the underlying intellectual property or the entity's promise in granting a license. Said differently, an exclusivity provision defines the scope of the customer's ability to use and benefit from the license, and does not represent a distinct promise that should be accounted for separately.

When a contract includes an upfront payment for "exclusivity," the entity must evaluate whether the payment indicates that there is a material right in the contract that needs to be accounted for as a separate performance obligation. For example, an upfront payment that allows the customer to purchase goods or services at a significant discount during the exclusivity period could indicate that the contract includes a material right. If the entity concludes there is not a material right in the contract in this scenario, the "exclusivity payment" would be allocated to other promised goods or services in the contract that constitute performance obligations.

[20] BC412(b), ASU 2014-09.

4.1.1 Immaterial promises

When a promise is immaterial in the context of a contract, an entity does not need to assess the promise to determine if it meets the definition of a performance obligation.

ASC 606-10-25-16A

An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer. If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, then the related costs to transfer those goods or services shall be accrued.

The FASB decided[21] that an entity is required to consider whether a promised good or service is immaterial only at the contract level (not at the entity level) because it would be unduly burdensome to require an entity to aggregate and determine the effect on its financial statements of those items or activities determined to be immaterial at the individual contract level. However, if multiple goods or services in a single contract are individually immaterial in the context of the contract, but those individually immaterial items are in the aggregate material to that contract, then an entity should not disregard those goods or services when identifying performance obligations in the contract.[22]

Grant Thornton insight: Promises that may be immaterial within the context of the contract

Entities must evaluate whether a promise is immaterial within the context of each individual contract. As a result, we believe that an entity should not include in its accounting policy a quantitative definition of immaterial, such as all promises under either a certain dollar amount or percentage threshold. This evaluation of whether a promise is immaterial within the context of each contract should be performed based on each individual customer contract, and should not be based on a measure of the company's financial statements. An entity should consider both quantitative and qualitative factors in determining whether a promise is immaterial. Qualitative considerations may include the promise's relationship to other promises in the contract and the significance of the promise to the customer's decision to enter into the contract.

[21] BC12, ASU 2016-10.
[22] BC14, ASU 2016-10.

Evaluation of promises that are individually immaterial but in aggregate are material in the context of the contract

A supplier provides multiple goods to a customer as part of its overall contract, including goods A, B, C, and D.

The supplier concludes that goods B, C, and D are individually quantitatively immaterial in the context of the contract; however, those goods are quantitatively material in aggregate. As a result, the supplier cannot disregard goods B, C, and D when identifying its performance obligations. The supplier should also evaluate whether goods B, C, and D are qualitatively immaterial.

Determining whether promised goods or services are immaterial in the context of the contract may require judgment; however, the Board expects that the assessment should be straightforward in many cases because it should be clear that the item is immaterial when considering the nature of the entity's arrangement with the customer.

BC12 of ASU 2016-10 states, in part, that when determining whether a promise is immaterial in the context of the contract, an entity should consider the relative significance or importance of a particular promised good or service in the contract to the arrangement with the customer as a whole, taking into consideration both the quantitative and qualitative nature of the promised goods or services in the contract. For example, when evaluating whether a promise is quantitatively immaterial, an entity could consider, among other factors, the significance of the estimated stand-alone selling price of the promised item relative to the aggregate stand-alone selling price of all promised goods or services. Similarly, when evaluating whether a promise is qualitatively immaterial, an entity should consider the customer's viewpoint, including factors such as whether the utility or benefit of the promised item is immaterial to the customer compared to the complete group of goods and services included in the contract.

Evaluation of immaterial promises

A national hotel chain provides hotel rooms to guests that stay at its locations across the United States. Part of the hotel's service includes placing two free bottles of water in the room for guests to enjoy. The hotel also slides a paper statement under guests' doors the last night of their stay so that they can review the statement prior to checking out and retain a copy for their records.

When considering the nature of its promise to the customer, the hotel chain concludes that the customer views the service of providing access to the hotel room as the promise. While the guest may appreciate the two bottles of free water and the paper statement under the door at the end of the stay, neither generally would influence a guest's decision about staying at the hotel. From a quantitative perspective, the hotel determines the cost of the water to be less than 0.4 percent of the price of the average room rate ([$0.50 per bottle × 2 bottles] ÷ $250 average price per room).

As a result, the hotel determines that offering the two bottles of water per room as well as the paper statement are both quantitatively and qualitatively immaterial in the context of the contract and therefore will not evaluate those promises to determine if they constitute separate performance obligations.

Evaluating promises in a contract to determine if immaterial

Entity A owns and operates a sports stadium, which hosts sporting events and other special events. In addition to providing events in the stadium, one of Entity A's ordinary activities is providing marketing services to customers at the sports stadium—for example, on billboards and on electronic devices throughout the stadium. Entity A enters into a contract with its customer, Entity B, for marketing services. The contract includes a promise for Entity A to provide Entity B with tickets to each event held at the stadium. Entity A considers if the tickets are both quantitatively and qualitatively immaterial in the context of the contract.

Entity A first concludes that the tickets are quantitatively immaterial to the contract based on an assessment of the dollar value of the tickets compared with the other promises in the contract.

Entity A then considers the following factors in assessing whether the tickets are qualitatively immaterial to the contract:

- Would the exclusion of the tickets have changed Entity B's decision to enter into the arrangement?
- Were the tickets critical to the negotiation of the contract?
- Is there a relationship between the marketing services and the tickets?

Because Entity A answered "no" to all three questions, it determines that the tickets were qualitatively immaterial in the context of the contract. As a result, Entity A does not further evaluate whether the tickets are a performance obligation.

An entity may choose not to evaluate whether a promise is immaterial in the context of a contract, but rather may evaluate (any or) all promises in a contract to determine if they constitute separate performance obligations. This is because the guidance is written to allow an entity flexibility in deciding whether to evaluate a promise as immaterial, or proceed instead to determine if the promise is a performance obligation.

The relief from evaluating immaterial promises, however, does not apply to customer options when the options provide the customer with a material right (for example, loyalty points that may be immaterial in the context of a single contract). Material rights are discussed further in Section 4.4.

ASC 606-10-25-16B

An entity shall not apply the guidance in paragraph 606-10-25-16A to a customer option to acquire additional goods or services that provides the customer with a material right, in accordance with paragraphs 606-10-55-41 through 55-45.

Costs related to immaterial promises

The costs related to transferring goods or services that are immaterial in the context of the contract should be accrued when the revenue related to a performance obligation that includes those goods or services is recognized before the immaterial goods or services are transferred to the customer. We believe that the costs related to goods or services that are immaterial in the context of the contract should

be classified consistently with the costs of the performance obligation that includes the immaterial goods or services. For example, an entity that sells equipment offers customers a one-hour training course within three months after delivery. The entity concludes that the training promise is immaterial in the context of the contract and recognizes the cost of training and the cost of the equipment in the cost of goods sold when control of the equipment transfers to the customer and revenue is recognized.

4.1.2 Shipping and handling

In some cases, an entity performs shipping and handling activities in connection with a contract for its goods. If an entity performs shipping and handling activities after it transfers control of the goods to the customer, the entity may elect to account for shipping and handling costs as a fulfillment cost (an expense) rather than as a promised service within the contract that must be evaluated to determine if it is a distinct performance obligation (as discussed in Section 4.2). The entity should apply the accounting policy election consistently to similar types of transactions. When an entity makes this election and recognizes revenue before the shipping and handling activities occur, the entity should accrue the related shipping and handling costs. BC23 of ASU 2016-10 indicates that this guidance cannot be applied by analogy to activities other than shipping and handling.

ASC 606-10-25-18B

If shipping and handling activities are performed after a customer obtains control of the good, then the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good. The entity shall apply this accounting policy election consistently to similar types of transactions. An entity that makes this election would not evaluate whether shipping and handling activities are promised services to its customers. If revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities shall be accrued. An entity that applies this accounting policy election shall comply with the accounting policy disclosure requirements in paragraphs 235-10-50-1 through 50-6.

Shipping and handling activities that occur after control of the goods transfers

Entity A produces small motors. The motors are not customized in any way for any particular customer. Entity A considers the following in determining that control of the motors transfers upon leaving its shipping docks:

- Entity A has an enforceable right to payment at the shipping point.
- Entity A uses an insured carrier for its shipments and the carrier will reimburse the legal title holder for lost or damaged goods.
- Legal title to the parts transfers to the customer at the shipping point.
- There are no customer acceptance criteria included in the contract or established by past practice.

Entity A makes an accounting policy election to account for shipping and handling as a fulfillment cost for all of its motors for which control transfers upon shipment. As a result, Entity A recognizes revenue

for the motors (including any fee for the shipping) and accrues the related shipping costs when control of the motors transfers upon shipment of the parts from the entity's shipping docks.

Shipping and handling activities that occur before the customer obtains control of the good are activities to fulfill the entity's promise to transfer the good and are not a promised service to the customer.

ASC 606-10-25-18A

An entity that promises a good to a customer also might perform shipping and handling activities related to that good. If the shipping and handling activities are performed before the customer obtains control of the good (see paragraphs 606-10-25-23 through 25-30 for guidance on satisfying performance obligations), then the shipping and handling activities are not a promised service to the customer. Rather, shipping and handling are activities to fulfill the entity's promise to transfer the good.

4.1.3 Preproduction activities

Some long-term supply arrangements require an entity to undertake efforts up-front to mobilize equipment or to design new technology or equipment, which are referred to as preproduction activities. Preproduction activities are often necessary before delivering any units under a manufacturing contract.

Section 11.3 includes a discussion of the accounting considerations related to preproduction activities, including guidance on when preproduction activities are separate performance obligations.

4.1.4 Stand-ready promises

A stand-ready promise is one whereby an entity promises a service of "standing ready" to provide goods and/or services, or it makes the goods or services available for a customer to use as and when the customer decides.

The concept of "standing ready" has been discussed by the TRG to help stakeholders distinguish these types of obligations from others.

TRG area of general agreement: What is the nature of the promise in a stand-ready obligation?

At its January 2015 meeting,[23] the TRG reached a general agreement that entities will need to exercise judgment to determine whether the nature of the entity's promise is to stand ready to provide goods or services or to actually provide the underlying specified goods or services, which would not be a stand-ready obligation. An indicator as to the nature of the entity's promise might be when the entity's obligation is to provide a defined good or service, which would indicate that the nature of the entity's promise is to provide those underlying specified goods or services. If instead the entity determines that the nature of its obligation is to provide an unknown type or quantity of goods or

[23] TRG Paper 16, *Stand-Ready Performance Obligations.*

services, this indicates that the nature of the entity's promise is to stand ready.

Judgment is necessary to determine when a promise is to stand ready as many contracts call for the entity to be prepared to provide the goods or services at the discretion of the customer, but not all such promises would necessarily lead to stand-ready performance obligations.

TRG Paper 16 includes the following four broad types of promises made to customers that could be considered stand-ready obligations.

Type	Description	Examples
A	Obligations in which the delivery of a good, service, or intellectual property underlying the obligation is controlled by the entity, but the item must still be further developed	A software vendor promises to transfer unspecified software upgrades at the vendor's discretion. A pharmaceutical company promises to provide when-and-if-available updates to previously licensed intellectual property based on advances in research and development.
B	Obligations in which the delivery of the underlying good or service is outside the control of the entity and the customer	An entity promises to remove snow from an airport's runways in exchange for a fixed fee over a one-year period.
C	Obligations in which the delivery of the underlying good or service is controlled by the customer	An entity agrees to provide periodic maintenance, when-and-if-needed, to customer's equipment after a pre-established amount of usage by the customer.
D	Obligations where a good or service is available to the customer continuously	An entity provides the customer unlimited access to a health club for a specified time.

The TRG agreed that in arrangements B, C, and D above, the entity promises to provide an uncertain quantity of goods or services and therefore the entity is "standing ready" to perform. With regard to Type A, an entity needs to evaluate whether its promise is for specified or unspecified updates. As noted in the example above, the nature of the entity's promise is to "stand ready" when its promise is to transfer unspecified upgrades or to provide when-and-if-available updates if the entity is unable to predict the timing of when those upgrades or updates will be made available. On the other hand, an entity should account for its promise to deliver a specified update as it would any other license of intellectual property. Determining whether a promise is for a specified or an unspecified update can be challenging and an entity may conclude that an arrangement includes both specified and unspecified updates.

In BC160 of ASU 2014-09, the Boards noted that in a typical health club contract, the entity's promise is to stand ready by making the health club available for a period of time, rather than providing a

service only when a member requests it. That is, the member benefits from the entity's service of making the health club available on a continuous basis. The extent to which the member uses the health club does not, in itself, affect the amount of the remaining goods or services to which the member is entitled. Further, the member must pay for the health club membership regardless of whether, or how often, it uses the club. As a result, for a stand-ready obligation, an entity should select a measure of progress (Section 7.1.2) based on its service of making goods or services available instead of when customers use the goods or services made available to them.

4.2 Identifying performance obligations

After identifying the implicit and explicit promises in the contract, the entity must evaluate each promise to determine if that promise constitutes a performance obligation. This evaluation is performed at contract inception.

A **performance obligation** is a promise in a contract with a customer to transfer to the customer either:

a. A good or service (or a bundle of goods or services) that is distinct

b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

ASC 606 provides the following guidance on identifying performance obligations. Keep in mind that a performance obligation may be a distinct good or service, or it may comprise a series of distinct goods or services, such as a repetitive service contract or contract for the sale of goods where the services performed or goods sold are substantially the same, and are transferred to the customer in a similar manner throughout the contract, and meet the over time revenue recognition criteria (see Section 7.1.1).

ASC 606-10-25-14

At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as performance obligations each promise to transfer to the customer either:

a. A good or service (or a bundle of goods or services) that is distinct

b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 606-10-25-15).

ASC 606-10-25-19

A good or service that is promised to a customer is distinct if both of the following criteria are met:

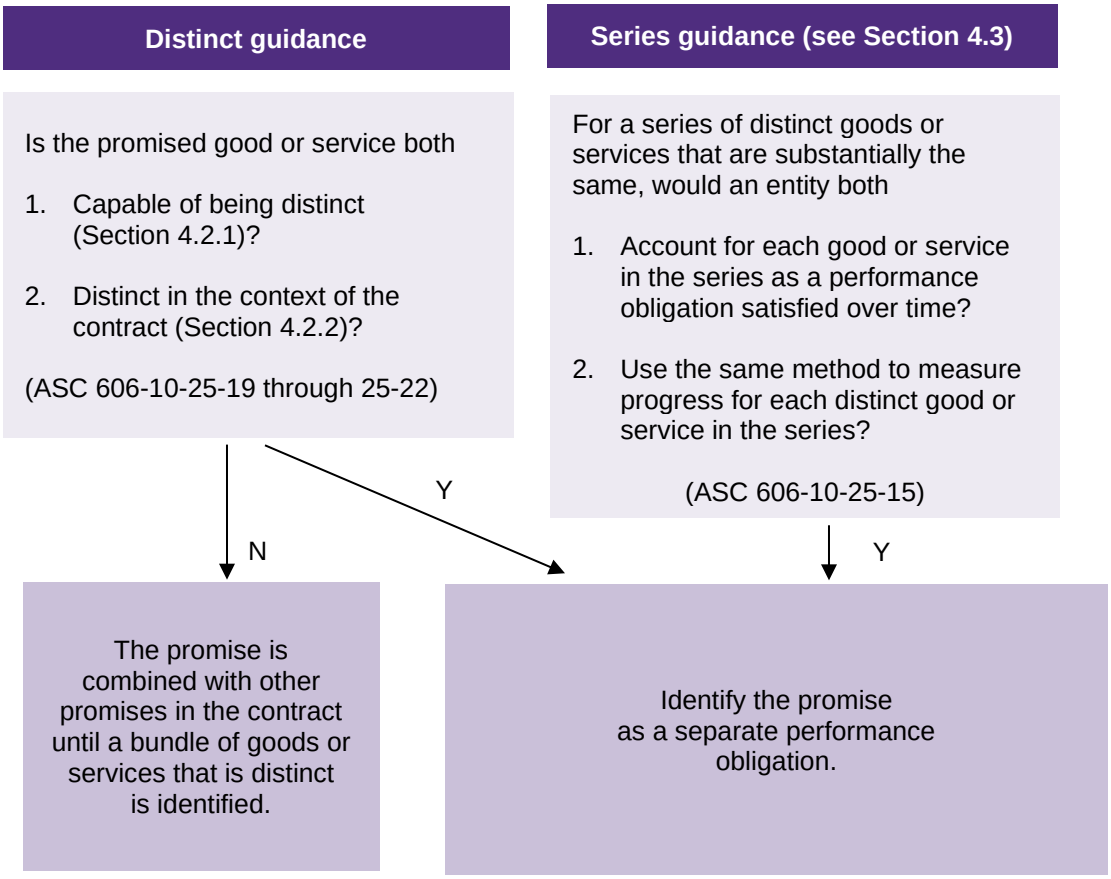
a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).

b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the

contract).

Accordingly, an entity accounts for a promise as a separate performance obligation if the promise meets the criteria to be distinct or if it represents a series of distinct goods or services. These criteria are explained in more detail below.

Figure 4.3: Identifying performance obligations



As noted in Figure 4.3, there may be situations where an entity combines a distinct good or service with other non-distinct goods or services to arrive at a bundle of distinct goods or services. The guidance in ASC 606 requires that if the promised good or service under evaluation is not deemed to be distinct, the entity needs to combine that good or service with other promises until it identifies a bundle that is distinct. As noted in ASC 606-10-25-22, sometimes that may result in an entity combining all of the goods or services in a contract into a single performance obligation.

ASC 606-10-25-22

If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

4.2.1 Capable of being distinct

The first criterion for being "distinct" is that the customer can benefit from the good or service either on its own or together with other resources that are readily available (that is, the good or service is capable of being distinct).

A customer can benefit from a good or service on its own if the good or service can be used, consumed, sold for an amount greater than scrap value, or otherwise held in a way that generates economic benefits.

Sometimes, a customer can benefit from a good or service only with other readily available resources. A "readily available resource" is a good or service that is sold separately (by the entity or by another entity) or one that the customer has already obtained from the entity or from other events or transactions.

The fact that the entity regularly sells a good or service on its own is an indicator that the good or service is capable of being distinct.

In BC100 of ASU 2014-09, the Boards observed that the assessment of whether the customer can benefit from a good or service on its own should be based on the characteristics of the goods or services themselves, excluding contractual limitations that might preclude the customer from obtaining readily available resources from a source other than the entity. For example, if a contract states that a customer can purchase a specific good or service only from the entity, that provision is irrelevant in determining if the customer can benefit from the goods or services on their own.

Further, BC101 of ASU 2014-09 states that an entity does not need to assess the customer's intended use in determining whether a good or service is capable of being distinct because it would be difficult, if not impossible, for an entity to know the customer's intended use of a good or service in a given contract.

4.2.2 Distinct within the context of the contract

In some situations, separately accounting for each promised good or service that is capable of being distinct would not faithfully represent the entity's performance in the contract. As a result, the Boards developed a second criterion that must be met for an entity to conclude that a good or service is distinct and is thus a performance obligation to be accounted for separately.

The second criterion for being "distinct" is that the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract—that is, the promise to transfer the good or service is distinct within the context of the contract.

In assessing whether an entity's promise to transfer a good or service to the customer is distinct within the context of the contract, the objective is to determine whether the nature of the contractual promise is to transfer each of the goods or services individually or instead to transfer a combined item to which the promised goods or services are inputs. Significant judgment may be required to determine whether promised goods or services are distinct within the context of the contract.

The guidance provides factors that indicate that a promise to transfer goods or services is not separately identifiable from other goods or services in the contract.

ASC 606-10-25-21

In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 606-10-25-19(b), the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

a. The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.

b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.

c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

Determining whether goods and installation services are distinct

Manufacturer A enters into a contract with Customer B for equipment and installation services. Manufacturer A always sells new equipment bundled with installation services to its customers. Because Manufacturer A sells the installation services to secondary purchasers of its equipment, it concludes that the equipment is capable of being distinct, since the equipment can be used with another readily available resource. The entity also conclude that the installation services are capable of being distinct because these services can be used with the equipment that has already been delivered (that is, the equipment is a readily available resource).

When evaluating whether the equipment and installation services are distinct in the context of the contract, Manufacturer A might consider the following factors:

- Is Manufacturer A providing a significant service of integrating the equipment and installation services?
- Do the installation services significantly modify or customize the equipment?
- Are the installation services and equipment significantly affected by each other, so that Manufacturer A is unable to fulfill its promise to Customer B if the equipment and installation

services are transferred individually? Are the equipment and services highly interdependent or interrelated?

The following select examples from ASC 606 demonstrate how to apply this guidance.

Example 11—Determining Whether Goods or Services are Distinct

Case A—Distinct Goods or Services (excerpt)

ASC 606-10-55-141

An entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, installation, and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

ASC 606-10-55-142

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. The customer can benefit from the updates together with the software license transferred at the outset of the contract. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 606-10-25-19(a) is met.

ASC 606-10-55-143

The entity also considers the principle and the factors in paragraph 606-10-25-21 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus the criterion in 606-10-25-19(b) is met). In reaching this determination, the entity considers that although it integrates the software into the customer's system, the installation services do not significantly affect the customer's ability to use and benefit from the software license because the installation services are routine and can be obtained from alternate providers. The software updates do not significantly affect the customer's ability to use and benefit from the software license because in contrast with Example 10 (Case C), the software updates in this contract are not necessary to ensure that the software maintains a high level of utility to the customer during the license period. The entity further observes that none of the promised goods or services significantly modifies or customizes one another and the entity does not provide a significant service of integrating the software and the services into a combined output. Lastly, the entity concludes that the software and services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the initial software license independent from its promise to subsequently provide the installation service, software updates, or technical support.

ASC 606-10-55-144

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

a. Software license

b. Installation service

c. Software updates

d. Technical support.

Example 11—Determining Whether Goods or Services are Distinct

Case E—Promises are Separately Identifiable (Consumables) (excerpt)

ASC 606-10-55-150G

An entity enters into a contract with a customer to provide a piece of off-the-shelf equipment (that is, it is operational without any significant customization and modification) and to provide specialized consumables for use in the equipment at predetermined intervals over the next three years. The consumables are produced only by the entity, but are sold separately by the entity.

ASC 606-10-55-150H

The entity determines that the customer can benefit from the equipment together with the readily available consumables. The consumables are readily available in accordance with paragraph 606-10-25-20 because they are regularly sold separately by the entity (that is, through refill orders to customers that previously purchased the equipment). The customer can benefit from the consumables that will be delivered under the contract together with the delivered equipment that is transferred to the customer initially under the contract. Therefore, the equipment and consumables are each capable of being distinct in accordance with paragraph 606-10-25-19(a).

ASC 606-10-55-150I

The entity determines that its promises to transfer the equipment and to provide consumables over a three-year period are each separately identifiable in accordance with paragraph 606-10-25-19(b). In determining that the equipment and the consumables are not inputs to a combined item in this contract, the entity considers that it is not providing a significant integration service that transforms the equipment and consumables into a combined output. Additionally, neither the equipment nor the consumables are significantly customized or modified by the other. Lastly, the entity concludes that the equipment and the consumables are not highly interdependent or highly interrelated because they do not significantly affect each other. Although the customer can benefit from the consumables in this contract only after it has obtained control of the equipment (that is, the consumables would have no use without the equipment) and the consumables are required for the equipment to function, the equipment and the consumables do not each significantly affect the other. This is because the entity would be able to fulfill each of its promises in the contract independently of the other. That is, the entity would be able to fulfill its promise to transfer the equipment even if the customer did not purchase any consumables and would be able to fulfill its promise to provide the consumables even if the customer acquired the equipment separately.

ASC 606-10-55-150J

On the basis of this assessment, the entity identifies two performance obligations in the contract for the following goods or services:

a. The equipment

b. The consumables

The factors indicating that two or more promises are not separately identifiable are not an exhaustive list, and not all of the factors need to be met to determine whether an entity's promises to transfer goods or services are separately identifiable. The Boards observed[24] that the factors are not mutually exclusive because each factor is based on the same underlying principle of inseparable risks. The factors are each evaluated in more detail below.

Grant Thornton insight: When goods and services are 'always sold together'

An entity may assert that it always sells its product with a complementary service. For example, a manufacturer may sell unique GPS units that can only be connected to its global satellite tracking services. The manufacturer's GPS units cannot be connected to other global satellite tracking services without significant rework given its proprietary technology. Further, the manufacturer may stipulate in the contract that a customer cannot simply buy the GPS unit on its own but must also sign up for the satellite tracking services for a period of time.

When evaluating whether its unit and service are "distinct" (meaning capable of benefiting from the product or service on its own), the entity must consider if there is a secondary market for its unit (for instance, if a customer sells its GPS unit to another user and that user then asks the entity to connect its unit to the global satellite tracking services). When there is a secondary market, the product would generally be considered capable of being distinct, despite any assertion that the entity always sells the product and service together.

Significant integration service

The first factor that indicates that two or more promises to transfer goods or services are not separately identifiable from other goods or services in the contract is that the entity provides significant integration services. Stated differently, the entity is using the goods or services as inputs to produce the combined output called for in the contract.

BC107 of ASU 2014-09 indicates that the Boards observed that this factor may be relevant for many construction contracts where a contractor provides a significant integration service and assumes the risk of integrating the various construction tasks. The factor may also apply to other industries and contracts.

[24] BC106, ASU 2014-09.

Example 10—Goods and Services are Not Distinct

Case A—Significant Integration Service

ASC 606-10-55-137

An entity, a contractor, enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping, and wiring, installation of equipment, and finishing.

ASC 606-10-55-138

The promised goods and services are capable of being distinct in accordance with paragraph 606-10-25-19(a). That is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling, or holding those goods or services.

ASC 606-10-55-139

However, the promises to transfer the goods and services are not separately identifiable in accordance with paragraph 606-10-25-19(b) (on the basis of the factors in paragraph 606-10-25-21). This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.

ASC 606-10-55-140

Because both criteria in paragraph 606-10-25-19 are not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

Grant Thornton insight: Service and equipment that are distinct within the context of the contract

At the 2018 AICPA Conference on Current SEC and PCAOB Developments,[25] one speech related to the evaluation of arrangements with equipment and subscription services to determine whether the two promises are distinct. The SEC staff discussed a consultation in which a registrant provided its customer with commercial security monitoring services along with integrated cameras and sensors (the equipment), which are integrated with the registrant's technology platform. The equipment is integrated through a control panel that is installed at the customer's location, allowing the equipment to communicate with the technology platform. The technology allows the cameras and sensors to "learn" from historical data to create a "smart" security monitoring service.

[25] 2018 AICPA Conference on Current SEC and PCAOB Developments, Speech by Sheri L. York, Professional Accounting Fellow, Office of the Chief Accountant.

The registrant concluded that each piece of equipment, the installation, and the monitoring services were capable of being distinct, but were not distinct in the context of the contract because the registrant provided a significant integration service, which resulted in a combined output of a "smart security monitoring service." The staff did not object as the registrant demonstrated reasonable judgment in concluding that the integration service transformed the equipment into a combined output that was greater than the sum of the individual parts.

We believe that the following indicators should be considered when determining whether the nature of a promise to a customer is to transfer a combined item, such as security monitoring services as in the SEC staff speech, or each item individually:

- Are the equipment and services sold separately?
- Do the services significantly modify the equipment?
- Is the functionality of the combined equipment and services transformative or, said another way, greater than the sum of the individual parts?
- Is the equipment sold on a stand-alone basis, including in an aftermarket?
- How is the arrangement described in marketing materials and public filings?

Grant Thornton insight: Bundle of goods and services provided as a 'solution'

Many entities call a bundle of goods and services a "solution" in their marketing materials or in the way that they describe the combination of goods in services when evaluating a contract with a customer under ASC 606. Calling the bundle a "solution" is insufficient in concluding that promised goods and services comprise a single, or bundled, performance obligation.

In fact, during the 2019 AICPA Conference on Current SEC and PCAOB Developments,[26] the SEC staff noted that registrants sometimes try to support a conclusion that bundled goods and services comprise a single performance obligation by asserting that the "customer wants" the promised goods and services as a "solution." While the term "solution" may be commonly used in marketing materials describing the goods and services, the SEC staff said that using the word "solution" does not result in a presumption that the promised goods and services that make up the "solution" should be bundled into one performance obligation. Instead, the staff said that entities must use the guidance in ASC 606-10-25-21 to support the assertion that promises to transfer goods or services are not separately identifiable. Additionally, entities may also find useful the guidance in BC29 in ASU 2016-10, which states that entities might consider whether the combined output of the promises is greater than, or substantively different from, the sum of the promised goods or services.

[26] 2019 AICPA Conference on Current SEC and PCAOB Developments, Speech by Susan M. Mercier, Professional Accounting Fellow, Office of the Chief Accountant.

Significant modification or customization

The second factor that indicates that two or more promises to transfer goods or services are not separately identifiable from other goods or services in the contract is that one or more of the goods or services significantly modifies or customizes other promised goods or services in the contract.

In some industries, such as the software industry, the notion of inseparable risks is more clearly illustrated by assessing whether one good or service significantly modifies or customizes another good or service in the contract. In this case, the goods or services are inputs to create a combined output—a customized product.

Example 11—Determining Whether Goods or Services are Distinct

Case B—Significant Customization (excerpt)

ASC 606-10-55-146

The promised goods and services are the same as in [Example 11] Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customized to add new functionality to enable the software to interface with other customized software applications used by the customer. The customized installation service can be provided by other entities.

ASC 606-10-55-147

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity first assesses whether the criterion in paragraph 606-10-25-19(a) has been met. For the same reasons as in Case A, the entity concludes that the software license, installation, software updates, and technical support each meet that criterion. The entity next assesses whether the criterion in paragraph 606-10-25-19(b) has been met by evaluating the principle and the factors in paragraph 606-10-25-21. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) specified in the contract (see paragraph 606-10-25-21(a)). The software is significantly modified and customized by the service (see paragraph 606-10-25-21(b)). Consequently, the entity determines that the promise to transfer the license is not separately identifiable from the customized installation service and, therefore, the criterion in paragraph 606-10-25-19(b) is not met. Thus, the software license and the customized installation service are not distinct.

ASC 606-10-55-148

On the basis of the same analysis as in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

ASC 606-10-55-149

On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

a. Software customization which is comprised of the license to the software and the customized installation service

b. Software updates

c. Technical support.

Highly interdependent or highly interrelated

The third factor that indicates that two or more promises to transfer goods or services are not separately identifiable from other goods or services in the contract is that the goods or services are highly interdependent or highly interrelated.

The Boards included this factor because, in some cases, it may be unclear whether the entity provides an integration service or whether the goods or services are significantly modified or customized; yet the individual goods or services are not separately identifiable from other goods or services because they are highly dependent on, or highly interrelated with, other promised goods or services in the contract.

As stated in BC32 of ASU 2016-10, the principle in evaluating whether promises are “distinct within the context of the contract” is to consider the level of integration, interrelation, or interdependence among promises to transfer goods or services. As a result, the entity must evaluate whether two or more promised goods or services significantly affect the other and are therefore highly interdependent or highly interrelated with other promised goods or services in the contract. An entity does not simply evaluate whether one item depends on another. There must be a two-way dependency. In other words, instead of concluding that an undelivered item would never be obtained by a customer absent the delivered item in the contract, the entity would consider whether the undelivered item and the delivered item each significantly affect the other and therefore are highly interdependent or highly interrelated.

Example 10—Goods and Services are Not Distinct

Case B—Significant Integration Service

ASC 606-10-55-140A

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

ASC 606-10-55-140B

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

ASC 606-10-55-140C

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

4.3 Series of distinct goods or services

When an entity provides the same distinct goods or services over a period of time (for example, a repetitive service contract for cleaning), it needs to consider if the promised goods or services in the contract meet the requirements of the "series guidance" (see Figure 4.4). Under the series guidance, an entity must account for a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer as a single performance obligation. The guidance is not optional. In other words, if a series of distinct goods or services meets the criteria in ASC 606-10-25-14(b), an entity is required to account for the series as a single performance obligation rather than accounting for the goods or services as individual performance obligations.

A series of distinct goods or services has the same pattern of transfer to the customer if both

- Each distinct good or service in the series would be accounted for as a performance obligation satisfied over time (Section 7.1).
- The entity would use the same method to measure progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer (Section 7.1.2).

ASC 606-10-25-15

A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

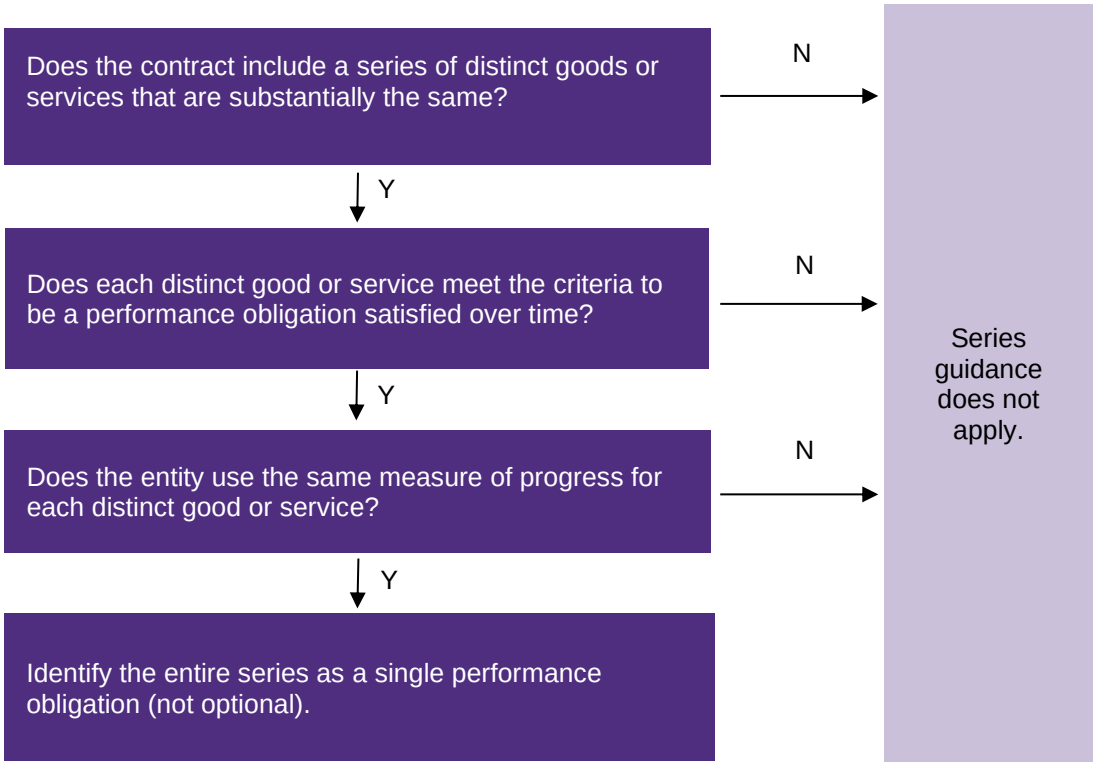
a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time.

b. In accordance with paragraphs 606-10-25-31 through 25-32, the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

BC113 of ASU 2014-09 states that the Boards included the series guidance to simplify the application of the model and to promote consistency in the identification of performance obligations when an entity provides the same good or service repetitively over a period of time. Without this guidance, an entity would be required to allocate the overall consideration in such a contract to each distinct good or service (for example, each day of cleaning in a five-year service contract).

Accordingly, correctly determining whether the series guidance applies is important because it may impact the subsequent accounting.

Figure 4.4: Applicability of the series guidance



TRG area of general agreement: How does the accounting treatment vary if an entity determines the series guidance applies?

An entity may conclude that a bundle of goods and services is a single performance obligation either because (1) the bundle includes goods and services that are not distinct, or (2) the bundle includes a series of distinct goods and services and the series guidance applies.

At the March 2015 meeting,[27] the TRG discussed areas in which the accounting treatment may vary depending on why an entity determines its promise is a single performance obligation, including the following examples:

- *Allocation of variable consideration:* ASC 606-10-32-40 indicates that if certain criteria are met, an entity may allocate a variable amount entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation accounted for as a series. For example, assume that an entity concludes that the series guidance applies and the criteria are met to allocate variable consideration (such as a performance bonus) to an increment of time within the series. The timing of revenue recognition in that fact pattern may differ from a situation where the entity concludes that the series guidance does not apply and it therefore would not allocate the variable consideration to a specific increment of time.
- *Contract modifications:* Generally, if the remaining undelivered goods or services are distinct, including parts of a single performance obligation accounted for as a series, a contract modification would be accounted for on a prospective basis. However, if the remaining goods and services are not distinct, the modification would result in a cumulative adjustment to revenue.
- *Changes in transaction price:* The guidance regarding changes in the transaction price in ASC 606-10-32-42 to 32-45 may apply differently to a single performance obligation resulting from the series guidance than a single performance obligation of non-distinct goods or services.

Grant Thornton insight: What are some examples of goods or services that constitute a series?

There are various examples of services in ASC 606 that constitute a series, including the following:

- Example 7: An entity provides weekly cleaning services to a customer for three years.
- Example 12A: A hotel manager provides hotel management services to a customer for 20 years.
- Example 13: An entity provides monthly payroll processing services to a customer for one year.
- Example 25: An entity provides asset management services to a client for five years.

Even though each instance of service (that is, each hour or day of service) is distinct, the entity accounts for each of these contracts as a single performance obligation because the entity transfers a series of distinct services that are substantially the same and that have the same pattern of transfer to the customer in each case. In other words, each service meets the over time criteria in ASC 606-10-25-27 and the entity uses the same method to measure its progress (that is, a time-based measure) in each case.

Other goods or services that might constitute a series include, but are not limited to, the following examples:

- A software as a service (SaaS) company providing a customer with continuous access to its platform

[27] TRG Paper 27, *Series of Distinct Goods or Services.*

- A telecommunications company providing network access to customers over a period of time

The TRG discussed how an entity determines if the underlying distinct goods or services are "substantially the same." The discussion suggests that the entity must first determine the nature of its promise to the customer.

TRG area of general agreement: How should an entity consider whether the performance obligation consists of distinct goods or services that are 'substantially the same'?

While discussing this question during the July 2015 meeting,[28] the TRG addressed how broadly or narrowly the guidance in ASC 606 should be applied, since an entity evaluating time increments in a services contract would need to conclude that each time increment is distinct and is substantially the same.

The TRG members generally agreed that an entity must first determine the nature of its promise in providing the service to the customer.

If the nature of the entity's promise is to deliver a specified quantity of a service, the entity should evaluate whether each service is distinct and substantially the same. If the nature of the entity's promise is the act of standing ready or providing a single service for a period of time, the entity may consider whether each time increment (for example, each day or hour), rather than the underlying activity, is distinct and substantially the same. The Boards intended that a series could consist of either distinct time increments or the good or service delivered, depending on the nature of the promise.

In ASC 606, Example 13, an entity enters into a contract to provide monthly payroll processing services to a customer for one year. The nature of the entity's promise is to deliver a specified quantity of a service—12 distinct instances of payroll processing. It is not a promise to stand ready to perform an undefined number of processing tasks. As a result, the entity evaluates whether each instance of payroll processing is distinct and substantially the same.

In contrast, Example 12A in ASC 606 describes a hotel manager that enters into a contract with a customer to manage a customer-owned property for 20 years. The hotel management service comprises various activities that may vary by day (for example, cleaning service, reservation services, and property maintenance).

In this contract, the nature of the promise is the act of standing ready to provide the hotel management service each day because the entity has promised to provide an unspecified quantity of activities rather than a defined number of services. Accordingly, the entity considers whether each time increment is distinct and substantially the same.

A question was raised to the TRG about whether goods must be delivered or services must be performed consecutively to apply the series guidance.

[28] TRG Paper 39, *Application of the Series Provision and Allocation of Variable Consideration.*

TRG area of general agreement: In order to apply the series guidance, must the goods be delivered or services be performed consecutively?

During the March 2015 meeting,[29] the TRG discussed a question raised by stakeholders as to whether the series provision applies when there is a gap or an overlap in the entity's delivery of goods or performance of services. While the term "consecutively" is not used in ASC 606, it is used in the Basis for Conclusions[30]. The TRG considered the following two examples:

> *Example A: An entity has contracted with a customer to provide a manufacturing service in which it will produce 1,000 units of a product per month for a 2-year period. The service will be performed evenly over the 2-year period with no breaks in production. The units produced under this service arrangement are substantially the same and are manufactured to the specifications of the customer. The entity does not incur significant up-front costs to develop the production process. Assume that its service of producing each unit is a distinct service in accordance with the criteria in paragraph 606-10-25-19. Additionally, the service is accounted for as a performance obligation satisfied over time in accordance with paragraph 606-10-25-27 because the units are manufactured specific to the customer (such that the entity's performance does not create an asset with an alternative use to the entity), and if the contract were to be cancelled, the entity has an enforceable right to payment (cost plus a reasonable profit margin). Therefore, the criteria in paragraph 606-10-25-15 have both been met.*
>
> *Example B: Assume the same facts as the example above, except that different from Example A, the entity does not plan to perform evenly over the 2-year service period. That is, the entity does not produce 1,000 units a month, continuously. Instead, the entity plans to perform the manufacturing service over the 2-year period, but in achieving the production targets, the entity produces 2,000 units in some months and zero units in other months.*

The TRG generally agreed that in order to apply the series guidance, the entity need not deliver the goods nor perform the services consecutively. In other words, the guidance still applies when there is a gap in delivery or service. While an entity may consider the pattern of performance in determining the measure of progress towards satisfying its performance obligation, the consideration of whether the pattern of performance is consecutive is not an explicit requirement in ASC 606-10-25-15 and therefore is not determinative as to whether the series provision applies. As a result, both Example A and B would be accounted for as single performance obligations in accordance with the series provision.

4.4 Customer options for additional goods or services

An entity that sells goods or services may also provide customers with an option to acquire additional goods or services for free or at a discount, for example, sales incentives, award credits or points, and renewal options. Under ASC 606, an entity must identify the option as a separate performance obligation if the option represents a "material right" to the customer that the customer would not have received without entering into that contract. If the option does not provide the customer with a material right, the option is considered a marketing offer.

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[29] TRG Paper 27, *Series of Distinct Goods or Services.*
[30] BC113 and BC116, ASU 2014-09.

As noted in Section 4.1.1, the relief from evaluating immaterial promises does not apply to customer options that provide a material right.

ASC 606 does not specify what constitutes a material right, but does provide as an example “a discount that is incremental to the range of discounts typically given for the goods or services to a particular class of customer in a geographical area or market.”

BC386 of ASU 2014-09 explains that the purpose of the guidance on material rights is to distinguish between:

- An option that the customer pays for as part of an existing contract (that is, a customer pays in advance for future goods or services, and therefore the entity identifies the option as a performance obligation and allocates part of the transaction price to that performance obligation)
- A marketing or promotional offer that the customer did not pay for and is not part of the contract (that is, an effort by the entity to obtain future contracts with the customer)

ASC 606-10-55-41

Customer options to acquire additional goods or services for free or at a discount come in many forms, including sales incentives, customer award credits (or points), contract renewal options, or other discounts on future goods or services.

ASC 606-10-55-42

If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

ASC 606, Example 49, illustrates an option that provides the customer with a material right.

Example 49—Option that Provides the Customer with a Material Right (Discount Voucher) (excerpt)

ASC 606-10-55-336

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

ASC 606-10-55-337

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

If the option only allows the customer to buy additional goods or services at their stand-alone selling price, the option will not constitute a material right. In this case, the entity has only made a marketing offer.

ASC 606-10-55-43

If a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those cases, the entity has made a marketing offer that it should account for in accordance with the guidance in this Topic only when the customer exercises the option to purchase the additional goods or services.

ASC 606, Example 50, illustrates an option that does not provide the customer with a material right.

Example 50—Option That Does Not Provide the Customer with a Material Right (Additional Goods or Services)

ASC 606-10-55-340

An entity in the telecommunications industry enters into a contract with a customer to provide a handset and monthly network service for two years. The network service includes up to 1,000 call minutes and 1,500 text messages each month for a fixed monthly fee. The contract specifies the price for any additional call minutes or texts that the customer may choose to purchase in any month. The prices for those services are equal to their standalone selling prices.

ASC 606-10-55-341

The entity determines that the promises to provide the handset and network service are each separate performance obligations. This is because the customer can benefit from the handset and network service either on their own or together with other resources that are readily available to the customer in accordance with the criterion in paragraph 606-10-25-19(a). In addition, the handset and network service are separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b) (on the basis of the factors in paragraph 606-10-25-21).

ASC 606-10-55-342

The entity determines that the option to purchase the additional call minutes and texts does not provide a material right that the customer would not receive without entering into the contract (see paragraph 606-10-55-43). This is because the prices of the additional call minutes and texts reflect the standalone selling prices for those services. Because the option for additional call minutes and texts does not grant

the customer a material right, the entity concludes it is not a performance obligation in the contract. Consequently, the entity does not allocate any of the transaction price to the option for additional call minutes or texts. The entity will recognize revenue for the additional call minutes or texts if and when the entity provides those services.

Optional purchases as separate performance obligations

When an entity determines that an option provides the customer with a material right, it identifies that option, not the underlying goods and/or services, as a separate performance obligation. In other words, when an entity determines that an option provides the customer with a material right, it will estimate the stand-alone selling price of the option and allocate a portion of the overall transaction price (excluding the amount a customer would pay for purchasing the additional goods or services) to the option. Section 6.3 discusses estimating the stand-alone selling price of an option.

Stakeholders asked the TRG if economic compulsion would impact this approach. In other words, if a customer is economically compelled to purchase additional goods or services from the entity, should the entity include the underlying goods and/or services as performance obligations in the contract? For example, an entity may sell equipment to a customer at a loss, hoping to make money on the subsequent sale of consumables to the customer, which the customer is required to purchase only from the vendor (either because the equipment functions only with the vendor's consumables or the customer is contractually obligated to do so). Stakeholders question, in this case, whether the vendor should include estimated amounts from the sale of consumables in the transaction price of the equipment contract? In other words, are the optional consumables a performance obligation in the equipment contract? The takeaway from the TRG's discussion is that the option is a performance obligation when it provides the customer with a material right—that is, the underlying goods or services are not the performance obligation. Further, if the upfront deliverable (in this case, the equipment) is considered distinct, it is counterintuitive to conclude that the customer is economically compelled to purchase additional items solely because they are utilized with the upfront good. If the equipment is distinct, then the customer can benefit from it on its own without any additional goods or services, and the promise is separately identifiable from other promises in the contract.

TRG area of general agreement: Economic compulsion

The TRG discussed the concept of "economic compulsion" and its impact on accounting for contracts with customers at its November 2015 meeting[31] using the following fact pattern:

> *An entity enters into an exclusive contract with a customer to sell equipment and consumable parts for the equipment (both are determined to be distinct). The equipment does not function without the consumable part, but the customer could resell the equipment. The stand-alone selling price of the equipment and each part are $10,000 and $100, respectively. The costs of the equipment and each part are $8,000 and $60, respectively. The entity sells the equipment for $6,000 (40 percent discount from stand-alone selling price) with a contractual option to purchase each part for $100. There are no contractual minimums, but the entity estimates that the customer will purchase 200 parts over the next two years.*

[31] TRG Paper 48, *Customer options for additional goods and services.*

Items that, as a matter of law, are optional from the customer's perspective are not promised goods or services in the contract. The options should instead be assessed to determine whether the customer has a material right. In the example above, the option does not represent a material right because the parts are priced at the stand-alone selling price. As a result, consideration that would be received for optional parts, if the customer exercises its right, should not be included when determining the transaction price for the initial contract.

On the flip side, if contractual penalties exist in the event the customer does not meet a minimum purchase requirement, the entity needs to assess whether those penalties are substantive. If the penalties are substantive, it may be appropriate to include the consideration from the goods and/or services underlying the option as part of the contract at contract inception. The entity should also consider whether the goods and/or services underlying the option are a performance obligation or part of a performance obligation to which a portion of the transaction price should be allocated.

In other words, substantive penalties effectively create minimum purchase obligations if the penalty is enforceable. If the penalties are not substantive, the consideration from the underlying goods are not included as part of the contract, and the option is instead evaluated to determine if it provides the customer with a material right.

The following example considers how the analysis might change when the contract includes a substantive penalty for the customer not satisfying minimum purchase requirements.

Contractual penalty if minimum purchases not met

Print Co. sells printers and ink cartridges, both of which are distinct goods that do not meet the over time revenue recognition criteria. The printer does not function without the ink cartridges, but the customer could resell the printer. The stand-alone selling price of the printer is $10,000 and the stand-alone selling price of each cartridge is $100. The costs of the printer and cartridges are $8,000 and $60, respectively.

The seller and customer have an exclusive contract whereby the customer cannot purchase the cartridges from other vendors during the contract term (five-year period). Print Co. sells the printer for $6,000 (40 percent discount from the stand-alone selling price), with a contractual option to purchase each cartridge for $100. The customer will incur a substantive penalty if it does not purchase at least 200 ink cartridges throughout the five-year contract term. The penalty decreases with every additional ink cartridge purchased at a rate of $20 per ink cartridge.

The substantive penalty effectively creates a minimum purchase obligation, and therefore the entity's performance obligation includes the printer as well as the 200 ink cartridges.

Class of customer

As previously noted, an example of a material right is "a discount that is incremental to the range of discounts typically given for the goods or services to a particular *class of customer* in a geographical area or market [emphasis added]." Questions have arisen about how an entity should determine the "class of customer" in making its determination of whether the option represents a material right.

TRG area of general agreement: How is the 'class of customer' considered when evaluating whether a customer option gives rise to a material right?

At the April 2016 meeting,[32] TRG members generally agreed with the framework outlined in the staff paper analyzing whether a material right exists. This framework suggests that customer options that would exist independently of an existing contract with a customer do not constitute performance obligations in that existing contract.

The staff paper includes the following example on prospective-tiered pricing:

> *A manufacturer produces component parts that have various uses to multiple customers. The parts are interchangeable and not customized for any particular customer. The entity enters into a long-term Master Supply Agreement with Customer 1 whereby the pricing of parts in subsequent years of the contract depends on the volume in the current year. For example, the entity charges Customer 1 $1.00 per part in Year 1 and if Customer 1's purchases exceed 100,000 parts in Year 1, the price per part decreases to $0.90 in Year 2. The tiered pricing (volume discount) offered to Customer 1 is similar to the terms offered to many of the entity's customers. Early in Year 1, Customer 1 enters into a contract with the manufacturer to purchase 8,000 parts. Customer 1 is required to pay $1.00 for each of those 8,000 parts.*

When evaluating whether the contract between the entity and Customer 1 includes a material right, the entity first evaluates whether the option to receive a $0.10 discount per part in Year 2 exists independently of the existing contract to purchase parts in Year 1.

To make this determination, the entity compares the discount offered to Customer 1 with the discount typically offered to similar high-volume customers that receive a discount independent of a prior contract with the entity.

The entity considers that Customer 2, another high-volume customer, has placed a single order with the entity for 105,000 parts. Customer 2 has purchased parts from the entity in the past, but none of its prior contracts with the entity created an expectation to purchase parts in the future at a specified price. Nor did any prior contracts create an expectation for the entity to sell parts in the future at a specified price.

Because the objective of the guidance on material rights is to determine whether the customer option exists independently of an existing contract with a customer, the entity does not compare the price offered to Customer 1 in Year 2 with offers to other customers receiving pricing that is contingent on the volume of purchases in a prior year. Doing so would not help the entity determine whether Customer 1 would have been offered the same pricing in Year 2 had it not entered into the contract to purchase the parts in Year 1.

If the entity determines that the price offered to Customer 1 in Year 2 and the price typically offered to Customer 2 and other similar customers are comparable, this may indicate that the price offered to Customer 1 exists independently of the existing contract. In other words, the discount is not incremental to the discount typically given to similar high-volume customers and is therefore not a

[32] TRG Paper 54, *Considering Class of Customer When Evaluating Whether a Customer Option Gives Rise to a Material Right.*

material right. In this case, the entity has made a marketing offer that it should account for only when the customer exercises the option to purchase the additional goods or services.

If the entity determines the price offered to Customer 1 in Year 2 and the price typically offered to Customer 2 and other similar customers are not comparable, this may indicate that a portion of the price Customer 1 pays for parts in Year 1 is a prepayment for parts purchased in Year 2. In other words, the discount provides a material right and the entity should account for the material right as a separate performance obligation, deferring a portion of the revenue for parts sold in Year 1, allocating that deferred revenue to the option, and recognizing that revenue when the parts purchased in Year 2 are transferred.

ASC 606 also provides examples of customer options that would not constitute material rights, including the following:

- A discount or other right that the customer could receive without entering into the contract
- A discount that is no more than the range of discounts typically given for those goods or services to that class of customers in that geographic area or market
- An option to acquire an additional good or service at a price that reflects the stand-alone selling price for that good or service

MSA with several products that have varying discounts

An entity enters into a one-year MSA with a customer that features pricing as follows:

- Product A: above stand-alone selling price (SASP)
- Product B: below SASP

The customer must submit purchase orders specifying the type and quantity of product it wants to purchase. The customer can order any mix or quantity of products throughout the MSA term; no minimum quantities are required.

Based on prior transactions with this customer, the entity expects that the customer will initially purchase a high volume of Product A in the first and second quarters of the contract, then shift to primarily purchasing Product B in the third and fourth quarters.

The customer's first purchase order is for 1,000 units of Product A at an amount above SASP. The entity considers whether it should anticipate future purchases to determine if the contract contains a material right related to the option to purchase Product B at an amount below SASP.

The entity considers relevant transactions, including its past, current, and anticipated transactions with the customer when evaluating whether a material right exists.[33] Because the entity expects, based on past transactions, that the customer will initially purchase Product A at an amount above SASP followed by purchases of Product B at an amount below SASP, the entity concludes that the discounted pricing of Product B provides a material right to the customer that it would not receive without entering into the

[33] TRG Paper 6, *Customer options for additional goods and services and nonrefundable upfront fees.*

contract. Therefore, the entity identifies the customer's right to purchase Product B at an amount below SASP as a separate performance obligation and defers a portion of the transaction price from the initial purchase of Product A.

Alternatively, if the entity lacked evidence of the customer's pattern of purchasing Product A earlier than Product B, the MSA pricing presumably would have been negotiated without regard for the sequence in which the products were purchased, and there would not be a material right.

Contract renewals

Contract renewals are common options that often need to be considered in the context of the material right guidance.

ASC 606, Example 51, illustrates a renewal option that provides the customer with a material right.

Example 51—Option that Provides the Customer with a Material Right (Renewal Option) (excerpt)

ASC 606-10-55-343

An entity enters into 100 separate contracts with customers to provide 1 year of maintenance services for $1,000 per contract. The terms of the contracts specify that at the end of the year, each customer has the option to renew the maintenance contract for a second year by paying an additional $1,000. Customers who renew for a second year also are granted the option to renew for a third year for $1,000. The entity charges significantly higher prices for maintenance services to customers that do not sign up for the maintenance services initially (that is, when the products are new). That is, the entity charges $3,000 in Year 2 and $5,000 in Year 3 for annual maintenance services if a customer does not initially purchase the service or allows the service to lapse.

ASC 606-10-55-344

The entity concludes that the renewal option provides a material right to the customer that it would not receive without entering into the contract because the price for maintenance services are significantly higher if the customer elects to purchase the services only in Year 2 or 3. Part of each customer's payment of $1,000 in the first year is, in effect, a nonrefundable prepayment of the services to be provided in a subsequent year. Consequently, the entity concludes that the promise to provide the option is a performance obligation.

Evaluating a renewal option

A golf course provides a holiday promotion to new members, granting them an option to renew their annual membership at a discount for up to two years. The golf course sells annual memberships for $5,000 per year. During the promotion period, members can renew their membership for $4,000 for the second and third years. The golf course does not offer discounts on renewals outside of the promotion period.

As discussed in TRG Paper 54,[34] in evaluating whether the discount provides a material right, an entity would compare the discount offered to a customer that purchased the initial membership during the promotional period ($1,000 off the second- and third-year renewals) with the discount typically offered to a similar customer that did not make that same purchase.

The golf course concludes that the renewal option provides a material right to the customer because the discount of $1,000 for the second and third years would not be available to that customer without entering into the arrangement. In making this determination, the golf course evaluated its history of providing discounts to new members and noted that the club does not offer a discount to members in their first year of membership.

When an entity requires a one-time upfront payment from the customer, this may lead to a conclusion that a renewal option constitutes a material right because the customer does not have to make that one-time payment again in order to extend the contract. Section 4.5 further addresses the considerations for nonrefundable upfront fees.

Accumulating rights (loyalty points)

When a customer's right to obtain additional goods or services for free or at a discount accumulates over a period of time, the entity will need to consider past, current, and expected future transactions with the customer in determining whether the option provides a material right to the customer. For example, when a coffee shop offers a loyalty program to its customers that entitles customers to a free cup of coffee after purchasing nine cups, the entity will need to consider the accumulating nature of the rights when determining whether the right constitutes a material right.

ASC 606, Example 52, provides an example of an entity evaluating its customer loyalty program.

Example 52—Customer Loyalty Program (excerpt)

ASC 606-10-55-353

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

ASC 606-10-55-354

The points provide a material right to customers that they would not receive without entering into a contract. Consequently, the entity concludes that the promise to provide points to the customer is a performance obligation.

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[34] TRG Paper 54, *Considering Class of Customer When Evaluating Whether a Customer Option Gives Rise to a Material Right.*

TRG area of general agreement: Should the evaluation of whether an option provides a material right be performed only in the context of the current transaction with a customer?

At the October 2014 meeting,[35] the TRG generally agreed that an entity should consider "relevant" transactions with the customer, meaning past, current, and future transactions, as well as both quantitative and qualitative factors, including whether the right accumulates, when evaluating whether an option provides a material right. As a result, the TRG agreed that generally, awarded credits or points provided under accumulating award programs will give rise to a material right and should be accounted for as a separate performance obligation to which a portion of the transaction price must be allocated.

Customer loyalty program

Health Store sells various health products, including supplements, drink mixes, and food products. All customers are eligible to participate in a loyalty program, with no cost of entry; however, customers must enroll in the program to participate. Points earned on purchases can be redeemed for rewards, such as gift cards or free products. Customers earn one point for every $1 spent on a product.

Health Store considers whether its loyalty program provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given), as follows:

- *Material right to the customer* – Health Store concludes that the loyalty program drives customer purchases because, as they earn more points, they have more opportunities to redeem points for a gift card or free product. Customers must take an extra step to opt into the program to participate, which indicates the program is important to them.
- *Incremental to the range of discounts typically given* – The points are incremental to the range of discounts typically given to customers that are not enrolled in the program. Therefore, the points are incremental discounts to customers who purchase products and earn points.

Based on this analysis and consistent with the October 14 TRG discussion, Health Store concludes that the points are a material right and therefore qualify as a separate performance obligation.

Tiered status program

Some entities offer tiered status programs that classify customers based on the total amount spent over a specified period of time. Customers, depending on their tier, are entitled to incremental benefits, such as a percentage of the amount spent as in-store credit, or discounted or free goods and services. Entities

[35] TRG Paper 6, *Customer options for additional goods and services and nonrefundable upfront fees.*

with these types of tiered status programs need to evaluate whether the status benefits represent a material right to the customer that is not available to other customers that have not qualified for tiered status. If the tiered status benefit is a material right, it should be accounted for as a separate performance obligation.

Entities, such as airlines or hospitality companies, may offer tiered status to existing or potential customers that have otherwise not qualified for the tiered status to encourage future spending from these customers. For example, a sponsoring entity may offer tiered status benefits for a limited time to certain individuals based on their demographic information, such as job title, profession, or employer, with the expectation that the individuals' future spending will be consistent with the spending level associated with that tier. If the sponsoring entity's business practice is to provide the status benefit discounts to a particular class of customer regardless of the customer's past level of spending with the sponsoring entity, the status benefits are a marketing incentive.

To determine whether a tiered status benefit is a marketing incentive or a material right, entities should evaluate the total transactions of the customer over a period of time rather than a single transaction.

The table below lists factors that may indicate a tiered status benefit is a marketing incentive or a material right and therefore a separate performance obligation).

Figure 4.5: Considering whether tiered status benefits are a material right

Indicators that tiered status benefit is a marketing incentive	Indicators that tiered status benefit is a material right
Tier status is provided to customers that have not previously spent the qualifying amount.	The sponsoring entity sells tier status in exchange for cash or customers who receive matched status must achieve a higher level of qualifying activity in the specific period than customers who earned equivalent status.
Tier status is provided temporarily based on the expectation that the customer will spend the qualifying amount in the future equivalent with that of individuals who earn tier status through past revenue transactions with the entity and the entity has a business practice of providing such temporary tier status	The sponsoring entity expects a net loss from the customer's future spending and future discounts.
Tier status can be earned by spending with unrelated entities that are marketing partners of the entity (affinity programs) and that results in little or no consideration to the entity sponsoring the affinity program.	The option is transferrable by the customer to others.

4.4.1 The exercise of a material right

ASC 606 does not contain explicit guidance on how an entity should account for a customer's exercise of a material right; however, as discussed by the TRG, the exercise of an option should not be accounted for as variable consideration. Instead, the guidance seems to support two reasonable approaches:

- Account for the exercise of the option as a continuation of the existing contract (that is, by updating the transaction price) (see Section 5.5)
- Account for the exercise of the option as a contract modification (see Section 10)

TRG area of general agreement: How should an entity account for the exercise of a material right: as the continuation of the existing contract, as a contract modification, or as variable consideration?

As noted above, the guidance seems to support accounting for the exercise of the option as either

- A continuation of the existing contract because the provision was contemplated as part of the original contract, as evidenced by a portion of the transaction price being allocated to the customer option as a separate performance obligation
- A contract modification because any additional consideration or any additional goods/services provided upon the exercise of the customer option could be viewed as a change in the price and scope of the contract

At the March 2015 meeting,[36] the TRG agreed that the exercise of an option should not be accounted for as variable consideration because, as the Boards made clear in BC186 of ASU 2014-09, the transaction price should only include amounts to which the entity has rights under the present contract, and should not include estimates of consideration from the future exercise of options for additional goods or services or from future change orders.

4.5 Nonrefundable upfront fees

Many contracts require a customer to pay a nonrefundable fee at or near contract inception. For example, health clubs often charge joining fees, telecommunication entities may charge activation fees, and service providers frequently charge setup fees.

When a customer is required to make a nonrefundable upfront payment, an entity must determine whether the activity associated with the fee results in the transfer of a promised good or service. In many cases, the fee relates to a necessary activity of the entity; however, that activity does not result in the transfer of a promised good or service to the customer.

When an upfront fee does not relate to the transfer of a promised good or service, the fee is an advance payment for future goods or services and the entity should recognize the fee as revenue when the future goods or services are provided. In addition, the entity should determine whether the upfront fee provides the customer with an option for additional goods or services that represents a material right.

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[36] TRG Paper 32, *Accounting for a Customer's Exercise of a Material Right*.

ASC 606-10-25-17

Promised goods or services do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not promised goods or services in the contract with the customer.

ASC 606-10-55-50

In some contracts, an entity charges a customer a nonrefundable upfront fee at or near contract inception. Examples include joining fees in health club membership contracts, activation fees in telecommunications contracts, setup fees in some services contracts, and initial fees in some supply contracts.

ASC 606-10-55-51

To identify performance obligations in such contracts, an entity should assess whether the fee relates to the transfer of a promised good or service. In many cases, even though a nonrefundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfill the contract, that activity does not result in the transfer of a promised good or service to the customer (see paragraph 606-10-25-17). Instead, the upfront fee is an advance payment for future goods or services and, therefore, would be recognized as revenue when those future goods or services are provided. The revenue recognition period would extend beyond the initial contractual period if the entity grants the customer the option to renew the contract and that option provides the customer with a material right as described in paragraph 606-10-55-42.

ASC 606-10-55-52

If the nonrefundable upfront fee relates to a good or service, the entity should evaluate whether to account for the good or service as a separate performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.

ASC 606-10-55-53

An entity may charge a nonrefundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks as described in paragraph 606-10-25-17). If those setup activities do not satisfy a performance obligation, the entity should disregard those activities (and related costs) when measuring progress in accordance with paragraph 606-10-55-21. That is because the costs of setup activities do not depict the transfer of services to the customer. The entity should assess whether costs incurred in setting up the contract have resulted in an asset that should be recognized in accordance with paragraph 340-40-25-5.

ASC 606, Example 53, illustrates the guidance for nonrefundable upfront fees.

Example 53—Nonrefundable Upfront Fee

ASC 606-10-55-358

An entity enters into a contract with a customer for one year of transaction processing services. The entity's contracts have standard terms that are the same for all customers. The contract requires the customer to pay an upfront fee to set up the customer on the entity's systems and processes. The fee is a nominal amount and is nonrefundable. The customer can renew the contract each year without paying an additional fee.

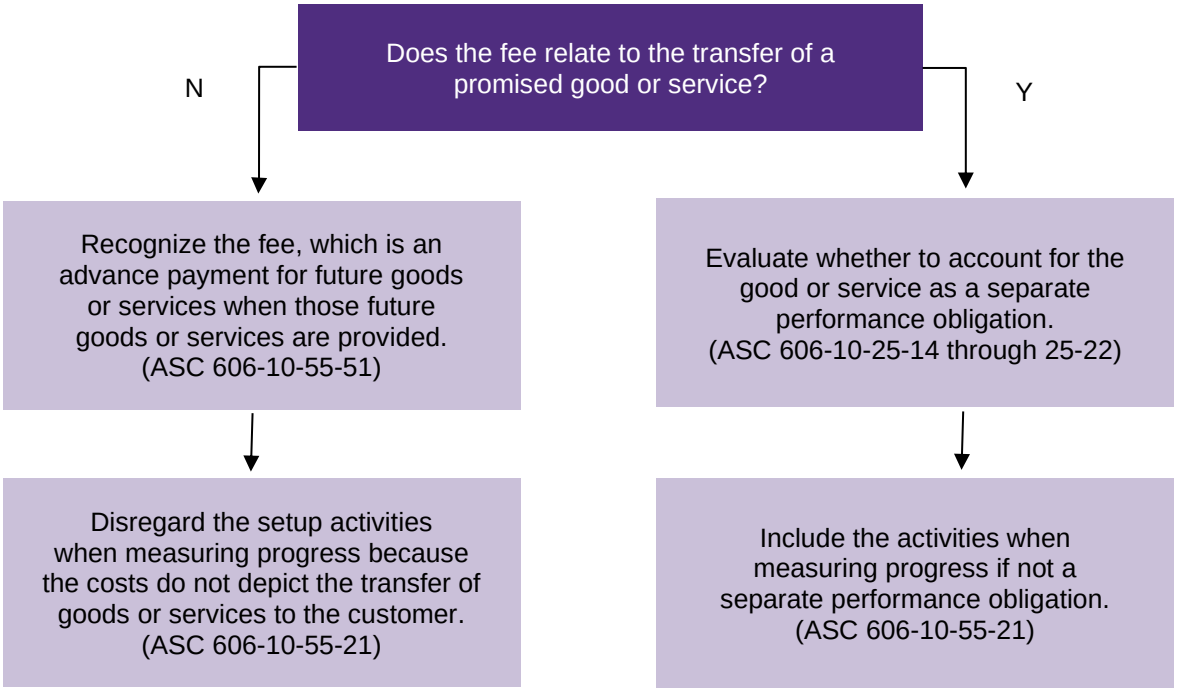
ASC 606-10-55-359

The entity's setup activities do not transfer a good or service to the customer and, therefore, do not give rise to a performance obligation.

ASC 606-10-55-360

The entity concludes that the renewal option does not provide a material right to the customer that it would not receive without entering into that contract (see paragraph 606-10-55-42). The upfront fee is, in effect, an advance payment for the future transaction processing services. Consequently, the entity determines the transaction price, which includes the nonrefundable upfront fee, and recognizes revenue for the transaction processing services as those services are provided in accordance with paragraph 606-10-55-51.

Figure 4.5: Nonrefundable upfront fees



TRG area of general agreement: Over what period should an entity recognize a nonrefundable upfront fee?

The TRG discussed the following example at the March 2015 meeting[37]:

> *An entity charges a one-time $50 activation fee to a customer that enters into a month-to-month contract for a price of $100 per month*.

The entity concludes that the activation fee charged for signing up the customer does not result in the transfer of a good or service to the customer, and therefore it does not represent an additional promised service in the contract. Rather, the activation fee represents an advance payment for the entity's services and should be deferred and recognized as the future services are provided.

When considering the period over which the activation fee should be recognized, the entity considers whether the activation fee provides the customer with a material right with respect to renewing the entity's services. In making this determination, the entity considers both quantitative and qualitative factors, for example:

- Whether the renewal price ($100 per month) compared with the price a new customer would pay for the same service ($100 per month + $50 activation fee = $150) provides the customer with a material right
- Availability and pricing of service alternatives (for example, can the customer obtain substantially equivalent services from another provider without paying an activation fee)
- Average customer lifespan (if the average customer lifespan extends well beyond the one-month contractual period, this may be an indication that the activation fee incentivizes customers to continue services)

If the entity concludes that the activation fee provides a material right, the entity would recognize the fee over the service periods during which the customer is expected to benefit from not having to pay the activation fee upon renewal of the service. Determining this period will require judgment.

On the other hand, if the entity concludes that the activation fee does not provide the customer with a material right, the activation fee is, in effect, an advance payment solely on the contracted services. Therefore, the entity would recognize the fee as part of the overall transaction price as revenue as those services are provided in the first month.

One possible indication that a renewal option constitutes a material right is when an entity requires an initial up-front fee, but subsequent contract renewals require a reduced fee or no fee. If an entity determines that the renewal option provides the customer with a material right, it must identify that option, and not the underlying services, as a separate performance obligation. The entity should account for the material right as a performance obligation by estimating the stand-alone selling price of the renewal option and allocating a portion of the overall transaction price to the option.

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[37] TRG Paper 32, *Accounting for a Customer's Exercise of a Material Right.*

Initial nonrefundable up-front fee and renewal options

On January 1, 20X8, Franchisor, a public company, enters into a franchise license agreement with Franchisee, and Franchisee pays an initial, nonrefundable fee of $30,000 to Franchisor. Franchisee receives a five-year license to operate a franchise location, including access to trademarks and the right to use proprietary operating methodologies and procedures. Before and during the opening of Franchisee's store, Franchisor performs certain setup activities, such as approving the store location, providing access to architectural plans and other store specifications, and assisting with the on-site opening activities. Franchisee may renew the license agreement for one additional five-year term. A nonrefundable fee of 10 percent of the initial license fee is due at renewal.

Franchisor considers whether the promised start-up activities transfer a good or service to Franchisee and concludes that the start-up activities alone do not transfer a benefit to Franchisee but are instead part of granting access to the franchise rights. Because Franchisor is a public company, it does not qualify to apply the practical expedient in ASC 952-606-25-2 and must therefore evaluate the start-up activities under the ASC 606 model.

Franchisor also considers whether the option to renew for an additional five-year term includes a discount that is a material right. Because Franchisee may renew the agreement for only 10 percent of the initial franchise fee, Franchisor concludes that the renewal option provides a material right to Franchisee.

Franchisor determines that the agreement contains two performance obligations: the franchise license and the renewal option. Franchisor allocates the initial fee of $30,000 to those performance obligations on a relative stand-alone selling price basis. Revenue for the franchise license is recognized over the term of the franchise agreement, while the amount allocated to the renewal option is recorded as a contract liability and recognized as revenue either over the renewal term if the option is exercised or when the renewal option expires.

Private franchisor practical expedient

The amendments in ASU 2021-02 provide a practical expedient for franchisors that are not public business entities. Under the expedient, qualifying entities may account for pre-opening services provided to a franchisee as distinct from the franchise license if the services are included in a predefined list set forth within the amendments, which is codified in ASC 952-606-25-2. Franchisors applying the practical expedient may make an accounting policy election to account for qualifying pre-opening services as a single performance obligation. Franchisors must disclose when they use the practical expedient.

Franchisors that do not elect the practical expedient need to apply Step 2 of the revenue model in ASC 606 to identify the performance obligations in their franchise agreements. Under Step 2, franchisors need to analyze pre-opening activities (such as site selection and training of the franchisee's personnel) in their arrangements to assess whether the activities represent promised goods or services and, if so, to determine whether the promises are distinct from one another and should be accounted for as separate performance obligations. Under ASC 606, an entity must determine and then allocate the transaction price among the distinct performance obligations in an arrangement on a relative stand-alone selling price basis.

ASC 952-606-25-2

As a practical expedient, when applying the guidance in Topic 606, a franchisor that enters into a franchise agreement may account for the following pre-opening services as distinct from the franchise license:

a. Assistance in the selection of a site

b. Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation

c. Training of the franchisee's personnel or the franchisee

d. Preparation and distribution of manuals and similar material concerning operations, administration, and record keeping

e. Bookkeeping, information technology, and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate, and other taxes or about regulations affecting the franchisee's business

f. Inspection, testing, and other quality control programs.

ASC 952-606-25-3

A franchisor that elects the practical expedient in paragraph 952-606-25-2 shall apply the guidance in paragraphs 606-10-25-19 through 25-22 to determine whether the pre-opening services are distinct from one another unless it makes an accounting policy election to account for the pre-opening services as a single performance obligation.

ASC 952-606-25-4

The practical expedient in paragraph 952-606-25-2 applies only to identifying performance obligations. An entity shall apply this guidance consistently to contracts with similar characteristics and in similar circumstances. An entity should see Topic 606 for guidance on the remaining aspects of recognizing revenue from contracts with customers, including allocating the transaction price and recognizing revenue. If an entity elects not to apply the practical expedient or if the services performed are not consistent with the list in paragraph 952-606-25-2, the entity shall apply the guidance in Topic 606 on identifying performance obligations.

Applying the private franchisor practical expedient

Franchisor A enters into a contract with a customer (a franchisee) and promises to grant a franchise license to operate a hotel for 10 years. In addition to the license, Franchisor A also promises to provide site selection services and training to the franchisee.

Franchisor A determines that it is eligible to apply the practical expedient since it is not a public business entity and falls within the scope of ASC 952. Next, Franchisor A determines that its pre-opening services (training and site selection) are included within the list of qualifying services in ASC 952-606-25-2 to apply the practical expedient. As a result, Franchisor A elects to account for the services as distinct from the franchise license and also makes an accounting policy election to account for all qualifying pre-

opening services as a single performance obligation. Franchisor A concludes that it has two distinct performance obligations in this arrangement: a franchise license and pre-opening services.

Franchisor A applies the guidance in ASC 606 to determine the transaction price, to allocate the transaction price to the two separate performance obligations, and to recognize revenue when or as it transfers control of the related performance obligations to the franchisee.

Finally, Franchisor A discloses its use of the practical expedient and policy election in the notes to the financial statements.

4.6 Warranties

ASC 606 contains guidance for the accounting for warranties. If a customer has the option to separately purchase a warranty, then an entity accounts for that warranty as a separate performance obligation. If a customer does not have the option to separately purchase a warranty, then the entity accounts for the warranty using the guidance on product warranties in ASC 460-10, unless all or part of the warranty provides the customer with an "additional service" beyond the assurance that the product complies with agreed-upon specifications.

ASC 606-10-55-30

It is common for an entity to provide (in accordance with the contract, the law, or the entity's customary business practices) a warranty in connection with the sale of a product (whether a good or service). The nature of a warranty can vary significantly across industries and contracts. Some warranties provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

ASC 606-10-55-31

If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity should account for the promised warranty as a performance obligation in accordance with paragraph 606-10-25-14 through 25-22 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 606-10-32-28 through 32-41.

ASC 606-10-55-32

If a customer does not have the option to purchase a warranty separately, an entity should account for the warranty in accordance with the guidance on product warranties in Subtopic 460-10 on guarantees, unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

ASC 606-10-55-33

In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity should consider factors such as:

a. Whether the warranty is required by law—If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.

b. The length of the warranty coverage period—The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

c. The nature of the tasks that the entity promises to perform—If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

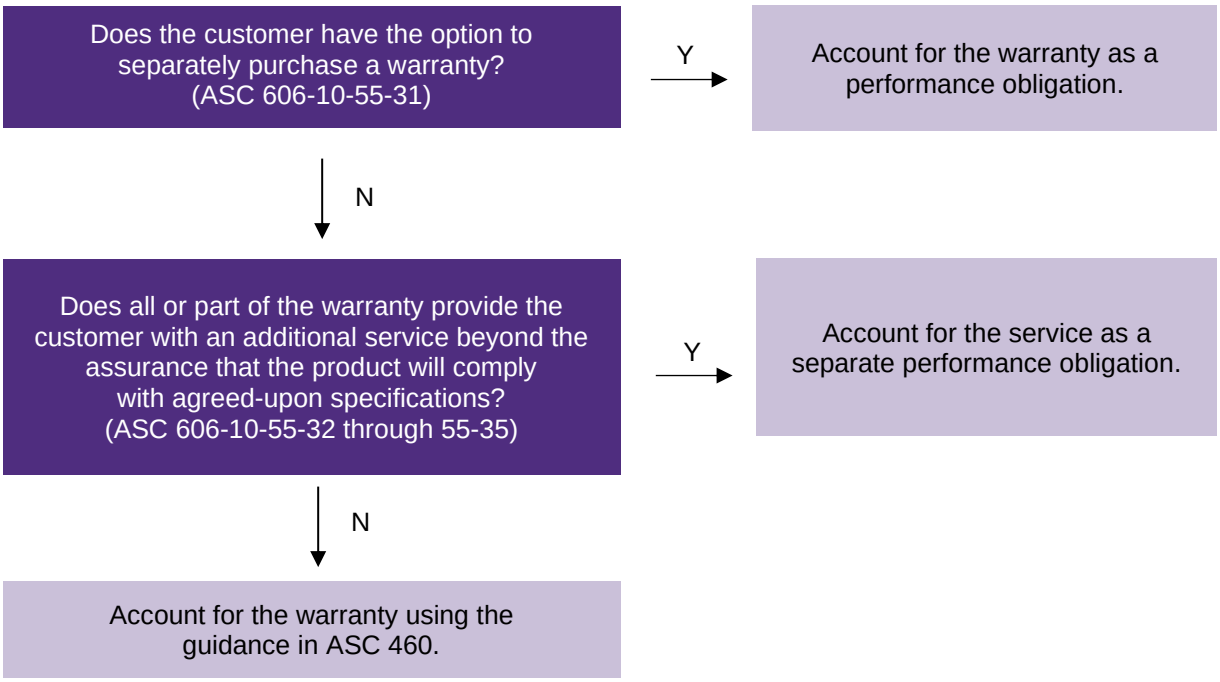
ASC 606-10-55-34

If a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation. Therefore, an entity should allocate the transaction price to the product and the service. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity should account for both of the warranties together as a single performance obligation.

ASC 606-10-55-35

A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity’s promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark, or other infringement by the entity’s products does not give rise to a performance obligation. The entity should account for such obligations in accordance with the guidance on loss contingencies in Subtopic 450-20 on contingencies.

Figure 4.7: Warranties



ASC 606-10-55-33 lists the following factors that an entity should consider in determining whether a warranty provides a customer with an "additional service."

Figure 4.8: Factors for evaluating warranties

Factor	Description
Whether the warranty is required by law	A legal requirement to provide a warranty indicates that the warranty is intended to protect the customer from purchasing a defective product.
Term of the warranty coverage period	The longer the coverage period, the more likely it is that the promised warranty includes a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.
The nature of the tasks the entity promises to perform under the warranty	If an entity must perform certain tasks to provide assurance to the customer that the product complies with agreed-upon specifications, those services would not likely constitute a separate performance obligation.

The guidance clarifies that the following situations do not give rise to a performance obligation:

- A law that requires the entity to compensate the customer for harm or damage caused by its products when used by the customer for its intended purpose
- An entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark, or other infringement by the entity's products

An entity accounts for such obligations in accordance with the guidance on loss contingencies in ASC 450-20.

Evaluating warranties

A manufacturing entity provides a two-year warranty and an extended five-year warranty to repair any of its products free of charge. The entity does not separately sell the warranties. The entity considers the following three factors when evaluating the warranties to determine if they provide an additional service:

1. *Whether the warranty is required by law* – No law exists that requires the manufacturing entity to provide a warranty.
2. *Term of the warranty coverage period* – The entity considers the two-year warranty to be its standard warranty coverage period based on its product offering and the estimated life of its products. The entity considers the five-year warranty to be extended warranty coverage. Because the estimated life of the product does not exceed two years, the entity expects to perform an additional service for those customers that purchase the five-year warranty.
3. *The nature of the tasks the entity promises to perform under the warranty* – The entity agrees to repair products that do not meet agreed-upon specifications. The entity also agrees to repair any products broken or damaged by the customer.

After evaluating the factors provided in the guidance, the entity concludes that its two-year warranty does not provide its customers with an additional service, while its five-year warranty does provide its customers with an additional service. As a result, the entity accounts for the first two years of its five-year warranty using the cost accrual guidance and the remaining three years as a separate performance obligation.

TRG area of general agreement: Lifetime warranties

The TRG discussed the following example at the March 2015 meeting:[38]

> A luggage company provides a lifetime warranty that states: "If your baggage is broken or damaged, we will repair it for free."

The TRG considered the following three factors in ASC 606-10-55-33 when evaluating the lifetime warranty to determine if it provides an additional service and is, therefore, a separate performance obligation:

[38] TRG Paper 29, *Warranties.*

- *Whether the warranty is required by law* – This indicator states that if the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a separate performance obligation. In this example, because there is no law that requires the entity to make a promise for the lifetime of the product, this indicator suggests the warranty is, in fact, a performance obligation.
- *Term of the warranty coverage period* – This indicator states that a longer warranty coverage period increases the likelihood that the warranty is a performance obligation. In the above example, the length of the warranty is for the life of the baggage, so this indicator suggests that the warranty is a performance obligation.
- *The nature of the tasks the entity promises to perform under the warranty* – In the above example, the nature of the tasks not only includes repairing baggage that does not meet the promised specifications, but also includes replacing broken or damaged baggage for free. Because the baggage warranty goes beyond the promise that the baggage complies with agreed-upon specifications, this indicator suggests the warranty is a performance obligation.

The TRG believed the warranty provided by the baggage company constitutes an additional service, beyond the assurance that the product complies with agreed-upon specifications. Consequently, the TRG concluded that the additional service should be accounted for as a performance obligation.

5. Determine the transaction price

After identifying the contract in Step 1 (Section 3) and the performance obligations in Step 2 (Section 4), an entity next applies Step 3 to determine the transaction price of the contract. The objective of Step 3 is to predict the total amount of consideration to which the entity will be entitled from the contract. The transaction price may include fixed amounts (for example, a fixed price of $10,000 for a single machine), variable amounts (for example, $10 per part, but an unknown quantity of parts), or both fixed and variable amounts. An entity estimates the transaction price at contract inception and updates the estimate each reporting period to reflect changes in facts and circumstances.

The **transaction price** is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

ASC 606-10-32-2

An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

For purposes of determining the transaction price, an entity assumes that the goods or services promised in the existing contract will be transferred to the customer. That is, the entity assumes that the contract will not be cancelled, renewed, or modified; therefore, the transaction price includes only those amounts to which the entity has rights under the present contract. For example, if an entity enters into a contract with a customer that has an original term of one year and the entity expects the customer to renew for a second year, the entity would determine the transaction price based on the one-year original term.

ASC 606-10-32-4

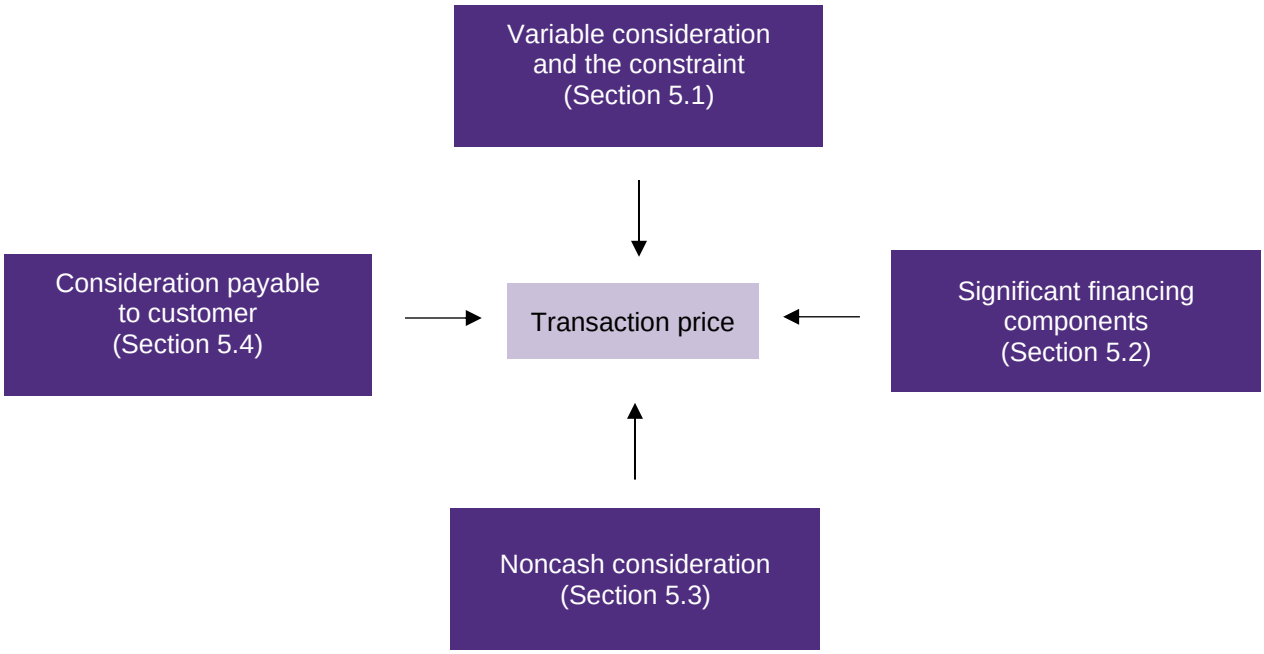
For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified.

When determining the transaction price, an entity first identifies the fixed consideration, which includes any nonrefundable upfront payment amounts. In addition to fixed consideration, an entity considers the effects of the following components in determining the transaction price:

- Variable consideration and the constraint (Section 5.1)
- Significant financing components (Section 5.2)
- Noncash consideration (Section 5.3)
- Consideration payable to the customer (Section 5.4)

Each component is discussed in more detail below.

Figure 5.1: Components for determining the transaction price



5.1 Variable consideration

When a contract includes a variable amount, the entity estimates the amount of variable consideration to which it expects to be entitled. After all, by definition, the transaction price is the amount of consideration to which an entity *expects* to be entitled in exchange for transferring promised goods or services to a customer.

ASC 606-10-32-5

If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

Variable consideration includes any consideration that is not fixed. In other words, the amount may fluctuate as a result of the outcome of uncertain events. Common examples of variable consideration include discounts, rebates, refunds, credits, price concessions, performance bonuses, and penalties. The variability may be explicitly stated in the contract or implicit (for example, based on the entity's business practice, the customer has a valid expectation that the entity will accept an amount of consideration that is less than the stated price in the contract). Variable consideration may be fixed in amount, but the entity's right to receive that consideration is contingent on a future outcome. For example, the amount of a performance bonus might be fixed, but because the entity is not entitled to that bonus until a performance target is met, the outcome is uncertain and therefore the amount is considered variable.

Price concessions

Price concessions may take the form of a discount, refund or credit, among others, and are a form of variable consideration.

ASC 606-10-32-7

The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer this offer may be referred to as a discount, rebate, refund, or credit.

b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

Under Step 1, an entity should distinguish between a price concession and collectibility. The inability to collect the promised consideration might lead an entity to conclude that it does not pass Step 1, while a price concession might result in variable consideration, allowing the entity to proceed to Step 2 with a lower transaction price. See further discussion of distinguishing price concessions from collectibility issues in Step 1 at Section 3.1.5.

ASC 606, Example 2, illustrates how an entity considers a price concession when determining if the Step 1 criteria are met. It also demonstrates the interaction of the guidance in Steps 1 and 3, because the entity needs to determine the transaction price (in this case, it is variable due to the price concession) in order to determine if it is probable that the entity will collect substantially all of the consideration to which it expects to be entitled, in accordance with ASC 606-10-25-1(e).

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

ASC 606-10-55-99

An entity sells 1,000 units of a prescription drug to a customer for promised consideration of $1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.

ASC 606-10-55-100

When assessing whether the criterion in paragraph 606-10-25-1(e) is met, the entity also considers paragraphs 606-10-32-2 and 606-10-32-7(b). Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not $1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to $400,000.

ASC 606-10-55-101

The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty it is probable that it will collect $400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 606-10-25-1(e) is met based on an estimate of variable consideration of $400,000. In addition, based on an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1 are also met. Consequently, the entity accounts for the contract with the customer in accordance with this Topic.

Estimating the amount of variable consideration

If a contract includes a variable amount, an entity estimates the transaction price.

Grant Thornton insight: When an entity is not required to estimate variable consideration

In limited situations, an entity may not be required to estimate the amount of variable consideration, including when the entity

- Is permitted to apply the right-to-invoice practical expedient (Section 7.1.3.)
- Meets the allocation objective described in Section 6.5.1 and is required to allocate variable consideration entirely to a distinct good or service that forms part of a series
- Is required to apply the "royalty exception" for a license of intellectual property (Section 8.5.)

The “royalty exception” provides relief from estimating and constraining variable consideration when the variability relates to consideration tied to the sales and usage of intellectual property; however, the “royalty exception” does not completely absolve the entity from all estimations.

For example, some pharmaceutical manufacturers receive sales reports from their distributors on a quarterly basis, and the manufacturers use these reports, which summarize sales by product and geography, to recognize revenue. Often, these reported numbers include critical estimates, such as sales rebates and product returns. The manufacturer should consider whether the estimates in the reported sales data are reasonable or if they require any further adjustments. See Section 8.5 for additional information and an example illustrating the factors an entity may consider in refining its estimate.

To estimate the variable consideration in a contract, an entity determines either the expected value or the most likely amount of consideration to be received, depending on which method better predicts the amount to which the entity will be entitled. In other words, the selection of a method to estimate the variable consideration is not a free choice or an accounting policy election.

ASC 606-10-32-8

An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

a. The expected value – The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

b. The most likely amount – The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

Grant Thornton insight: Selecting the best method for estimating variable consideration

As stated in ASC 606-10-32-8, the “expected value” of consideration is the sum of probability-weighted amounts in a range of possible amounts. Therefore, if an entity utilizes an expected value approach to estimate the amount of consideration that it expects to be entitled to, we believe that management should support this assertion by demonstrating its use of probability weighting for the identified outcomes.

While ASC 606 says the “most likely amount” may be an appropriate estimate of variable consideration for contracts with only two possible outcomes, we believe this method may also be appropriate in other circumstances. For example, some entities track their customers’ historical returns or rebates to support their estimate of variable consideration. In other words, an entity might be able to demonstrate

that its customers' historical data best predicts the "most likely amount" it expects to be entitled to in the future. Because the objective of Step 3 in the revenue model is to estimate the amount of consideration to which the entity *expects to be entitled to* in exchange for transferring the promised goods or services, we believe that some entities could achieve this objective, in part, by utilizing historical data while also considering whether any adjustments are needed to the historical data based on other available information.

An entity uses the same method to estimate the variable consideration throughout the life of a contract; however, the Boards note in BC202 of ASU 2014-09 that this does not mean that an entity needs to use one method to measure each uncertainty in a single contract. Instead, an entity may use different methods for different uncertainties in a single contract.

ASC 606-10-32-9

An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current, and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

The following example demonstrates the application of the expected value and most likely amount approaches when estimating the amount of variable consideration in a contract.

Estimating variable consideration

Construction Co. enters into a contract with a customer to build a manufacturing facility. The entity determines that the contract contains one performance obligation satisfied over time.

Construction is scheduled to be completed by the end of the eighteenth month for an agreed-upon price of $25 million.

The entity has the opportunity to earn a performance bonus for early completion as follows:

- 15 percent bonus of the $25 million contract price if completed by the fifteenth month (20 percent likelihood)
- 10 percent bonus if completed by the sixteenth month (50 percent likelihood)
- 5 percent bonus if completed by the seventeenth month (20 percent likelihood)

In addition to the potential performance bonus for early completion, Construction Co. is entitled to a quality bonus of $2 million if a health and safety inspector assigns the facility a gold star rating as defined by the agency in the terms of the contract. Construction Co. concludes that it is 80 percent likely that it will receive the quality bonus.

In determining the transaction price, Construction Co. separately estimates variable consideration for each element of variability: the early completion bonus and the quality bonus.

Construction Co. decides to use the expected value method to estimate the variable consideration associated with the early completion bonus because there is a range of possible outcomes and the entity has experience with a large number of similar contracts that provide a reasonable basis to predict future outcomes.

Drawing from its past experience, Construction Co. identifies the following factors that could impact its ability to predict when the manufacturing facility will be completed:

- Completing projects with similar requirements in the same geographic region
- Working with the same subcontractors who completed similar construction projects ahead of schedule
- Relying on the same suppliers
- Performing in similar weather conditions

Therefore, the entity expects this method to best predict the amount of variable consideration associated with the early completion bonus. Construction Co.'s best estimate of the early completion bonus is $2.250 million, calculated as shown in the following table.

Possible bonus outcomes	Probability	Probability-weighted amount
$3,750,000	20%	$ 750,000
$2,500,000	50%	$1,250,000
$1,250,000	20%	$ 250,000
$ 0	10%	$ 0
		$2,250,000

Construction Co. decides to use the most likely amount to estimate the variable consideration associated with the potential quality bonus because there are only two possible outcomes ($2 million or $0) and this method would best predict the amount of consideration associated with the quality bonus. Construction Co. believes the most likely amount of the quality bonus is $2 million.

The entity next considers the guidance on constraining the estimates of variable consideration (Section 5.1.1) to determine whether it should include some or all of the estimates of variable consideration in the transaction price.

Grant Thornton insight: Estimating variable consideration using multiple methods in a single contract

As noted in BC202 of ASU 2014-09 and in ASC 606-10-32-9, the Boards decided that an entity may use different methods to estimate variable consideration in a contract with multiple uncertainties; however, once an entity selects its estimation method for a particular uncertainty, it must continue to apply that method for the duration of the contract.

While we acknowledge that an entity may apply different methods for different uncertainties, we believe entities should apply similar estimation methods to similar uncertainties across their portfolio of revenue contracts.

The Boards acknowledged[39] that applying the expected value method using a probability-weighted method does not require an entity to consider all possible outcomes because, in many cases, using a limited number of discrete outcomes and probabilities provides a reasonable estimate of the distribution of possible outcomes. Nonetheless, in order to use the expected value method, the entity should have a sufficient volume of similar transactions or other reliable data.

A sufficient volume of similar transactions might exist if an entity has a large volume of customer contracts for the same good or service; however, an entity is not strictly required to have a population of homogeneous transactions to apply the expected value method. In the example above, while the construction company has only one customer contract for this specific manufacturing facility, it may apply the expected value method to estimate the early performance bonus because it has a sufficient volume of historical customer contracts where similar factors impacted its ability to achieve the early performance bonus.

At the July 2015 meeting,[40] most TRG members agreed that the estimated transaction price determined using the expected value method can be an amount that is not a possible outcome of an individual contract. As an entity updates its estimate of variable consideration at the end of each reporting period (Section 5.1.6), the expected value will converge toward a possible outcome.

Entities may experience difficulty estimating the transaction price when little or no entity-specific data exists. The discussion below includes examples of other reliable data that may be used in such situations.

Grant Thornton insight: Estimating variable consideration using the expected value method when no entity-specific data exists

If an entity lacks a population of similar contracts, it would be inappropriate to default to zero as the amount of estimated variable consideration for a single customer contract. Instead, entities should make a good faith effort to estimate the amount of variable consideration based on the available information, including

[39] BC201, ASU 2014-09.

[40] TRG Paper 38, *Portfolio Practical Expedient and Application of Variable Consideration Constraint.*

- Industry data for similar products or services (for example, competitor contracts in the same market)
- Information used internally in the bid and proposal process, such as in negotiating the sales price
- Data used internally in the product development process (for example, market studies)
- Information shared with external stakeholders

When an entity estimates variable consideration using the expected value method, we believe it is unlikely that the amount of variable consideration would be zero. While an entity may consider variable consideration of zero as one of the possibilities since the expected value method is based on a probability-weighting of multiple possible outcomes, we expect that the estimated variable consideration under this method would be greater than zero.

Entities may also question whether variable consideration should be constrained to zero when no entity-specific data exists. To meet the objective of the constraint guidance (see Section 5.1.1), an entity assesses whether it is probable that changes in its estimate of variable consideration will not result in a significant downward adjustment to the cumulative amount of revenue recognized on the contract. An entity may include some or all of an estimate of variable consideration in the transaction price, but only to the extent it is probable that a significant revenue reversal will not occur.

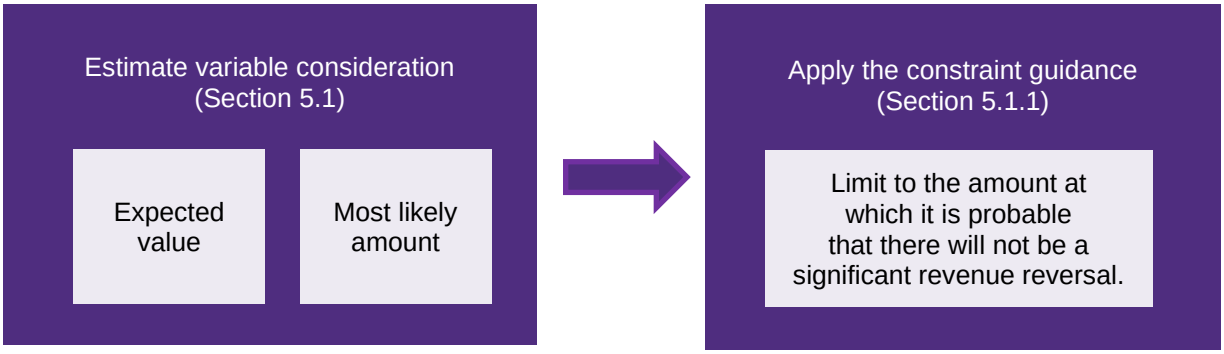
While entities should carefully apply the constraint guidance, entities generally enter into revenue contracts with customers with the expectation of earning a profit. Accordingly, we do not expect variable consideration to be constrained to zero solely due to lack of entity-specific data.

When a contract's consideration is primarily variable, if the consideration is constrained to zero this may call into question whether the criteria to establish a contract were met, in particular, whether the contract has commercial substance.

5.1.1 Constraint on variable consideration

If an amount of consideration in a customer contract is variable, an entity evaluates whether to constrain the amount of estimated variable consideration. The objective of the constraint is for an entity to recognize revenue only to the extent it is probable that a significant reversal in cumulative revenue recognized for the contract will not occur when the uncertainty is resolved. In other words, an entity includes some or all of its estimate of variable consideration in the transaction price to the extent that it is probable that a significant revenue reversal will not occur when the uncertainty leading to the variability is resolved.

Figure 5.2: Variable consideration and the constraint



ASC 606-10-32-11

An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

To meet the objective of the constraint guidance, an entity assesses whether it is "probable" (meaning the future event or events are likely to occur) that changes in the entity's estimate of variable consideration will not result in a significant downward adjustment to the cumulative amount of revenue recognized on the contract. In making this assessment, an entity considers all of the facts and circumstances associated with both the likelihood and the magnitude of the reversal if that uncertain event were to occur or fail to occur.

The Boards stated[41] that the analysis an entity undertakes to determine whether its estimate meets the "probable" threshold is largely qualitative and requires judgment. The evaluation also requires an entity to consider both the likelihood and the magnitude of the potential revenue reversal.

ASC 606-10-32-12 includes factors that might increase the likelihood of a significant revenue reversal if an entity includes an estimate of variable consideration in the transaction price.

ASC 606-10-32-12

In assessing whether it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or magnitude of a revenue reversal include, but are not limited to, any of the following:

[41] BC212, ASU 2014-09.

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

e. The contract has a large number and broad range of possible consideration amounts.

When determining the transaction price, an entity applies the constraint guidance at the contract level, rather than at the performance obligation level, before allocating the amounts to individual performance obligations. The TRG discussed which unit of account to use (that is, contract versus performance obligation) at its January 2015 meeting.

TRG area of general agreement: Should the constraint be applied at the contract or performance obligation level?

ASC 606-10-32-11 states that an entity should include in the transaction price some or all of an amount of variable consideration, but only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. While the guidance does not specify at which level the assessment should take place (that is, at the contract level or at the performance obligation level), the guidance might be read to suggest that the assessment takes place at the performance obligation level.[42]

At its January 2015 meeting,[43] TRG members generally agreed with the FASB and IASB staff that the unit of account for determining the transaction price is the contract and not the performance obligation. While the guidance does not explicitly address the unit of account for the constraint guidance, the BC[44] does state that the unit of account for other considerations in Step 3, namely identifying a significant financing component, is the contract level. Therefore, the TRG and staff generally agreed that entities should apply the constraint guidance at the contract level.

While it seems like a two-step process to estimate the transaction price and then to consider the constraint guidance, the entity's process to estimate the transaction price may already incorporate considerations for the constraint so that the entity may accomplish the two steps in one.

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[42] BC216 and 217, ASU 2014-09.

[43] TRG Paper 14, *Variable Consideration.*

[44] BC234, ASU 2014-09.

The following example illustrates how an entity might apply the constraint guidance.

Applying the constraint guidance

Consider the same facts outlined in the example of estimating variable consideration in Section 5.1 above.

Construction Co. considers the factors that might signify a significant revenue reversal when determining whether it should include in the transaction price all or a portion of the estimated variable consideration for the early completion bonus of $2.250 million and the quality bonus of $2 million. The evaluation of whether the bonus amounts should be constrained requires judgment, and the entity may evaluate each bonus separately.

Construction Co. considers the following factors

- The project is sufficiently similar to past projects and Construction Co. has significant experience in building facilities in compliance with health and safety regulations, consistently receiving gold-star ratings.
- The ratings align with objective criteria that the entity understands, and its completed projects routinely comply with the objective criteria.

Based on its facts and circumstances, Construction Co. concludes it is probable that a significant reversal in the cumulative amount of revenue recognized related to the quality bonus will not occur.

With respect to the early completion bonus, the entity may conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur when the uncertainty is resolved (that is, when the project is finalized) if

- The entity has a significant history in building this type of facility in this geographic area, and there are no additional risks associated with this project that would render this historical experience irrelevant.
- Progress is highly dependent upon favorable weather conditions at certain points during the year, but, after reviewing the historical temperature and rainfall for the period of work, the entity concludes that there should be minimal disruptions.
- The entity does not have a practice of offering a broad range of price concessions or changing the payment terms for similar contracts in the past.

On the other hand, the entity may determine that it cannot include all or a portion of the estimated variable consideration in the transaction price related to the early completion bonus because it cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur. This may be the case if the building project is highly susceptible to factors outside the entity's influence. For instance, the construction may be highly susceptible to delays due to adverse weather or the entity may rely extensively on third-party contractors to carry out its work.

5.1.2 Volume discounts

Tiered pricing clauses or volume discounts (hereafter referred to as "volume discounts") are common in customer contracts. In accordance with these types of clauses, the price per good or unit of service changes (usually decreases) as the customer purchases an increased volume of goods or services. For

example, an entity sells the first 1,000 units to a customer at $100 per unit, but any purchases in excess of 1,000 units are invoiced at $90 per unit. The accounting for volume discounts depends upon whether the volume discount results in retrospective price changes or only in prospective price changes.

Retrospective volume discounts

Contracts that include retrospective volume discounts include variable consideration because the transaction price depends upon the total volume of purchases by the customer. An entity accounts for these arrangements in a manner similar to rebates. That is, the entity estimates the expected volume of total purchases, uses the corresponding pricing, and considers the constraint guidance when determining the transaction price for contracts that include retrospective volume discounts. In the example in the preceding paragraph, contract pricing is $100 per unit, but the pricing is retrospectively reduced to $90 per unit if the customer purchases more than 1,000 units in the calendar year. In this case, if the entity estimates that purchases will exceed 1,000 units, it uses $90 per unit as the transaction price and, for each unit billed at $100, recognizes $10 per unit as a refund liability because it expects to have to refund that amount to the customer.

If an entity cannot reasonably estimate the total quantity of goods or services that the customer will purchase, it should use the minimum price per unit to determine the transaction price at inception, which is consistent with the constraint guidance. To include a higher price per unit in determining the transaction price could result in a significant revenue reversal if the customer ultimately purchases sufficient volume to achieve the minimum price per unit. As better information becomes available throughout the life of the contract, the entity updates its estimated transaction price.

Example 24 from ASC 606 illustrates the accounting for a retrospective volume discount.

Example 24—Volume Discount Incentive

ASC 606-10-55-216

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

ASC 606-10-55-217

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

ASC 606-10-55-218

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

ASC 606-10-55-219

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

ASC 606-10-55-220

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

It's worth noting that, in Example 24 above, the entity continues to invoice the customer $100 per unit for Product A and the customer continues to pay $100 per unit for Product A as the customer makes purchases up to the 1,000 unit-threshold. The entity also recognizes a corresponding refund credit for the amount it expects to refund the customer once the 1,000-unit threshold is met (that is, $10 per unit).

Prospective volume discounts

An entity must evaluate contracts that include prospective volume discounts to determine if the discount provides the customer with a material right. To determine whether the discount constitutes a material right (Section 4.4), an entity compares the discount offered to similar customers that receive a discount independently of a prior contract with the entity.

If the entity determines that the discount offered to a customer for prospective purchases and the price offered to other similar customers, independent of a prior contract, are comparable, this may indicate that the price offered exists independently of the existing contract. In other words, the discount is not incremental to the discount typically given to similar high-volume customers and is therefore not a material right. In this case, the entity has made a marketing offer that it should account for only when the customer exercises the option to purchase the additional goods or services.

If, however, the entity determines that the volume-based discount offered to the customer and the price typically offered to other similar customers independent of a prior contract are not comparable, this may indicate that a portion of the customer's payment at the earlier higher price (higher tier) is really just a prepayment for later purchases at a lower price (lower tier). In other words, the discount provides the customer with a material right and the entity should account for the material right as a separate performance obligation, allocating a portion of the transaction price to the material right, which results in the deferral of a portion of the earlier payment received. The entity recognizes the deferred revenue when the future goods and services underlying the option are transferred to the customer.

The TRG discussed how an entity might determine if a prospective volume discount provides a material right to the customer.

TRG area of general agreement: How should an entity determine if a prospective volume discount provides a material right?

At the April 2016 meeting,[45] TRG members generally agreed with the framework outlined in a FASB staff paper analyzing whether a material right exists when the contract price decreases per unit prospectively based upon the volume of purchases. This framework suggested that customer options that would exist independently of an existing contract with a customer do not constitute performance obligations. That is, these options are not material rights.

The analysis was demonstrated through various examples, including the following arrangement with prospective tiered pricing:

> *A manufacturer produces component parts that have various uses to multiple customers. The parts are interchangeable and not customized for any particular customer. The entity enters into a long-term Master Supply Agreement with Customer 1 whereby the pricing of parts in subsequent years of the contract depends on the volume in the current year. For example, the entity charges Customer 1 $1.00 per part in Year 1, and if Customer 1's purchases exceed 100,000 parts in Year 1, the price per part decreases to $0.90 in Year 2. The tiered pricing (volume discount) offered to Customer 1 is similar to the terms offered to many of the entity's customers.*

When evaluating whether the contract between the entity and Customer 1 includes a material right, the entity first evaluates whether the option to receive a $0.10 discount per part in Year 2 exists independently of the contract to purchase parts in Year 1.

To make this determination, the entity compares the discount offered to Customer 1 with the discount typically offered to similar high-volume customers that receive a discount independent of a prior contract with the entity.

The entity considers that Customer 2, another high-volume customer, has placed a single order with the entity for 105,000 parts. Customer 2 has purchased parts from the entity in the past but none of its prior contracts with the entity created an expectation to purchase parts in the future at a specified price (and did not create an expectation for the entity to sell parts in the future at a specified price).

Because the objective of the guidance on material rights is to determine whether the customer option exists independently of an existing contract with a customer, the entity does not compare the price offered to Customer 1 in Year 2 with offers to other customers receiving pricing that is contingent on the volume of purchases in a prior year. Doing so would not help the entity determine whether Customer 1 would have been offered the same pricing in Year 2 had it not entered into the contract to purchase the parts in Year 1.

If the entity determines that the price offered to Customer 1 in Year 2 and the price typically offered to Customer 2 and other similar customers are comparable, this may indicate that the price offered to Customer 1 exists independently of the existing contract. In other words, the discount is not incremental to the discount typically given to similar high-volume customers and is therefore not a material right. In this case, the entity has made a marketing offer that it should account for only when the customer exercises the option to purchase the additional goods or services.

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[45] TRG Paper 54, *Considering Class of Customer when Evaluating Whether a Customer Option Gives Rise to a Material Right.*

If the entity determines the price offered to Customer 1 in Year 2 and the price typically offered to Customer 2 and other similar customers are not comparable, this may indicate that a portion of the price Customer 1 pays for parts in Year 1 is a prepayment for parts purchased in Year 2. In other words, the discount provides a material right and the entity should account for the material right as a separate performance obligation, deferring a portion of the revenue for parts in Year 1, allocating that deferred revenue to the option, and recognizing that revenue when the future goods and services are transferred.

Grant Thornton insight: When an entity does not have a single, high-volume customer for comparison purposes

TRG Paper 54, discussed at the April 18, 2016 TRG meeting, provided various examples to determine whether a volume discount provides a material right to the customer. The paper suggested that an entity should compare the volume discount with the discount typically offered to similar high-volume customers that receive a discount independently of a prior contract with the entity.

The example from TRG Paper 54 included above assumes that the manufacturer has another high-volume customer that has placed a single order for 105,000 parts. But, what if the entity does not have another high-volume customer? Or, what if all of the entity's contracts contain tiered pricing clauses?

If the entity does not have evidence of similar pricing for other product sales independent of prior purchases, this indicates that the discount gives rise to a material right. If the entity has evidence of similar pricing for other product sales independent of prior purchases, this indicates that the discount does not give rise to a material right. This assessment may require significant judgment. It is also important to note that an entity cannot simply assume that no material right exists if all contracts contain similar tiered pricing.

Pricing step-downs

In some contracts, the pricing decreases per unit or in future years due to expected increased efficiencies in the entity's processes. The next example illustrates how to evaluate whether this type of arrangement includes a material right.

Evaluating pricing step-downs

Pricing step-down reflects stand-alone selling price

A manufacturing entity enters into a multi-year contract with an automobile manufacturer to produce specialized parts related to a specific model car. According to the contract, the price per part decreases by 5 percent each year based on expected increased efficiencies in the manufacturing process. The practice of reduced prices over the term of these contracts is a common industry practice. The pricing is as follows:

Year 1: $100 per part
Year 2: $ 95 per part
Year 3: $ 90 per part

The entity evaluates whether the contract includes a material right.

The entity has sufficient evidence from analyzing its historical data and cost projections to support that the declining pricing is consistent with the stand-alone selling price for the parts (using a cost-plus-a-margin approach) for each of the three years due to the expected efficiencies, which are then passed on to the customer. Because the customer has the option to acquire the parts at a price that reflects the expected stand-alone selling price, the option does not provide the customer with a material right.

Pricing step-down does not reflect stand-alone selling price

A manufacturing entity enters into a multiyear contract with a mobile phone manufacturer to produce specialized parts. Offering customers reduced prices over the term of these contracts is a common industry practice. The pricing is as follows:

Year 1: $100 per part
Year 2: $ 90 per part
Year 3: $ 81 per part

The entity evaluates whether the contract includes a material right as a result of the customer's ability to purchase the parts in Years 2 and 3 at reduced prices compared to the initial year.

The entity considers the available evidence as it evaluates whether the declining pricing is consistent with the stand-alone selling price for the parts in each of the three years. The entity uses a cost-plus-a-margin approach to determine the stand-alone selling price, considering its direct labor compensation forecasts, whether the cost of the physical inputs to the component decline over the same period under contracts with its supplier, and the viability of increased efficiencies due to current research and development activity. The entity concludes that the anticipated stand-alone selling price for the parts in Years 2 and 3 does not decline in comparison to Year 1.

After considering these items, the entity concludes the contract prices do not reflect the stand-alone selling price. In this case, because the customer has the option to acquire the parts at a price that does not reflect the expected stand-alone selling price independent of a prior contract (that is, the early years in the contract), the option provides the customer with a material right.

5.1.3 Rights of return

Retailers and manufacturers commonly provide customers with the right to return a product for a full or partial refund, a credit, or an exchange for another product. This right of return may be explicitly stated or implicit within the contract with a customer.

The exchange of a product for another product of the same type, quality, condition, and price (such as the exchange of a sweater for the same sweater in a different color) is not considered a return and is not subject to the guidance in this section. Further, contracts that permit the exchange of a defective product for a functioning product should be evaluated using the warranty guidance discussed in Section 4.6.

The rest of this section discusses the accounting for rights of return.

ASC 606-10-55-22

In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

a. A full or partial refund of any consideration paid

b. A credit that can be applied against amounts owed, or that will be owed, to the entity

c. Another product in exchange.

Broadly, the entity recognizes revenue for these arrangements, net of estimated returns, as follows:

- Revenue for the sold products, reduced for estimated returns (the guidance on variable consideration applies to determine the amount of the estimated returns)
- A refund liability equal to the amount of consideration received that the entity expects to refund
- An asset initially measured at the carrying amount of the returned inventory, less costs of recovery, and a corresponding adjustment to cost of sales

The entity should update its estimate of the refund liability at the end of each reporting period for any new information, with a corresponding adjustment to revenue.

ASC 606-10-55-23

To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity should recognize all of the following:

a. Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for the products expected to be returned)

b. A refund liability

c. An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

ASC 606-10-55-24

An entity's promise to stand ready to accept a returned product during the return period should not be accounted for as a performance obligation in addition to the obligation to provide a refund.

ASC 606-10-55-25

An entity should apply the guidance in paragraphs 606-10-32-2 through 32-27 (including the guidance on constraining estimates of variable consideration in paragraphs 606-10-32-11 through 32-13) to determine the amount of consideration to which the entity expects to be entitled (that is, excluding the products expected to be returned). For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity should not recognize revenue when it transfers products to customers but should recognize those amounts received (or receivable) as a refund liability.

Subsequently, at the end of each reporting period, the entity should update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the transaction price and, therefore, in the amount of revenue recognized.

ASC 606-10-55-26

An entity should update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity should recognize corresponding adjustments as revenue (or reductions of revenue).

ASC 606-10-55-27

An asset recognized for an entity's right to recover products from a customer on settling a refund liability initially should be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity should update the measurement of the asset arising from changes in expectations about products to be returned. An entity should present the asset separately from the refund liability.

Example 22 in ASC 606 illustrates how an entity should account for the sale of goods with a right of return.

Example 22—Right of Return

ASC 606-10-55-202

An entity enters into 100 contracts with customers. Each contract includes the sale of 1 product for $100 (100 total products × $100 = $10,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is $60.

ASC 606-10-55-203

The entity applies the guidance in this Topic to the portfolio of 100 contracts because it reasonably expects that, in accordance with paragraph 606-10-10-4, the effects on the financial statements from applying this guidance to the portfolio would not differ materially from applying the guidance to the individual contracts within the portfolio.

ASC 606-10-55-204

Because the contract allows a customer to return the products, the consideration received from the customer is variable. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method (see paragraph 606-10-32-8(a)) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 97 products will not be returned.

ASC 606-10-55-205

The entity also considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of $9,700 ($100 × 97 products not expected to be returned) can be included in the

transaction price. The entity considers the factors in paragraph 606-10-32-12 and determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (that is, the 30-day return period). Thus, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $9,700) will not occur as the uncertainty is resolved (that is, over the return period).

ASC 606-10-55-206

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

ASC 606-10-55-207

Upon transfer of control of the 100 products, the entity does not recognize revenue for the 3 products that it expects to be returned. Consequently, in accordance with paragraphs 606-10-32-10 and 606-10-55-23, the entity recognizes the following:

Cash	$10,000			($100 × 100 products transferred)
		Revenue	$9,700	($100 × 97 products not expected to be returned)
		Refund liability	$300	($100 refund × 3 products expected to be returned)
Cost of sales	$5,820			($60 × 97 products not expected to be returned)
Asset	$180			($60 × 3 products for its right to recover products from customers on settling the refund liability)
		Inventory	$6,000	($60 × 100 products)

5.1.4 Distinguishing variable consideration from optional goods or services

It may be challenging to distinguish between a contract that contains an option to purchase additional goods and services and a contract that includes variable consideration based on variable quantities (such as a usage-based fee). This is an important distinction because of the difference in the accounting and disclosure requirements for options and variable consideration.

As discussed in Section 4.4, when an entity concludes that a contract option does not provide a material right to the customer, the entity does not consider the additional goods or services provided by the customer option in determining the transaction price until the customer exercises its option.

In contrast, as discussed in Section 5.1, when a contract includes variable consideration due to unknown quantities, discounts, performance bonuses, penalties, refunds, or other similar items that cause the amount of consideration to vary, the entity estimates the amount of consideration to which it expects to be entitled in exchange for transferring the promised goods or services to the customer. The entity should apply the constraint guidance discussed in Section 5.1.1 and include the estimated variable consideration within its transaction price only to the extent that it is probable that a significant revenue reversal in the amount of cumulative revenue recognized will not occur when the uncertainty causing the variability is resolved.

From a disclosure perspective, an entity is not required to disclose an estimate of consideration expected if the customer exercises future options; however, when an entity concludes that a contract includes

variable consideration, it must disclose the remaining transaction price allocated to the unsatisfied or partially satisfied performance obligations at the end of the reporting period, as well as an explanation of when the entity expects to recognize the amounts, unless it qualifies for certain practical expedients.[46] Disclosure requirements are discussed in further detail in Section 13.

The TRG discussed how an entity may distinguish between optional purchases and variable consideration.

TRG area of general agreement: How can an entity distinguish between an optional purchase and variable consideration?

At the November 2015 meeting,[47] the TRG reached general agreement that an entity needs to apply judgment to distinguish between contracts that contain an option to purchase additional goods or services and contracts that contain variable consideration.

The TRG also generally agreed that the evaluation depends on the nature of the promise and what the enforceable rights and obligations are under the existing contract. An indication that a contract contains variable consideration is when the existing contract obligates the vendor to transfer the promised goods or services, and the customer to pay for those goods or services, and the customer's future actions or events that result in additional consideration occur as or after control is transferred. In this case, the customer's future actions or events do not obligate the entity to transfer additional distinct goods or services.

Alternatively, an indication that a contract contains an option for additional goods and services is when the customer has a present contractual right to choose the amount of additional distinct goods or services that are purchased (that is, it is a separate purchasing decision). Before the customer exercises that right, the vendor is not obligated to provide those goods or services; rather, the customer's action in an optional purchase results in a new obligation for the vendor to transfer additional distinct goods or services.

TRG Paper 48 includes the following examples to assist in distinguishing between variable consideration and an option to purchase additional goods or services.

Example of variable consideration

> *A transaction processor enters into a 10-year agreement with a customer to provide continuous access to its system and to process all transactions on behalf of its customer. The customer is obligated to use the transaction processor's system to process all of its transactions and is charged on a per transaction basis; however, the ultimate quantity of transactions is not known and remains outside the control of both the transaction processor and the customer. The customer simultaneously receives and consumes the benefit of the system and, therefore, the entity recognizes revenue over time.*

The TRG generally agreed that the customer does not control the number of transactions processed and that the nature of the promise is to provide the customer with continuous access to the processing platform. Because the transaction processor is already obligated to provide continuous access to the

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[46] ASC 606-10-50-13 through 50-14.

[47] TRG Paper 48, *Customer options for additional goods and services.*

platform, the events that result in additional payment do not result in an obligation to transfer additional goods or services, which indicates that the contract includes variable consideration instead of a customer option.

Example of an option to purchase additional goods or services

> *A supplier enters into a five-year exclusive MSA with a customer, which obligates the supplier to produce and sell customized parts as requested by the customer. The contract does not include any minimum purchase requirements, but it is highly likely that the customer will purchase parts from the supplier. Each part is distinct and is transferred to the customer at a point in time.*

The TRG generally agreed that the nature of the promise in this example is the delivery of the parts rather than a service of standing ready to deliver. In this example, the contract provides a right to choose the quantity of additional distinct goods, in contrast with the preceding example's right to use the services for which control is being, or has been, transferred to the customer in the form of continuous access to the platform. In other words, the supplier is not obligated to transfer any parts until the customer submits a purchase order, while in the prior example, the transaction processor is obligated to make the platform (promised services) available to the customer without any additional decisions made by the customer.

TRG Paper 48 cautions that not all transaction processing activities and MSAs should be accounted for as outlined in these examples. The determination of whether a contract contains variable consideration or an optional purchase depends upon the nature of the promise and the specific facts and circumstances of each situation.

5.1.5 Minimum purchase commitments

Often, entities include a minimum purchase commitment, or a "floor," within their contracts to ensure a minimum amount of revenue. Some "take or pay" contracts also achieve the same goal. Questions have arisen as to whether it is appropriate to recognize a portion of the revenue attributable to the floor ratably over the contract period.

Grant Thornton insight: When an entity does not expect the customer to meet its minimum purchase commitment in a take-or-pay arrangement

Take-or-pay contracts usually require a customer to purchase a defined minimum number of goods, and even if the customer does not meet the minimum purchase commitment, it is still required to pay the contractual minimum. When an entity expects that the customer will not purchase the minimum number of goods specified in a contract, we believe that the entity may apply, in certain circumstances, either the breakage model or the contract modification model in ASC 606 to recognize revenue associated with any shortfall in customer purchases.

If using the breakage approach (see Section 7.7), the entity would account for its expectation that the customer will order fewer than the minimum number of goods specified in the contact as *breakage*. The breakage model in ASC 606 allows an entity to apply either the proportional method, whereby the entity recognizes revenue in proportion to the number of goods ordered, or the remote method, whereby the entity waits to recognize revenue until the likelihood that the customer will exercise its remaining rights becomes remote. We have observed that use of the remote method in practice is rare,

because an entity would only constrain the revenue to an amount that it does not expect to see a significant revenue reversal on cumulative revenue recognized to date. Applying the proportional method to breakage results in changes in estimated breakage accounted for as an adjustment to cumulative revenue recognized to date in the contract.

On the other hand, we believe that it may also be appropriate, in certain circumstances, for the entity to account for its expectation that the customer will purchase fewer than the minimum number of goods as a modification under ASC 606-10-25-10 through 25-13 that reduces the scope of the contract. This approach results in accounting for the contract modification when the enforceable rights and obligations of the parties change, whereby there are fewer performance obligations in the "new" contract and the transaction price allocated to each good will therefore be higher.

In order to apply the contract modification model, there must be a change in enforceable rights and obligations, according to ASC 606-10-25-10. For example, if a customer fails to meet the minimum purchase commitment after year one under a three-year contract that specifies annual minimum purchase volumes, then there has been a change in enforceable rights and obligations at the end of the first year of the contract.

We do not believe this view applies to stand-ready obligations or to intellectual property licensing arrangements with usage-based fees, because in these types of arrangements, the number of performance obligations does not change. For example, even if an entity expects the coming winter to bring inadequate snowfall to plow, the contract with its customer still has a single stand-ready obligation to be available to plow snow. This example is unlike a take-or-pay arrangement involving a variable number of goods, whereby the entity may expect to transfer fewer goods for the same contractual minimum contract price.

Contracts with minimum purchase commitments (or 'floors')

Part 1: When an entity expects that the minimum purchase commitment will be met

A manufacturing entity executes a three-year MSA with a customer on January 1, 20X0, which allows it to be the exclusive provider of parts A, B, and C. The MSA specifies that the price for parts A, B, and C are $100, $150, and $200, respectively. The entity determines that the contract pricing is at the stand-alone selling prices of the individual products. The MSA also specifies a minimum purchase requirement of $30,000 over the three-year contract period. The customer will submit individual purchase orders specifying the quantity and mix of parts A, B, and C that it wishes to purchase throughout the three-year agreement. After the first purchase order is submitted, the entity concludes that it passes Step 1 of the revenue model and that each part is distinct. The entity transfers control of the parts to the customer at a point in time.

With hindsight, the manufacturing entity's actual sales under the MSA for the three-year period are as follows.

Year-end	Annual sales
12/31/20X0	$ 8,000

12/31/20X1	15,000
12/31/20X2	10,000
Total	$33,000

In determining how to account for the contract, the entity considers the TRG's November 2015 discussion[48] and determines that the nature of its promise to the customer is the delivery of parts. The entity is not obligated to transfer any parts until the customer submits a purchase order specifying the quantity of parts A, B, and C it wishes to purchase. In other words, the contract contains an option to purchase additional goods, not variable consideration. Because the pricing for the additional parts is at the stand-alone selling price, the entity concludes that the contract does not contain a material right.

Assuming the entity expects the customer to purchase at least the minimum amount of parts at all points throughout the contract, the entity recognizes revenue of $8,000 in Year 1, $15,000 in Year 2, and $10,000 in Year 3 when control of the parts transfers to the customer. Paragraph 41 in TRG Paper 48 states that a customer's purchase under a MSA is not similar to a stand-ready obligation. When a customer submits a purchase order, it is contracting for a specific number of distinct goods, and the new purchase order creates new performance obligations for the supplier.

Part 2: When an entity expects that the minimum commitment will not be met and the floor is enforced

Assume the same facts in Part 1 above, except that the manufacturing entity's estimated sales under the MSA for the three-year period and actual sales (using hindsight) are as follows.

Year	Estimated total contract sales at beginning of reporting period	Actual annual sales at period-end
20X0	$ 30,000	$ 1,000
20X1	$10,000	5,000
20X2	$15,000	10,000
Total		$16,000

In this case, while the entity expected the contractual minimum to be met in Year 1, after 12/31/X0, the entity reevaluated its position and determined that it does not anticipate its transaction price to exceed the contractual minimum.

[48] TRG Paper 48, *Customer options for additional goods and services*.

We believe the entity may account for its expected obligations under this arrangement by applying a breakage model.

If applying the breakage approach, the entity would account for the expectation that the customer will order fewer than the minimum parts as breakage, and account for that breakage using the proportional method (whereby the entity recognizes breakage revenue in proportion to the number of parts ordered) or the remote method (waiting to recognize breakage revenue until the likelihood that the customer will exercise its remaining rights becomes remote). For this particular example, we do not believe the entity may apply the modification approach to account for its expectation that the customer will not meet its minimum purchase commitment, because the modification guidance applies only when the rights and obligations in the contract change (that is, a change in price and/or scope). Because the contract stipulates no established minimums for each annual period, the customer does not decide to change its rights or obligations during the contract (say, after 12/31/X0).

5.1.6 Reassessing variable consideration

An entity updates its estimate of variable consideration, including the application of the constraint, at the end of each reporting period to reflect changes in facts and circumstances. The entity accounts for changes in estimates of variable consideration in the same way that it accounts for other changes in the transaction price, as discussed in Section 5.5.

ASC 606-10-32-14

At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity shall account for changes in the transaction price in accordance with paragraphs 606-10-32-42 through 32-45.

Grant Thornton insight: Reassessing variable consideration for an in-process contract

Under the guidance in ASC 606-10-32-14, an entity is required to update its estimate of variable consideration included in the transaction price at period-end, and to allocate any changes in the transaction price to all performance obligations in the contract on the *same basis that was used at contract inception*. In other words, the entity updates the transaction price after contract inception, but does not update the stand-alone selling price; therefore, any reallocation of the updated transaction price post-contract inception is based on the stand-alone selling prices that existed at contract inception.

Further, it is important to keep in mind that any amounts that are allocated to a satisfied performance obligation should be recognized as revenue (or as a reduction of revenue) in the period during which the entity updates its estimate of variable consideration.

Change in estimate or correction of an error

If an entity previously determined that the transaction price for a contract should include $100 of variable consideration and in a later reporting period estimates the variable amount of the contract is $200, this revision to the overall transaction price is subject to the constraint discussed in Section 5.1.1. In reaching a conclusion to increase the transaction price to $200, the entity would assert that it is probable that a subsequent change in the estimate of variable consideration will not result in a significant revenue reversal based on the facts and circumstances that exist at the time of updating the estimated transaction price.

Grant Thornton insight: Evaluating whether a change in the estimated transaction price is a change in estimate or the correction of an error

Facts and circumstances can change throughout the contract period that require an entity to update the transaction price. For example, consider a revenue transaction where an event gives rise to variable consideration and the related uncertainty is resolved during the contract period. An entity must update the transaction price in each reporting period based on the current information available related to the variable consideration estimate.

In contrast, changes to the estimated transaction price that result from the correction of an oversight or misuse of facts that existed when the financial statements were previously issued, or from the correction of a prior mathematical mistake or misapplication of GAAP, are considered the correction of an error. When a change in transaction price is due to the correction of an error, an entity should evaluate the materiality of the error(s) and determine the appropriate application of the presentation and disclosure guidance in ASC 250.

Evaluating whether a change in the estimated transaction price is a change in estimate or the correction of an error may require judgment. If an entity knew, or could have known, about the facts related to the change in estimate when the original estimate was made, then the change in estimate is likely an error. Alternatively, if the facts related to the change in estimate arose after, or if an entity could not have known about them at the time of the original estimate, the change in estimate is likely not an error.

When the estimated transaction price changes significantly, particularly in the case of a revenue reversal, entities should also consider

- The facts that led to the change in estimate and, in the case of a revenue reversal, whether variable consideration should be further constrained in the future
- Whether the entity needs to make changes to its estimation process to prevent similar errors from occurring in the future
- Whether the change in estimate indicates a weakness in controls

5.2 Significant financing components

In determining the transaction price, an entity reflects the time value of money if the agreed-upon timing of payments in the contract includes a significant financing component, whether explicit or implicit. The objective in adjusting the transaction price for the time value of money is to reflect revenue for the selling price as though the customer had paid cash for the goods or services when the entity transferred those goods or services. Either party may benefit from financing—that is, the customer may pay before the

entity performs its obligation (a customer loan to the entity) or the customer may pay after the entity performs its obligation (a loan by the entity to the customer).

To determine whether a contract contains a significant financing component, an entity considers all relevant facts and circumstances, including, but not limited to, the following:

- The difference, if any, between the promised consideration and the cash price that would be paid if the customer had paid as the goods or services were delivered
- The combined effect of the time between delivery of the goods or services and receipt of payment, as well as the prevailing market interest rates

ASC 606-10-32-15

In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

ASC 606-10-32-16

The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services

b. The combined effect of both of the following:

    1. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services

    2. The prevailing interest rates in the relevant market.

The Boards clarified[49] that an entity considers the significance of a financing component only at a contract level and not whether the financing is material at a portfolio level. The Boards thought it would have been “unduly burdensome” to require an entity to account for a financing component if the effects of the financing component were not material to the individual contract, but the combined effects for a portfolio of similar contracts were material to the entity as a whole.

[49] BC234, ASC 2014-09.

Notwithstanding the guidance in ASC 606-10-32-15 and 32-16, there is *not* a significant financing component if any one of the following three conditions exists:

- Advance payments have been made, but the customer will decide on the timing of the transfer of the good or service (for example, a customer made advance payment and will notify the vendor when it wants the goods shipped).
- The consideration is mostly variable and based on factors outside the vendor's or customer's control (for example, a usage-based royalty).
- The difference between the promised consideration and the cash price relates to something other than financing, and the difference is proportional to the reason for the difference, such as protecting one of the parties from the other party's nonperformance (for example, a customary retainage of a certain percentage of all payments made until completion of a project).

ASC 606-10-32-17

Notwithstanding the assessment in paragraph 606-10-32-16, a contract with a customer would not have a significant financing component if any of the following factors exist:

a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.

b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).

c. The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

The table below illustrates how to evaluate common contract terms to determine whether a financing component exists.

Financing component or not?

Description	Analysis
A customer pays in full at contract inception for the construction of a building expected to be completed 20 months from contract inception.	There appears to be a financing component because the customer pays 100 percent of the consideration more than 12 months before the entity completes part of its performance obligation (that is, construction done in months 13-20). The entity needs to determine if the financing component is significant.
An entity constructs a building over three years. The customer makes quarterly progress payments, and retains 10 percent of consideration due until construction is complete.	The difference between the promised consideration and the cash price relates to something other than financing (that is, retention) and the entity considers the difference proportional to the reason for the difference. As a result, there does not appear to be a financing component in this contract.
An entity agrees to produce a large machine for a customer. The entity determines that control transfers when the customer takes possession of the machine. The payment terms specify that the customer must pay the entity 24 months after taking possession of the machine.	There appears to be a financing component because the customer makes payments more than 12 months after the entity's performance is complete. The entity needs to determine if the financing component is significant.

The Boards decided that an entity can ignore the effects of financing if the entity expects, at contract inception, that the time between the delivery of the goods or services and the customer payment will be one year or less.

ASC 606-10-32-18

As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

The table below illustrates how to evaluate whether the financing component practical expedient applies.

Financing component practical expedient

Description	Analysis
A customer pays in full at contract inception for the construction of a building expected to be completed 20 months from contract inception. Construction takes place throughout the 20-month period.	The financing component practical expedient does not apply because the customer pays 100 percent of the consideration more than 12 months before the entity satisfies the performance obligation. The entity needs to determine if the financing component is significant. The entity ignores the fact that some of the work is performed in the year after contract inception.
An entity constructs a building over three years. The customer makes quarterly progress payments so that the cumulative amount paid at the end of each quarter is proportional to the agreed-upon progress toward completing the building.	Although the contract performance takes place over three years, the financing component practical expedient applies because the customer pays for the work as it is completed on a quarterly basis.

Stakeholders have asked whether entities can use this practical expedient if a single payment stream is received for multiple performance obligations, and one or more of those performance obligations are satisfied in less than one year while others are satisfied after one year. The TRG addressed one such question at its March 2015 meeting.

TRG area of general agreement: How should entities determine if the practical expedient can be applied when there is a single payment stream for multiple performance obligations?

The TRG considered the following example at the March 2015 meeting[50]:

> *An entity offers a 24-month contract to customers which includes the delivery of a device at contract inception and related services over 24 months. The entity concludes that the device and services are each distinct. The promised amount of consideration (combined amount for device and services) is $2,400 payable in 24 monthly installments of $100. Assume that the transaction price is allocated both to the device ($500) and to the services ($1,900 or $79 per month).*

[50] TRG Paper 30, *Significant Financing Components.*

Assuming that the arrangement contains a significant financing component, the TRG discussed whether the practical expedient can be applied.

The TRG generally agreed that absent evidence supporting which performance obligation a payment specifically relates to, an entity should proportionally allocate the consideration to the performance obligations in the contract for purposes of determining whether the practical expedient applies. For example, the contract terms may provide evidence supporting allocation of the payment to specific performance obligations.

Assume that the entity transfers the device first and recognizes revenue for $500. Each month, the entity transfers the services and recognizes revenue of $79 per month. Assuming that the cash payment cannot be directly tied to the device, the entity would proportionally allocate the monthly consideration to the device and services. Therefore, each month the entity would allocate $79 of the cash to the services and $21 to the device. The amount related to the service receivable is fully settled at the end of each month. However, because it will receive the full amount outstanding on the device over 24 months ($21 per month for 24 months), the entity concludes that the period between delivery of the device and receipt of the related consideration will be more than one year. That is, in this case, the practical expedient does not apply and the entity would adjust the transaction price for the time value of money.

At the same March 2015 meeting, the TRG discussed certain promotions where retailers offer “0 percent financing.” ASC 606-10-35-16 says that an entity should consider the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services when determining if the contract contains a significant financing component. However, the analysis might be confusing when the customer can pay, for example, $2,000 today or $2,000 over three years. A significant financing component might exist when the cash selling price and promised consideration are equal.

TRG area of general agreement: If the promised consideration is equal to the cash selling price, does a financing component exist?

At the March 2015 meeting,[51] the TRG discussed the following example:

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

The TRG reached general agreement that an entity should not automatically assume that there is not a significant financing component when the list price, cash selling price, and the promised consideration are all equal. The difference, if any, between the amount of promised consideration and the cash selling price is one, but not the only, consideration in determining whether a significant financing component exists. The entity must consider all relevant facts and circumstances and apply judgment in determining whether a significant financing component exists in a contract. If the entity in the example offers a discount from list price to customers that pay in full upfront, this may indicate that the transaction includes a financing component.

[51] TRG Paper 30, *Significant Financing Components.*

If, on the other hand, the list price, cash selling price, and the promised consideration are in fact all equal, this may indicate that there is not a financing component (or, if there is a financing component, it is not significant).

Example 26 of ASC 606 illustrates a contract that contains a significant financing component.

Example 26—Significant Financing Component and Right of Return (excerpt)

ASC 606-10-55-227

An entity sells a product to a customer for $121 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new, and the entity has no relevant historical evidence of product returns or other available market evidence.

ASC 606-10-55-228

The cash selling price of the product is $100, which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. The entity's cost of the product is $80.

ASC 606-10-55-229

The entity does not recognize revenue when control of the product transfers to the customer. This is because the existence of the right of return and the lack of relevant historical evidence means that the entity cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur in accordance with paragraphs 606-10-32-11 through 32-13. Consequently, revenue is recognized after three months when the right of return lapses.

ASC 606-10-55-230

The contract includes a significant financing component, in accordance with paragraphs 606-10-32-15 through 32-17. This is evident from the difference between the amount of promised consideration of $121 and the cash selling price of $100 at the date that the goods are transferred to the customer.

5.2.1 Adjusting for a significant financing component

To adjust the amount of consideration for a significant financing component, an entity should use the discount rate that would be reflected for a separate financing transaction between the entity and the customer at contract inception. That rate should reflect the credit risk of whichever party is receiving credit (for example, the customer's rate if payment is deferred and the vendor's rate if payment is made in advance).

ASC 606-10-32-19

To meet the objective in paragraph 606-10-32-16 when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

Example 29 of ASC 606 demonstrates how an entity would account for the significant financing component in a contract.

Example 29—Advanced Payment and Assessment of Discount Rate

ASC 606-10-55-240

An entity enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (that is, the performance obligation will be satisfied at a point in time). The contract includes 2 alternative payment options: payment of $5,000 in 2 years when the customer obtains control of the asset or payment of $4,000 when the contract is signed. The customer elects to pay $4,000 when the contract is signed.

ASC 606-10-55-241

The entity concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

ASC 606-10-55-242

The interest rate implicit in the transaction is 11.8 percent, which is the interest rate necessary to make the 2 alternative payment options economically equivalent. However, the entity determines that, in accordance with paragraph 606-10-32-19, the rate that should be used in adjusting the promised consideration is 6 percent, which is the entity's incremental borrowing rate.

ASC 606-10-55-243

The following journal entries illustrate how the entity would account for the significant financing component.

a. Recognize a contract liability for the $4,000 payment received at contract inception.

Cash $4,000

Contract liability $4,000

b. During the 2 years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration (in accordance with paragraph 606-10-32-20) and accretes the contract liability by recognizing interest on $4,000 at 6 percent for 2 years.

Interest expense $494 [(a)]

Contract liability $494

[(a)] $494 = $4,000 contract liability × (6 percent interest per year for 2 years)

c. Recognize revenue for the transfer of the asset.

Contract liability $4,494

Revenue $4,494

TRG area of general agreement: How should an entity calculate the adjustment of revenue in arrangements that contain a significant financing component?

At the March 2015 meeting,[52] the TRG noted that ASC 606 does not provide guidance on how to calculate interest income or expense or how to subsequently account for these items. Entities should refer to ASC 835-30 to determine the appropriate accounting.

5.2.2 Presentation

The guidance on identifying a significant financing component is designed to isolate financing income or expense from revenue from contracts with customers. These financing activities do not constitute revenue and therefore should be isolated to better reflect the true revenue-generating activities of the entity. An entity presents the effects of financing separately from revenue as interest expense or interest income in the statement of comprehensive income.

ASC 606-10-32-20

An entity shall present the effects of financing (interest income or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income (statement of activities). Interest income or interest expense is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer. In accounting for the effects of the time value of money, an entity shall also consider the subsequent measurement guidance in Subtopic 835-30, specifically the guidance in paragraphs 835-30-45-1A through 45-3 on presentation of the discount and premium in the financial statements and the guidance in paragraphs 835-30-55-2 through 55-3 on the application of the interest method.

[52] TRG Paper 30, *Significant Financing Components*.

5.3 Noncash consideration

Sometimes a customer promises to pay for a good or service in a form other than cash, such as shares of common stock or other equity instruments, advertising, or equipment. An entity measures the estimated fair value of the noncash consideration at contract inception when determining the transaction price.

ASC 606-10-32-21

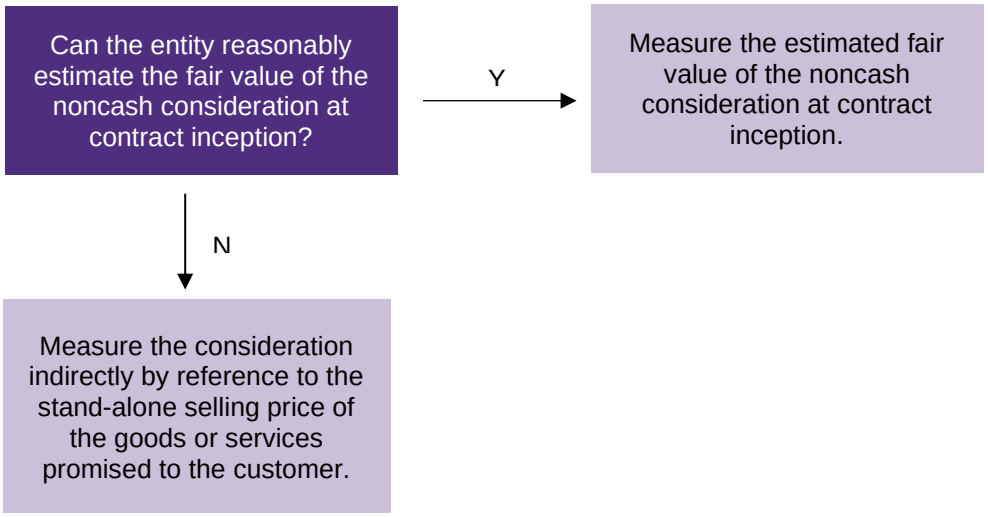
To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the estimated fair value of the noncash consideration at contract inception (that is, the date at which the criteria in paragraph 606-10-25-1 are met).

The starting point for estimating fair value is the noncash consideration itself; however, if the entity cannot reasonably estimate the fair value of the noncash consideration, the entity looks to the stand-alone selling price of the goods or services that it is providing to the customer in exchange for the consideration in accordance with the contract.

ASC 606-10-32-22

If an entity cannot reasonably estimate the fair value of the noncash consideration, the entity shall measure the consideration indirectly by reference to the standalone selling price of the goods or services promised to the customer (or class of customer) in exchange for the consideration.

Figure 5.3: Noncash consideration



Example 31 in ASC 606 illustrates how an entity should account for noncash consideration received in exchange for a good or service.

Example 31—Entitlement to Noncash Consideration

ASC 606-10-55-248

An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on January 1, 20X1, and work begins immediately. The entity concludes that the service is a single performance obligation in accordance with paragraph 606-10-25-14(b). This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

ASC 606-10-55-249

In exchange for the service, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

ASC 606-10-55-250

To determine the transaction price (and the amount of revenue to be recognized), the entity measures the estimated fair value of 5,200 shares at contract inception (that is, on January 1, 20X1). The entity measures its progress toward complete satisfaction of the performance obligation and recognizes revenue as each week of service is complete. The entity does not reflect any changes in the fair value of the 5,200 shares after contract inception in the transaction price. However, the entity assesses any related contract asset or receivable for impairment. Upon receipt of the noncash consideration, the entity would apply the guidance related to the form of the noncash consideration to determine whether and how any changes in fair value that occurred after contract inception should be recognized.

Noncash consideration includes customer-provided goods or services to the vendor when the vendor obtains control as discussed in ASC 606-10-25-25. Often, customer-supplied goods or services may be provided to the vendor, but the vendor does not obtain control. That said, a customer may transfer control of the goods or services to the vendor instead of cash to help the vendor fulfill its obligation under the contract. For example, a customer of an automobile manufacturer may contribute equipment or materials to one of its vendors for use in producing the end product for the customer. If the vendor obtains control of the provided goods or services, it accounts for the goods or services as noncash consideration received.

ASC 606-10-32-24

If a customer contributes goods or services (for example, materials, equipment, or labor) to facilitate an entity's fulfillment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as noncash consideration received from the customer.

The following example illustrates the accounting for goods that are contributed by a customer to an entity to use in satisfying its obligations under a contract with the customer.

Contributed goods or services

A themed-events company agrees to prepare food and provide wait staff services for an end-of-production party for its customer, a movie studio. The customer agrees to pay $200,000 for the food and service. The customer requests the events company to prepare and serve food and decorate the venue in the theme of the film. The movie studio contributes props, costumes, and pieces of the set worth $50,000 for the events company to use in staging the event.

The events company has discretion in staging the party and takes ownership of the props, costumes, and set pieces after the event, and expects to be able to reuse many of the contributed goods at future engagements. The events company concludes that it obtains control of the goods in accordance with ASC 606-10-25-25.

As a result, at contract inception, the entity includes the fair value of the contributed goods in the transaction price, which it determines to be $250,000.

At the crossroads: Scope clarifications for a share-based payment from a customer in a revenue contract

In practice, there is a lack of clarity about which guidance an entity should apply when it receives share-based payments from its customer, such as warrants or shares, that “vest” when the entity transfers goods or services to the customer. Some stakeholders believe the entity should recognize a derivative asset under ASC 815 or an equity security under ASC 321 at contract inception, while others believe the entity should wait to recognize the derivative asset or equity security until the entity satisfies its performance obligation under ASC 606.

Because the accounting implications can be significant depending upon which view an entity applies, the FASB has taken up a project to clarify the guidance in this area (see the Current Projects webpage on the FASB’s website).

5.3.1 Subsequent measurement of noncash consideration

As explained in ASC 606 Example 31, if the fair value of the noncash consideration varies after contract inception because of its form, the entity does not adjust the transaction price for any changes in the fair value of the consideration.

In Example 31, the form of the consideration is the customer’s common stock and the price of the shares may change. The entity would not adjust the transaction price for changes in the market price of the customer’s common stock.

If the facts were slightly different in Example 31 such that the fair value of the noncash consideration changes for reasons other than the form of the consideration (for example, the entity may receive an additional 100 shares if the entity’s performance under the contract meets certain quality ratings), the entity is required to apply the guidance on variable consideration and the constraint when determining the transaction price, considering the performance bonus.

ASC 606-10-32-23

The fair value of the noncash consideration may vary after contract inception because of the form of the consideration (for example, a change in the price of a share to which an entity is entitled to receive from a customer). Changes in the fair value of noncash consideration after contract inception that are due to the form of the consideration are not included in the transaction price. If the fair value of the noncash consideration promised by a customer varies for reasons other than the form of the consideration (for example, the exercise price of a share option changes because of the entity's performance), an entity shall apply the guidance on variable consideration in paragraphs 606-10-32-5 through 32-14. If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, the entity shall apply the guidance in paragraphs 606-10-32-5 through 32-14 on variable consideration only to the variability resulting from reasons other than the form of the consideration.

The following example illustrates when the fair value of the noncash consideration varies for reasons other than the form of the consideration.

Fair value of noncash consideration varies for reasons other than the form of the consideration

A construction entity enters into a contract to build an office building for a real estate entity over an 18-month period. The real estate entity agrees to pay the construction entity $50 million for the project. The construction entity will receive a bonus of 10,000 common shares of the real estate entity if it completes construction of the office building within one year. Assume a fair value of $100 per share at contract inception.

The ultimate value of any shares the entity might receive could change for two reasons: 1) the entity earns or does not earn the shares and 2) the fair value per share may change during the contract term. When determining the transaction price, the entity would reflect changes in the number of shares to be earned. However, the entity would not reflect changes in the fair value per share. Said another way, the share price of $100 is used to value the potential bonus throughout the life of the contract.

As a result, if the entity earns the bonus, its revenue would be $50 million plus 10,000 common shares at $100 per share for total consideration of $51 million.

5.4 Consideration payable to a customer

The logic behind the "consideration payable to a customer" guidance is that an entity should not inflate its revenue by amounts given to customers in a contract that it will receive back through the purchase of its goods or services. For example, a product manufacturer enters into a contract with a retailer for 100,000 units of product at $20 per unit, but the retailer also requires the manufacturer to pay $10,000 as an incentive to enter into the contract. Because the manufacturer does not receive a distinct good or service from the retailer, it should not recognize $2 million in revenue; rather, its transaction price is $1.99 million.

Consideration payable to a customer includes amounts that an entity pays or expects to pay to a customer and occurs in many forms, including cash, credits, and other items that the customer can apply against amounts owed to the entity, or equity instruments granted in conjunction with selling goods or services. Consideration payable to a customer may include, but is not limited to, the following:

- Slotting fees
- Pay-to-play payments
- Cooperative advertising arrangements
- Rebates or coupons
- Common shares

The key to appropriately accounting for consideration payable to a customer is determining whether the payment is made in exchange for a distinct good or service. When the entity receives a good or service from the customer, it applies the guidance in ASC 606-10-25-18 through 25-22 that it uses in Step 2 in identifying its performance obligations (Section 4.2) to determine if that good or service is distinct.

When an entity concludes that the consideration paid to a customer is in exchange for a distinct good or service, it accounts for the distinct good or service as it would any other purchase from a supplier, as long as the consideration paid does not exceed the fair value of the goods or services received. When the consideration exceeds the fair value of the distinct goods or services received, any excess is accounted for as a reduction in the transaction price.

If, on the other hand, the entity concludes that the consideration paid to the customer is not in exchange for a distinct good or service, the entity would reduce the transaction price by the amount it pays or owes the customer.

ASC 606-10-32-25

Consideration payable to a customer includes:

a. Cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer)

b. Credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer)

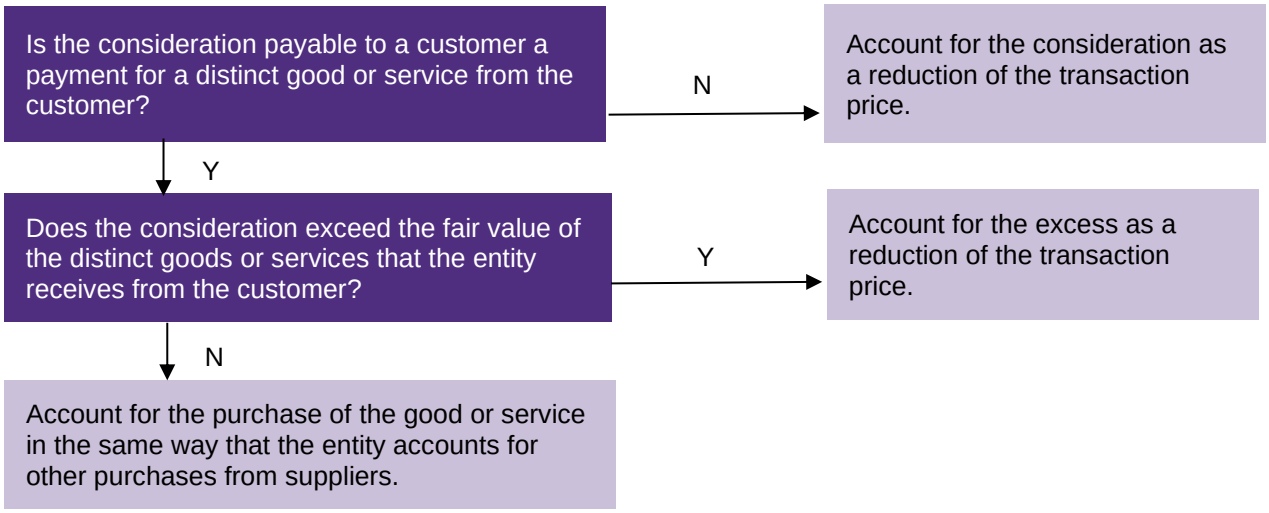
c. Equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments).

An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13.

ASC 606-10-32-26

If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.

Figure 5.4: Consideration payable to a customer



If, after applying the above guidance, an entity determines that the consideration it paid, or promises to pay, to a customer is a reduction of the transaction price, that reduction is recognized at the later of when the entity (1) recognizes revenue for the goods or services, or (2) pays or promises to pay the consideration.

ASC 606-10-32-27

Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:

a. The entity recognizes revenue for the transfer of the related goods or services to the customer.

b. The entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

Slotting fees

In Example 32 from ASC 606 below, a manufacturer pays slotting fees to a retailer. Because the fees are "consideration payable to a customer," the entity considers whether the fees paid are in exchange for a distinct good or service. Since the entity concludes that the fees are not in exchange for a distinct good or service, the entity recognizes the fees as a reduction of the transaction price at the later of when the entity (1) recognizes revenue for transferring the related goods or services, or (2) pays or promises to pay the consideration. In this case, the later event is when the entity transfers the goods to the customer.

Example 32—Consideration Payable to a Customer

ASC 606-10-55-252

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

ASC 606-10-55-253

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

ASC 606-10-55-254

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

Pay-to-play payments

An entity may make a payment to a customer or potential customer in order to lure business or incentivize future business. These payments may also serve to reimburse the customer for costs it will incur to switch suppliers, including termination penalties paid to existing suppliers. Questions on the appropriate accounting for these types of payments have been discussed by the TRG.

TRG area of general agreement: How should an entity account for an upfront payment when that payment relates to both current and anticipated contracts?

At the November 2016 meeting,[53] the TRG considered the following two examples:

> *Example 1: A supplier makes a $1 million payment to a potential customer as part of its negotiations for a three-year exclusive supply contract to provide specialized parts that are a component in one of the target customer's main products. The payment is made as an incentive and also to reimburse the customer for costs incurred to switch from its existing supplier, including termination fees and other costs. The target customer provides a nonbinding forecast of its supply requirements, which forecasts expected total purchases of 100,000 parts at $100 per part (totaling $10 million). The supplier has never previously contracted with this potential customer before.*
>
> *Example 2: Assume the same facts as in Example 1, except that the supplier receives a purchase order for 20,000 parts at the same time it makes the payment to the customer.*

The TRG discussed how the supplier should account for the upfront payment in each of the two examples and agreed that, depending upon the particular facts and circumstances surrounding the upfront payment, payments made to a customer may be recognized as either an asset that is subsequently amortized as a reduction to revenue or as an expense, particularly in the case of Example 1 where a contract does not exist at the time of the payment.

After considering the specific facts and circumstances surrounding the payment and evaluating the guidance in FASB Statement of Financial Accounting Concepts 6, the entity would likely conclude that the payments to a customer in Examples 1 and 2 constitute assets.

In Example 1, it would be unlikely for an entity to make a $1 million payment without a valid expectation that the customer will enter into a future contract. In such cases, the entity would need to evaluate the asset for impairment in subsequent periods. TRG members observed that the impairment assessment should be evaluated on the basis of expected future revenue from the customer. Depending on the facts and circumstances of a particular situation, the entity may conclude, however, that the payment is best reflected as an expense when paid. This may be appropriate if an existing contract is not in place (for example, an entity makes a payment in anticipation that the customer will enter into a purchase contract) and the entity deems that the payment does not constitute an asset.

TRG members agreed that the determination of whether the payment represents an asset or expense is not an accounting policy election; rather, an entity should consider the facts and circumstances surrounding the payment, apply judgment, and make appropriate disclosures.

Cooperative advertising

An entity may agree to pay its customer certain amounts in exchange for the customer advertising the entity's products or services. In this case, the entity is required to evaluate the contract to determine if it receives a distinct good or service in exchange for the payment in accordance with the guidance in ASC 606-10-32-25 through 32-27.

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[53] TRG Paper 59, *Payments to Customers.*

Cooperative advertising arrangements

An entity that manufacturers sinks sells its products to a home goods retailer. The entity's contract with the retailer specifies that the entity will deliver 5,000 sinks for $1,000 per sink and will give the retailer a credit of $100,000 for advertising its products in the retailer's store circulars. The entity receives a copy of the retailer's circular, which evidences the advertising on its behalf, and concludes that the fair value of the advertising approximates $100,000.

The entity evaluates the criteria in ASC 606-10-32-25 through 32-27 to determine if the advertising is distinct. The entity concludes that the advertising is capable of being distinct. The entity concludes that the advertising is also distinct within the context of the contract because the advertising does not customize or modify the promise to transfer the sinks, and the sinks do not customize or modify the advertising. In addition, there is no significant integration service, and the advertising and sinks are not highly interdependent or highly interrelated since they do not significantly affect each other.

As a result, the entity accounts for the advertising payment as it does for other purchases from suppliers (in this case, in selling, general, and administrative expense).

Equity

"Consideration payable to a customer" in the form of equity is addressed in both ASC 606 and ASC 718. An entity uses the guidance in ASC 606 to determine how to *present* share-based payments issued to customers in the financial statements, as discussed above in Section 5.4, while it uses the guidance in ASC 718 to determine how to *classify* and *measure* the award (see Sections 3 to 7 in our *Share-based payments guide*). The sections that follow discuss the classification and measurement of equity awards issued as payments to a customer in a revenue contract.

Grant Thornton insight: Clarifications to share-based consideration payable to a customer

It is becoming more common for grantors to issue share-based payment awards to customers that vest based on the customer's purchases of the entity's goods and services as a way to incentivize sales. For example, an entity may grant its customer a share-based payment award that vests upon the grantee purchasing a specified volume or monetary value of goods or services from the entity. Today, some entities account for this vesting provision as a performance condition, while others account for it as a service condition. While ASC 718 requires a grantor to estimate the "probable outcome" for a performance condition (that is, if is it probable the grantee will achieve the specified volume of sales), a grantor may elect to account for forfeitures as they occur if the vesting condition is deemed to be a service condition. In that case, revenue recognition may be delayed for awards that are not probable of vesting.

When we last updated this publication in March 2025, the FASB had proposed amendments that would clarify that a grantor should account for the vesting condition as a performance condition in this scenario in accordance with ASC 718. As a result, the grantor would be required to assess the probability that an award will vest using only the guidance in ASC 718. Further, the grantor would not apply the guidance in ASC 606 on constraining estimates of variable consideration to share-based consideration payable to a customer.

In addition, the proposed amendments would clarify that when measuring share-based consideration with a service condition payable to a customer, the grantor would also be required to estimate the number of forfeitures expected to occur; that is, the proposed amendments would eliminate the policy election that currently allows the grantor to account for forfeitures as they occur.

Follow the Current Projects webpage on the FASB website for the latest on this project.

Classification and initial measurement

An entity should use the guidance in ASC 718 to determine how to classify and measure a share-based payment award, which includes guidance on identifying the grant date (see Section 3 as well as Sections 4 to 7 in our *Share-based payments* guide for more information).

ASC 606-10-32-25A (excerpt)

Equity instruments granted by an entity in conjunction with selling goods or services shall be measured and classified under Topic 718 on stock compensation. The equity instrument shall be measured at the grant date in accordance with Topic 718 (for both equity-classified and liability-classified share-based payment awards). …

Entities must carefully evaluate each award's terms and conditions to determine whether the award should be classified in equity or as a liability. Equity awards are initially measured at their grant-date fair value and are not subsequently remeasured, while liability awards are measured at their grant-date fair value and are then marked-to-market at each financial reporting date until settlement. In general, share-based payments must be classified as a liability when any one of the following conditions is met:

- The award is classified as a liability under the guidance in ASC 480.
- Shares underlying options or similar instruments are classified as liabilities.
- Cash settlement may be required.
- The award has certain repurchase features.
- The award is indexed to conditions other than market, performance, or service conditions.
- The substantive terms of the award indicate that it is a liability.

In accordance with ASC 718, the entity must recognize the grant-date fair value of the consideration payable to a customer on the award's grant date. The grant date is the date when the grantor and grantee (that is, the customer in this case) reach a mutual understanding of the key terms and conditions of the share-based payment award.

The grant date is typically established when all of the following conditions are met:

- A mutual understanding of the terms of the award exists between the grantor and the grantee.
- All appropriate approvals have been obtained.
- The entity is contingently obligated to issue the award.
- The grantee is affected by subsequent changes in the share price.

Measurement date of awards granted to customers as part of an MSA

Entity S signs a master supply agreement (MSA) with a customer on January 1, 20X1 to provide widgets over a four-year period in exchange for consideration. As part of the agreement, Entity S also incentivizes the customer by providing 10 share-based payment awards to the customer for each widget purchased. The price per widget is specified in the MSA. The customer executes purchase orders on June 30, 20X1, January 1, 20X2, and June 30, 20X3.

Because there is not a minimum purchase guarantee, legally enforceable rights and obligations do not exist in accordance with ASC 606 until the individual purchase orders are executed. However, the grant date for initially classifying and measuring the share-based payment awards is the date when both parties sign the MSA (January 1, 20X1), because that is the date when the parties establish a mutual understanding of the key terms and conditions of the arrangement, resulting in a single measurement date for the share-based payment awards, as described in BC14 of ASU 2019-08.

Subsequent measurement

The fair value of consideration payable to a customer in the form of a share-based payment award may vary after contract inception due to the form of the consideration, according to the guidance in ASC 606-10-32-25A. This guidance specifies that subsequent changes in the measurement of an award due to the form of the consideration should not be included in the transaction price (for example, if an entity is required to remeasure liability-classified awards throughout the life of the award until settlement).

In contrast, sometimes the number of awards is variable because of a service or performance condition. As circumstances change, the subsequent changes in measurement that are not due to the form of the consideration should be reflected in the transaction price (for example, varying numbers of shares depending upon which EBITDA target an entity achieves within a five-year period). As circumstances change, the entity should update its estimate of the number of shares that it will be required to issue to the customer and should reflect the associated changes in the transaction price.

ASC 606-10-32-25A (excerpt)

… Changes in the measurement of the equity instrument (through the application of Topic 718) after the grant date that are due to the form of the consideration shall not be included in the transaction price. Any changes due to the form of the consideration shall be reflected elsewhere in the grantor's income statement. See paragraphs 606-10-55-88A through 55-88B for implementation guidance on equity instruments granted as consideration payable to a customer.

ASC 606-10-55-88A

Paragraph 606-10-32-25A requires that equity instruments granted in conjunction with an entity selling goods or services be measured and classified under Topic 718 on stock compensation. If the number of equity instruments promised in a contract is variable due to a service condition or a performance condition that affects the vesting of an award, an entity should estimate the number of equity instruments that it will be obligated to issue to its customer and update the estimate of the number of equity instruments until the award ultimately vests in accordance with Topic 718. When measuring each instrument, the entity should include, in accordance with Topic 718, the effect of any market conditions and service or performance conditions that affect factors other than vesting. Examples of

factors other than vesting are included in paragraph 718-10-30-15. Changes in the grant-date fair value of an award due to revisions in the expected outcome of a service condition or a performance condition (both those that affect vesting and those that affect factors other than vesting) are not deemed to be changes due to the form of the consideration (as described in paragraph 606-10-32-23) and, therefore, should be reflected in the transaction price.

ASC 606-10-55-88B

Paragraph 606-10-32-25A requires that equity instruments granted by an entity in conjunction with selling goods or services be measured and classified under Topic 718 at the grant date of the instrument. When an estimate of the fair value of an equity instrument is required before the grant date in accordance with the guidance on variable consideration in paragraph 606-10-32-7, the estimate should be based on the fair value of the award at the reporting dates that occur before the grant date. An entity should change the transaction price for the cumulative effect of measuring the fair value at each reporting period after the initial estimate until the grant date occurs. In the period in which the grant date occurs, the entity should change the transaction price for the cumulative effect of measuring the fair value at the grant date rather than the fair value previously used at any prior reporting date.

5.5 Changes in the transaction price

Facts and circumstances can change throughout the contract period that require an entity to update the transaction price. For example, an event gives rise to variable consideration and the related uncertainty is resolved during the contract period. An entity must update the transaction price when these circumstances arise throughout the contract period.

ASC 606-10-32-42

After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

An entity must distinguish a change in the transaction price from a change that arises because of a modification to the contract. Changes that arise because of a modification are addressed in Section 10. However, an entity would apply the guidance in this section to changes in the transaction price that occur after a contract modification, as prescribed below.

ASC 606-10-32-45

An entity shall account for a change in the transaction price that arises as a result of a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. However, for a change in the transaction price that occurs after a contract modification, an entity shall apply paragraphs 606-10-32-42 through 32-44 to allocate the change in the transaction price in whichever of the following ways is applicable:

a. An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 606-10-25-13(a).

b. In all other cases in which the modification was not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

5.6 Sales and other similar taxes

The transaction price excludes amounts collected from the customer on behalf of third parties. In addition, an entity may elect to exclude all sales and other similar taxes from the transaction price as long as it discloses its accounting policy election to do so. In this case, the entity would not be required to evaluate sales and other similar tax laws on a jurisdiction-by-jurisdiction basis to determine whether the entity is acting as a principal or agent for purposes of determining the appropriate amount to include in the transaction price.

ASC 606-10-32-2A

An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process shall be excluded from the scope of the election. An entity that makes this election shall exclude from the transaction price all taxes in the scope of the election and shall comply with the applicable accounting policy guidance, including the disclosure requirements in paragraphs 235-10-50-1 through 50-6.

If an entity does not make a policy election to present qualifying taxes on a net basis, it must apply the principal versus agent guidance on a jurisdiction-by-jurisdiction basis to determine whether amounts collected from customers for those taxes should be included in the transaction price. See Section 9 for principal versus agent considerations.

6. Allocate the transaction price to the performance obligations

The goal when allocating the transaction price is to allocate an amount that best represents consideration that the entity expects to receive for transferring each promised good or service to the customer. Generally, the best way to accomplish this goal is to allocate the contract's transaction price to each of the performance obligations identified in Step 2 on a relative stand-alone selling price basis. The Boards decided that in most cases, an allocation based on stand-alone selling prices faithfully depicts the different margins that may apply to promised goods or services.[54]

There are two exceptions to the general allocation guidance: allocating discounts (see Section 6.4) and allocating variable consideration (see Section 6.5). Under these exceptions, an entity allocates a disproportionate amount of the transaction price to specific performance obligations based on evidence that suggests the discount or variable consideration relates to those specific performance obligations.

Grant Thornton insight: Allocating a discount and/or variable consideration to one or more, but not all, performance obligations

It is important to note that the Boards decided that allocating the transaction price on a relative stand-alone selling price basis enhances comparability both within an entity and across different entities and that the relative stand-alone selling price basis should be the "default" method for allocating the transaction price.[55] That said, the Boards acknowledged that in certain cases, there may be evidence that suggests that the discount or the variable consideration should be allocated entirely to one or more performance obligations in the contract rather than across all performance obligations. For that reason, ASC 606 includes specific guidance for allocating discounts and variable consideration when certain conditions are met.

ASC 606-10-32-28

The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

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[54] BC266, ASU 2014-09.
[55] BC280, ASU 2014-09.

ASC 606-10-32-29

To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).

The guidance in Step 4 applies only when an entity has identified more than one performance obligation in a contract. However, the guidance may also apply if an entity has identified a series of distinct goods or services as a single performance obligation in accordance with the "series guidance" in ASC 606-10-25-14(b).

ASC 606-10-32-30

Paragraphs 606-10-32-31 through 32-41 do not apply if a contract has only one performance obligation. However, paragraphs 606-10-32-39 through 32-41 may apply if an entity promises to transfer a series of distinct goods or services identified as a single performance obligation in accordance with paragraph 606-10-25-14(b) and the promised consideration includes variable amounts.

6.1 Determining stand-alone selling price

Stand-alone selling price: The price at which an entity would sell a promised good or service separately to a customer.

An entity determines the stand-alone selling price of the goods or services underlying each performance obligation at contract inception. ASC 606 defines the "stand-alone selling price" as the price at which an entity would sell a promised good or service separately to a customer.

In determining the stand-alone selling price, an entity is required to maximize the use of observable inputs. In other words, the best evidence of the stand-alone selling price, if available, is the observable price charged by the entity to similar customers in similar circumstances.

ASC 606-10-32-31

To allocate the transaction price to each performance obligation on a relative standalone selling price basis, an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those standalone selling prices.

ASC 606-10-32-32

The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service.

Entities frequently sell together a combination of goods and services, which are marketed as a bundle. The bundle may consist of multiple performance obligations, discussed further in Chapter 4. The stand-alone selling price should be determined for each performance obligation, regardless of whether the goods and/or services are always bundled and sold together.

Price changes in a contract and evaluation of stand-alone selling price

Scenario A

Entity A and Customer B have an existing contract for the sale of equipment for $100 per unit over two years. At the beginning of Year 2, the parties modify the pricing of the equipment in the contract to $90 per unit. The cost reduction is related to decreased supply costs and general efficiencies, causing sales prices to decrease across the board for all of Entity A's customers. As a result, Entity A may use this pricing data as an input in determining the stand-alone selling price of the equipment when evaluating future contracts.

Scenario B

Assume the same facts as above, but the cost reduction in this scenario is due to negotiations to maintain a relationship only with Customer B. Entity A's other customers have not received similar price decreases. As a result, Entity A may determine that this pricing data should not be used as an input in determining the stand-alone selling price in future contracts.

Grant Thornton insight: Bundled sales and stand-alone selling price

When an entity always sells two products or two services together, a common misconception is that the sale of the bundle is evidence of an observable stand-alone selling price of the individual products or services. However, to constitute "an observable sale price" under ASC 606-10-32-32, an entity must sell the good or service *by itself,* on a stand-alone basis. For example, say that Entity A always sells Product A and Product B as a bundle for $120, with a contract price of $20 for Product A and $100 for Product B. Because Entity A does not sell Product A or Product B on a stand-alone basis, it does not have observable stand-alone sales data. As a result, it must use one of the allowable methods in ASC 606, such as the adjusted market assessment, cost-plus-a-margin, or residual approach, to estimate the stand-alone selling price of each product. Entity A uses a cost-plus-a-margin approach given its facts and circumstances and determines that the estimated stand-alone selling price for both Products A and B is $60 each. If Product A is delivered in a different reporting period than Product B, there may

be a significant impact on revenue recognition if Entity A inappropriately concludes that the bundled price constitutes stand-alone selling prices ($20 for Product A and $100 for Product B).

If the stand-alone selling price is not observable because, for example, the entity does not sell the good or service separately, an entity should estimate the stand-alone selling price using all information that is reasonably available to the entity, maximizing the use of observable inputs.

ASC 606-10-32-33

If a standalone selling price is not directly observable, an entity shall estimate the standalone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 606-10-32-28. When estimating a standalone selling price, an entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances.

"All information that is reasonably available to the entity" may include,[56] but is not limited to, the following items:

- Reasonably available data points such as a stand-alone selling price of the good or service, costs incurred to manufacture or provide the good or service, related profit margins, published price listings, third-party or industry pricing, and the pricing of other goods or services in the same contract
- Market conditions such as supply and demand for the good or service in the market, competition, restrictions, and trends
- Entity-specific factors such as business pricing strategy and practices
- Information about the customer or class of customer such as type of customer, geographical region, and distribution channel

Evaluating the evidence related to estimating a stand-alone selling price may require significant judgment.

An entity should establish policies and procedures for estimating stand-alone selling price and apply those policies and procedures consistently to similar performance obligations. As a best practice, an entity should document its evaluation of the market conditions and entity-specific factors considered in estimating each stand-alone selling price, including factors that it considers to be irrelevant and the reasons why.

[56] BC269, ASU 2014-09.

Grant Thornton insight: Determining stand-alone selling price when standard price lists are not supported by stand-alone sales

We believe that entities should consider factors beyond the standard price lists when determining the stand-alone selling price of a good or service.

Some market conditions to consider might include:

- Overall economic conditions and trends
- Customer awareness and demand for the good or service
- Impact of competition for the good or service, including competitor pricing
- Pricing caps in the market
- Profit margins realized by entities in the industry
- Impact of product customization
- Impact of geographic location
- Expected technological life of the product and impact of expected industry advancements

Some entity-specific factors might include

- Impact of geographic factors
- The entity's pricing practices for the same goods or services, including such discounts as
  - Volume discounts
  - Price reductions to gain market share
  - Lower inventory levels due to obsolescence or an improved model

The Boards decided[57] not to preclude or prescribe any particular method for estimating stand-alone selling price, as long as the method results in an estimate that provides a faithful representation of the price at which the entity would separately sell the good or service to a customer. While ASC 606 does not prescribe an estimation method, it does indicate that the following methods are acceptable for estimating the stand-alone selling price when the selling price is not directly observable:

- Adjusted market assessment approach
- Expected cost-plus-a-margin approach
- Residual approach

[57] BC268, ASU 2014-09.

ASC 606-10-32-34

Suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:

a. Adjusted market assessment approach—An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

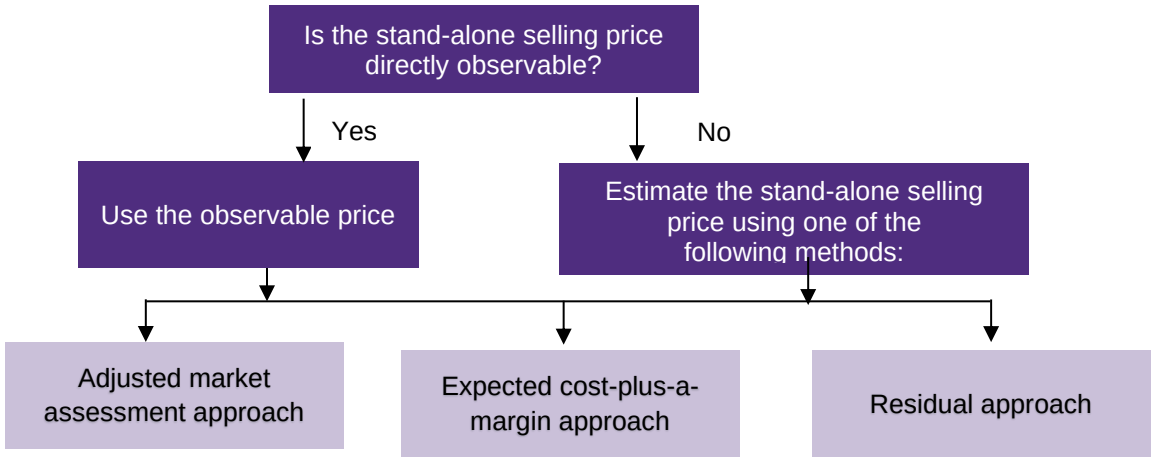
b. Expected cost plus a margin approach—An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

c. Residual approach—An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met.

    1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).

    2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

Figure 6.1: Determining stand-alone selling price



6.1.1 Adjusted market assessment approach

Under the adjusted market assessment approach, an entity evaluates the market in which it sells the goods or services and estimates the price that customers in that market would pay for those goods or services when sold separately. An entity could also look to competitor pricing information for similar goods or services and adjust that information to reflect its own costs and margins. In other words, if an entity's product differs from the competitor's product, those differences might indicate that the entity would not sell its product for the same price as its competitor.

6.1.2 Expected cost-plus-a-margin approach

Under the expected cost-plus-a-margin approach, an entity forecasts its expected costs to provide the good or service and adds an appropriate margin. When determining which costs to include in the selling price analysis, an entity should develop and consistently apply a methodology that considers direct and indirect costs, as well as other relevant costs considered in its normal pricing practices, such as research and development costs. Determining the margin to use when applying a cost-plus-a-margin approach requires significant judgment, particularly when the entity is not planning to separately sell a product or service. Furthermore, using an expected cost-plus-margin approach may not be appropriate in many circumstances, such as when direct fulfillment costs are not easily identifiable or when costs are not a significant input in setting the price for the goods or services.

6.1.3 Residual approach

Under the residual approach, an entity estimates the stand-alone selling price of a performance obligation by subtracting the sum of the observable stand-alone selling prices for other goods and services promised under the contract from the total transaction price. This method is permitted only if either of the following conditions is met:

- *The selling price of the good or service is highly variable.* This means that the entity sells the same good or service to different customers, at or near the same time, for a broad range of amounts so that a representative stand-alone price is not discernible.
- *The selling price of the good or service is uncertain.* The entity has not yet established a price for the good or service and the good or service has not been sold on a stand-alone basis.

Grant Thornton insight: A performance obligation cannot have SASP of zero

In ASC 606, the residual approach may be used in limited circumstances to determine the stand-alone selling price of a distinct good or service. As a result, the distinct good or service cannot have a stand-alone selling price of zero because, by definition, a good or service that is distinct has value on a stand-alone basis. The Boards noted in BC273 of ASU 2014-09 that if no, or very little, consideration is allocated to a good or service or to a bundle of goods or services as a result of applying the residual approach, the entity should consider whether the estimate is appropriate.

Method of estimating stand-alone selling prices

Scenario 1

Entity A enters a contract with a customer to manufacture and install new, highly specialized equipment in a customer's facility. Entity A determines that there are two performance obligations in this contract—the equipment and the installation services. Entity A has not yet sold the equipment on a stand-alone basis, so there is no directly observable price. The selling price is uncertain due to the new, highly specialized nature of the equipment, although market research and product backlog indicate a strong demand for the equipment. The installation services have a directly observable price as Entity A regularly performs installation services separately for other products at consistent prices and believes that those installation services are similar to the installation services in this contract.

Entity A evaluated the facts and circumstances and determined that because there is sufficient cost information, an estimate of stand-alone selling price using the expected cost-plus a margin approach will maximize the use of observable inputs and is more appropriate than using the residual approach.

Scenario 2

Entity B, a software vendor, enters into a contract with a customer to license the rights to use its software product on a perpetual basis and to provide post-contract customer support (PCS), including when-and-if-available updates, for one year. Entity B concludes that there are two separate performance obligations in the contract—the software license and the PCS.

Entity B always bundles its software licenses with PCS and does not license its software on a stand-alone basis. However, there is a directly observable price for the PCS, as the services are regularly sold separately at consistent prices that are evidenced through annual renewals.

Entity B owns various software platforms, and the level of discount offered in the bundled arrangements varies significantly based on individual customer negotiations. As a result, Entity B determines that the selling prices of its software licenses are highly variable.

Entity B determines that it will estimate the stand-alone selling price of the software license using the residual method, because the prices offered to customers are highly variable based on individual customer relationships.

The following table presents examples of when it may or may not be appropriate to apply each of these methods to estimate the stand-alone selling price of a performance obligation.

Figure 6.2: When to apply select methods to estimate stand-alone selling price

Method	Description	May be appropriate	May not be appropriate
Adjusted market assessment approach	An entity looks to the relevant market to determine what the market will pay for the good or service.	The good or service is not new to the market and sufficient data supports the market demand.	The entity is selling a new product or service.
Expected cost-plus-a-margin approach	An entity looks to entity-specific factors, such as the cost basis of the good or service.	The entity has sufficient data supporting the direct costs of providing the good or service.	The entity does not have good data supporting the direct costs of providing the good or service.
Residual approach	An entity subtracts the sum of the observable stand-alone selling prices for other goods or services promised under the contract from the total transaction price, to arrive at an estimated selling price for the remaining performance obligation(s).	The entity determines a stand-alone selling price in contracts for IP and other intangible products or for two or more goods or services with highly variable or uncertain stand-alone selling prices if at least one of the other promised goods or services has an observable stand-alone selling price.	The entity has information that can be used for the adjusted market assessment or expected cost-plus-a-margin approach. The entity sells the good or service on a stand-alone basis but does not believe the price is representative of the stand-alone selling price.

6.1.4 Using a combination of approaches

An entity may need to use a combination of approaches to estimate the stand-alone selling prices when two or more of the goods or services in the contract have highly variable or uncertain stand-alone selling prices.

ASC 606-10-32-35

A combination of methods may need to be used to estimate the standalone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain standalone selling prices. For example, an entity may use a residual approach to estimate the aggregate standalone selling price for those promised goods or services with highly variable or

uncertain standalone selling prices and then use another method to estimate the standalone selling prices of the individual goods or services relative to that estimated aggregate standalone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the standalone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated standalone selling prices would be consistent with the allocation objective in paragraph 606-10-32-28 and the guidance on estimating standalone selling prices in paragraph 606-10-32-33.

In some circumstances, an entity might find it challenging to determine a stand-alone selling price using one of the three methods described in ASC 606-10-32-34. In those situations, it is important to consider the guidance in ASC 606-10-32-33, which states that an entity should maximize observable inputs and consider all reasonably available information when estimating the stand-alone selling price of goods or services.

Grant Thornton insight: Using a percentage of the license price as the stand-alone selling price for post-contract customer support

For certain contracts, it might be difficult to use one of the three methods described in ASC 606-10-32-34 to determine the stand-alone selling price for goods or services, for example, a contract granting a perpetual software license and maintenance services or post-contract customer support (PCS) when the software product is not sold on a stand-alone basis and the pricing of bundled arrangements varies among customers.

In those situations, we believe that a substantive renewal rate, expressed as a consistent percentage of the software license fee, could be helpful in determining the stand-alone selling price of both the software product and related, PCS, even if the dollar amounts of the initial license fees vary among customers for the same software product.

For example, an entity may sell a perpetual software license bundled with one year of PCS and also sell PCS renewals on a stand-alone basis. The entity may conclude that the practice of pricing and selling PCS as a percentage of the net fee for related software licenses indicates that it has established a value relationship between the software and the PCS, which supports the use of a set percentage of the original software license fee as the stand-alone selling price for the PCS.

The key is for a vendor to use a consistent percentage for the PCS renewal rate from contract to contract.

6.2 Allocating the transaction price to the performance obligations

Once an entity determines the transaction price in the arrangement, it allocates the transaction price to each performance obligation on a relative stand-alone selling price basis. This section illustrates how an entity allocates the transaction price based on the stand-alone selling prices, as determined in Section 6.1. As noted above, allocating the transaction price to the performance obligations on a stand-alone selling price basis is the “default” method in ASC 606.

Example 33 in ASC 606 demonstrates how an entity may allocate the transaction price to performance obligations in a contract based on the stand-alone selling price of each good or service. The Example also illustrates the allocation of a discount which is discussed in Section 6.4.

Example 33—Allocation Methodology

ASC 606-10-55-256

An entity enters into a contract with a customer to sell Products A, B, and C in exchange for $100. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately, and, therefore the standalone selling price is directly observable. The standalone selling prices of Products B and C are not directly observable.

ASC 606-10-55-257

Because the standalone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the standalone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, the entity maximizes the use of observable inputs (in accordance with paragraph 606-10-32-33). The entity estimates the standalone selling prices as follows:

Product	Standalone Selling Price	Method
Product A	$ 50	Directly observable (see paragraph 606-10-32-32)
Product B	25	Adjusted market assessment approach (see paragraph 606-10-32-34(a))
Product C	75	Expected cost plus a margin approach (see paragraph 606-10-32-34(b))
Total	$ 150	

ASC 606-10-55-258

The customer receives a discount for purchasing the bundle of goods because the sum of the standalone selling prices ($150) exceeds the promised consideration ($100). The entity considers whether it has observable evidence about the performance obligation to which the entire discount belongs (in accordance with paragraph 606-10-32-37) and concludes that it does not. Consequently, in accordance with paragraphs 606-10-32-31 and 606-10-32-36, the discount is allocated proportionately across Products A, B, and C. The discount, and therefore the transaction price, is allocated as follows:

Product	Allocated Transaction Price	
Product A	$ 33	($50 ÷ $150 × $100)
Product B	17	($25 ÷ $150 × $100)
Product C	50	($75 ÷ $150 × $100)

Total	$ 100

The following example illustrates the principle of estimating the stand-alone selling price of services in a consulting contract and then allocating the transaction price when there are no directly observable prices. In this example, the entity establishes stand-alone selling prices by referring to average realization from standard hourly rates to charged hourly rates.

Estimating stand-alone selling price: consulting services

On January 1, 20X0, Entity Z, a provider of consulting services, enters into a contract with a customer to provide the following services for total consideration of $725,000.

Service	Dates service will be provided	Contract price
A	During year 20X0	$150,000
B	During years 20X0 and 20X1	200,000
C	During year 20X1	75,000
D	During years 20X0 through 20X2	300,000
		$725,000

Payments of $300,000, $150,000, $150,000, and $125,000 are due and payable on January 1, 20X0, January 1, 20X1, January 1, 20X2, and June 30, 20X2, respectively. Entity Z concludes that each service is a separate performance obligation. Entity Z does not sell any of the services on a stand-alone basis and, therefore, does not have a directly observable price for each service, so it must estimate the stand-alone selling price for each performance obligation.

Entity Z determines pricing for its services based on an estimate of expected hours, using standard billing rates. Gross standard billing rates are set annually, based on Entity Z's annual budget. In setting the standard billing rates, Entity Z considers the overall economic conditions, customer demand, competition, and average cost incurred to deliver the services. Entity Z typically provides its customers with a discount from its standard billing rates, with the level of discount based on various factors, including headcount, the timing and type of work, geographic location, the number of services purchased, leverage in contract negotiations, and other general market forces. Although the entity occasionally receives 100 percent of its gross billing rates for services offered in certain arrangements, an analysis of historic data indicates an average realization of approximately 60 percent for services A and B, and 65 percent for services C and D.

Based on these facts and circumstances, Entity Z determines that average realization is an appropriate measure to use in estimating stand-alone selling prices. The budgeted hours and rates for each of the consulting projects are obtained from the project managers to determine the gross billable amounts. Entity Z then multiplies the gross billable amounts by the average realization for the type of service performed in estimating the stand-alone selling price. Total transaction price is allocated to the performance obligations on a relative stand-alone selling price basis.

The table below summarizes the results.

Service	Estimated hours	Blended hourly rate	Estimated billings at standard rates	Realization	Stand-alone selling price	Ratio	Arrangement consideration allocation
A	1,500	$200	$300,000	60%	$180,000	21%	$152,250
B	2,125	$200	425,000	60%	255,000	30%	217,500
C	500	$250	125,000	65%	81,250	10%	72,500
D	2,000	$250	500,000	65%	325,000	39%	282,750
			$1,350,000		$841,250	100%	$725,000

6.2.1 Allocating based on a range of estimated stand-alone selling prices

ASC 606 does not address using a range of estimated stand-alone selling prices. However, we believe that as long as the range maximizes the use of observable inputs, the use of such a range would not be inconsistent with the objective of Step 4—to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services. If an entity believes a range represents its estimate of stand-alone selling price, the range should be sufficiently narrow so that any price within the range represents a price that the entity would accept if the good or service were sold regularly on a stand-alone basis. It is not appropriate for an entity to establish a point estimate and then calculate stand-alone selling price as a narrow range of prices on either side of the point estimate. An entity might conclude that multiple data points, adjusted for market and entity-specific factors, provide valid pricing points that are within a narrow range of one another.

If the contract prices for the performance obligations are within the applicable range(s) established, then the contract prices are deemed to approximate the entity's estimated stand-alone selling price. If the arrangement contains performance obligations with contractually stated prices that are not within the range of estimated stand-alone selling prices, then the entity should not use the stated contract price as the estimated stand-alone selling price, and should instead allocate the transaction price using a price within the range, as illustrated in the following example.

Utilizing a range of estimated stand-alone selling prices

Entity A sells manufacturing equipment to customers in a variety of industries. Entity A enters into a contract to sell a conveyor system to a customer for total consideration of $1 million. The contract includes the following performance obligations and stated contract prices: conveyor – $875,000, installation – $117,000, and eight days of training – $8,000. Entity A estimates a narrow range of stand-alone selling prices for each of the performance obligations as follows:

Conveyor	$825,000 to $890,000
Installation	$100,000 to $125,000
Training	$975 to $1,000 per day

Because all of the stated contract prices fall within the stand-alone selling price ranges established by Entity A, the stated contract prices are used to allocate the transaction price to the performance obligations, and no further allocation is required.

Now assume the same facts, except that the stated contract prices for the performance obligations are conveyor – $865,000, installation – $90,000, and training – $9,000, for total consideration of $964,000.

Because the stated contract prices for the installation and training are outside the respective stand-alone selling price ranges, Entity A would allocate the transaction price on a relative stand-alone selling price basis. Entity A's policy in these situations is to use the endpoint of the range nearest the stated contract price as the estimated stand-alone selling price. As a result, Entity A allocates the transaction price as shown below.

	Stand-alone selling price	Ratio	Allocation
Conveyor	$865,000	88.9%	$857,000
Installation (low end of range)	100,000	10.3	99,075
Training (high end of range)	8,000	0.8	7,925
	$973,000	100.0%	$964,000

Grant Thornton insight: Selecting a policy when utilizing a range for stand-alone selling price

In the example above, the stated contract prices for the installation and training are outside the respective stand-alone selling price ranges established by Entity A. Entity A states that its policy is to use the endpoint of the range nearest the stated contract price as the estimated stand-alone selling price.

In our view, if an entity has a practice of utilizing a range of estimated stand-alone selling prices, it must clearly establish its policy for identifying a stand-alone selling price to use when a contract amounts fall outside that range. For example, the entity can use the endpoint of the range nearest the stated contract price as in Entity A's case above, the midpoint of the range, or another reasonable method. We believe that the entity should clearly state its policy and consistently apply that policy in each case it utilizes a range to estimate the stand-alone selling price for a good or service.

The wider the range, the less relevant that range is in estimating a stand-alone selling price. If a wider range exists, an entity may wish to consider whether its transactions should be stratified for purposes of developing an estimate of stand-alone selling price.

6.3 Estimating the stand-alone selling price of an option

If an entity determines that a customer option constitutes a material right and therefore should be recognized as a separate performance obligation (Section 4.4), then the entity must determine a stand-alone selling price for that option for purposes of allocating a portion of the transaction price to that performance obligation. If the stand-alone selling price is not directly observable, which is often the case for an option, it must be estimated. The estimate should reflect the discount the customer will obtain when exercising the option, adjusted for both any discount that the customer might receive without exercising and the likelihood of exercise.

ASC 606-10-55-44

Paragraph 606-10-32-29 requires an entity to allocate the transaction price to performance obligations on a relative standalone selling price basis. If the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity should estimate it. That estimate should reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

a. Any discount that the customer could receive without exercising the option

b. The likelihood that the option will be exercised.

Allocating stand-alone selling price to a renewal option

A golf course provides a holiday promotion to new members, granting them an option to renew their annual membership at a discount for up to two years. The golf course sells annual memberships for $5,000 per year, but new members are offered the option to renew their membership for $4,000 per year in years two and three.

Based on historical data, the course expects 20 people to join during the promotional period. After the initial membership year, it expects renewals to be 50 percent in year two and to decline by another 50 percent in year three.

The golf course concludes that the renewal option provides a material right to the customer and that there is no directly observable stand-alone selling price for the option.

To estimate the stand-alone selling price of the option, the entity performs the following analysis.

Performance obligation	Stand-alone selling price	Description/Calculation
One-year membership	$ 100,000	Expect 20 people to join during promotion at SASP of $5,000
Option for a $1,000 discount on renewal	15,000	Expect 20 people to join, with 50 percent of those people renewing each year (10 + 5) = 15 annual renewals × $1,000 discount per annual period
Total	$ 115,000	

Performance obligation	Stand-alone selling price	Calculation
Membership	$86,957	($100,000 ÷ 115,000) × $100,000
Renewal option	13,043	($15,000 ÷ 115,000) × $100,000
Total	$100,000	

As a result, the golf course allocates $86,957 to the initial membership and $13,043 to the renewal option.

End of year-two facts

Suppose that in year two, eight customers (40 percent of the new members) renew their membership, and the entity expects that four of those customers (50 percent) will renew for a third year. The entity would perform the following analysis.

Performance obligation	Allocated transaction price	Description/Calculation	
Membership	$41,565	Cash received: $4,000 (renewal price) × 8	$ 32,000
		Revenue recognized for options exercised: $869.50 ($13,043 ÷ 15 originally expected renewal years) × 8 (number of renewals)	6,956
		Revenue recognized for options no longer expected to be exercised: $869.50 × 3 (2 from year two + 1 from year three)	2,609
			$ 41,565
Renewal option	$3,478	Remaining balance in contract liability ($869.50 × 4) OR ($13,043 – 6,956 – 2,609)	$ 3,478

As a result, the golf course recognizes membership revenue of $41,565 over time throughout year two and retains a liability for the option of $3,478 to be recognized over year three or when the option to renew expires.

6.3.1 Practical alternative to estimating the stand-alone selling price of an option

ASC 606 provides a practical alternative that may be used when a customer has a material right under the terms in the original contract to acquire future goods and services that are similar to the original goods or services in the contract. This guidance generally applies to customer rights to renew a contract on pre-agreed terms. The practical alternative permits an entity to allocate the transaction price to the optional goods or services by referring to the goods or services expected to be provided and the corresponding expected consideration.

ASC 606-10-55-45

If a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, then an entity may, as a practical alternative to estimating the standalone selling price of the option, allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration. Typically, those types of options are for contract renewals.

Evaluating a renewal option using the practical alternative

Assume the same facts as in the previous example about the promotional golf course membership.

The golf course concludes that the discounted membership option provides a material right to the customer and that there is no directly observable stand-alone selling price for the option. The entity uses the practical alternative to estimate the stand-alone selling price of the option as shown in the following table for year one. A similar updated calculation will be made at the end of years one and two.

Description	Amount	Calculation
Total expected consideration	$ 160,000	(20 members × $5,000) + (10 members × $4,000) + (5 members × $4,000)
Allocated to each membership period	$ 4,571	$160,000 ÷ 35 membership periods (20 + 10 + 5)
Revenue in year one	$ 91,420	$4,571 × 20 membership periods
Liability for option to renew in year one	$ 8,580	$100,000 consideration received – $91,420 revenue recognized

Valuing an option when a nonrefundable fee gives rise to a material right

A software company hosts a software platform for its customer. The entity charges nonrefundable fees of $20,000 at contract inception for setup activities and an ongoing $1,000 monthly fee. The initial contract term is three years. The customer has the option to renew the contract for an additional three years for $1,000 per month without repaying the $20,000 setup fee. The entity expects the customer to exercise its renewal option.

The entity determines that its promise to host the software platform represents a series of distinct services (consisting of monthly time increments) in accordance with ASC 606-10-25-14(b) and is therefore a single performance obligation. The entity concludes that the $20,000 setup fee does not relate to the transfer of a promised good or service.

The entity next considers if the prepayment of the setup fee provides the customer with a material right in relation to the renewal option. In making this determination, the entity considers the following:

- The renewal price ($1,000 per month × 12 months × 3 years = $36,000) is much lower than the price a new customer would pay for the same service ($1,000 per month × 12 months × 3 years + $20,000 setup fee = $56,000).
- There are no similar service alternatives available to the customer (for example, the customer cannot obtain substantially equivalent services from another provider without paying an activation fee).
- The average customer life is six years (an indication that the setup fee incentivizes customers to continue service).

Because the customer does not have to pay the set-up fee again when it renews and the fee provides the customer with an incremental discount that it would not otherwise receive without entering into the initial contract, the entity concludes that the setup fee provides the customer with a material right related to the renewal option that is accounted for as a separate performance obligation.

The entity next estimates the stand-alone selling price of the option using the practical alternative.

Description	Amount	Calculation
Upfront fee	$ 20,000	
First three years of service fees	$ 36,000	$1,000 per month × 36 months
Second three years of service fees (renewal period)	$ $36,000	
Total	$ 92,000	
Total consideration per month	$ 1,278	$92,000 ÷ 72 months (six years)

Therefore, total consideration of $56,000 received for the first three years of service would be allocated as shown in the following table.

Performance obligation	Allocation		Calculation
Hosting service (initial contract term)	$	46,000	$1,278 per month × 36 months
Option	$	10,000	$56,000 received less amount allocated to initial contract term

During the first three years, the entity recognizes monthly revenue of $1,278 as it performs the hosting services and defers the $10,000 allocated to the option, since that amount is essentially a prepayment for services to be provided during the renewal period.

During the second three-year term of the contract (the renewal period), the entity recognizes $1,278 in revenue per month. That is, $36,000 that it receives from the customer ($1,000 per month × 36 months) plus the $10,000 related to the option ÷ 36 months.

Taking a step back, the entity concludes that the accounting reflects the nature of its promise to transfer a series of the same services over the entire six-year period. As a result, recognizing the same amount of revenue for each month of service is in line with the core principle of the revenue guidance.

6.4 Allocating a discount

This guidance in this section generally applies to a contract that contains three or more performance obligations. If the sum of the stand-alone selling price for the promised goods or services exceeds the contract's total consideration, the excess is a discount that is allocated to the performance obligations. Unless an entity has observable evidence that the entire discount relates to only one or more, but not all, performance obligations in the contract, the entity should allocate the discount proportionately to all performance obligations in the contract based on relative stand-alone selling prices.

ASC 606-10-32-36

A customer receives a discount for purchasing a bundle of goods or services if the sum of the standalone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract. Except when an entity has observable evidence in accordance with paragraph 606-10-32-37 that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract. The proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the transaction price to each performance obligation on the basis of the relative standalone selling prices of the underlying distinct goods or services.

The allocation methodology in Example 33 in ASC 606, illustrated above in Section 6.2, should be used when there is no observable evidence that the discount applies to less than all of the performance obligations included in the bundle of goods or services. However, an entity should allocate a discount to a

specific performance obligation (or obligations), but not all of the performance obligations, in the contract if all of the following criteria exist:

- The entity regularly sells each distinct good or service on a stand-alone basis.
- The entity regularly sells a bundle (or bundles) of some of the distinct goods or services at a discount.
- The bundle's discount is substantially the same as the discount in the contract and there is observable evidence of the performance obligations to which the discount belongs.

Under ASC 606, if an entity meets the above criteria for allocating the discount entirely to one or more performance obligations, it should allocate the discount before using a residual approach to estimate a stand-alone selling price for a good or service.

ASC 606-10-32-37

An entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.

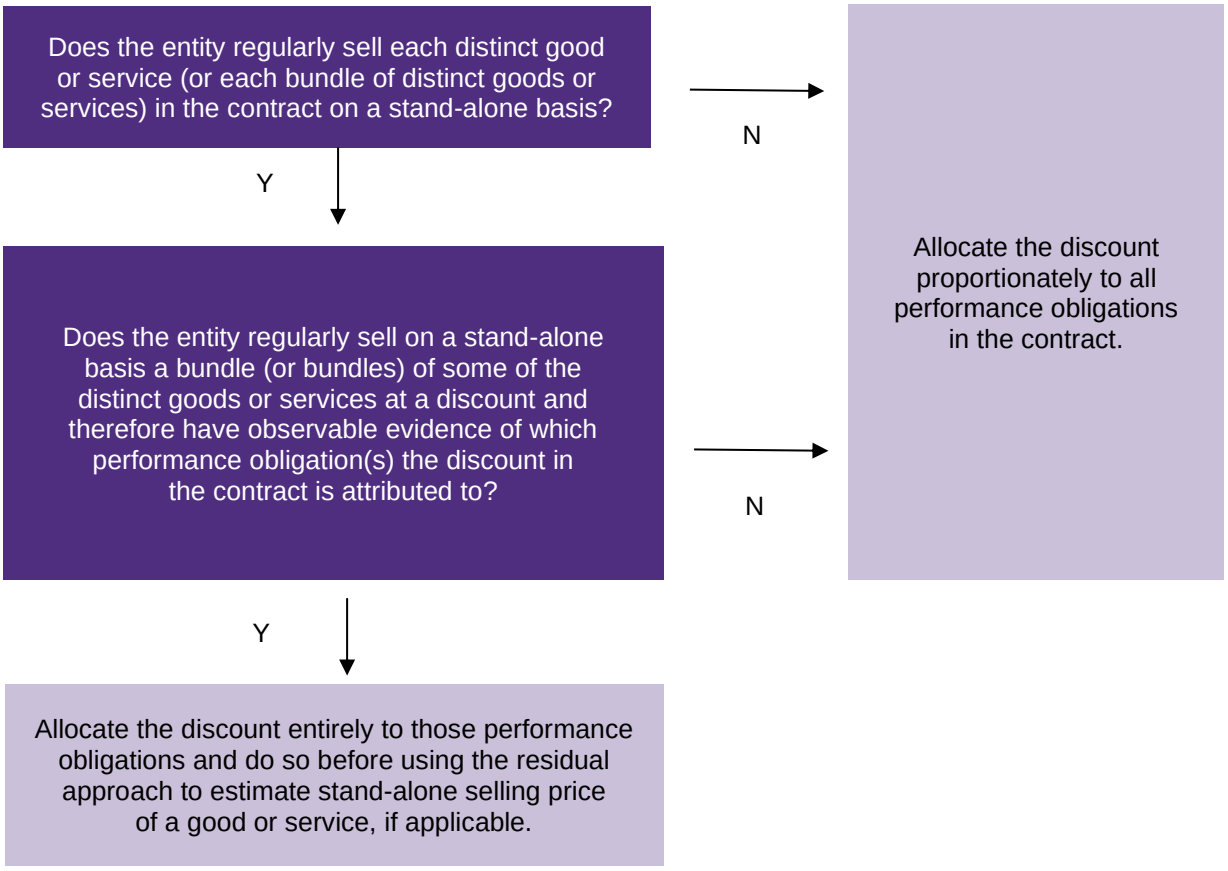
b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.

c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

ASC 606-10-32-38

If a discount is allocated entirely to one or more performance obligations in the contract in accordance with paragraph 606-10-32-37, an entity shall allocate the discount before using the residual approach to estimate the standalone selling price of a good or service in accordance with paragraph 606-10-32-34(c).

Figure 6.4: Allocating discounts



ASC 606 provides an example of the application of this guidance.

Example 34—Allocating a Discount

ASC 606-10-55-259

An entity regularly sells Products A, B, and C individually, thereby establishing the following standalone selling prices:

Product	Standalone Selling Price
Product A	$ 40
Product B	55
Product C	45
Total	$ 140

ASC 606-10-55-260

In addition, the entity regularly sells Products B and C together for $60.

Case A – Allocating a Discount to One or More Performance Obligations

ASC 606-10-55-261

The entity enters into a contract with a customer to sell Products A, B, and C in exchange for $100. The entity will satisfy the performance obligations for each of the products at different points in time.

ASC 606-10-55-262

The contract includes a discount of $40 on the overall transaction, which would be allocated proportionately to all 3 performance obligations when allocating the transaction price using the relative standalone selling price method (in accordance with paragraph 606-10-32-36). However, because the entity regularly sells Products B and C together for $60 and Product A for $40, it has evidence that the entire discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 606-10-32-37.

ASC 606-10-55-263

If the entity transfers control of Products B and C at the same point in time, then the entity could, as a practical matter, account for the transfer of those products as a single performance obligation. That is, the entity could allocate $60 of the transaction price to the single performance obligation and recognize revenue of $60 when Products B and C simultaneously transfer to the customer.

ASC 606-10-55-264

If the contract requires the entity to transfer control of Products B and C at different points in time, then the allocated amount of $60 is individually allocated to the promises to transfer Product B (standalone selling price of $55) and Product C (standalone selling price of $45) as follows:

Product	Allocated Transaction Price	
Product B	$ 33	($55 ÷ $100 total standalone selling price × $60)
Product C	27	($45 ÷ $100 total standalone selling price × $60)
Total	$ 60	

Case B – Residual Approach is Appropriate

ASC 606-10-55-265

The entity enters into a contract with a customer to sell Products A, B, and C as described in Case A. The contract also includes a promise to transfer Product D. The consideration in the contract is $130. The standalone selling price for Product D is highly variable (see paragraph 606-10-32-34(c)(1)) because the entity sells Product D to different customers for a broad range of amounts ($15 – $45). Consequently, the entity decides to estimate the standalone selling price of Product D using the residual

approach.

ASC 606-10-55-266

Before estimating the standalone selling price of Product D using the residual approach, the entity determines whether any discount should be allocated to the other performance obligations in the contract in accordance with paragraphs 606-10-32-37 and 32-38.

ASC 606-10-55-267

As in Case A, because the entity regularly sells Products B and C together for $60 and Product A for $40, it has observable evidence that $100 should be allocated to those 3 products and a $40 discount should be allocated to the promises to transfer Products B and C in accordance with paragraph 606-10-32-37. Using the residual approach, the entity estimates the standalone selling price of Product D to be $30 as follows:

Product	Standalone Selling Price	Method
Product A	$ 40	Directly observable (see paragraph 606-10-32-32)
Products B and C	60	Directly observable with discount (see paragraph 606-10-32-37)
Product D	30	Residual approach (see paragraph 606-10-32-34(c))
Total	$ 130	

ASC 606-10-55-268

The entity observes that the resulting $30 allocated to Product D is within the range of its observable selling prices ($15 – $45). Therefore, the resulting allocation (see above table) is consistent with the allocation objective in paragraph 606-10-32-28 and the guidance in paragraph 606-10-32-33.

Case C – Residual Approach is Inappropriate

ASC 606-10-55-269

The same facts as in Case B apply to Case C except the transaction price is $105 instead of $130. Consequently, the application of the residual approach would result in a standalone selling price of $5 for Product D ($105 transaction price less $100 allocated to Products A, B, and C). The entity concludes that $5 would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product D because $5 does not approximate the standalone selling price of Product D, which ranges from $15 – $45. Consequently, the entity reviews its observable data, including sales and margin reports, to estimate the standalone selling price of Product D using another suitable method. The entity allocates the transaction price of $105 to Products A, B, C, and D using the relative standalone selling prices of those products in accordance with paragraphs 606-10-32-28 through 32-35.

6.5 Allocating variable consideration

Variable consideration may be attributable to the entire contract or to only part of the contract, such as a specific performance obligation or a specific good or service in a series of distinct goods or services. For example, a contract may include two performance obligations: the construction of a building and the provision of services related to the ongoing maintenance of the property after construction. But a bonus for early completion may relate entirely to the construction of the building.

ASC 606-10-32-39

Variable consideration that is promised in a contract may be attributable to the entire contract or to a specific part of the contract, such as either of the following:

a. One or more, but not all, performance obligations in the contract (for example, a bonus may be contingent on an entity transferring a promised good or service within a specified period of time)

b. One or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) (for example, the consideration promised for the second year of a two-year cleaning service contract will increase on the basis of movements in a specified inflation index).

ASC 606 requires entities to allocate variable consideration entirely to a single performance obligation (or to a distinct good or service that forms part of a series that is a single performance obligation) if both

- The variable payment relates specifically to the entity's efforts toward satisfying that performance obligation or transferring the distinct good or service.
- The allocation to the performance obligation (or distinct good or service) is consistent with the general allocation principle.

When assessing whether the allocation is consistent with the general allocation principle, a relative stand-alone selling price allocation is not required; however, it may be useful in determining the reasonableness of the allocation (see the TRG discussion in Section 6.5.1).

ASC 606-10-32-40

An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) if both of the following criteria are met:

a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).

b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

ASC 606-10-32-41

The allocation requirements in paragraphs 606-10-32-28 through 32-38 shall be applied to allocate the remaining amount of the transaction price that does not meet the criteria in paragraph 606-10-32-40.

Example 35 in ASC 606 illustrates how and when to allocate variable consideration to one or more performance obligations in a contract.

Example 35 – Allocation of Variable Consideration

ASC 606-10-55-270

An entity enters into a contract with a customer for two intellectual property licenses (Licenses X and Y), which the entity determines to represent two performance obligations each satisfied at a point in time. The standalone selling prices of Licenses X and Y are $800 and $1,000, respectively.

Case A—Variable Consideration Allocated Entirely to One Performance Obligation

ASC 606-10-55-271

The price stated in the contract for License X is a fixed amount of $800, and for License Y the consideration is 3 percent of the customer's future sales of products that use License Y. For purposes of allocation, the entity estimates its sales-based royalties (that is, the variable consideration) to be $1,000, in accordance with paragraph 606-10-32-8.

ASC 606-10-55-272

To allocate the transaction price, the entity considers the criteria in paragraph 606-10-32-40 and concludes that the variable consideration (that is, the sales-based royalties) should be allocated entirely to License Y. The entity concludes that the criteria in paragraph 606-10-32-40 are met for the following reasons:

a. The variable payment relates specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y).

b. Allocating the expected royalty amounts of $1,000 entirely to License Y is consistent with the allocation objective in paragraph 606-10-32-28. This is because the entity's estimate of the amount of sales-based royalties ($1,000) approximates the standalone selling price of License Y and the fixed amount of $800 approximates the standalone selling price of License X. The entity allocates $800 to License X in accordance with paragraph 606-10-32-41. This is because, based on an assessment of the facts and circumstances relating to both licenses, allocating to License Y some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 606-10-32-28.

ASC 606-10-55-273

The entity transfers License Y at inception of the contract and transfers License X one month later. Upon the transfer of License Y, the entity does not recognize revenue because the consideration allocated to License Y is in the form of a sales-based royalty. Therefore, in accordance with paragraph

606-10-55-65, the entity recognizes revenue for the sales-based royalty when those subsequent sales occur.

ASC 606-10-55-274

When License X is transferred, the entity recognizes as revenue the $800 allocated to License X.

Case B—Variable Consideration Allocated on the Basis of Standalone Selling Prices

ASC 606-10-55-275

The price stated in the contract for License X is a fixed amount of $300, and for License Y the consideration is 5 percent of the customer's future sales of products that use License Y. The entity's estimate of the sales-based royalties (that is, the variable consideration) is $1,500 in accordance with paragraph 606-10-32-8.

ASC 606-10-55-276

To allocate the transaction price, the entity applies the criteria in paragraph 606-10-32-40 to determine whether to allocate the variable consideration (that is, the sales-based royalties) entirely to License Y. In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y), allocating the variable consideration entirely to License Y would be inconsistent with the principle for allocating the transaction price. Allocating $300 to License X and $1,500 to License Y does not reflect a reasonable allocation of the transaction price on the basis of the standalone selling prices of Licenses X and Y of $800 and $1,000, respectively. Consequently, the entity applies the general allocation requirements in paragraphs 606-10-32-31 through 32-35.

ASC 606-10-55-277

The entity allocates the transaction price of $300 to Licenses X and Y on the basis of relative standalone selling prices of $800 and $1,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative standalone selling price basis. However, in accordance with paragraph 606-10-55-65, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognize revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

ASC 606-10-55-278

License Y is transferred to the customer at the inception of the contract, and License X is transferred three months later. When License Y is transferred, the entity recognizes as revenue the $167 ($1,000 ÷ $1,800 × $300) allocated to License Y. When License X is transferred, the entity recognizes as revenue the $133 ($800 ÷ $1,800 × $300) allocated to License X.

ASC 606-10-55-279

In the first month, the royalty due from the customer's first month of sales is $200. Consequently, the entity recognizes as revenue the $111 ($1,000 ÷ $1,800 × $200) allocated to License Y (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognizes a contract liability for the $89 ($800 ÷ $1,800 × $200) allocated to License X. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

6.5.1 Allocating variable consideration to a series

The discussion in BC285 of ASU 2014-09 clarifies that when variable consideration is allocated entirely to a distinct good or service that forms part of a series, an entity is not required to estimate the total variable consideration because the uncertainty related to the consideration is resolved as each distinct good or service in the series is transferred to the customer. Instead, the entity allocates variable consideration (and subsequent changes in the amount) entirely to a distinct good or service that forms part of a series if both

- The terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service.
- Allocating the variable amount of consideration entirely to the distinct good or service is consistent with the allocation objective in ASC 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

An entity that meets the requirements to allocate variable consideration entirely to a distinct good or service that forms part of a series (see Section 4.3) should follow the guidance in ASC 606-10-32-40. In other words, the entity does not make a policy election in this situation because the guidance is not optional.

Example 25 in ASC 606 illustrates the guidance on allocating variable consideration to a distinct good or service that forms part of a series.

Example 25—Management Fees Subject to the Constraint

ASC 606-10-55-221

On January 1, 20X8, an entity enters into a contract with a client to provide asset management services for five years. The entity receives a 2 percent quarterly management fee based on the client's assets under management at the end of each quarter. In addition, the entity receives a performance-based incentive fee of 20 percent of the fund's return in excess of the return of an observable market index over the 5-year period. Consequently, both the management fee and the performance fee are variable consideration.

ASC 606-10-55-222

The entity accounts for the services as a single performance obligation in accordance with paragraph 606-10-25-14(b), because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

ASC 606-10-55-223

At contract inception, the entity considers the guidance in paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. The entity observes that the promised consideration is dependent on the market and, thus, is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in determining the future performance of the market. Therefore, at contract inception, the entity cannot conclude that it is

probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

ASC 606-10-55-224

At each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price at those dates. This is because there has not been a change in its assessment from contract inception—the variability of the fee based on the market index indicates that the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the incentive fee in the transaction price. At March 31, 20X8, the client's assets under management are $100 million. Therefore, the resulting quarterly management fee and the transaction price is $2 million.

ASC 606-10-55-225

At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter in accordance with paragraphs 606-10-32-39(b) and 606-10-32-40. This is because the fee relates specifically to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters, and the resulting allocation will be consistent with the allocation objective in paragraph 606-10-32-28. Consequently, the entity recognizes $2 million as revenue for the quarter ended March 31, 20X8.

Software as a service (SaaS) arrangements with fixed and variable fees

A SaaS provider enters into a contract with a customer to provide access to its hosted platform for a fixed fee of $12,000 for a one-year period. The customer is also charged a fee of $10 every time it prints a report from the platform. The entity concludes that there is no license transferred to the customer and that this is therefore a service arrangement.

The entity identifies the promises in the contract: monthly access to the hosted system. After evaluating the Step 2 criteria, the entity identifies one performance obligation: its service of providing continuous access to the software, which constitutes a series (each month of service is distinct).

In determining the transaction price, the entity considers that it is entitled to fixed consideration ($12,000 for the annual access to the platform) and to variable consideration based on the number of reports the customer prints using the platform. The entity allocates the variable consideration associated with printing the reports entirely to the monthly time increment (the distinct service that forms part of a single performance obligation) because doing so is consistent with the allocation objective in ASC 606-10-32-28. Therefore, the entity does not need to estimate the total variable consideration associated with the report printing.

The TRG discussed whether entities should allocate variable consideration to distinct goods or services in a series on a stand-alone selling price basis in order to meet the allocation objective in ASC 606-10-32-28 as required in ASC 606-10-32-40(b).

TRG area of general agreement: Is an entity required to allocate variable consideration to a distinct good or service in a series on a stand-alone selling price basis?

To allocate a variable amount entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation, both (1) the terms of the variable payment must relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service, and (2) allocating the variable amount entirely to the performance obligation or to the distinct good or service must be consistent with the overall allocation objective in Step 4. Stakeholders asked if variable consideration needs to be allocated to distinct goods or services in a series on a stand-alone selling price basis in order to meet the latter requirement.

At the July 2015 meeting,[58] TRG members generally agreed that an entity is not required to use stand-alone selling prices to allocate variable consideration, but that doing so is one acceptable method of providing evidence about the reasonableness of the allocation. Judgment is required in assessing whether the allocation objective is met when variable consideration is allocated entirely to a distinct good or service in a series.

Consider Example A in TRG Paper 39:

> *IT Seller and IT Buyer execute a 10-year IT outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term. The total monthly invoice amount is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power (MIPs), number of software applications used, or number of employees supported, and the price per unit differs for each type of activity.*
>
> *The price per unit charged by IT Seller declines over the life of the contract. The agreed-upon pricing at the onset of the contract is considered to reflect market pricing. The pricing decreases to reflect the associated costs decreasing over the term of the contract as the level of effort to complete the tasks decreases. Initially, the tasks are performed by more expensive personnel for activities that require more effort. Later in the contract, the level of effort for the activities decreases, and the tasks are performed by less expensive personnel. The contract includes a price benchmarking clause whereby IT Buyer engages a third-party benchmarking firm to compare the contract pricing to market rates at certain points in the contract term. There is an automatic prospective price adjustment if the benchmark is significantly below IT Seller's price.*
>
> *IT Seller concludes that there is a single performance obligation satisfied over time because the customer simultaneously receives and consumes the benefits provided by its services as IT Seller performs them.*

In this example, the events that trigger the variable consideration are the same throughout the contract, but the price per unit decreases each year. Even with the declining prices, the allocation objective can be met if the pricing is based on market terms or if the changes in price are substantive and linked to changes in the entity's cost to fulfill the obligation or value provided to the customer. In this example, the contract contains a price benchmarking clause whereby IT Buyer engages a third-party benchmarking firm to compare the contract pricing to current market rates, which may help support the

[58] TRG Paper 39, *Application of the Series Provision and Allocation of Variable Consideration.*

allocation objective is met when allocating the variable consideration to each distinct service (time increment) in the contract.

An entity should apply reasonable judgment and consider the facts and circumstances specific to a contract to determine whether the allocation of variable consideration results in a reasonable outcome.

6.6 Interaction between allocating discounts and allocating variable consideration

When a contract includes variable consideration, including a discount, an entity should first apply the guidance on allocating variable consideration before considering the guidance on allocating discounts.

TRG area of general agreement: What is the interaction between the guidance on allocating discounts and allocating variable consideration?

The criteria in ASC 606 for allocating discounts to one or more, but not all, performance obligations in a contract differ from the criteria for allocating variable consideration to one or more, but not all, performance obligations.

At the March 2015 meeting,[59] TRG members generally agreed that if a discount is variable, an entity should first determine whether the variable discount meets the variable consideration allocation guidance in ASC 606-10-32-39 and 32-40. If not, the entity would consider whether it meets the discount allocation criteria in ASC 606-10-32-36 through 32-38. If a discount is not variable, an entity would consider only whether it meets the discount allocation criteria.

6.7 Changes in transaction price

The transaction price can change for a number of reasons after contract inception, such as when contingencies or other events that give rise to variable consideration are resolved.

ASC 606-10-32-42

After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

When the transaction price changes, an entity should allocate the change to the performance obligations on the same basis used at contract inception, unless the contract has been modified, as discussed in Section10. In other words, an entity should not reallocate the transaction price to reflect changes in the stand-alone selling price of goods or services that occur after contract inception. If the reallocation process causes an entity to allocate amounts to satisfied performance obligations, those amounts should be recognized either as revenue or as a reduction in revenue in the period when the change occurs.

[59] TRG Paper 31, *Allocation of the Transaction Price for Discounts and Variable Consideration.*

ASC 606-10-32-43

An entity shall allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Consequently, an entity shall not reallocate the transaction price to reflect changes in standalone selling prices after contract inception. Amounts allocated to a satisfied performance obligation shall be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

Grant Thornton insight: Changes in stand-alone selling prices

When contracts are modified by changing the sales price, the impact of that modification may be considered when evaluating the stand-alone selling price of performance obligations in a contract. Entities should not revisit the stand-alone selling price for an existing contract that is modified, but may use the pricing as a data point for future contracts with customers.

As a reminder, stand-alone selling price and the impact on the allocation of the transaction price to the performance obligations should be evaluated on a contract-by-contract basis. We believe that an entity should evaluate whether the sales price in a modified contract with a customer reflects a true stand-alone sale.

When reallocating consideration because of a change in the transaction price, the entity continues to allocate the variable amount entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) if the criteria in ASC 606-10-32-40 continue to be met.

ASC 606-10-32-44

An entity shall allocate a change in the transaction price entirely to one or more, but not all, performance obligations or distinct goods or services promised in a series that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) only if the criteria in paragraph 606-10-32-40 on allocating variable consideration are met.

If the change in transaction price is the result of a contract modification, the entity should follow the contract modification guidance (Section 10).

However, when the transaction price changes after a modification, the entity should allocate the change in transaction price to the performance obligations identified before the modification if both

- The change in the transaction price is attributable to variable consideration promised prior to the modification.
- The modification is accounted for as a termination of the old contract and the creation of a new contract.

An entity allocates all other changes in the transaction price to performance obligations under the modified contract as long as the modification was not accounted for as a separate contract in accordance with ASC 606-10-25-12.

ASC 606-10-32-45

An entity shall account for a change in the transaction price that arises as a result of a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. However, for a change in the transaction price that occurs after a contract modification, an entity shall apply paragraphs 606-10-32-42 through 32-44 to allocate the change in the transaction price in whichever of the following ways is applicable:

a. An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 606-10-25-13(a)

b. In all other cases in which the modification was not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

Changes in the transaction price should be allocated entirely to one or more, but not all, distinct goods or services promised in a series that forms part of a single performance obligation if the criteria for allocating variable consideration are met in ASC 606-10-32-40.

Allocating a change in transaction price

On February 1, a consultant enters into an arrangement to provide due diligence, valuation, and software implementation services to a customer for $2 million. The consultant can earn a $200,000 bonus if it completes the software implementation by August 1 or a $100,000 bonus if it completes the software implementation by October 1.

The due diligence, valuation, and software implementation services are distinct and therefore are accounted for as separate performance obligations. The consultant allocates the transaction price, disregarding the potential bonus, on a relative stand-alone selling price basis as follows:

Due diligence	$ 800,000
Valuation	$ 200,000
Software implementation	$ 1,000,000

At contract inception, the consultant believes it will complete the software implementation by November 1. After considering the factors in ASC 606-10-32-12, the consultant cannot conclude that a significant reversal in the cumulative amount of revenue recognized would not occur when the uncertainty is resolved since the consultant lacks experience in completing similar projects. As a result, the consultant does not include the amount of the early completion bonus in its estimated transaction price at contract inception.

On May 1, the consultant notes that the project has progressed better than expected and believes that implementation will be completed by August 1 based on a revised forecast. As a result, the consultant updates its estimated transaction price to reflect a bonus of $200,000.

After reviewing its progress as of May 1, the consultant determines that it is 100 percent complete in satisfying its performance obligations for due diligence and valuation and 60 percent complete in satisfying its performance obligation for software implementation.

On May 1, the consultant allocates the bonus of $200,000 to the software implementation performance obligation, for total consideration of $1.2 million allocated to that performance obligation, and adjusts the cumulative revenue to date for the software implementation services to $720,000 (60 percent of $1.2 million).

6.8 Allocating a significant financing component

If a contract includes a significant financing component, its effect is excluded from the transaction price calculated in Step 3 of the revenue model because the effect of the financing (interest income or interest expense) is not in exchange for promised goods or services. When a revenue contract includes more than one performance obligation and a significant financing component, entities may question whether the significant financing component should be attributed to one or more, but not all, of the performance obligations, which the TRG discussed in 2015.

TRG area of general agreement: Could a significant financing component ever be attributed to one or more performance obligations but not all?

Under ASC 606, after an entity determines the transaction price, it allocates the transaction price to the performance obligations. Generally, the transaction price is allocated to the performance obligations on a relative stand-alone selling price basis, although if certain criteria are met, discounts or variable consideration may be allocated on a basis other than the relative stand-alone selling price. At the March 2015 meeting,[60] the TRG generally agreed that it would be reasonable for entities to analogize to the guidance on allocating variable consideration or a discount, and to attribute a significant financing component to one or more, but not all, of the performance obligations in a transaction. Doing so will require judgment, and an entity may consider factors similar to those used for allocating a discount or variable consideration in its evaluation.

[60] TRG Paper 30, *Significant Financing Components*.

Allocating a significant financing component

An entity enters into a contract with a customer for Product A and Product B. Product A has a stand-alone selling price of $1,000, and the entity transfers control of Product A to the customer at the start of year one of the contract. Product B has a stand-alone selling price of $200, and the entity transfers control of Product B to the customer at the start of year three of the contract. The customer pays $120 per year for 10 years for the two products, with payment being made at the end of each year. The entity determines that it provides a significant financing benefit to the customer by allowing it to pay for Products A and B over 10 years. The entity excludes the significant financing component from the transaction price calculated in Step 3 of the revenue model.

The entity considers the following facts in determining whether it should allocate the significant financing component to both Product A and Product B:

- Because of Product A's high price point, the entity regularly sells Product A on a stand-along basis with no payments required for 24 months and annual payments only thereafter. When product B is sold on a stand-alone basis, the entity has a practice of collecting payment in full at the time of delivery.
- The delivery and payment structure of the contract more closely aligns with the financing plan offered for Product A, since Product A is delivered at the outset of the contract and the majority of the total payment is due after 24 months. In addition, on a relative stand-alone selling price basis, Product A (83 percent = $1,000 / $1,200) is more significant than Product B (17 percent = $200 / $1,200).

The entity may conclude that the significant financing component should be attributed to only Product A; however, if it did not reach this conclusion, the entity generally would allocate the significant financing component to Product A and Product B on a pro-rata basis.

7. Recognize revenue when or as performance obligations are satisfied

Timing is everything when it comes to revenue recognition, which is why Step 5 of the new five-step revenue recognition model is so critical. Step 5 of the model is to recognize revenue when or as the entity transfers the promised goods or services in the contract. An entity “transfers” the promised goods or services when, or as, the customer obtains control of the goods or services. A customer “obtains control” of an asset when, or as, it can direct the use of, and obtain substantially all the remaining benefits from, an asset.

ASC 606-10-25-23

An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

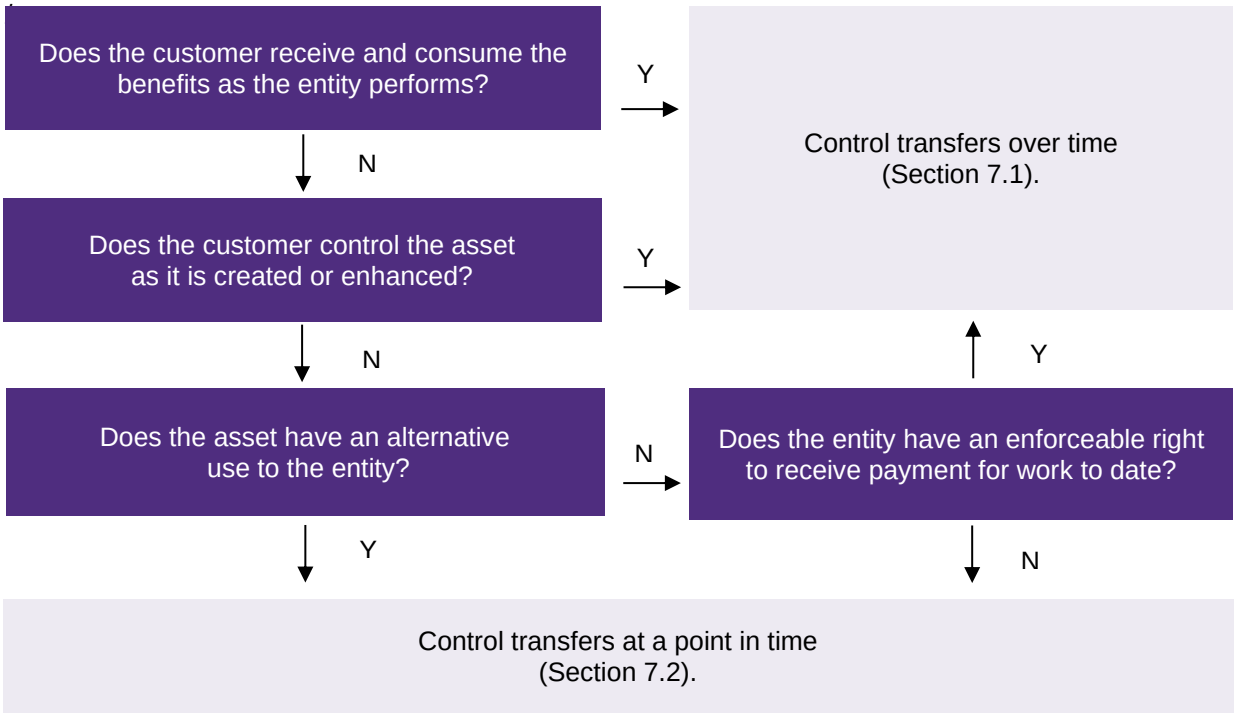
A key part of ASC 606 is the concept that for some performance obligations, control is transferred over time, while for other performance obligations, control transfers at a point in time. ASC 606 specifies a sequence that requires entities first to determine whether control transfers over time for each performance obligation in a contract. If control of a good or service does not transfer over time, control transfers at a point in time.

ASC 606-10-25-24

For each performance obligation identified in accordance with paragraphs 606-10-25-14 through 25-22, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 606-10-25-27 through 25-29) or satisfies the performance obligation at a point in time (in accordance with paragraph 606-10-25-30). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

Figure 7.1 illustrates the three criteria to determine whether control of a good or service transfers to the customer over time. If any one of the three criteria is met, an entity recognizes revenue for that good or service over time using the most appropriate measure of progress that best depicts the transfer of control of the good or service to the customer. If none of the three criteria are met, the entity recognizes revenue for the good or service at a point in time. The remainder of this section discusses in more detail each of the criteria that indicate control transfers over time and provides further insight on when control transfers (that is, at what point in time) when none of the three over-time criteria are met.

Figure 7.1: Recognizing revenue over time or at a point in time



The new control model and new criteria to recognize revenue over time will result in a change in the timing of revenue recognition for certain performance obligations. As such, all entities should take a fresh look at their contracts and performance obligations to determine whether any one of the three criteria to recognize revenue over time is met for each performance obligation. If not, the entity recognizes revenue at a point in time for the performance obligation.

Since ASC 606 is a control-based model rather than a risk-and-reward-based model, it is important to keep in mind the concept of control. “Control” in ASC 606 refers to the ability to direct the use of the asset and to obtain substantially all of the remaining benefits from the asset. The “benefits from the asset” are the potential cash flows that can be obtained either directly or indirectly from the asset, such as by:

- Using the asset to produce goods or provide services, to enhance the value of other assets, or to settle liabilities or reduce expenses
- Selling or exchanging the asset
- Pledging the asset to secure a loan
- Holding the asset

The concept of control in ASC 606 also includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

7.1 Control transferred over time

An entity determines at contract inception whether each separate performance obligation will be satisfied (that is, control will be transferred) over time or at a specific point in time.

Control is considered transferred over time if any one of following criteria is met:

- The customer simultaneously receives and consumes the benefits of the asset as the entity performs.
- The entity's performance creates or enhances an asset (for example, work in process) that the customer controls.
- The entity's performance creates or enhances an asset that has no alternative use to the entity, and the entity has the right to payment for work completed to date.

As illustrated in Figure 7.1, if the entity does not meet any of these three criteria, control transfers at a point in time.

ASC 606-10-25-27

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6).

b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7).

c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph 606-10-25-28), and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29).

Each of the conditions is explored in further detail below.

7.1.1 Criteria to recognize revenue over time

Customer receives and consumes benefits as the entity performs

The criterion that "the customer receives and consumes the benefits as the entity performs" applies to contracts in which the entity's performance is immediately consumed by the customer. For typical service contracts, the customer simultaneously receives and consumes the asset created by the entity (even if the asset only exists momentarily), which means that the customer obtains control of the entity's output as soon as the entity performs. As such, the entity's performance obligation is satisfied over time.

ASC 606-10-55-5

For some types of performance obligations, the assessment of whether a customer receives the benefits of an entity's performance as the entity performs and simultaneously consumes those benefits as they are received will be straightforward. Examples include routine or recurring services (such as a cleaning service) in which the receipt and simultaneous consumption by the customer of the benefits of the entity's performance can be readily identified.

A customer also simultaneously receives and consumes the benefits of the entity's performance if another entity could step in and fulfill the remaining performance obligation(s) for the customer without substantially re-performing the work that the entity has completed to date. When determining whether another entity would need to re-perform the work completed to date, an entity should

- Disregard potential contractual restrictions or practical limitations
- Assume that the other entity fulfilling the remaining performance obligation(s) would not have the benefit of any work in process

ASC 606-10-55-6

For other types of performance obligations, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs. In those circumstances, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially reperform the work that the entity has completed to date if that other entity were to fulfill the remaining performance obligation to the customer. In determining whether another entity would not need to substantially reperform the work the entity has completed to date, an entity should make both of the following assumptions:

a. Disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity

b. Presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

The reason that the entity disregards contractual restrictions and practical limitations is because the objective is to determine whether control of the goods or services has transferred to the customer. This objective is accomplished by using a hypothetical assessment of what another entity would need to do if it assumed the remaining performance obligation.

Does the customer receive and consume the benefits as the entity performs?

Scenario 1

A trucking company contracts with a customer to transport goods from Los Angeles to Boston. It identifies one performance obligation, that is, to provide shipping services for its customer. In evaluating whether the performance obligation meets one of the three criteria to recognize revenue over time, the trucking company first considers whether the customer receives and consumes the benefits of the shipping services as the company performs.

Because another entity would not need to substantially re-perform the work that the entity has completed to date if the goods were delivered only partway (say, from Los Angeles to Chicago), the trucking company concludes that the customer receives a benefit from the entity's services as they are provided.

As a result, the trucking company recognizes revenue over time.

Scenario 2

A consulting firm contracts with a manufacturer to provide business process improvement services. As part of the engagement, the consulting firm will spend significant time with personnel in each of the customer's three major business lines and ultimately provide recommendations on how the manufacturer can streamline operations, gain efficiencies, and cut costs. The consulting firm determines that its performance obligation is to provide a report at the end of its engagement, which will summarize the firm's suggested improvements. The consulting firm will not provide interim recommendations because it believes that it can make the appropriate recommendations only after studying all three business lines. The consulting firm considers whether the customer receives and consumes the benefits as it performs.

The consulting firm determines that the manufacturer does not obtain control of its consulting services as it performs. It then considers whether another entity would need to substantially re-perform the work that it has completed to date if the other entity were to step in and fulfill the remaining performance obligation for the customer partway through the contract. Because another entity fulfilling the remaining performance obligation would lack the benefit of the research, interviews, and other work in process controlled by the consulting firm, the firm concludes that another entity would need to substantially re-perform the work completed to date. As a result, the customer does not receive and consume the benefits as the firm performs.

The consulting firm next assesses whether its performance creates an asset with an alternative use to the entity and, if so, whether it has an enforceable right to payment for performance completed to date.

Example 13—Customer Simultaneously Receives and Consumes the Benefits

ASC 606-10-55-159

An entity enters into a contract to provide monthly payroll processing services to a customer for one year.

ASC 606-10-55-160

The promised payroll processing services are accounted for as a single performance obligation in accordance with paragraph 606-10-25-14(b). The performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed. The fact that another entity would not need to reperform payroll processing services for the service that the entity has provided to date also demonstrates that the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs. (The entity disregards any practical limitations on transferring the remaining performance obligation, including setup activities that would need to be undertaken by another entity.) The entity recognizes revenue over time by measuring its progress toward complete satisfaction of that performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

Customer controls the asset as it is created or enhanced

This criterion applies if an entity's performance creates or enhances an asset that the customer controls as the asset is being created. Because the customer controls the work in process, the customer obtains control as the entity performs, and therefore the entity recognizes revenue over time.

Contracts to which this criterion may apply include, but are not limited to, the following:

- Construction contracts and other contracts where an entity builds on the customer's land
- Contracts with a government whereby the government is entitled to any work in process

ASC 606-10-55-7

In determining whether a customer controls an asset as it is created or enhanced in accordance with paragraph 606-10-25-27(b), an entity should apply the guidance on control in paragraphs 606-10-25-23 through 25-26 and 606-10-25-30. The asset that is being created or enhanced (for example, a work in process asset) could be either tangible or intangible.

Does the customer control the asset as it is created or enhanced?

Scenario 1

A construction company contracts with a customer to build a home on the customer's land. Because the customer controls any work in process arising from the entity's performance, the entity determines that control transfers as it performs, and therefore it recognizes revenue over time.

Scenario 2

A defense contractor engages with the U.S. government to build a missile. The contract entitles the U.S. government to any work in process if the defense contractor stops performing for any reason. As a result, the contractor determines that control transfers as it performs, and it recognizes revenue over time.

Asset with no alternative use and right to receive payment for work to date

The last of the three criteria that indicate that control of a good or service transfers over time is met when both of the following conditions exist:

- The entity's performance does not create an asset with an alternative use.
- The entity has an enforceable right to payment for performance completed to date.

The Board developed this two-part criterion to help entities assess the transfer of control for services specific to a customer, such as consulting services that ultimately result in a professional opinion, and for the creation of certain tangible or intangible goods, such as customized goods or real estate with contractual restrictions.

The logic behind this two-part criterion is that if an entity creates an asset with no alternative use, it is effectively creating an asset at the customer's discretion and likely wants to be economically protected in the event the customer terminates the contract. When a customer is obligated to pay for performance completed to date, this suggests that the customer obtains the benefits as the entity performs and therefore, it is appropriate to recognize revenue over time.

ASC 606-10-25-28

An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation. Paragraphs 606-10-55-8 through 55-10 provide guidance for assessing whether an asset has an alternative use to an entity.

ASC 606-10-25-29

An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 606-10-25-27(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Paragraphs 606-10-55-11 through 55-15 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.

The following discussion takes a closer look at the third criterion's dual components ("no alternative use" and "enforceable right to payment for performance completed to date").

No alternative use

An entity evaluates whether a promised asset has an alternative use to the entity at contract inception only. It does not revisit this evaluation unless the contract is modified. Further, when considering whether the asset has an alternative use, the entity considers the characteristics of the asset that ultimately will be transferred to the customer, rather than the characteristics at any point during production (see the November 2016 TRG discussion below).

While the guidance in ASC 606-10-55-6 requires an entity to ignore contractual restrictions and practical limitations when considering whether the customer receives and consumes the benefits as the entity performs, the guidance in ASC 606-10-55-8 specifies that an entity should consider practical limitations and contractual restrictions in determining whether the asset could be redirected to another customer without incurring a significant cost to rework the asset—that is, the cost to repurpose or direct the asset to another customer. The Boards[61] decided that customization may be a helpful factor to consider, but

[61] BC137, ASU 2014-09.

should not be the determinative factor in assessing whether an asset has an alternative use. The Boards reasoned that in some cases, an asset may be standardized, but still may not have an alternative use because contractual restrictions preclude the entity from redirecting the asset (for example, a real estate contract in which the entity is contractually obligated to direct the asset to the customer).

Figure 7.2: Considering practical limitations and contractual restrictions

Over-time criterion	Consider practical limitations and contractual restrictions?
Customer simultaneously receives and consumes the benefits as the entity performs	No – ignore
The entity's performance does not create an asset with an alternative use	Yes – consider practical limitations and substantive contractual restrictions

A practical limitation exists if an entity would incur significant economic losses to direct the asset for another use. An asset that is highly customized for a particular customer does not likely have an alternative use because the entity would incur significant costs to reconfigure the asset for another customer or could only sell the asset at a significant loss. As long as the entity has an enforceable right to payment for performance completed to date, the customer essentially receives the benefits of the entity's performance and therefore obtains control of the goods or services as the entity performs. On the other hand, the customer generally cannot control a standard inventory item because it does not have the ability to restrict the entity from directing the asset to another customer. In the latter case, the entity has the ability to substitute inventory for different customers, and the asset is considered to have an alternative use.

If a substantive contract provision precludes an entity from directing an asset for another use during the creation or enhancement of the asset, the entity does not have an alternative use for that asset because it is legally obliged to transfer the specific asset to the customer. Contractual restrictions are common in real estate contracts because the customer specifies the specific plot of land or unit it wishes to purchase.

However, a contractual restriction that provides a protective right to the customer is not sufficient to conclude that the restriction is "substantive." A provision is not substantive if the entity can substitute a different asset to transfer to the customer and still comply with the contract. Such a provision may protect the customer in the event that the entity breaches the contract by not transferring the asset to the customer, but it does not indicate that the customer controls the asset as it is being produced.

ASC 606-10-55-8

In assessing whether an asset has an alternative use to an entity in accordance with paragraph 606-10-25-28, an entity should consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different customer. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use.

ASC 606-10-55-9

A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset not to have an alternative use to the entity. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. In contrast, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the entity could transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract.

ASC 606-10-55-10

A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss could arise because the entity either would incur significant costs to rework the asset or would only be able to sell the asset at a significant loss. For example, an entity may be practically limited from redirecting assets that either have design specifications that are unique to a customer or are located in remote areas.

As noted earlier, the TRG discussed whether an entity should consider the completed asset or the in-production asset when determining whether the asset has an alternative use. A summary of the discussion follows below.

TRG area of general agreement: Should an entity consider the completed or in-production asset in assessing whether the asset has no alternative use?

At the November 2016 meeting,[62] the TRG discussed the following example:

> *An entity enters into a contract with a customer to build equipment. The entity is in the business of building custom equipment for various customers. The customization of the equipment occurs when the manufacturing process is approximately 75 percent complete. In other words, for approximately 75 percent of the manufacturing process, the in-process asset could be redirected to fulfill another customer's equipment order, assuming that there is no contractual restriction to do so. However, the equipment cannot be sold in its completed state to another customer without incurring a significant economic loss. The design specifications of the*

[62] TRG Paper 56, *Over Time Revenue Recognition.*

equipment are unique to the customer, and the entity would only be able to sell the completed equipment at a significant loss.

The TRG reached general agreement that the entity would evaluate at contract inception whether there is any contractual restriction or practical limitation on its ability to readily direct the asset in its completed state for another use. The entity would not revisit this assessment unless there is a contract modification. Because the entity cannot sell the completed equipment to another customer without incurring a significant economic loss, the entity has a practical limitation on its ability to direct the equipment in its completed state, and, therefore, the asset does not have an alternative use. However, before concluding that revenue should be recognized over time, the entity must evaluate whether it has an enforceable right to payment.

The TRG also agreed that if the entity is contractually restricted or has a practical limitation on its ability to direct the asset for another use, then the asset would not have an alternative use, regardless of the characteristics of the ultimate asset.

Example 15 in ASC 606 illustrates how to apply the guidance on assessing whether an asset has an alternative use.

Example 15—Asset Has No Alternative Use to the Entity

ASC 606-10-55-165

An entity enters into a contract with a customer, a government agency, to build a specialized satellite. The entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differ substantially, on the basis of each customer's needs and the type of technology that is incorporated into the satellite.

ASC 606-10-55-166

At contract inception, the entity assesses whether its performance obligation to build the satellite is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.

ASC 606-10-55-167

As part of that assessment, the entity considers whether the satellite in its completed state will have an alternative use to the entity. Although the contract does not preclude the entity from directing the completed satellite to another customer, the entity would incur significant costs to rework the design and function of the satellite to direct that asset to another customer. Consequently, the asset has no alternative use to the entity (see paragraphs 606-10-25-27(c), 606-10-25-28, and 606-10-55-8 through 55-10) because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.

ASC 606-10-55-168

For the entity's performance obligation to be satisfied over time when building the satellite, paragraph 606-10-25-27(c) also requires the entity to have an enforceable right to payment for performance completed to date. This condition is not illustrated in this Example.

Grant Thornton insight: Factors to consider in evaluating 'no alternative use' criterion

To evaluate whether an asset has no alternative use, an entity should consider practical limitations and contractual restrictions to assess whether the asset can be redirected to another customer without incurring a significant cost to rework the asset.

Within certain industries, customers may negotiate a protective right that contractually restricts the entity from redirecting an asset to another customer for a specified period of time. In many cases, protective rights are not substantive, but an asset might have no alternative use if the specified time period is so long that it effectively precludes the entity from ever redirecting the asset. For example, the asset might have no alternative use if it has a limited shelf life or technology that becomes obsolete prior to the end of the specified time period.

In other situations, an entity may be able to redirect an asset to another customer, but the margin in the second transaction may not be as high as the margin with the original customer, such as when an asset is sold at auction or in liquidation. A practical limitation exists if the entity can only sell the asset at a significant loss. If the entity is expected to recover costs or to recover costs and earn a reduced margin, the asset has an alternative use.

Enforceable right to receive payment for performance completed to date

In order to determine whether an entity has an "enforceable right to receive payment for performance completed to date," the entity considers whether it would have an enforceable right to demand or retain payment for its performance completed to date if the contract were terminated before completion for reasons other than the entity's failure to perform.

The amount that would compensate an entity for its performance to date is an amount that approximates the selling price of the goods or services transferred to date (for example, costs plus a reasonable profit margin). A reasonable profit margin need not be the margin as if the contract were fully performed, but should entitle the entity to either

- A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance
- A reasonable return on the entity's cost of capital for similar contracts if the contract-specific margin is higher than the typical return for similar contracts

An amount that compensates an entity for lost profit is not sufficient for the entity to conclude that it has a right to payment for performance completed to date.

ASC 606-10-55-11

In accordance with paragraph 606-10-25-29, an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than

compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

a. A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)

b. A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

The guidance in ASC 606-10-55-11 specifies that a "reasonable profit margin" need not equal the expected profit margin at the outset of the contract; however, it also clarifies that the recovery of costs alone is not enough to satisfy this criterion. Ultimately, significant judgment may be required to determine whether a payment upon termination of a contract for reasons other than nonperformance satisfies the "right to payment for performance completed to date" criterion. BC144 in ASU 2014-09 clarifies that an entity should focus on the amount that it would be entitled to upon termination rather than on the amount that it might ultimately be willing to settle for after negotiations. Ultimately, an entity may need to consult with internal or external council to determine its rights if the contract terms are silent or unclear as to termination payments.

Right to recover costs

An entity enters into a contract with a customer to build a customized machine. The written terms of the contract are silent as to the rights and obligations of the parties if the contract is terminated before its successful completion for reasons other than the entity's failure to perform. The chief legal officer of the company maintains that the entity is entitled to recover its costs in such cases.

The contract does not meet the "right to payment for performance completed to date" condition, as defined in ASC 606-10-55-11, because the entity would not be entitled to an amount that compensates the entity at least for its performance completed to date. An amount that would compensate an entity for performance completed to date is an amount that approximates the selling price of the goods or services transferred to date (for example, cost plus a reasonable profit margin). Recovery of costs alone is not enough to meet this requirement.

Grant Thornton insight: Comparison of qualitative economic recovery thresholds in 'no alternative use' and 'enforceable right to payment' criteria

The economic threshold used to consider whether an asset has an alternative use differs from the threshold used to evaluate whether an entity has an enforceable right to payment for performance to date.

In evaluating whether an asset has an alternative use, a practical limitation exists if an entity would incur significant economic losses to redirect the asset for another use.

In evaluating whether an enforceable right to payment exists, the entity considers the amount of the payment within the context of the contract's selling price, irrespective of whether it would incur a loss if it was compensated for the performance completed to date. ASC 606-10-55-11 states that

> … an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated.

Accordingly, in assessing if it has an enforceable right to payment, an entity would need to determine whether the payment to which it is entitled if the customer terminates the contract would be an amount that approximates the selling price of the goods or services transferred to date. The logic underlying this guidance is that an entity who creates an asset with no alternative use would likely want to be economically protected if the customer terminates the contract.

Example 14 in ASC 606 illustrates how to apply the guidance on assessing whether the asset has an alternative use and whether there is a right to payment for performance completed to date.

Example 14—Assessing Alternative Use and Right to Payment (excerpt)

ASC 606-10-55-161

An entity enters into a contract with a customer to provide a consulting service that results in the entity providing a professional opinion to the customer. The professional opinion relates to facts and circumstances that are specific to the customer. If the customer were to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the customer to compensate the entity for its costs incurred plus a 15 percent margin. The 15 percent margin approximates the profit margin that the entity earns from similar contracts.

ASC 606-10-55-163

… [T]he entity's performance obligation meets the criterion in paragraph 606-10-25-27(c) and is a performance obligation satisfied over time because of both of the following factors:

a. In accordance with paragraphs 606-10-25-28 and 606-10-55-8 through 55-10, the development of the professional opinion does not create an asset with alternative use to the entity because the professional opinion relates to facts and circumstances that are specific to the customer. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.

b. In accordance with paragraphs 606-10-25-29 and 606-10-55-11 through 55-15, the entity has an enforceable right to payment for its performance completed to date for its costs plus a reasonable margin, which approximates the profit margin in other contracts.

ASC 606-10-55-164

Consequently, the entity recognizes revenue over time by measuring the progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

An entity does not need to have an unconditional right to payment at all times throughout the contract. Rather, the entity needs to have an enforceable right to demand payment for performance to date if the customer or another party terminates the contract before completion for a reason other than the entity's failure to perform.

ASC 606-10-55-12

An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed-upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity should consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.

Some contracts allow an entity to continue to perform even after a customer terminates the contract. If the contract or law allows the entity to continue to transfer the promised goods or services and requires the customer to pay for those goods or services, the entity would have an enforceable right to payment for performance completed to date.

ASC 606-10-55-13

In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

In assessing the existence and enforceability of a right to payment for performance completed to date, an entity may consider the contractual terms, relevant legislation, legal precedent, and its customary business practices.

An entity may also consider whether the local laws supplement or override any existing contractual terms. Similarly, an entity cannot ignore any evidence suggesting that contractual terms are deemed unenforceable based on legal precedent in the relevant jurisdiction.

Grant Thornton insight: Evaluation of enforceable right to payment when contract terms are silent

When a contract does not explicitly address whether an entity has an enforceable right to payment for its performance completed to date, entities may look to other factors, such as past practices, laws in the jurisdiction(s) where business is being conducted, and legal positions, among other things. In practice, it might be difficult for entities to prove or disprove the existence of an enforceable right to payment, particularly if an entity conducts business in multiple jurisdictions that could have different laws and different legal precedence.

Some constituents have taken the position that there is a presumption an enforceable right to payment does not exist if a written contract is silent about whether there is an enforceable right to payment when a customer cancels the contract. The FASB staff confirmed in a Private Company Council memo[63] that such an approach is reasonable.

An entity's history of not enforcing the right to payment could impact the determination of whether a contract meets the criteria in ASC 606-10-25-27(c). If an entity customarily waives its right to payment in the event of termination, the right may be legally unenforceable in a particular jurisdiction, and the contract would not meet the criterion in ASC 606-10-25-27(c). However, the right to payment for performance to date may still remain enforceable, despite the entity's practice of waiving its right.

ASC 606-10-55-14

In assessing the existence and enforceability of a right to payment for performance completed to date, an entity should consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:

a. Legislation, administrative practice, or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer.

b. Relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect.

c. An entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

An entity should not rely on a contractual payment schedule to support that it has an enforceable right to payment for performance completed to date; rather, as stated above, the entity should support its position using contract terms, company precedent, and legal precedent. Even if the cumulative payments

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[63] Private Company Council Memo No. 3, *Definition of an Accounting Contract and Short Cycle Manufacturing (Right to Payment)*.

throughout the contract are expected to correspond to the amount that would at least compensate the entity for its performance completed to date, the consideration may be refundable for reasons other than the entity failing to perform as promised. That said, if an entity receives nonrefundable payment of all of the contract consideration at contract inception, this would indicate that the entity has an enforceable right to payment for performance completed to date.

ASC 606-10-55-15

The payment schedule specified in a contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the payment schedule in a contract specifies the timing and amount of consideration that is payable by a customer, the payment schedule might not necessarily provide evidence of the entity's right to payment for performance completed to date. This is because, for example, the contract could specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract.

Example 16 in ASC 606 illustrates how a payment schedule may not correspond to an amount that would be necessary to compensate the entity for performance completed to date.

Example 16—Enforceable Right to Payment for Performance Completed to Date

ASC 606-10-55-169

An entity enters into a contract with a customer to build an item of equipment. The payment schedule in the contract specifies that the customer must make an advance payment at contract inception of 10 percent of the contract price, regular payments throughout the construction period (amounting to 50 percent of the contract price), and a final payment of 40 percent of the contract price after construction is completed and the equipment has passed the prescribed performance tests. The payments are nonrefundable unless the entity fails to perform as promised. If the customer terminates the contract, the entity is entitled only to retain any progress payments received from the customer. The entity has no further rights to compensation from the customer.

ASC 606-10-55-170

At contract inception, the entity assesses whether its performance obligation to build the equipment is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.

ASC 606-10-55-171

As part of that assessment, the entity considers whether it has an enforceable right to payment for performance completed to date in accordance with paragraphs 606-10-25-27(c), 606-10-25-29, and 606-10-55-11 through 55-15 if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. Even though the payments made by the customer are nonrefundable, the cumulative amount of those payments is not expected, at all times throughout the contract, to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date. This is because at various times during construction the cumulative amount of consideration paid by the customer might be less than the selling price of the partially

completed item of equipment at that time. Consequently, the entity does not have a right to payment for performance completed to date.

ASC 606-10-55-172

Because the entity does not have a right to payment for performance completed to date, the entity's performance obligation is not satisfied over time in accordance with paragraph 606-10-25-27(c). Accordingly, the entity does not need to assess whether the equipment would have an alternative use to the entity. The entity also concludes that it does not meet the criteria in paragraph 606-10-25-27(a) or (b), and, thus, the entity accounts for the construction of the equipment as a performance obligation satisfied at a point in time in accordance with paragraph 606-10-25-30.

The criterion in ASC 606-10-25-27(c) might apply to construction entities selling multi-unit business and residential real estate. Entities in this industry should pay particular attention to the local laws and legal precedent in their particular jurisdictions. Example 17 in ASC 606 illustrates how an entity developing multi-unit residential complexes determines if it has an enforceable right to payment for performance completed to date.

Example 17—Assessing Whether a Performance Obligation is Satisfied at a Point in Time or Over Time

ASC 606-10-55-173

An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

Case A—Entity Does Not Have an Enforceable Right to Payment for Performance Completed to Date

ASC 606-10-55-174

The customer pays a deposit upon entering into the contract, and the deposit is refundable only if the entity fails to complete construction of the unit in accordance with the contract. The remainder of the contract price is payable on completion of the contract when the customer obtains physical possession of the unit. If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.

ASC 606-10-55-175

At contract inception, the entity applies paragraph 606-10-25-27(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that it does not have an enforceable right to payment for performance completed to date because until construction of the unit is complete, the entity only has a right to the deposit paid by the customer. Because the entity does not have a right to payment for work completed to date, the entity's performance obligation is not a performance obligation satisfied over time in accordance with paragraph 606-10-25-27(c). Instead, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time in accordance with paragraph 606-10-25-30.

Case B—Entity Has an Enforceable Right to Payment for Performance Completed to Date

ASC 606-10-55-176

The customer pays a nonrefundable deposit upon entering into the contract and will make progress payments during construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

ASC 606-10-55-177

At contract inception, the entity applies paragraph 606-10-25-27(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that the asset (unit) created by the entity's performance does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.

ASC 606-10-55-178

The entity also has a right to payment for performance completed to date in accordance with paragraphs 606-10-25-29 and 606-10-55-11 through 55-15. This is because if the customer were to default on its obligations, the entity would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.

ASC 606-10-55-179

Therefore, the terms of the contract and the practices in the legal jurisdiction indicate that there is a right to payment for performance completed to date. Consequently, the criteria in paragraph 606-10-25-27(c) are met, and the entity has a performance obligation that it satisfies over time. To recognize revenue for that performance obligation satisfied over time, the entity measures its progress toward complete satisfaction of its performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

ASC 606-10-55-180

In the construction of a multi-unit residential complex, the entity may have many contracts with individual customers for the construction of individual units within the complex. The entity would account for each contract separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction works (that is, the foundation and the basic structure), as well as the construction of common areas, may need to be reflected when measuring its progress toward complete satisfaction of its performance obligations in each contract.

Case C—Entity has an enforceable right to payment for performance completed to date

ASC 606-10-55-181

The same facts as in Case B apply to Case C, except that in the event of a default by the customer, either the entity can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a

proportion of the contract price.

ASC 606-10-55-182

Notwithstanding that the entity could cancel the contract (in which case the customer's obligation to the entity would be limited to transferring control of the partially completed asset to the entity and paying the penalty prescribed), the entity has a right to payment for performance completed to date because the entity also could choose to enforce its rights to full payment under the contract. The fact that the entity may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment (see paragraph 606-10-55-13), provided that the entity's rights to require the customer to continue to perform as required under the contract (that is, pay the promised consideration) are enforceable.

ASC 606-10-25-29 requires that at "all times throughout the duration of the contract," the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform. In the context of customized goods, an entity that does not have an enforceable right to payment for performance completed to date prior to the point at which the entity begins customization (that is, performance for the customer) would not be precluded from meeting ASC 606-10-25-27(c).

ASC 606-10-25-29

An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 606-10-25-27(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Paragraphs 606-10-55-11 through 55-15 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.

Evaluating an enforceable right to payment

Scenario 1: Enforceable right to payment from contract inception

Based on an example included in TRG Paper 56 discussed at the November 2016 TRG meeting, an entity enters into a contract with a customer to build specialized equipment. The customization of the equipment begins when the manufacturing process is approximately 75 percent complete. In other words, for approximately 75 percent of the manufacturing process, the in-process asset could be redirected to fulfill another customer's equipment order, assuming that there is no contractual restriction prohibiting the entity from redirecting the asset. However, the entity cannot sell the equipment in its completed state to another customer without incurring a significant economic loss because the design specifications of the equipment are unique to the original customer. The entity has an enforceable right

to payment at contract inception.

At contract inception, the entity determines whether the asset in its completed state has an alternative use and whether it has an enforceable right to payment for its performance under the contract which begins at the point of customization.

Because the entity cannot sell the completed equipment to another customer without incurring a significant economic loss, the entity has a practical limitation on its ability to direct the equipment in its completed state. Therefore, the asset does not have an alternative use. Further, the entity concludes that it has an enforceable right to payment for performance completed to date and thus, it meets the over time revenue recognition criteria.

Scenario 2: Enforceable right to payment only at point of customization

Assume the same facts as in Scenario 1, except that the entity has an enforceable right to payment only when the customization begins.

Because the entity cannot sell the completed equipment to another customer without incurring a significant economic loss, the entity has a practical limitation on its ability to direct the equipment in its completed state. Therefore, the asset does not have an alternative use.

In this particular contract, since the entity has an enforceable right to payment beginning at the point of customization (approximately 75 percent of the way through production), it has an enforceable right to payment for performance completed to date since performance begins under the particular contract at the point of customization. As a result, the entity concludes that it meets the criteria to recognize revenue over time. It selects a measure of progress that best depicts the transfer of control to the customer.

Evaluating no alternative use and enforceable right to payment when customization process is brief

An entity manufactures pens for a hotel chain. Up until the point when the pens are stamped with the hotel chain's logo, which takes only seconds, the pens can be redirected to another customer. The entity is prohibited from giving the hotel chain's customized pens to other parties while the agreement is in place. The entity concludes that the end product—the customized pens—are an asset with no alternative use because the entity is not permitted to redirect the customized pens to another entity after customization.

If the hotel chain terminates the contract, it is required to pay for the pens imprinted with its logo. Further, the contract also indicates that if the hotel chain terminates the contract, any work in process (that is, unstamped pens set aside by the entity related to orders received from the hotel chain) will be completed, added to the other finished goods, and become part of the merchandise that the hotel chain must pay for as part of the agreement's termination.

Based on the terms of the contract, the entity has an enforceable right to payment for both the work in process and completed pens at the time the customer terminates the contract. As a result, the entity concludes that it meets the criteria to recognize revenue over time and selects a measure of progress that best depicts the transfer of control to the customer.

Enforceable right to payment in a loss contract

An entity may price a contract at a loss for various strategic reasons, for example, to attract a new customer. An entity may question whether a contract that is priced at a loss can have an enforceable right to payment for performance completed to date.

ASC 606-10-55-11 refers to “an amount that approximates the selling price of the goods or services transferred to date” and cites “cost plus a reasonable profit margin” as an example of an amount that represents the selling price for performance completed to date. While the selling price is typically based on cost plus a margin, the selling price will not have a margin if the contract is priced at cost or at a loss.

Although ASC 606 provides “cost plus a reasonable profit margin” as an example of an enforceable right to payment, that is because it is generally assumed that contracts are priced at a profit, and the FASB did not intend to preclude contracts priced at a loss from “over time” recognition.

Accordingly, the objective of the “right to payment” criterion[64] is to assess whether the customer is obligated to pay for performance to date. This analysis should focus on whether the entity has a right to a proportionate amount of the selling price reflecting its performance to date, rather than on whether this amount is greater or less than the entity’s costs to fulfill the contract. Therefore, if the customer is obligated to pay a proportionate amount of the contract price, this objective would be met.

ASC 606 does not include guidance on loss contracts. However, the FASB retained the guidance on loss contracts in ASC 606-35 for construction-type and production-type contracts within its scope, updating the content to reflect ASC 606 terminology. See the discussion of loss contracts at Section 11.5.1.

Enforceable right to payment in a loss contract

A government entity (the customer) requests bids for the design of a highly customized defense system. The customer expects to award subsequent contracts for tens of thousands of systems over the next 10 years to whomever wins the design contract. There are four contractors bidding for this contract. Contractor A knows that it must bid at a loss in order to win the design contract, but expects to recoup the value in expected orders over the next 10 years.

Contractor A wins the contract with a value of $100 million and estimated costs to complete of $110 million. The contract is noncancellable, but the contract terms stipulate that if the customer terminates the contract, Contractor A would be entitled to payment for work done to date. The payment amount upon cancellation would be equal to a proportional amount of the price of the contract based upon the performance of work to date. For example, at the termination date, if Contractor A completed 50 percent of its performance or incurred $55 million in costs (50 percent of total costs of $110 million), it would be entitled to a $50 million payment from the customer (50 percent of the $100 million contract price).

Contractor A concludes that its performance does not create an asset with an alternative use due to the highly customized design of the defense system. Contractor A then considers if it has an enforceable right to payment to determine whether revenue should be recognized over time or at a point in time.

Contractor A has a right to payment for performance completed to date since it is entitled to receive a proportionate amount of the contract price in the event the customer terminates the agreement. The principle for assessing right to payment is based on whether the entity has a right to an amount that

[64] BC142 - BC144, ASU 2014-09.

approximates the selling price; therefore, an entity does not need to earn a profit in order to meet this criterion. Accordingly, the loss contract may qualify for over-time recognition under 606-10-25-27(c).

This example does not address whether Contractor A would be required to record a loss accrual related to the contract. Contractor A would also need to evaluate whether the contract is within the scope of ASC 606-35 and whether a loss should be recognized at the inception of the contract.

7.1.2 Methods to measure progress

An entity recognizes revenue associated with a performance obligation that is satisfied over time by measuring its progress toward completion of that performance obligation. The guidance does not require or prescribe a particular method to measure progress toward completion, but does include a measurement objective: to align with the entity's performance in transferring control of the related goods or services in the contract. The selection of a method is not a free choice;[65] rather, an entity should select the method that best depicts its performance under the contract.

ASC 606-10-25-31

For each performance obligation satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity shall recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation).

ASC 606 discusses two categories of methods that are appropriate for measuring an entity's progress toward completion of a performance obligation: output methods and input methods. In determining the best method for measuring progress, an entity must consider the nature of the good or service that it promises to transfer to the customer.

Figure 7.3 provides descriptions, examples, and disadvantages associated with using input and output methods for measuring progress toward satisfying a performance obligation. The methods are addressed in more detail below.

[65] BC159, ASU 2014-09.

Figure 7.3: Acceptable methods of measuring progress

Method	Description	Examples	Disadvantages
Output method	Recognize revenue by directly measuring the value of the goods and services transferred to date to the customer relative to the remaining goods or services yet to be delivered or performed.	Surveys of performance completed to date, appraisals of results achieved, time elapsed, units produced, or units delivered	The outputs may not be directly observable, and the information required to apply an output method may not be readily available.
Input method	Recognize revenue based on the extent of efforts or inputs expended toward satisfying a performance obligation compared to the expected total efforts or inputs.	Resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used	There may not be a direct relationship between an entity's inputs and the transfer of control of the goods/services to the customer.

Items to exclude from the measure of progress

Regardless of the method selected, when measuring progress, an entity includes in the measure only goods or services that transfer to the customer. For example, when a health club signs up a member, it may perform necessary account setup or administrative activities, but those activities do not transfer a good or service to the customer. As a result, the health club would exclude the setup activities from its measure of progress.

ASC 606-10-25-34

When applying a method for measuring progress, an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.

Similarly, a contract may include a nonrefundable upfront fee to compensate an entity for costs incurred when setting up a contract. If the entity determines that those activities do not transfer control of a performance obligation, it should disregard the activities (and costs) when measuring its progress because the activities do not depict the transfer of services to the customer.

ASC 606-10-55-53

An entity may charge a nonrefundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks as described in paragraph 606-10-25-17). If those setup activities do not satisfy a performance obligation, the entity should disregard those activities (and related costs) when measuring progress in accordance with paragraph 606-10-55-21. That is because the costs of setup activities do not depict the transfer of services to the customer. The entity should assess whether costs incurred in setting up a contract have resulted in an asset that should be recognized in accordance with paragraph 340-40-25-5.

Output methods

Under an output method, an entity recognizes revenue by directly measuring the value of the goods and services transferred to date to the customer (for example, units delivered, time elapsed, or units produced). Although output methods might be the most faithful depiction of an entity's performance, there are challenges in applying output methods. For instance, outputs often are not readily observable, and the information required to use them may be costly to obtain.

ASC 606-10-55-17

Output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract. Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered. When an entity evaluates whether to apply an output method to measure its progress, the entity should consider whether the output selected would faithfully depict the entity's performance toward complete satisfaction of the performance obligation. An output method would not provide a faithful depiction of the entity's performance if the output selected would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in process or finished goods controlled by the customer that are not included in the measurement of the output.

ASC 606-10-55-19

The disadvantages of output methods are that the outputs used to measure progress may not be directly observable and the information required to apply them may not be available to an entity without undue cost. Therefore, an input method may be necessary.

Example 18 in ASC 606 outlines the analysis performed by a health club in selecting its best measure of progress toward complete satisfaction of its performance obligation to make the health club available for the customer to use as and when it wishes.

Example 18—Measuring Progress When Making Goods or Services Available

ASC 606-10-55-184

An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the clubs and promises to pay $100 per month.

ASC 606-10-55-185

The entity determines that its promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes. This is because the extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The entity concludes that the customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available. Consequently, the entity's performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a).

ASC 606-10-55-186

The entity also determines that the customer benefits from the entity's service of making the health clubs available evenly throughout the year. (That is, the customer benefits from having the health clubs available, regardless of whether the customer uses it or not.) Consequently, the entity concludes that the best measure of progress toward complete satisfaction of the performance obligation over time is a time-based measure, and it recognizes revenue on a straight-line basis throughout the year at $100 per month.

Work in process

As stated in ASC 606-10-55-17, an output method may not be appropriate if the method fails to measure the goods or services for which control has transferred to the customer. For example, an output method based on units produced or units delivered would not depict an entity's progress in satisfying its performance obligation if there is a material amount of work in process at any given time that is controlled by the customer, but not included in the measure of progress. In other words, in over time recognition, the customer is presumed to control the products as they are produced. An entity's assertion that in-process products should be excluded from the measure of progress therefore is in conflict with the concept of over time transfer.

ASC 606-10-55-17 includes "milestones reached" as an example of an output method. The TRG discussed the use of this method, specifically whether control of a good or service underlying a performance obligation that is satisfied over time would transfer at discrete points in time. In other words, is the concept of "over time" compatible with a milestone method to measure progress?

TRG area of general agreement: Can control of a good or service underlying a performance obligation transfer at discrete points in time?

At the April 2016 meeting,[66] the TRG generally agreed that when an entity meets any of the three criteria to recognize revenue over time, control does not transfer at discrete points in time, and an appropriate measure of progress should not result in the recognition of work in process or a similar asset from the entity's performance. This doesn't mean that an entity is prohibited from recognizing revenue over time merely because there is or may be a gap in performance, for example, because an entity does not perform any activities toward satisfying a performance obligation in a particular reporting period.

Grant Thornton insight: Milestones reached

Given the TRG discussion above, we believe that the use of a "milestones reached" method would not be appropriate if it results in material work in process or finished goods controlled by the customer that are not included in the measure of progress, despite the Boards' use of "milestones reached" as an example of an output method in ASC 606-10-55-17.

Use of output method with significant work in process

A manufacturing entity produces sink faucets for a home fixtures entity. The home fixtures entity provides the specifications for its patented sink faucets and the related component parts, both of which are built by the manufacturer.

The contract indicates that if the home fixtures entity cancels the contract before the end of the five-year contract term, it must pay the manufacturer for any work-in-process or completed but undelivered sink faucets. The contract also stipulates that the patented component parts and sink faucets may not be transferred to any entities other than the home fixtures entity.

The manufacturer concludes that over-time revenue recognition is appropriate in accordance with ASC 606-10-25-27(c) because its performance does not create an asset with an alternative use and it has an enforceable right to payment for performance completed to date.

The home fixtures entity's products are carried in thousands of home improvement stores and it submits orders daily to the manufacturer based on demand in various locations. At any period-end, the manufacturer has a significant amount of completed, patented component parts on hand that have not yet been incorporated into a fully assembled sink faucet.

The manufacturer considers what might be an appropriate measure of progress for over-time revenue recognition, noting that it would be inappropriate to use a measure of progress calculated as the per order ratio of number of completed sink faucets to the total number of sink faucets in the order, as that would result in a significant amount of work in process related to the completed component parts. Accordingly, the entity selects a different, appropriate measure of progress that better reflects its

[66] TRG Paper 53, *Evaluating How Control Transfers Over Time.*

progress toward satisfaction of the performance obligation and does not result in a significant work in process balance.

Input methods

With an input method, an entity recognizes revenue based on the extent of its efforts or inputs toward satisfying a performance obligation compared to the expected total efforts or inputs needed to completely satisfy the performance obligation. Examples of input measures include labor hours expended, machine hours used, and costs incurred. A straight-line basis may be appropriate if efforts or inputs are expended evenly throughout the performance period.

ASC 606-10-55-20

Input methods recognize revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis.

An entity that selects an input method, such as costs incurred, to measure its progress is required to make adjustments to that measure of progress if including some of those costs (for example, wasted materials) distorts the entity's performance under the contract.

Further, if a performance obligation consists of goods and related services and the customer obtains control of the goods (for instance, uninstalled materials) significantly before receiving the related services, an entity might best depict its performance by recognizing revenue associated with those goods in an amount equal to their cost when the goods are transferred to the customer. An entity might recognize revenue equal to costs if all of the following conditions are met at contract inception:

- The good is not distinct.
- The customer is expected to obtain control of the good significantly before receiving services related to the good.
- The cost of the good is significant compared to the total expected costs associated with the performance obligation.
- The entity obtains the good from another entity and is not significantly involved in its design or manufacture.

ASC 606-10-55-21

A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. Therefore, an entity should exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 606-10-25-31, do not depict the entity's performance in transferring control of goods or

services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

a. When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognize revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labor, or other resources that were incurred to satisfy the performance obligation).

b. When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:

    1. The good is not distinct.

    2. The customer is expected to obtain control of the good significantly before receiving services related to the good.

    3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.

    4. The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs 606-10-55-36 through 55-40).

Example 19 in ASC 606 illustrates how an entity may account for uninstalled materials.

Example 19 – Uninstalled Materials

ASC 606-10-55-187

In November 20X2, an entity contracts with a customer to refurbish a 3-story building and install new elevators for total consideration of $5 million. The promised refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time. Total expected costs are $4 million, including $1.5 million for the elevators. The entity determines that it acts as a principal in accordance with paragraphs 606-10-55-36 through 55-40 because it obtains control of the elevators before they are transferred to the customer.

ASC 606-10-55-188

A summary of the transaction price and expected costs is as follows:

Transaction price	$ 5,000,000
Expected costs:	
Elevators	1,500,000
Other costs	2,500,000
Total expected costs	$ 4,000,000

ASC 606-10-55-189

The entity uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation. The entity assesses whether the costs incurred to procure the elevators are proportionate to the entity's progress in satisfying the performance obligation in accordance with paragraph 606-10-55-21. The customer obtains control of the elevators when they are delivered to the site in December 20X2, although the elevators will not be installed until June 20X3. The costs to procure the elevators ($1.5 million) are significant relative to the total expected costs to completely satisfy the performance obligation ($4 million). The entity is not involved in designing or manufacturing the elevators.

ASC 606-10-55-190

The entity concludes that including the costs to procure the elevators in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph 606-10-55-21, the entity adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. The entity recognizes revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (that is, at a zero margin).

ASC 606-10-55-191

As of December 31, 20X2, the entity observes that:

a. Other costs incurred (excluding elevators) are $500,000.

b. Performance is 20% complete (that is, $500,000 ÷ $2,500,000).

ASC 606-10-55-192

Consequently, at December 31, 20X2, the entity recognizes the following:

Revenue	$ 2,200,000[(a)]
Costs of goods sold	2,000,000[(b)]
Profit	$ 200,000

(a) Revenue recognized is calculated as (20% × $3,500,000) + $1,500,000 ($3,500,000 is $5,000,000 transaction price - $1,500,000 costs of elevators.)

(b) Cost of goods sold is $500,000 of costs incurred + $1,500,000 costs of elevators.

Grant Thornton insight: Selecting the best measure of progress

ASC 606 requires a single measure of progress to be used to recognize revenue for a performance obligation satisfied over time. As noted above, the choice of which method to apply to measure an entity's progress is not a "free choice"; rather, an entity should select the best measure of its progress to satisfy its performance obligation.

An entity should carefully consider the impact of using an input measure other than total cost to measure its progress in satisfying its performance obligation in the contract and should understand how such a measure relates to its overall progress to satisfy its performance obligation. For example, consider an entity that recognizes revenue over time from a production contract because it has an enforceable right to payment for performance completed to date and the asset has no alternative use to the entity. If such a contract involves significant material costs, selecting labor hours as a measure of progress may not be the best measure of progress because the expenditure of labor hours may not align with the timing of when materials are either procured or used in the production process. In these cases, total cost would likely provide a more accurate depiction of the entity's progress to date.

7.1.3 Right to invoice practical expedient

The guidance provides a "right to invoice" practical expedient that allows an entity to bypass Steps 3, 4, and 5 when applying the five-step revenue model. Under the expedient, an entity may recognize revenue equal to the invoice amount if it has a contractual right to invoice its customer in an amount equal to the value provided to the customer for the entity's performance completed to date.

ASC 606-10-55-18

As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.

The TRG addressed stakeholder questions about how to evaluate whether an entity's right to consideration from a customer corresponds directly with the "value to the customer." Specifically, stakeholders asked whether an entity would be precluded from using the practical expedient if

- Billing rates change throughout the life of the contract.
- The contract includes a minimum payment.
- The contract includes upfront or back-end payments.

After discussing each of these considerations, the TRG generally agreed that a fixed price is not always required for the duration of the contract to apply the practical expedient. However, a price increase or decrease must be based on the value of the units subsequently transferred to the customer. Determining whether the price change is consistent with the value to the customer often requires the use of judgment. The TRG's discussions are summarized below.

TRG area of general agreement: Can an entity use the 'right to invoice' practical expedient for a contract that includes changing rates, minimum guarantees, or upfront or back-end payments?

Rate changes

There may be cases where the billing rates change throughout the life of the contract, which does not necessarily mean that an entity cannot qualify to use the practical expedient for the contract. The entity must be able to demonstrate that the changing rate reflects the value received by its customer for its performance to date.

Market prices or stand-alone selling prices might reflect the value received by a customer for the entity's performance to date, but entities are not required to assess[67] these prices to demonstrate that the amount invoiced reflects the value to the customer. Rather, the phrase "value to customer" is meant to imply that judgment is required to determine whether the practical expedient is applicable. An entity may determine that another means demonstrates that the amount invoiced to the customer corresponds directly to the value to the customer for the entity's performance to date. Any price increase or price decrease must be based on the value of subsequent units transferred to the customer.

The TRG considered the following example to illustrate the concept at the July 2015 meeting[68]:

> *Power Seller and Power Buyer execute a contract for the purchase and sale of electricity over a six-year term. Power Buyer is obligated to purchase 10 megawatts (MW) of electricity per hour for each hour during the contract term (87,600 MWh per annual period) at prices that contemplate the forward market price of electricity at contract inception. The contract prices are as follows:*
>
> *Years 1-2: $50 per MWh*
>
> *Years 3-4: $55 per MWh*
>
> *Years 5-6: $60 per MWh*
>
> *The transaction price, which represents the amount of consideration to which Power Seller expects to be entitled in exchange for transferring electricity to Power Buyer, is $28.908 million (annual contract prices per MWh multiplied by annual contract quantities). Power Seller concludes that the promise to sell electricity represents one performance obligation that will be satisfied over time.*

The TRG generally agreed that Power Seller qualifies to use the "right to invoice" practical expedient because the amount that it will bill to Power Buyer corresponds directly with the value to Power Buyer of its performance completed to date. The amount that will be billed is based on both

- Units of power transferred

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[67] TRG Paper 40, *Practical Expedient for Measuring Progress toward Complete Satisfaction of a Performance Obligation.*
[68] Ibid.

- A rate per unit of power that is priced by reference to one or more market indicators (for example, the observable forward commodity price curve)

While the rate per unit of power is not the same for the duration of the contract, the rates per unit reflect the value to the customer because the rates are based on one or more market indicators. Market prices or stand-alone selling prices might reflect value to the customer, but are not required to be assessed to demonstrate that the amount invoiced reflects the value to the customer. An entity may conclude that another means could be used to demonstrate that the amount invoiced to the customer corresponds directly to the value to the customer for the entity's performance to date.

Contract minimums

The TRG also generally agreed that the existence of a contractual minimum payment would not impact an entity's ability to use the practical expedient (should it qualify to do so) as long as the minimum payment is not expected to be "substantive" (meaning the entity expects to exceed the minimum amount).

Upfront or back-end payments

When a customer makes a significant upfront payment or the entity provides a significant back-end adjustment, an entity may struggle to conclude that the amount invoiced corresponds directly with the value provided to the customer for the goods or services. Judgment is required to determine if the practical expedient can be applied in contracts with these types of fees. The TRG generally agreed that an entity would need to assess the significance of these fees relative to the overall consideration in the arrangement.

Upfront payment and the 'right to invoice' practical expedient

Assume the same facts as in the TRG example above, except that Power Seller requires Power Buyer to make a $5 million upfront payment at the beginning of the 6-year term.

Judgment is required to determine whether the right to invoice practical expedient can be applied in a contract with an upfront adjustment that shifts payment to the beginning of the contract term, resulting in an invoiced amount that does not directly correspond with the value provided to the customer for the goods.

Because the upfront fee is significant relative to the overall consideration in the arrangement, Power Seller concludes that it is ineligible to use the right to invoice practical expedient, since it cannot demonstrate that the amounts that will be invoiced correspond directly to the value provided to the customer for goods transferred to date. Power Seller needs to select an appropriate measure of progress to recognize revenue as it satisfies its promise to provide electricity over the six-year term.

7.1.4 Selecting a single measure of progress

The guidance requires an entity to apply a single method of measuring progress to depict the entity's performance in satisfying each performance obligation. The FASB and IASB explained that utilizing more than one method to measure performance for a single performance obligation would effectively bypass the guidance on identifying performance obligations. Identifying just one measure of progress may be challenging in cases where a single performance obligation contains multiple promised goods and

services that are not distinct and are therefore combined into a distinct bundle of goods and services. In especially challenging cases, the entity may want to revisit the Step 2 analysis to verify that it has appropriately identified the performance obligations in the contract.

ASC 606-10-25-32

An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress toward complete satisfaction of a performance obligation satisfied over time.

The TRG discussed whether an entity can use multiple measures of progress for a single performance obligation, as well as how to determine the single best measure of progress when a performance obligation contains multiple goods or services and those underlying goods or services are not distinct. Summaries of these discussions are provided below.

TRG area of general agreement: Considerations for selecting a measure of progress when a combined performance obligation contains multiple goods or services

At its July 2015 meeting,[69] the TRG generally agreed that using multiple methods of measuring progress for the same performance obligation would not be appropriate, because their use would ignore the unit of account prescribed in the guidance, and revenue would be recognized in a manner that overrides the separation and allocation in Steps 2 and 4 of the revenue model.

The TRG generally agreed that an entity should consider the nature of both the entity's overall promise for the combined performance obligation and the performance required to completely satisfy that obligation. To make that assessment, the entity should consider the reasons why it decided that the goods or services are not distinct and have been bundled into a combined performance obligation. If an entity concludes that the result of a single measure of progress for a combined performance obligation does not faithfully depict the economics of the arrangement, this could indicate that the entity did not identify the appropriate performance obligations (meaning that there could be more than one performance obligation). Nonetheless, some situations require significant judgment in selecting a measure of progress for a combined performance obligation, even though the performance obligations have been appropriately identified.

The TRG considered the following example to illustrate this point:

> *An entity promises to provide a software license and installation services that will substantially customize the software to add significant new functionality that enables the software to interface with other customized applications used by the customer.*
>
> *The entity concludes that the software and services are not separately identifiable from the customized installation service; therefore, the software and installation are combined into a*

[69] TRG Paper 41, *Measuring progress when multiple goods or services are included in a single performance obligation.*

single performance obligation. The entity concludes that the performance obligation is satisfied over time. If the license was distinct, it would be considered a point-in-time license.

Because the customized software solution is the promise that is being performed over time, the measure of progress should be based on a method that reflects the entity's progress toward the completion of that service and therefore complete satisfaction of the combined performance obligation. Under this view, all of the revenue would be recognized over the period during which the customization services are provided.

The TRG did not think an output method based on estimated value for each good or service delivered would be appropriate in this case because this method effectively accounts for the license and services as two separate performance obligations, which ignores the unit of account (that is, the single performance obligation) and overrides the separation and allocation guidance.

Further, the TRG did not think the entity should recognize revenue when the software was delivered on the basis that the software is the predominant item in the combined performance obligation. The entity could not conclude that the software is the primary or dominant component of the combined performance obligation because the nature of the entity's promise is to provide a customized software solution. In this situation, the base software license is not the dominant feature as the customization services are also likely to be significant to the customer.

7.1.5 Ability to reasonably measure progress

An entity recognizes revenue for a performance obligation satisfied over time only if it can reasonably measure its progress, which means the entity must have access to reliable information that allows it to apply the most appropriate method of measurement.

ASC 606-10-25-36

An entity shall recognize revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress toward complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress.

If an entity cannot reasonably measure its progress toward completion, but still expects to recover the costs, the entity should recognize revenue to the extent of costs incurred until it can reasonably measure its progress. This practice may be applicable in the initial stages of a contract or when an entity initiates a new product or service and has no or limited history or experience in measuring progress. In recognizing revenue to the extent of costs incurred, the entity is at least reflecting progress toward satisfying the performance obligation. Once the entity can reasonably measure progress, it should recognize revenue using that measure of progress.

ASC 606-10-25-37

In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognize revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

7.1.6 Updates to measuring progress

An entity must update its measure of progress throughout the life of the contract. For example, if an entity concludes part-way through a contract that its costs will double to complete the work, it recalculates revenue to date and recognizes the change in its measure of progress as a change in accounting estimate, in accordance with the guidance in ASC 250.

ASC 606-10-25-35

As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

7.1.7 Pre-contract activities

An entity sometimes begins work on an anticipated contract before agreeing to all the contract terms or before the agreement satisfies the criteria for an accounting contract in accordance with Step 1. This work may include activities that

- Do not transfer goods or services to the customer (for example, administrative tasks)
- Fulfill the anticipated contract but do not result in the transfer of a good or service to the customer (for example, setup costs)
- Transfer a good or service to the customer at or subsequent to the date the contract meets Step 1

If an entity concludes that the activities performed before a contract meets the Step 1 criteria result in progress toward satisfying a performance obligation, it would recognize the revenue to which it expects to be entitled for that progress when the Step 1 criteria are met. In other words, in the period that the contract passes Step 1, the entity recognizes revenue on a cumulative catch-up basis reflecting the performance obligation(s) that are wholly or partially satisfied. This adjustment reflects the fact that control of a portion of the goods or services has transferred to the customer on the date when the contract passes the Step 1 criteria.

TRG area of general agreement: How should revenue arising from pre-contract establishment date (pre-CED) activities be recognized?

The TRG at its March 2015 meeting[70] considered the following example:

> *A manufacturer enters into a long-term contract with a customer to manufacture a highly customized good. The customer issues purchase orders for 30 days of supply on a rolling calendar basis (that is, every 30 days a new purchase order is issued). Purchase orders are noncancelable and the manufacturer has a contractual right to payment for all work in process for goods once an order is received. The manufacturer will pre-assemble some goods in order to meet anticipated demand from the customer based on a nonbinding forecast provided by the customer. At the time the customer issues a purchase order, the manufacturer has some goods on hand that are completed and others that are partially completed.*
>
> *The entity has determined that each customized good represents a performance obligation satisfied over time because the customized goods have no alternative use and the manufacturer has an enforceable right to payment once it receives the purchase order.*

The TRG generally agreed that if an entity has transferred promised goods or services within a performance obligation to the customer on the date it passes the Step 1 criteria, revenue should be recognized on a cumulative catch-up basis to reflect the entity's progress as of the date it satisfies the Step 1 criteria. The entity should include costs that reflect the goods or services that the customer controls in the measure of progress

Preproduction activities

Preproduction activities are common in some long-term supply arrangements that require an entity to undertake efforts up front to mobilize equipment or design new technology or equipment. Section 11.3 includes a discussion of the accounting considerations related to preproduction activities, which may also apply to certain pre-contract activities.

7.1.8 Stand-ready obligations

When the nature of an entity's performance obligation is to stand ready to provide goods or services, it may be appropriate to utilize a time-based measure of progress. When the pattern of benefit and the entity's efforts to fulfill the contract are not even throughout the contract period, a time-based method of measuring progress may not be appropriate. On the other hand, when an entity expects the customer will receive and consume the benefits of the entity's promise equally throughout the contract period, or if the entity does not know and cannot reasonably estimate how and when the customer will request performance, then a straight-line revenue attribution resulting from a time-based measure of progress may be appropriate.

A summary of the TRG discussion regarding measures of progress for stand-ready obligations follows.

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[70] TRG Paper 33, *Partial Satisfaction of Performance Obligations Prior to Identifying the Contract.*

TRG area of general agreement: How should an entity measure progress toward the satisfaction of a stand-ready obligation?

The TRG generally agreed during the January 2015 meeting[71] that entities need to exercise judgment to determine whether the nature of the entity's promise is to stand ready to provide goods or services or to provide the underlying specified goods or services, which is not a stand-ready obligation (see Section 4.1.3).

An appropriate measure of progress for a stand-ready obligation satisfied over time may vary depending upon the type of stand-ready obligation. It is not appropriate to default to a straight-line revenue attribution method when this measurement method does not depict the entity's performance. For example, a straight-line approach over the contract period for an annual snow removal contract would not be reasonable because the pattern of benefits received by the customer and the entity's efforts to perform would generally not occur evenly throughout the year given there is no reasonable expectation of snowfall during the warm months.

On the other hand, if the entity expects the customer will receive and consume the benefits of the entity's promise equally throughout the contract period or if it does not know and is unable to reasonably estimate how and when the customer will request performance, then a straight-line revenue attribution resulting from a time-based measure of progress may be appropriate. Example 18 in ASC 606 concludes that the nature of the entity's promise is to stand ready to provide the customer with access to its health club facilities for the contract period. Because the customer will benefit from the entity's service of making the health clubs available for the customer's use evenly throughout the contract period, a time-based measure of progress is appropriate.

The TRG generally agreed that when an entity promises unspecified updates or upgrades to a customer but is unable to predict the timing of when those updates or upgrades will be made available, then the nature of its promise is to stand ready to provide updates or upgrades if and when they become available. The customer benefits evenly throughout the contract period from the guarantee that any updates or upgrades developed by the entity will be made available. As a result, a time-based measure of progress would generally be appropriate in this situation.

7.2 Control transferred at a point in time

If a performance obligation does not meet one of the three criteria to recognize revenue over time, the entity recognizes revenue for that performance obligation at a point in time. The entity determines the point in time by evaluating when the customer obtains control of the asset (that is, the goods or services that the entity has promised to transfer to the customer).

In performing this evaluation, the entity considers indicators that control has transferred to the customer, including, but not limited to, the following:

- The entity has a present right to receive payment for the asset.
- The customer has legal title to the asset.
- The customer has physical possession of the asset.
- The customer has assumed the significant risks and rewards of owning the asset.

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[71] TRG Paper 16, *Stand-Ready Performance Obligations.*

- The customer has accepted the asset.

When an entity has a present right to receive payment for its performance, this indicates that the customer has obtained control over the asset, meaning that the customer can generally obtain the benefits from, and direct the use of, the asset.

Possession of legal title of an asset generally indicates which party controls the asset. However, if an entity retains legal title only to protect itself against the customer's failure to pay, this would not prevent the customer from obtaining control of the asset.

Similarly, the customer's physical possession of an asset may indicate that the customer controls the asset because it can direct the use of the asset, obtain substantially all of the remaining benefits of the asset, and/or restrict other entities' access to the benefits of the asset; however, the entity must consider if anything overrides this presumption. For example, a customer's physical possession of an asset does not automatically mean that it has control of the asset if substantive repurchase terms (see Section 7.4) suggest that control remains with the entity. The same may be said for consignment arrangements (see Section 7.6).

When a customer assumes the significant risks and rewards of owning the asset, this may indicate that the customer controls the asset and has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

Grant Thornton insight: 'Synthetic' FOB destination and control

Synthetic free on board (FOB) destination occurs when the shipping terms specify FOB shipping point but the entity continues to bear the risk of loss until the products are delivered to the customer's premises. The terms can be either explicitly stated in the contract or implicitly established by the entity's customary practice of providing replacement products for goods lost or damaged in transit.

Because the risks and rewards of owning the asset do not transfer to the customer until the entity delivers the goods to the customer's premises, this may indicate that control does not transfer to the customer until the goods are delivered to the customer. In addition to this consideration, the entity will need to evaluate other indicators including those in ASC 606-10-25-30 to determine the point in time at which control transfers.

Finally, the customer's acceptance of an asset indicates that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Customer acceptance clauses are discussed in Section 7.2.1.

ASC 606-10-25-30

If a performance obligation is not satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the guidance on control in paragraphs 606-10-25-23 through 25-26. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. The entity has a present right to payment for the asset—If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.

b. The customer has legal title to the asset—Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

c. The entity has transferred physical possession of the asset—The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.

d. The customer has the significant risks and rewards of ownership of the asset—The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

e. The customer has accepted the asset—The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.

None of the indicators discussed above is individually determinative; rather, an entity should consider all of the indicators collectively to make a determination as to when control passes to the customer.

Figure 7.4 provides additional guidance for each control indicator that may suggest either the entity or the customer has control of the asset.

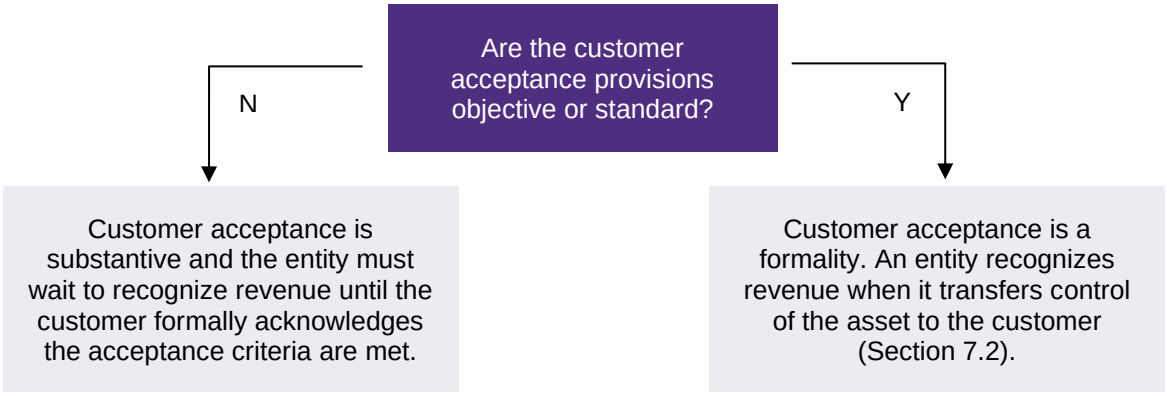
Figure 7.4: Evaluating when control transfers

Indicator that the entity maintains control of the asset	Control indicator	Indicator that the customer controls the asset
When the entity does not yet have the right to invoice the customer, this may indicate that the entity has not yet transferred control of the asset.	Present right to payment	When a customer is obligated to pay for the asset, this may indicate that the customer has control.
When the entity maintains legal title to the asset and the retention is not solely as protection against the customer's failure to pay, this may indicate that the entity still maintains control.	Legal title	When the customer obtains legal title to the asset or the entity maintains legal title only for protection against the customer's failure to pay, this may indicate that the customer has obtained control.
When the entity maintains physical possession of the asset, this may indicate that the entity still controls the asset, except in circumstances such as a bill-and-hold arrangement (see Section 7.5).	Physical possession	When the customer has physical possession of the asset, this may indicate that the customer controls the asset; however, in arrangements such as repurchase agreements or consignment arrangements, physical possession may not coincide with control of an asset.
If the entity can still direct the use of the asset and obtain substantially all of the benefits from the asset, this may indicate that the entity still controls the asset.	Significant risks and rewards of ownership	If the customer can direct the asset to another location or to another party, if the customer is exposed to changes in market value, or if the customer is responsible for damages to the asset, this may indicate that the customer has control of the asset.
When the entity has not yet satisfied substantive customer acceptance provisions, this may indicate that the entity still controls the asset.	Customer acceptance (see Section 7.2.1)	When the customer has formally indicated that its acceptance criteria have been met, this may indicate that control has transferred to the customer.

7.2.1 Customer acceptance provisions

Customer acceptance provisions allow a customer to cancel a contract or require remedial action by the entity if a good or service does not meet the agreed-upon acceptance criteria. When evaluating customer acceptance provisions, an entity must first determine whether these provisions are objective.

Figure 7.5: Customer acceptance provisions



When the provisions are "objective," customer acceptance is deemed a formality that does not impact the entity's determination of when a customer obtains control of the good or service.

On the other hand, when the customer acceptance provisions are not objective or are nonstandard, the entity must receive the customer's formal acceptance before it can conclude that the customer has obtained control of the good or service.

Factors that may indicate that the customer's acceptance is substantive and therefore not a formality may include

- The acceptance terms are not customarily included in the entity's contracts.
- The acceptance terms are specified by the customer.
- The product subject to acceptance is complex, and testing results at the entity's premises are not indicative of testing results at the customer's premises.
- The product is new or the entity lacks sufficient history to support regular customer acceptance.

ASC 606-10-55-85

In accordance with paragraph 606-10-25-30(e), a customer's acceptance of an asset may indicate that the customer has obtained control of the asset. Customer acceptance clauses allow a customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed-upon specifications. An entity should consider such clauses when evaluating when a customer obtains control of a good or service.

ASC 606-10-55-86

If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. For example, if the customer acceptance clause is based on meeting specified size and weight characteristics, an entity would be able to determine whether those criteria have been met before receiving confirmation of the customer's acceptance. The entity's experience with contracts for similar goods or services may provide evidence that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract. If revenue is recognized before customer acceptance, the entity still must consider whether there are any remaining performance obligations (for example, installation of equipment) and evaluate whether to account for them separately.

ASC 606-10-55-87

However, if an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance. That is because, in that circumstance the entity cannot determine that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.

The following examples illustrate how to apply the customer acceptance guidance in ASC 606.

Evaluating customer acceptance provisions

Entity A sells a machine to Customer B for $1,000 on June 15, 20X8. Entity A delivers the machine to Customer B's premises on June 30, 2018. Entity A determines that the contract contains a single performance obligation (the machine) and that control transfers at a point in time. Title transfers to the customer as well as the significant risks and rewards of ownership upon receipt of the machine. Entity A has the right to invoice the customer upon delivery of the machine to Customer B's premises. Customer B formally accepts the machine on July 5.

Consider Entity A's accounting for the machine if the contract includes either of the following customer acceptance clauses.

Scenario 1

The customer acceptance is based on the machine meeting specified size and weight characteristics. Entity A sells the same, noncomplex machine to multiple customers and typically includes this particular acceptance clause in the agreement.

Because Entity A can objectively determine that the specifications are met, the acceptance provision is deemed to be objective and standard, and the entity determines that control has transferred. Entity A recognizes revenue upon delivery on June 30, 20X8.

Scenario 2

The customer acceptance is based on Customer B's internal quality checklist whereby the contract specifies that the customer has 30 days to give formal written acceptance to Entity A for the machine.

The machine is highly complex and part of a relatively new product line, so Entity A does not have much data on historical customer acceptance.

Entity A determines that the acceptance provision is nonstandard, specified by the customer, and relates to a highly complex device with which it has limited history. As a result, control does not transfer until formal acceptance by the customer and Entity A waits to recognize revenue until July 5.

7.3 Trial periods

When an entity offers a good or service to a customer on a trial basis and the customer is not required to pay for the product until the trial period lapses, control of the product or service does not transfer to the customer until the customer accepts the product or service or the trial period lapses. In fact, a contract does not exist under Step 1 of the model (see Section 3.1) until the customer accepts the product or the trial period lapses because enforceable rights and obligations do not yet exist.

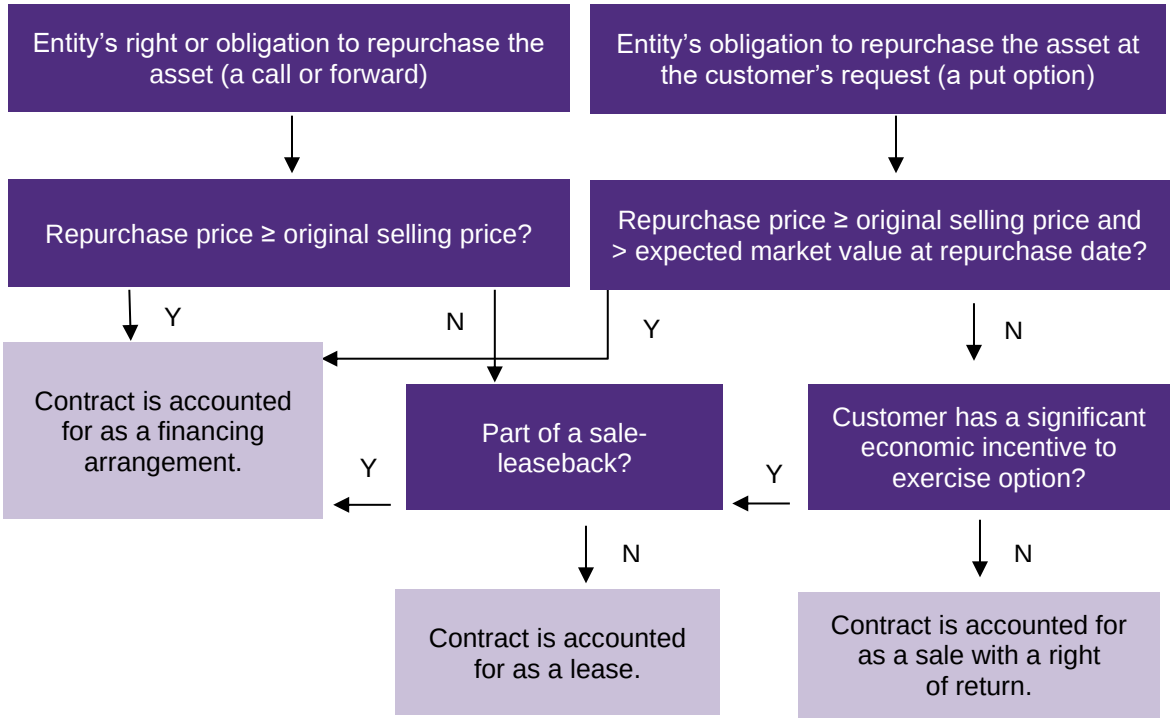
ASC 606-10-55-88

If an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses.

7.4 Repurchase agreements

Sometimes an entity that enters into a contract to sell an asset also promises, or has the option, to repurchase the same asset, an asset that is substantially the same, or another asset that is a component of the original asset. Under ASC 606, an entity should evaluate the form of the promise to repurchase the asset (for example, a forward, call option, or put option) in determining the appropriate accounting.

Figure 7.6: Accounting for repurchase rights and obligations



7.4.1 Forwards or calls

If a contract includes a forward (an entity's obligation to repurchase an asset) or a call option (an entity's right to repurchase an asset), an entity should account for the contract in one of two ways:

- As a lease if it can or must repurchase the asset for an amount that is less than the original selling price and the contract is not part of a sale-leaseback transaction
- As a financing arrangement if it can or must repurchase the asset for an amount that is equal to or more than the original selling price

While the customer may have physical possession of the asset, the customer does not have control of the asset because its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset is limited due to the entity's repurchase obligation or right.

ASC 606-10-55-68

If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity should account for the contract as either of the following:

a. A lease in accordance with Topic 840 (842) on leases, if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset unless the contract is part of a sale-leaseback transaction. If the contract is part of a sale-leaseback transaction, the

entity should account for the contract as a financing arrangement and not as a sale-leaseback in accordance with Subtopic 840-40 (842-40).

b. A financing arrangement in accordance with paragraph 606-10-55-70, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

ASC 606-10-55-69

When comparing the repurchase price with the selling price, an entity should consider the time value of money.

When an entity accounts for a forward or call repurchase agreement as a financing arrangement, it continues to recognize the asset as well as a financial liability for any consideration received from the customer. The entity recognizes the difference between the amount of consideration received from the customer and the amount to be paid to the customer as interest and, if applicable, as processing or holding costs (for example, insurance). If the option lapses unexercised, the entity derecognizes the liability and recognizes revenue.

ASC 606-10-55-70

If the repurchase agreement is a financing arrangement, the entity should continue to recognize the asset and also recognize a financial liability for any consideration received from the customer. The entity should recognize the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest and, if applicable, as processing or holding costs (for example, insurance).

ASC 606-10-55-71

If the option lapses unexercised, an entity should derecognize the liability and recognize revenue.

Example 62, Case A, in ASC 606 illustrates how an entity applies the guidance when it has a right to repurchase an asset (a call option).

Example 62—Repurchase Agreements (excerpt)

ASC 606-10-55-401

An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.

Case A—Call Option: Financing

ASC 606-10-55-402

The contract includes a call option that gives the entity the right to repurchase the asset for $1.1 million on or before December 31, 20X7.

ASC 606-10-55-403

Control of the asset does not transfer to the customer on December 31, 20X7, because the entity has a right to repurchase the asset and therefore the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Consequently, in accordance with paragraph 606-10-55-68(b), the entity accounts for the transaction as a financing arrangement because the exercise price is more than the original selling price. In accordance with paragraph 606-10-55-70, the entity does not derecognize the asset and instead recognizes the cash received as a financial liability. The entity also recognizes interest expense for the difference between the exercise price ($1.1 million) and the cash received ($1 million) which increases the liability.

ASC 606-10-55-404

On December 31, 20X7, the option lapses unexercised; therefore, the entity derecognizes the liability and recognizes revenue of $1.1 million.

7.4.2 Put options

If a customer is granted the right to require an entity to repurchase the asset (a put option) at a price that is less than the original selling price, the entity should assess whether the customer has a significant economic incentive to exercise its right. This assessment takes into consideration various factors, including the relationship between the repurchase price and the expected market value of the asset at the date of repurchase. If the repurchase price is expected to significantly exceed market value, then a significant economic incentive exists. The agreement is then accounted for as a lease (because the customer is effectively paying the entity for the right to use the asset for a period of time), unless the contract is a part of a sale-leaseback arrangement, in which case, the agreement is accounted for as a financing arrangement.

If the customer does not have a significant economic incentive to exercise the put option, the entity accounts for the agreement as a sale with a right of return (see Section 5.1.3).

If a contract grants the customer a put option, and if the repurchase price of the asset is equal to or greater than its original selling price and is more than the asset's expected market value, the contract is considered a financing arrangement. In such circumstances, the entity continues to recognize the asset and a liability initially measured at the asset's original selling price.

ASC 606-10-55-72

If an entity has an obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 840 (842) on leases unless the contract is part of a sale-leaseback transaction. If the contract is part of a sale-leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale-leaseback in accordance with Subtopic 840-40 (842-40).

ASC 606-10-55-73

To determine whether a customer has a significant economic incentive to exercise its right, an entity should consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of the repurchase and the amount of time until the right expires. For example, if the repurchase price is expected to significantly exceed the market value of the asset, this may indicate that the customer has a significant economic incentive to exercise the put option.

ASC 606-10-55-74

If the customer does not have a significant economic incentive to exercise its right at a price that is lower than the original selling price of the asset, the entity should account for the agreement as if it were the sale of a product with a right of return as described in paragraphs 606-10-55-22 through 55-29.

ASC 606-10-55-75

If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is in effect a financing arrangement and, therefore, should be accounted for as described in paragraph 606-10-55-70.

ASC 606-10-55-76

If the repurchase price of the asset is equal to or greater than the original selling price and is less than or equal to the expected market value of the asset, and the customer does not have a significant economic incentive to exercise its right, then the entity should account for the agreement as if it were the sale of a product with a right of return as described in paragraphs 606-10-55-22 through 55-29.

ASC 606-10-55-77

When comparing the repurchase price with the selling price, an entity should consider the time value of money.

If either a call or put option expires unexercised, an entity derecognizes any liability recorded and recognizes revenue.

ASC 606-10-55-78

If the option lapses unexercised, an entity should derecognize the liability and recognize revenue.

Example 62, Case B, in ASC 606 illustrates how an entity applies the guidance when the contract provides the customer with a right to require the entity to repurchase the asset (a put option).

Example 62—Repurchase Agreements (excerpt)

ASC 606-10-55-401

An entity enters into a contract with a customer for the sale of a tangible asset on January 1, 20X7, for $1 million.

Case B—Put Option: Lease

ASC 606-10-55-405

Instead of having a call option, the contract includes a put option that obliges the entity to repurchase the asset at the customer's request for $900,000 on or before December 31, 20X7. The market value is expected to be $750,000 on December 31, 20X7.

ASC 606-10-55-406

At the inception of the contract, the entity assesses whether the customer has a significant economic incentive to exercise the put option, to determine the accounting for the transfer of the asset (see paragraphs 606-10-55-72 through 55-78). The entity concludes that the customer has a significant economic incentive to exercise the put option because the repurchase price significantly exceeds the expected market value of the asset at the date of repurchase. The entity determines there are no other relevant factors to consider when assessing whether the customer has a significant economic incentive to exercise the put option. Consequently, the entity concludes that control of the asset does not transfer to the customer because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

ASC 606-10-55-407

In accordance with paragraphs 606-10-55-72 through 55-73, the entity accounts for the transaction as a lease in accordance with Topic 840 (842) on leases.

7.5 Bill-and-hold arrangements

In a bill-and-hold arrangement, a customer takes title to, and agrees to pay for, goods but is not yet ready for the goods to be delivered. The entity retains physical possession of the products until later transferred to the customer. A customer may request a sale on a bill-and-hold basis in various situations, including, for example, when the customer does not have space to store the goods or is behind in a production process that uses the good as a component.

ASC 606-10-55-81

A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules.

In these arrangements, the customer may obtain control of the goods even though it does not have physical possession, and an entity must determine whether it has transferred control of the product to the customer.

For an entity to conclude that it has transferred control of the product to the customer in a bill-and-hold arrangement, all of the following criteria must be met:

- The reason for the arrangement must be substantive.

- The product must be separately identified for the customer and ready for physical transfer.
- The entity cannot have the ability to use the product or direct it to another customer.

If any one of the conditions above is not met, the customer does not have control of the product, and the entity is precluded from recognizing revenue.

ASC 606-10-55-82

An entity should determine when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product (see paragraph 606-10-25-30). For some contracts, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset.

ASC 606-10-55-83

In addition to applying the guidance in paragraph 606-10-25-30, for a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).

b. The product must be identified separately as belonging to the customer.

c. The product currently must be ready for physical transfer to the customer.

d. The entity cannot have the ability to use the product or to direct it to another customer.

An entity no longer controls the product, and therefore recognizes revenue for the sale of the product, when it concludes that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product, even though the customer has not yet taken physical possession. In this case, the entity is required to consider whether it has any remaining performance obligations, such as providing custodial services to the customer. If it does, the entity should allocate a portion of the transaction price to the remaining performance obligation(s).

ASC 606-10-55-84

If an entity recognizes revenue for the sale of a product on a bill-and-hold basis, the entity should consider whether it has remaining performance obligations (for example, for custodial services) in accordance with paragraphs 606-10-25-14 through 25-22 to which the entity should allocate a portion of the transaction price in accordance with paragraphs 606-10-32-28 through 32-41.

Example 63 in ASC 606 illustrates how an entity may apply the bill-and-hold guidance.

Example 63—Bill-and-Hold Arrangements

ASC 606-10-55-409

An entity enters into a contract with a customer on January 1, 20X8 for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.

ASC 606-10-55-410

Upon completion of the manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On December 31, 20X9, the customer pays for the machine and spare parts but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts, and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of the warehouse, and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years, and the entity does not have the ability to use the spare parts or direct them to another customer.

ASC 606-10-55-411

The entity identifies the promise to provide custodial services as a performance obligation because it is a service provided to the customer and it is distinct from the machine and spare parts. Consequently, the entity accounts for three performance obligations in the contract (the promises to provide the machine, the spare parts, and the custodial services). The transaction price is allocated to the three performance obligations and revenue is recognized when (or as) control transfers to the customer.

ASC 606-10-55-412

Control of the machine transfers to the customer on December 31, 20X9, when the customer takes physical possession. The entity assesses the indicators in ASC 606-10-25-30 to determine the point in time at which control of the spare parts transfers to the customer, noting that the entity has received payment, the customer has legal title to the spare parts, and the customer has inspected and accepted the spare parts. In addition, the entity concludes that all of the criteria in ASC 606-10-55-83 are met, which is necessary for the entity to recognize revenue in a bill-and-hold arrangement. The entity recognizes revenue for the spare parts on December 31, 20X9, when control transfers to the customer.

ASC 606-10-55-413

The performance obligation to provide custodial services is satisfied over time as the services are provided. The entity also considers whether the payment terms include a significant financing component in accordance with paragraphs 606-10-32-15 through 32-20.

7.6 Consignment arrangements

A consignment arrangement exists when a product is delivered to another party (for example, a dealer) but the other party has not obtained control of the product. Accordingly, an entity should not recognize revenue upon delivery if the product is held on consignment by the dealer.

Indicators of a consignment arrangement include, but are not limited to, the following:

- The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period of time passes.
- The entity can require the return of the product or its transfer to a third party.
- The dealer does not have an unconditional obligation to pay for the product, although it may be required to pay a deposit.

ASC 606-10-55-79

When an entity delivers a product to another party (such as a dealer or a distributor) for sale to end customers, the entity should evaluate whether that other party has obtained control of the product at that point in time. A product that has been delivered to another party may be held in a consignment arrangement if that other party has not obtained control of the product. Accordingly, an entity should not recognize revenue upon delivery of a product to another party if the delivered product is held on consignment.

ASC 606-10-55-80

Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:

a. The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.

b. The entity is able to require the return of the product or transfer the product to a third party (such as another dealer).

c. The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

The following example illustrates the guidance on consignment arrangements.

Evaluating consignment arrangements

A jewelry designer sells its jewelry through local boutiques (not related parties of the designer). Third-party customers visit the local boutiques to shop for jewelry and purchase the merchandise directly from the boutiques. The terms of the arrangement between the designer and the boutique owners provide that the designer retains title of the jewelry until the sale of the merchandise to the third-party customers. The designer also may require the boutique to send the unsold jewelry to other retailers or

back to the designer. Further, the boutique owner is not required to remit payment to the designer until the sale to its customer occurs.

The arrangement is a consignment arrangement in accordance with ASC 606 because

- The product is controlled by the designer until a specified event (that is, the sale to the boutique's customer) occurs.
- The designer can direct the jewelry to another boutique.
- The boutique owner is not required to pay for the jewelry until it sells the jewelry to its end customer.

As a result, the designer does not recognize revenue until the jewelry is sold to the boutique owner's customer.

7.7 Customer's unexercised rights

Sometimes a customer makes a payment to an entity that entitles the customer to a right to receive a good or service in the future, but the customer may leave that right unexercised (for example, a gift card that the customer never redeems). The unexercised rights are commonly referred to as "breakage." Upon receipt of the payment, the entity must recognize a contract liability that represents its obligation to transfer goods or services in the future. The timing of when the entity can derecognize the contract liability depends upon whether the entity expects to be entitled to breakage.

If the entity expects to be entitled to breakage, it recognizes the estimated breakage amount as revenue in proportion to the pattern of rights exercised by the customer. If the entity does not expect to be entitled to breakage, it waits to recognize the breakage amount as revenue until the likelihood of the customer exercising its right becomes remote.

When unclaimed property laws or similar regulations require an entity to remit any consideration received that is attributable to a customer's unexercised rights, the entity recognizes a liability for the amount of consideration received.

An entity should consider the constraint guidance in Section 5.1.1 to determine whether it expects to be entitled to breakage.

ASC 606-10-55-46

In accordance with paragraph 606-10-45-2, upon receipt of a prepayment from a customer, an entity should recognize a contract liability in the amount of the prepayment for its performance obligation to transfer, or to stand ready to transfer, goods or services in the future. An entity should derecognize that contract liability (and recognize revenue) when it transfers those goods or services and, therefore, satisfies its performance obligation.

ASC 606-10-55-47

A customer's nonrefundable prepayment to an entity gives the customer a right to receive a good or service in the future (and obliges the entity to stand ready to transfer a good or service). However, customers may not exercise all of their contractual rights. Those unexercised rights are often referred to as breakage.

ASC 606-10-55-48

If an entity expects to be entitled to a breakage amount in a contract liability, the entity should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, the entity should recognize the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote. To determine whether an entity expects to be entitled to a breakage amount, the entity should consider the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

ASC 606-10-55-49

An entity should recognize a liability (and not revenue) for any consideration received that is attributable to a customer's unexercised rights for which the entity is required to remit to another party, for example, a government entity in accordance with applicable unclaimed property laws.

8. Intellectual property licenses

The revenue standard provides supplemental implementation guidance for licenses of intellectual property (license guidance) because intellectual property (IP) is inherently different from other goods or services due to its uniquely "divisible" nature[72] (in other words, more than one entity may use the same IP at the same time). Entities are required to consider the supplemental guidance for licenses within the scope of ASC 606 (see Section 8.1), in addition to the overall revenue guidance in Steps 1 through 5.

In accordance with the license guidance, when a contract includes a license of IP, the entity considers the nature of its promise to determine whether it should recognize revenue related to the license over time or at a point in time. Applying the license guidance may require significant judgment. To assist with the evaluation, ASC 606 distinguishes between an entity's promise to grant a customer a license to "functional" IP and "symbolic" IP. The distinction focuses on the utility of the IP, which is the IP's ability to provide benefits or value to the customer.

8.1 Scope

This guidance applies to licenses of IP only. Sales of IP are not within the scope of this guidance. Therefore, the form of the arrangement matters. Even a license that is exclusive and perpetual does not constitute a sale of IP, and an entity should apply the supplemental license guidance discussed in this section for such an arrangement.

Because the supplemental license guidance differs in many ways from the rest of the revenue model, an entity should confirm that it has appropriately identified contracts that contain licenses of IP. Licenses of IP are common in the technology, media, pharmaceuticals, and retail industries. ASC 606 identifies numerous examples of licenses of IP.

The supplemental license guidance does not apply to a license that is a component in a tangible good that is integral to the functionality of that good.[73] In this case, the license is not distinct from the good, and the entity applies the general five-step revenue model to the good, without regard to the license. In other circumstances, however, a license included in a performance obligation might impact the accounting for the performance obligation as discussed in Section 8.2.

ASC 606-10-55-54

A license establishes a customer's rights to the intellectual property of an entity. Licenses of intellectual property may include, but are not limited to, licenses of any of the following:

a. Software (other than software subject to a hosting arrangement that does not meet the criteria in paragraph 985-20-15-5) and technology

b. Motion pictures, music, and other forms of media and entertainment

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[72] BC51, ASU 2016-10.
[73] ASC 606-10-55-56(a).

c. Franchises

d. Patents, trademarks, and copyrights.

It is important to note that software as a service (SaaS) and other hosting arrangements are within the scope of the licensing guidance in ASC 606 only if the criteria in ASC 985-20-15-5 (outlined below) are met. A SaaS contract that meets the criteria in ASC 985-20-15-5 includes a software license as well as a hosting service and is subject to the supplemental license guidance.

If the software does not meet the criteria in ASC 985-20-15-5, the arrangement includes only a hosting service. The entity accounts for this service following the five-step model and does not apply the supplemental license guidance.

ASC 985-20-15-5

The software subject to a hosting arrangement is within the scope of this Subtopic only if both of the following criteria are met:

a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.

b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

The term “significant penalty” in the first criterion in ASC 985-20-15-5 implies two distinct conditions: (1) the customer can accept delivery of the software without incurring significant cost, and (2) the customer has the ability to use the software separately without a significant decrease in its utility or value.[74]

The following examples help clarify the appropriate guidance to apply to various hosting arrangements.

Hosting arrangements

Scenario 1

Hosting Entity A enters into an arrangement to grant a nonexclusive perpetual software license and to provide hosting services for a one-year period to Customer B for total consideration of $600,000, due at the arrangement’s inception. The hosting services can be renewed in subsequent periods for $200,000 per year. Customer B does not have the ability to take possession of the software at any time during the arrangement.

Because Customer B cannot take possession of the software, the arrangement does not include a license and is not within the scope of the supplemental license guidance.

[74] ASC 985-20-15-6.

Scenario 2

Entity A enters into a hosting arrangement to grant a nonexclusive perpetual software license and to provide hosting services for a period of two years to Customer B for total consideration of $500,000, due at the arrangement's inception. At the end of the two-year period, the hosting services can be renewed for an additional year for $200,000. Customer B has the right to take possession of the software at any time during the arrangement without significant penalty and can feasibly run the software on its own hardware. The software is essential to the functionality of the hosting element in this arrangement.

Since the customer has the right to take possession of the software without incurring a significant penalty and the software can feasibly run on the customer's hardware, this arrangement contains a software license that is accounted for using the supplemental license guidance.

8.2 Applying Step 2 to license arrangements

Sometimes, a license of IP is the only promise in a contract with a customer, in which case, the supplemental license guidance applies. In other contracts, the license is just one of many promises in a contract with the customer, and the entity should apply the Step 2 guidance to identify the distinct goods and services provided in the arrangement (see Section 4). The license implementation guidance not only applies to distinct licenses, but should also be considered when assessing a performance obligation that includes a license of IP except when the license is a component in a tangible good that is integral to the functionality of that good.

Licenses of intellectual property that are not distinct

A contract may include a license and another good or service that are bundled as a single performance obligation because the license is not distinct. An example of a license that is not distinct from other goods or services in the contract is a license of IP that the customer can benefit from only with a related service, such as an online service that allows a customer to access content.[75]

When a single performance obligation includes a license of IP as well as one or more other goods or services, an entity should consider the nature of the combined good or service in determining whether the entity satisfies that combined good or service over time or at a point in time.

ASC 606-10-55-57

When a single performance obligation includes a license (or licenses) of intellectual property and one or more other goods or services, the entity considers the nature of the combined good or service for which the customer has contracted (including whether the license that is part of the single performance obligation provides the customer with a right to use or a right to access intellectual property in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A) in determining whether that combined good or service is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and, if over time, in selecting an appropriate method for measuring progress in accordance with paragraphs 606-10-25-31 through 25-37.

[75] ASC 606-10-55-56.

Example 56, Case A, in ASC 606 illustrates when a license is not distinct from other promises in the contract.

Example 56—Identifying a Distinct License (excerpt)

ASC 606-10-55-367

An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer for 5 years, while the customer develops its own manufacturing capability. The drug is a mature product; therefore, there is no expectation that the entity will undertake activities to change the drug (for example, to alter its chemical composition). There are no other promised goods or services in the contract.

Case A—License Is Not Distinct

ASC 606-10-55-368

In this case, no other entity can manufacture this drug while the customer learns the manufacturing process and builds its own manufacturing capability because of the highly specialized nature of the manufacturing process. As a result, the license cannot be purchased separately from the manufacturing service.

ASC 606-10-55-369

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer cannot benefit from the license without the manufacturing service; therefore, the criterion in paragraph 606-10-25-19(a) is not met. Consequently, the license and the manufacturing service are not distinct, and the entity accounts for the license and the manufacturing service as a single performance obligation.

ASC 606-10-55-370

The nature of the combined good or service for which the customer contracted is a sole sourced supply of the drug for the first five years; the customer benefits from the license only as a result of having access to a supply of the drug. After the first five years, the customer retains solely the right to use the entity's functional intellectual property (see Case B, paragraph 606-10-55-373), and no further performance is required of the entity during Years 6–10. The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation (that is, the bundle of the license and the manufacturing service) is a performance obligation satisfied at a point in time or over time. Regardless of the determination reached in accordance with paragraphs 606-10-25-23 through 25-30, the entity's performance under the contract will be complete at the end of Year 5.

Contractual restrictions

When identifying the performance obligations in a contract that includes an IP license, an entity should distinguish between (a) contractual provisions that require it to transfer to the customer control of additional rights to use or rights to access IP, and (b) contractual provisions that, explicitly or implicitly, define the attributes of a single promised license (for example, restrictions of time, geographical region, or use). The provisions listed in (a), but not those listed in (b), should be evaluated as separate promises when applying Step 2 and determining the performance obligations in the arrangement.

The attributes of a promised license define the scope of a customer's right to use or right to access an entity's IP. As a result, such attributes do not define whether the entity satisfies its performance over time or at a point in time, and do not create an obligation for the entity to transfer any additional IP rights to the customer. The customer already controls the rights conveyed by the license, and there is no additional promise for the entity to fulfill. Therefore, an entity would not evaluate the attributes of a license as separate promises for purposes of identifying the performance obligations in the arrangement.

Evaluating whether a contractual provision is either a single license with multiple attributes or multiple licenses can be challenging and may require significant judgment. A substantive break between the periods when the customer has the right to use the IP might suggest that the two periods are separate licenses.

ASC 606-10-55-64

Contractual provisions that explicitly or implicitly require an entity to transfer control of additional goods or services to a customer (for example, by requiring the entity to transfer control of additional rights to use or rights to access intellectual property that the customer does not already control) should be distinguished from contractual provisions that explicitly or implicitly define the attributes of a single promised license (for example, restrictions of time, geographical region, or use). Attributes of a promised license define the scope of a customer's right to use or right to access the entity's intellectual property and, therefore, do not define whether the entity satisfies its performance obligation at a point in time or over time and do not create an obligation for the entity to transfer any additional rights to use or access its intellectual property.

The following example from ASC 606 illustrates the distinction between contractual provisions that require an entity to transfer additional rights to use or rights to access IP to the customer and contractual provisions that define the attributes of a single promised license.

Example 61B—Distinguishing Multiple Licenses from Attributes of a Single License

ASC 606-10-55-399K

On December 15, 20X0, an entity enters into a contract with a customer that permits the customer to embed the entity's functional intellectual property in two classes of the customer's consumer products (Class 1 and Class 2) for five years beginning on January 1, 20X1. During the first year of the license period, the customer is permitted to embed the entity's intellectual property only in Class 1. Beginning in Year 2 (that is, beginning on January 1, 20X2), the customer is permitted to embed the entity's intellectual property in Class 2. There is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period. There are no other promised goods or services in the contract. The entity provides (or otherwise makes available—for example, makes available for download) a copy of the intellectual property to the customer on December 20, 20X0.

ASC 606-10-55-399L

In identifying the goods and services promised to the customer in the contract (in accordance with guidance in paragraphs 606-10-25-14 through 25-18), the entity considers whether the contract grants

the customer a single promise, for which an attribute of the promised license is that during Year 1 of the contract the customer is restricted from embedding the intellectual property in the Class 2 consumer products, or two promises (that is, a license for a right to embed the entity's intellectual property in Class 1 for a five-year period beginning on January 1, 20X1, and a right to embed the entity's intellectual property in Class 2 for a four-year period beginning on January 1, 20X2).

ASC 606-10-55-399M

In making this assessment, the entity determines that the provision in the contract stipulating that the right for the customer to embed the entity's intellectual property in Class 2 only commences one year after the right for the customer to embed the entity's intellectual property in Class 1 means that after the customer can begin to use and benefit from its right to embed the entity's intellectual property in Class 1 on January 1, 20X1, the entity must still fulfill a second promise to transfer an additional right to use the licensed intellectual property (that is, the entity must still fulfill its promise to grant the customer the right to embed the entity's intellectual property in Class 2). The entity does not transfer control of the right to embed the entity's intellectual property in Class 2 before the customer can begin to use and benefit from that right on January 1, 20X2.

ASC 606-10-55-399N

The entity then concludes that the first promise (the right to embed the entity's intellectual property in Class 1) and the second promise (the right to embed the entity's intellectual property in Class 2) are distinct from each other. The customer can benefit from each right on its own and independently of the other. Therefore, each right is capable of being distinct in accordance with paragraph 606-10-25-19(a). In addition, the entity concludes that the promise to transfer each license is separately identifiable (that is, each right meets the criterion in paragraph 606-10-25-19(b)) on the basis of an evaluation of the principle and the factors in paragraph 606-10-25-21. The entity concludes that it is not providing any integration service with respect to the two rights (that is, the two rights are not inputs to a combined output with functionality that is different from the functionality provided by the licenses independently), neither right significantly modifies or customizes the other, and the entity can fulfill its promise to transfer each right to the customer independently of the other (that is, the entity could transfer either right to the customer without transferring the other). In addition, neither the Class 1 license nor the Class 2 license is integral to the customer's ability to use or benefit from the other.

ASC 606-10-55-399O

Because each right is distinct, they constitute separate performance obligations. On the basis of the nature of the licensed intellectual property and the fact that there is no expectation that the entity will undertake activities to change the functionality of the intellectual property during the license period, each promise to transfer one of the two licenses in this contract provides the customer with a right to use the entity's intellectual property and the entity's promise to transfer each license is, therefore, satisfied at a point in time. The entity determines at what point in time to recognize the revenue allocable to each performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Because a customer does not control a license until it can begin to use and benefit from the rights conveyed, the entity recognizes revenue allocated to the Class 1 license no earlier than January 1, 20X1, and the revenue on the Class 2 license no earlier than January 1, 20X2.

In many cases, a contractual restriction defines the attributes of the license and therefore does not constitute a separate promise. The following table highlights some common examples of contractual restrictions and how they are accounted for under the licensing guidance in ASC 606.

Contractual restriction	Example	Generally a separate promise or an attribute of the license?
Establishes the period of time the customer may use the license	The licensee may use a patent beginning January 1, 20X1 through December 31, 20X1.	Attribute
Defines the jurisdiction and the time period in which the customer may use the license	The licensee may use the patent in the United States only from January 1, 20X1 through December 31, 20X1.	Attribute
Expands the scope of the rights over the contractual period	The licensee may use the patent in the United States from January 1, 20X1 through December 31, 20X1 and in the United Kingdom as well as the United States from January 1, 20X2 through December 31, 20X2.	Two separate promises: one for use in the United States in 20X1 – 20X2 and a second for use in the United Kingdom in 20X2
Expands the rights provided under the license over the contractual period	The licensee may use only in the United States patent A from January 1, 20X1 through December 31, 20X2 and patent B from January 1, 20X2 through December 31, 20X2.	Two separate promises: one for patent A in 20X1 through 20X2 and a second for patent B in 20X2

Guarantees to defend a patent

The guidance states that a promise to defend a patent right is not a promised good or service because it provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract. This provision is consistent with the guidance on warranties in ASC 606 (Section 4.6), which stipulates that an entity should not identify a warranty as a separate performance obligation if that warranty only assures the customer that the product will operate as intended.

ASC 606-10-55-64A

Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorized use do not affect whether a license provides a right to access the entity's intellectual property or a right to use the entity's intellectual property. Similarly, a promise to defend a patent right is not a promised good or service because it provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract.

8.3 Determining the nature of the entity's promise in granting a license

To decide whether revenue for a license should be recognized over time or at a point in time, an entity must determine the nature of its promise in granting the license. ASC 606-10-55-58 provides two types of IP licenses:

- A right to access the entity's IP
- A right to use the entity's IP

ASC 606-10-55-58

In evaluating whether a license transfers to a customer at a point in time or over time, an entity should consider whether the nature of the entity's promise in granting the license to a customer is to provide the customer with either:

a. A right to access the entity's intellectual property throughout the license period (or its remaining economic life, if shorter)

b. A right to use the entity's intellectual property as it exists at the point in time at which the license is granted.

In addition to determining whether the license is "to access" or "to use" the IP, ASC 606 distinguishes between whether the IP is "functional" or "symbolic." The distinction focuses on the utility of the IP, which is the IP's ability to provide benefits or value to the customer.

ASC 606-10-55-59

To determine whether the entity's promise [is] to provide a right to access its intellectual property or a right to use its intellectual property, the entity should consider the nature of the intellectual property to which the customer will have rights. Intellectual property is either:

a. Functional intellectual property. Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality.

b. Symbolic intellectual property. Intellectual property that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities.

8.3.1 Functional intellectual property

As stated in ASC 606-10-55-59, functional IP derives a substantial portion of its utility from its significant stand-alone functionality. It includes most software, biological compounds or drug formulas, and completed media content. "Stand-alone functionality" includes the ability to process a transaction, perform

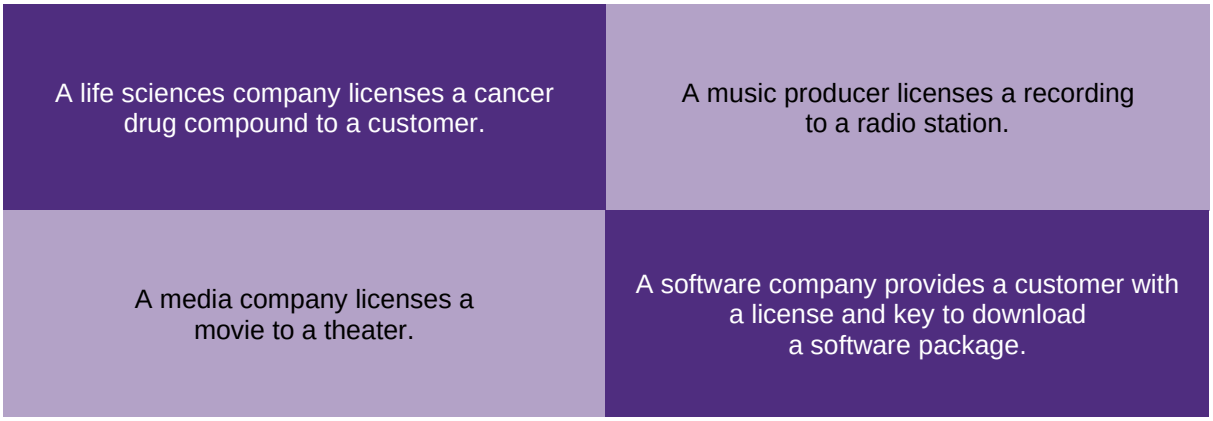
a function or task, or be played or aired. An entity's promise to grant a customer a license to functional IP does not include a promise to support or maintain that IP during the license period; therefore, an entity satisfies its obligation at the point in time when the customer can use and benefit from the license.

ASC 606-10-55-58B

An entity's promise to provide a customer with the right to use its intellectual property is satisfied at a point in time. The entity should apply paragraph 606-10-25-30 to determine the point in time at which the license transfers to the customer.

The figure below provides common examples of functional IP.

Figure 8.1: Common examples of functional IP



Example 54 in ASC 606 illustrates how to apply the revenue model to a right-to-use license of functional software.

Example 54—Right to Use Intellectual Property

ASC 606-10-55-362

Using the same facts as in Case A in Example 11, (see paragraphs 606-10-55-141 through 55-145), the entity identifies four performance obligations in a contract:

a. The software license

b. Installation services

c. Software updates

d. Technical support.

ASC 606-10-55-363

The entity assesses the nature of its promise to transfer the software license. The entity first concludes that the software to which the customer obtains rights as a result of the license is functional intellectual property. This is because the software has significant standalone functionality from which the customer can derive substantial benefit regardless of the entity's ongoing business activities.

ASC 606-10-55-363A

The entity further concludes that while the functionality of the underlying software is expected to change during the license period as a result of the entity's continued development efforts, the functionality of the software to which the customer has rights (that is, the customer's instance of the software) will change only as a result of the entity's promise to provide when-and-if available software updates. Because the entity's promise to provide software updates represents an additional promised service in the contract, the entity's activities to fulfill that promised service are not considered in evaluating the criteria in paragraph 606-10-55-62. The entity further notes that the customer has the right to install, or not install, software updates when they are provided such that the criterion in 606-10-55-62(b) would not be met even if the entity's activities to develop and provide software updates had met the criterion in paragraph 606-10-55-62(a).

ASC 606-10-55-363B

Therefore, the entity concludes that it has provided the customer with a right to use its software as it exists at the point in time the license is granted and the entity accounts for the software license performance obligation as a performance obligation satisfied at a point in time. The entity recognizes revenue on the software license performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C.

Functional IP

Entity A contracts with a customer to provide a two-year software license and post-contract customer support (PCS). The customer can download the software using a passcode provided by Entity A at the time the contract is signed, and thereafter the customer may use the software on its own device.

Entity A determines that there are two performance obligations in the arrangement—the license and the PCS—because both the license and PCS are capable of being distinct and are distinct in the context of the contract.

Entity A concludes that the license provides a right to use the software, which means the software is functional IP. The software has significant stand-alone functionality and derives a substantial portion of its utility from its functionality. As a result, Entity A recognizes revenue at the point in time when the customer can use and benefit from the license.

Entity A concludes that the PCS meets the criterion for over-time revenue recognition in ASC 606-10-25-27(a) because the customer simultaneously receives and consumes the benefits of the PCS as the entity performs. As a result, the entity recognizes revenue allocated to the PCS over the PCS period.

Functional software expected to substantively change

There is an exception to the general guidance for functional IP when the functionality of the IP is expected to change substantively due to the entity's actions, and the customer must either contractually or practically use the updated IP. In this case, the entity's promise to grant the customer a license includes a promise to support or maintain that IP during the license period, and therefore the entity recognizes revenue over the license period.

ASC 606-10-55-62

A license to functional intellectual property grants a right to use the entity's intellectual property as it exists at the point in time at which the license is granted unless both of the following criteria are met:

a. The functionality of the intellectual property to which the customer has rights is expected to substantively change during the license period as a result of activities of the entity that do not transfer a promised good or service to the customer (see paragraphs 606-10-25-16 through 25-18). Additional promised goods or services (for example, intellectual property upgrade rights or rights to use or access additional intellectual property) are not considered in assessing this criterion.

b. The customer is contractually or practically required to use the updated intellectual property resulting from the activities in criterion (a).

If both of those criteria are met, then the license grants a right to access the entity's intellectual property.

Example 59 in ASC 606 demonstrates how an entity evaluates whether the criteria in ASC 606-10-55-62 are met.

Example 59—Right to Use Intellectual Property (excerpt)

Case A—Initial License

ASC 606-10-55-389

An entity, a music record label, licenses to a customer a recording of a classical symphony by a noted orchestra. The customer, a consumer products company, has the right to use the recorded symphony in all commercials, including television, radio, and online advertisements for two years in Country A starting on January 1, 20X1. In exchange for providing the license, the entity receives fixed consideration of $10,000 per month. The contract does not include any other goods or services to be provided by the entity. The contract is noncancellable.

ASC 606-10-55-390

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity concludes that its only performance obligation is to grant the license. The term of the license (two years), the geographical scope of the license (that is, the customer's right to use the symphony only in Country A), and the defined permitted uses for the recording (that is, use in commercials) are all attributes of the promised license in

this contract.

ASC 606-10-55-391

In determining that the promised license provides the customer with a right to use its intellectual property as it exists at the point in time at which the license is granted, the entity considers the following:

a. The classical symphony recording has significant standalone functionality because the recording can be played in its present, completed form without the entity's further involvement. The customer can derive substantial benefit from that functionality regardless of the entity's further activities or actions. Therefore, the nature of the licensed intellectual property is functional.

b. The contract does not require, and the customer does not reasonably expect, that the entity will undertake activities to change the licensed recording.

Therefore, the criteria in paragraph 606-10-55-62 are not met.

ASC 606-10-55-392

In accordance with paragraph 606-10-55-58B, the promised license, which provides the customer with a right to use the entity's intellectual property, is a performance obligation satisfied at a point in time. The entity recognizes revenue from the satisfaction of that performance obligation in accordance with paragraphs 606-10-55-58B through 55-58C. Additionally, because of the length of time between the entity's performance (at the beginning of the period) and the customer's monthly payments over two years (which are noncancellable), the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

8.3.2 Symbolic intellectual property

In contrast to functional IP, symbolic IP does not have significant stand-alone functionality. As stated in ASC 606-10-55-59, its utility is derived from the licensor's past and ongoing activities. Examples of symbolic IP are brands, team or trade names, logos, and franchise rights. An entity's promise to grant a customer a license to symbolic IP includes supporting or maintaining that IP during the license period; therefore, the customer simultaneously receives and consumes the benefits from its right to access symbolic IP as the entity performs, which means that an entity satisfies its promise to provide a license to symbolic IP over time.

ASC 606-10-55-58A

An entity should account for a promise to provide a customer with a right to access the entity's intellectual property as a performance obligation satisfied over time because the customer will simultaneously receive and consume the benefit from the entity's performance of providing access to its intellectual property as the performance occurs (see paragraph 606-10-25-27(a)). An entity should apply paragraphs 606-10-25-31 through 25-37 to select an appropriate method to measure its progress toward complete satisfaction of that performance obligation to provide access to its intellectual property.

ASC 606-10-55-60

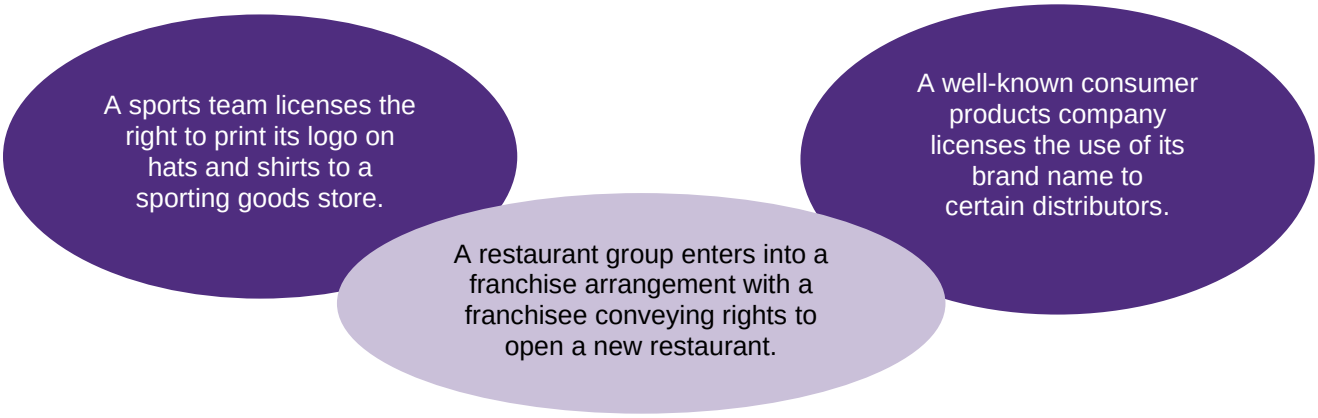
A customer's ability to derive benefit from a license to symbolic intellectual property depends on the entity continuing to support or maintain the intellectual property. Therefore, a license to symbolic

intellectual property grants the customer a right to access the entity's intellectual property, which is satisfied over time (see paragraphs 606-10-55-58A and 606-10-55-58C) as the entity fulfills its promise to both:

a. Grant the customer rights to use and benefit from the entity's intellectual property

b. Support or maintain the intellectual property. An entity generally supports or maintains symbolic intellectual property by continuing to undertake those activities from which the utility of the intellectual property is derived and/or refraining from activities or other actions that would significantly degrade the utility of the intellectual property.

Figure 8.2: Common examples of symbolic IP



Example 61 in ASC 606 provides an example of a right to access symbolic IP.

Example 61—Access to Intellectual Property

ASC 606-10-55-395

An entity, a well-known sports team, licenses the use of its name and logo to a customer. The customer, an apparel designer, has the right to use the sports team's name and logo on items including t-shirts, caps, mugs, and towels for one year. In exchange for providing the license, the entity will receive fixed consideration of $2 million and a royalty of 5 percent of the sales price of any items using the team name or logo. The customer expects that the entity will continue to play games and provide a competitive team.

ASC 606-10-55-396

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity concludes that the only good or service promised to the customer in the contract is the license. The additional activities associated with the license (that is, continuing to play games and provide a competitive team) do not directly transfer a good or service to the customer. Therefore, there is one performance obligation in the contract.

ASC 606-10-55-397

To determine whether the entity's promise in granting the license provides the customer with a right to access the entity's intellectual property or a right to use the entity's intellectual property, the entity assesses the nature of the intellectual property to which the customer obtains rights. The entity concludes that the intellectual property to which the customer obtains rights is symbolic intellectual property. The utility of the team name and logo to the customer is derived from the entity's past and ongoing activities of playing games and providing a competitive team (that is, those activities effectively give value to the intellectual property). Absent those activities, the team name and logo would have little or no utility to the customer because they have no standalone functionality (that is, no ability to perform or fulfill a task separate from their role as symbols of the entity's past and ongoing activities).

ASC 606-10-55-398

Consequently, the entity's promise in granting the license provides the customer with the right to access the entity's intellectual property throughout the license period and, in accordance with paragraph 606-10-55-58A, the entity accounts for the promised license as a performance obligation satisfied over time.

ASC 606-10-55-399

The entity recognizes the fixed consideration allocable to the license performance obligation in accordance with paragraphs 606-10-55-58A and 606-10-55-58C. This includes applying paragraphs 606-10-25-31 through 25-37 to identify the method that best depicts the entity's performance in satisfying the license. For the consideration that is in the form of a sales-based royalty, paragraph 606-10-55-65 applies because the sales-based royalty relates solely to the license that is the only performance obligation in the contract. The entity concludes that recognizing revenue from the sales-based royalty when the customer's subsequent sales of items using the team name or logo occur is consistent with the guidance in paragraph 606-10-55-65(b). That is, the entity concludes that ratable recognition of the fixed consideration of $2 million plus recognition of the royalty fees as the customer's subsequent sales occur reasonably depict the entity's progress toward complete satisfaction of the license performance obligation.

Grant Thornton insight: No exceptions to recognizing revenue related to symbolic IP over time

In the spirit of increased operability, the FASB opted to require entities to recognize revenue from all licenses to symbolic IP over time. As a result, revenue from a license to symbolic IP should be recognized over time, regardless of whether the entity undertakes activities that significantly affect the utility of the IP during the license term.

Figure 8.3 summarizes the guidance for symbolic and functional IP included in ASC 606.

Figure 8.3: Symbolic and functional IP

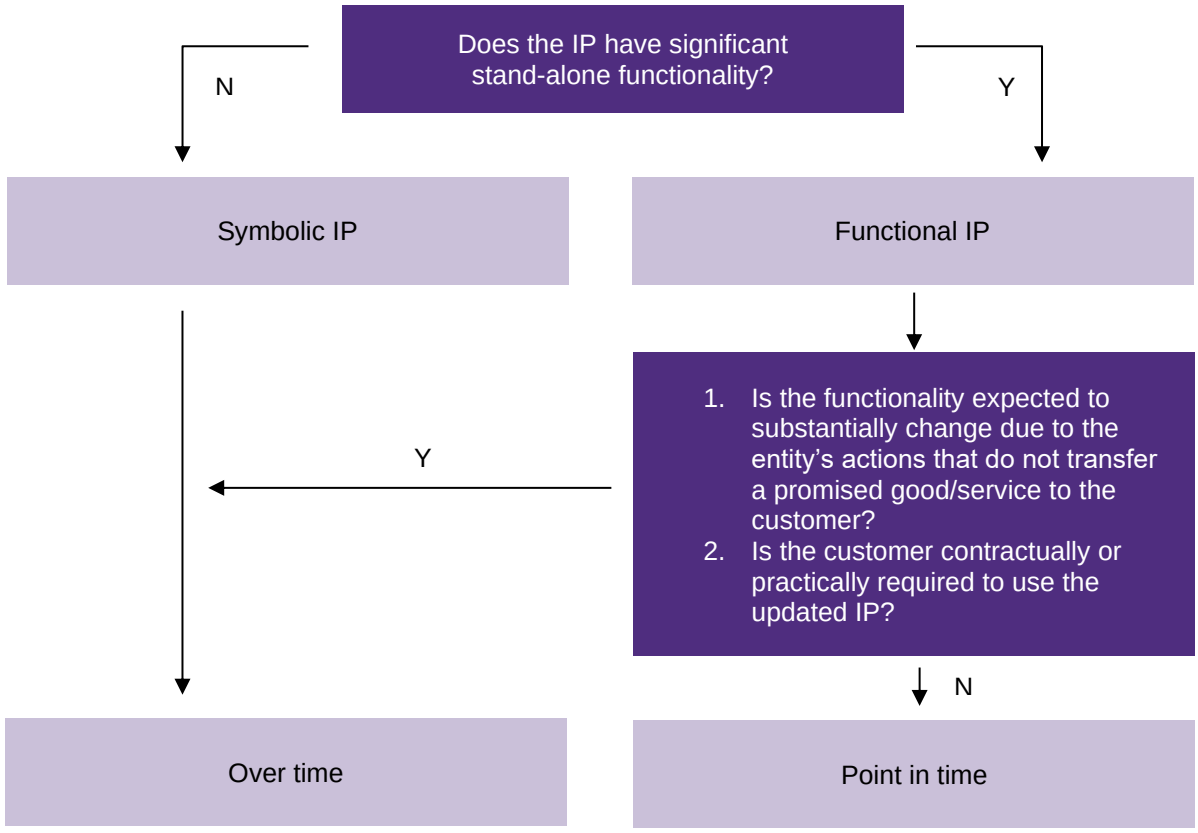


Figure 8.4 provides examples of both symbolic and functional IP as well as the basis for recognizing revenue in each case. The figure does not include functional IP that meets the exception criteria because it is expected to substantively change (see Section 8.3.1).

Figure 8.4: Functional versus symbolic IP at a glance

Type of IP	Type of right provided	Examples	Revenue recognized	Basis for revenue recognition pattern
Symbolic	Right to access	Brands, team or trade names, logos, franchise rights	Over time	A license to symbolic IP includes a promise by the entity to support and maintain the IP. The customer simultaneously receives and consumes the benefits from the entity's performance of providing access to its IP as the performance occurs (ASC 606-10-25-27(a)).

Type of IP	Type of right provided	Examples	Revenue recognized	Basis for revenue recognition pattern
Functional	Right to use	Software, biological compounds or drug formulas, completed media content	Point in time	Unlike symbolic IP, functional IP has significant stand-alone functionality. When an entity grants a license to functional IP, it does not promise to support or maintain the IP. None of the over time criteria in ASC 606-10-25-27 are met, so the entity recognizes revenue at the point when control of the right to use the functional IP transfers to the customer.

Franchise rights

Because franchise rights provide the customer with a right to access the entity's logo and trade name and/or sell the entity's products or services, these rights are accounted for as rights to symbolic IP. The utility of the products developed or services provided by a franchisee in accordance with a franchise agreement is derived largely from the products' or services' association with the franchise brand. Substantially all of the utility inherent in the trade name, logo, and product or service rights stem from the entity's past and ongoing activities. As a result, an entity recognizes any consideration received for a franchise license over time, including any upfront or fixed fees.

Example 57 in ASC 606 illustrates how to account for franchise rights.

Example 57—Franchise Rights

ASC 606-10-55-375

An entity enters into a contract with a customer and promises to grant a franchise license that provides the customer with the right to use the entity's trade name and sell the entity's products for 10 years. In addition to the license, the entity also promises to provide the equipment necessary to operate a franchise store. In exchange for granting the license, the entity receives a fixed fee of $1 million, as well as a sales-based royalty of 5 percent of the customer's sales for the term of the license. The fixed consideration for the equipment is $150,000 payable when the equipment is delivered.

Identifying Performance Obligations

ASC 606-10-55-376

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the entity, as a franchisor, has developed a customary business practice to undertake activities such as analyzing the consumers' changing preferences and implementing product improvements, pricing strategies,

marketing campaigns, and operational efficiencies to support the franchise name. However, the entity concludes that these activities do not directly transfer goods or services to the customer.

ASC 606-10-55-377

The entity determines that it has two promises to transfer goods or services: a promise to grant a license and a promise to transfer equipment. In addition, the entity concludes that the promise to grant the license and the promise to transfer the equipment are each distinct. This is because the customer can benefit from each good or service (that is, the license and the equipment) on its own or together with other resources that are readily available (see paragraph 606-10-25-19(a)). The customer can benefit from the license together with the equipment that is delivered before the opening of the franchise, and the equipment can be used in the franchise or sold for an amount other than scrap value. The entity also determines that the promises to grant the franchise license and to transfer the equipment are separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b). The entity concludes that the license and the equipment are not inputs to a combined item (that is, they are not fulfilling what is, in effect, a single promise to the customer). In reaching this conclusion, the entity considers that it is not providing a significant service of integrating the license and the equipment into a combined item (that is, the licensed intellectual property is not a component of, and does not significantly modify, the equipment). Additionally, the license and the equipment are not highly interdependent or highly interrelated because the entity would be able to fulfill each promise (that is, to license the franchise or to transfer the equipment) independently of the other. Consequently, the entity has two performance obligations:

a. The franchise license

b. The equipment.

Allocating the Transaction Price

ASC 606-10-55-378

The entity determines that the transaction price includes fixed consideration of $1,150,000 and variable consideration (5 percent of the customer's sales from the franchise store). The standalone selling price of the equipment is $150,000 and the entity regularly licenses franchises in exchange for 5 percent of customer sales and a similar upfront fee.

ASC 606-10-55-379

The entity applies paragraph 606-10-32-40 to determine whether the variable consideration should be allocated entirely to the performance obligation to transfer the franchise license. The entity concludes that the variable consideration (that is, the sales-based royalty) should be allocated entirely to the franchise license because the variable consideration relates entirely to the entity's promise to grant the franchise license. In addition, the entity observes that allocating $150,000 to the equipment and allocating the sales-based royalty (as well as the additional $1 million in fixed consideration) to the franchise license would be consistent with an allocation based on the entity's relative standalone selling prices in similar contracts. Consequently, the entity concludes that the variable consideration (that is, the sales-based royalty) should be allocated entirely to the performance obligation to grant the franchise license.

Licensing

ASC 606-10-55-380

The entity assesses the nature of the entity's promise to grant the franchise license. The entity concludes that the nature of its promise is to provide a right to access the entity's symbolic intellectual property. The trade name and logo have limited standalone functionality; the utility of the products developed by the entity is derived largely from the products' association with the franchise brand. Substantially all of the utility inherent in the trade name, logo, and product rights granted under the license stems from the entity's past and ongoing activities of establishing, building, and maintaining the franchise brand. The utility of the license is its association with the franchise brand and the related demand for its products.

ASC 606-10-55-381

The entity is granting a license to symbolic intellectual property. Consequently, the license provides the customer with a right to access the entity's intellectual property and the entity's performance obligation to transfer the license is satisfied over time in accordance with paragraph 606-10-55-58A. The entity recognizes the fixed consideration allocable to the license performance obligation in accordance with paragraph 606-10-55-58A and paragraph 606-10-55-58C. This includes applying paragraphs 606-10-25-31 through 25-37 to identify the method that best depicts the entity's performance in satisfying the license (see paragraph 606-10-55-382).

ASC 606-10-55-382

Because the consideration that is in the form of a sales-based royalty relates specifically to the franchise license (see paragraph 606-10-55-379), the entity applies paragraph 606-10-55-65 in recognizing that consideration as revenue. Consequently, the entity recognizes revenue from the sales-based royalty as and when the sales occur. The entity concludes that recognizing revenue resulting from the sales-based royalty when the customer's subsequent sales occur is consistent with the guidance in paragraph 606-10-55-65(b). That is, the entity concludes that ratable recognition of the fixed $1 million franchise fee plus recognition of the periodic royalty fees as the customer's subsequent sales occur reasonably depict the entity's performance toward complete satisfaction of the franchise license performance obligation to which the sales-based royalty has been allocated.

8.4 Transferring control of the license

Regardless of whether an entity transfers a license to functional or to symbolic IP, the entity cannot recognize revenue from the license before both (1) the entity provides or otherwise makes available a copy of the IP to the customer, and (2) the customer can use and benefit from the IP.

ASC 606-10-55-58C

Notwithstanding paragraphs 606-10-55-58A through 55-58B, revenue cannot be recognized from a license of intellectual property before both:

a. An entity provides (or otherwise makes available) a copy of the intellectual property to the customer.

b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property. That is, an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy

of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.

The example below demonstrates how to apply the guidance in ASC 606-10-55-58C.

Transferring control of the license

On January 1, 20X0, Entity A enters into a one-year contract with a customer to grant the customer the right to use Entity A's technology in two of the customer's products beginning February 1, 20X0. Entity A provides the customer with the technology on January 15, 20X0.

Control of the technology does not transfer until February 1, 20X0. Therefore, Entity A cannot begin to recognize revenue until February 1, 20X0 because that's the date when the customer can start to use and benefit from its right to use Entity A's technology.

8.4.1 Renewals

The guidance specifies that an entity should not recognize revenue from a license renewal any earlier than the beginning of the renewal period. BC50 in ASU 2016-10 clarifies that when two parties enter into a contract to renew or extend a license, the entity should not combine the initial contract with the renewal unless the contract combination criteria in ASC 606-10-25-9 are met. The additional rights granted by the renewal are evaluated in the same manner as any other rights granted to the customer. In other words, the entity recognizes revenue from the transfer of the license only when the customer can begin to use and benefit from the license renewal, which generally is the beginning of the renewal period.

ASC 606-10-55-58C

Notwithstanding paragraphs 606-10-55-58A through 55-58B, revenue cannot be recognized from a license of intellectual property before both:

a. An entity provides (or otherwise makes available) a copy of the intellectual property to the customer.

b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property. That is, an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.

Grant Thornton insight: Revenue from renewals

The FASB decided to require entities to recognize revenue from a renewal of a "right to use" license at the beginning of the renewal period rather than when the renewal is agreed to by the parties, in part, to make the guidance more operable, since it alleviates the need to evaluate whether a renewal is for the same or a different IP as the initial license.[76]

Example 59 in ASC 606, specifically Case B, describes how an entity accounts for the renewal of a license to use functional IP. Note that Case B builds on Case A about the classical symphony recording, which is outlined above.

Example 59—Right to Use Intellectual Property (excerpt)

Case B—Renewal of the License

ASC 606-10-55-392A

At the end of the first year of the license period, on December 31, 20X1, the entity and the customer agree to renew the license to the recorded symphony for two additional years, subject to the same terms and conditions as the original license. The entity will continue to receive fixed consideration of $10,000 per month during the 2-year renewal period.

ASC 606-10-55-392B

The entity considers the contract combination guidance in paragraph 606-10-25-9 and assesses that the renewal was not entered into at or near the same time as the original license and, therefore, is not combined with the initial contract. The entity evaluates whether the renewal should be treated as a new license or the modification of an existing license. Assume that in this scenario, the renewal is distinct. If the price for the renewal reflects its standalone selling price, the entity will, in accordance with paragraph 606-10-25-12, account for the renewal as a separate contract with the customer. Alternatively, if the price for the renewal does not reflect the standalone selling price of the renewal, the entity will account for the renewal as a modification of the original license contract.

ASC 606-10-55-392C

In determining when to recognize revenue attributable to the license renewal, the entity considers the guidance in paragraph 606-10-55-58C and determines that the customer cannot use and benefit from the license before the beginning of the two-year renewal period on January 1, 20X3. Therefore, revenue for the renewal cannot be recognized before that date.

ASC 606-10-55-392D

Consistent with Case A, because the customer's additional monthly payments for the modification to the license will be made over two years from the date the customer obtains control of the second license,

[76] BC50, ASU 2016-10.

the entity considers the guidance in paragraphs 606-10-32-15 through 32-20 to determine whether a significant financing component exists.

License renewal with a modification

A renewal of a license of IP often is accompanied by other modifications to the contract, including adding or removing other goods or services from the contract or changing the original pricing of the IP granted to the customer. The interaction of the renewal guidance and the modification guidance in ASC 606 has triggered questions about how to account for contract modifications if an entity both extends the term of the arrangement and adds new rights, as well as how to account for the revocation of licensing rights, such as the conversion of a term software license into a SaaS arrangement.

Grant Thornton insight: Modification of licenses of intellectual property

In 2019, the EITF added Issue 19-B to its agenda, with the objective of reducing the diversity in practice around accounting for modifications of IP licenses. This project included the following scenarios within its scope

- Modifications where the term for existing rights was extended and new rights were added
- Accounting for the revocation of licensing rights, including conversion of term software licenses to software as a service (SaaS) arrangements

In situations where the modification results in an extension of the contractual term and additional rights, some entities recognize revenue for the license renewal at the modification date, while others recognize revenue at the start of the renewal period. (See “Extending contract term and simultaneously adding rights” for more information.)

When there is a contract modification that includes the revocation of licensing rights, such as when a software license is converted into a SaaS arrangement, there have been questions regarding how to account for the modification when a functional IP license recognized at a point in time converts to a service provided over time. Some entities apply a right-of-return model to account for the potential conversion of the functional IP license to SaaS. The right of return is treated as variable consideration, subject to the constraint, and the estimate is updated at each reporting period. If the customer exercises the option to convert the license, the amount deferred would be recognized as SaaS revenue over the remaining contractual term. However, other entities account for the conversion as a contract modification, which results in prospective accounting treatment. In other words, there is no revenue deferral at inception of the term license and no adjustment to revenue upon the conversion. Unrecognized revenue at the date of conversion (if any) is recognized over the remaining SaaS arrangement.

The Board decided to remove the EITF project from its technical agenda. Because the project is not active, we believe an entity must make a policy election to account for these modifications and must apply that policy election consistently to similar arrangements.

Extending contract term and simultaneously adding rights

There is currently diversity in how the contract modification guidance and the renewal guidance in ASC 606 is applied when an entity extends the original license term and grants additional rights to the licensee in a single arrangement. In other words, in this scenario, the contract extension does not retain the same terms and conditions as the original license.

One view is that the entity should follow the licensing renewal guidance in ASC 606-10-55-58C, which states that the entity cannot recognize revenue prior to the start of the renewal period. An alternative view is that the entity should follow the contract modification guidance in ASC 606-10-25-12 and 25-13, meaning the modification would be accounted for as the termination of the existing contract and the creation of a new contract. Because the EITF and FASB decided not to address the issue, we believe that entities should make a policy election and apply the election consistently for similar modifications and renewals to similar contracts.

Modification and renewal of an IP license

On January 1, 20X0, Entity A enters into a two-year contract with a customer to grant the customer a license to use 10 seats of software A (functional IP) for $10,000. On December 31, 20X0, the parties modify the contract to add an additional 5 seats for a two-year term for an additional $5,000 and to extend the term of the original 10 seats to December 31, 20X2.

Policy Choice 1 – Contract renewal for existing rights and new contract for new rights

The entity's performance under the original contract is complete. The entity transfers control of the license to 10 seats on January 1, 20X0 and recognizes $10,000 on that date. The modification should be accounted for separately as a new contract with two performance obligations:

- A renewal of the original license for 10 seats for one year beginning on January 1, 20X2 and
- A new contract with a license for 5 additional seats for two years beginning on the modification date

The $5,000 for the modification to add the additional five seats and to extend the contract for two years is allocated on a relative SASP basis to the two performance obligations. The amount allocated to the renewal of the original 10 seats is recognized at the start of the renewal period (January 1, 20X2), and the amount allocated to the 5 new seats is recognized on the modification date.

Policy Choice 2 – Termination of the existing contract and the creation of a new contract

Under the second policy election, the modification results in the termination of the existing contract and the creation of a new contract. Accordingly, there is no need to analyze whether the additional rights are priced at SASP. Entity A recognizes $5,000 as revenue on the modification date when the license to the 5 new seats is provided.

8.5 Sales-based and usage-based royalties

ASC 606 provides an exception to applying Step 3's estimation guidance and Step 5's recognition guidance, referred to as the "royalty exception." The exception applies only to licenses of IP when the consideration is wholly or partially based on a customer's subsequent sales or usage and may not be applied by analogy to non-IP license arrangements as discussed in Section 8.5.1 below.

The Board decided to include this exception in the guidance because, without it, an entity would need to estimate the amount of IP royalties it expects to be entitled to throughout the life of the contract and to recognize a minimum amount of revenue, which would inevitably require significant adjustments as a result of changes in circumstances that are not related to the entity's performance.[77] This approach of estimating and adjusting could result in information that is of limited use to financial statement users.

Instead, as a result of the exception provided in ASC 606-10-55-65, an entity recognizes revenue for a sales-based or usage-based royalty related to a license of IP at the later of when (a) the underlying sale or usage occurs, or (b) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated is satisfied (or partially satisfied).

ASC 606-10-55-65

Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.

b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

An entity recognizes revenue from a sales-based or usage-based royalty when or as the customer's subsequent sale or usage occurs, unless this approach accelerates the recognition of revenue ahead of the entity's performance. The Board explains in BC71 of ASU 2016-10 that revenue recognition might be accelerated ahead of the entity's performance in some circumstances where the performance obligation is satisfied over time. This may occur when the consideration, in the form of a sales-based or usage-based royalty, declines over the license period because of a declining royalty rate. For example, an entity may receive 8 percent of sales until cumulative sales equal $1 million, and then the entity may receive 4 percent of sales up to the next $3 million, and 2 percent of sales thereafter. The declining royalty rate does not reflect changing value to the customer if the entity's performance is equal in each period. Recognizing royalties as the sales occur where the royalty rate declines over time may subvert the recognition principle of the guidance. In this case and similar cases, an entity should apply judgment to determine the appropriate pattern of revenue recognition based on the facts and circumstances of the arrangement.

Many licensors learn of licensee sales or usage and the related royalty after the close of a period. Historic practices included recognizing those royalties on a consistent lag basis in the period the information was made available to the licensor. The guidance in ASC 606-10-55-65, however, does not provide an exception to the guidance for any time lags in receiving data that supports the sales or usage, as explained below.

[77] BC73, ASU 2016-10.

Grant Thornton insight: Reporting royalties on a lag

In a speech before the 35th Annual SEC and Financial Reporting Institute Conference in 2016, Wesley R. Bricker, then Deputy Chief Accountant for the SEC, reminded stakeholders that the FASB did not provide a "lagged reporting exception" for sales-based and usage-based royalties. As a result, entities need to estimate the sales- and usage-based royalties to which they expect to be entitled for the current period so that the royalties are recognized in the appropriate period. While the "royalties exception" allows an entity to avoid estimating royalties using the variable consideration and constraint guidance in Step 3, the entity still needs to determine its best estimate of the expected royalties for the current reporting period if it is unable to obtain timely data on actual sales- or usage-based royalties.

Grant Thornton insight: Estimating sales-based and usage-based royalties

The "royalty exception" in ASC 606 provides an entity with relief from estimating and constraining variable consideration when the variability relates to consideration tied to the sales and usage of intellectual property; however, the "royalty exception" does not completely absolve the entity from all estimations.

For example, some pharmaceutical manufacturers receive sales reports from their distributors on a quarterly basis, and the manufacturers use these reports, which summarize sales by product and geography, to recognize revenue. Often, these reported numbers include estimates, such as sales rebates and returns, which the distributor will update and finalize in a future report based on the actual number of rebates and returns related to sales in the current period. The manufacturer should consider whether the estimates in the reported sales data are reasonable or if they require further adjustments—for example, modifications based on the manufacturer's historical records and statistics.

8.5.1 Scope of the exception

The royalties exception applies to a "royalty promised in exchange for a license of intellectual property." The FASB clarified in ASC 606-10-55-65A that the exception applies when an IP license is the sole or predominant item to which the royalty relates. In other words, the royalty may also constitute consideration for other goods or services in the contract, but the royalty exception would apply only if the customer ascribes significantly more value to the IP license than to the other goods or services in the contract. An entity needs to apply judgment to determine whether a license is the predominant item to which the sales-based or usage-based royalty relates.

ASC 606 limits the sales-based or usage-based royalty guidance to IP licenses.

ASC 606-10-55-65A

The guidance for a sales-based or usage-based royalty in paragraph 606-10-55-65 applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the

customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

Example 60 in ASC 606 demonstrates a situation in which a sales-based royalty relates to both a license and other promotional goods and services, and the entity concludes that the license is the predominant item to which the royalty relates. However, the Example also says that if the license is a separate performance obligation from the other goods and services in a contract, the entity would need to allocate the sales-based royalty to each performance obligation, regardless of whether it can apply the sales-based royalty exception.

Example 60—Sales-Based Royalty Promised in Exchange for a License of Intellectual Property and Other Goods and Services

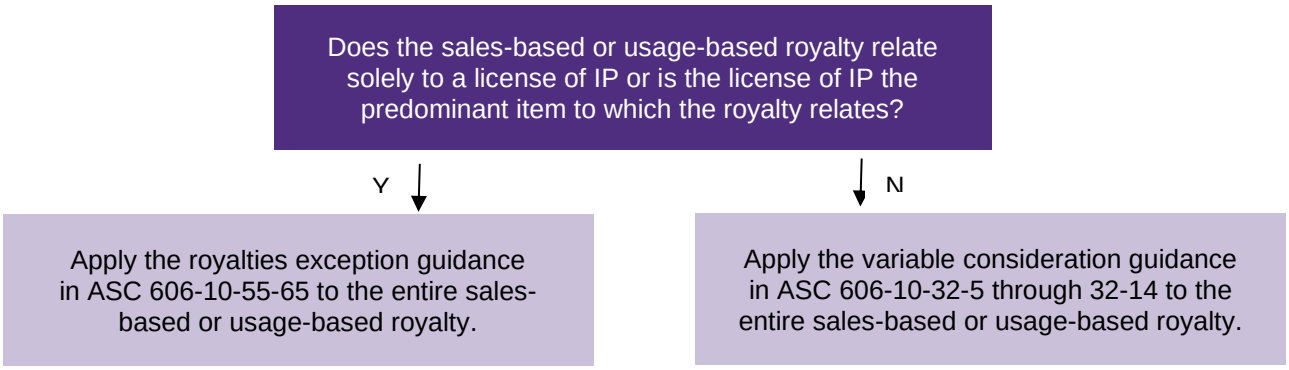
ASC 606-10-55-393

An entity, a movie distribution company, licenses Movie XYZ to a customer. The customer, an operator of cinemas, has the right to show the movie in its cinemas for six weeks. Additionally, the entity has agreed to provide memorabilia from the filming to the customer for display at the customer's cinemas before the beginning of the six-week airing period and to sponsor radio advertisements for Movie XYZ on popular radio stations in the customer's geographical area throughout the six-week airing period. In exchange for providing the license and the additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for Movie XYZ (that is, variable consideration in the form of a sales-based royalty).

ASC 606-10-55-394

The entity concludes that the license to show Movie XYZ is the predominant item to which the sales-based royalty relates because the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the related promotional goods or services. The entity will recognize revenue from the sales-based royalty, the only fees to which the entity is entitled under the contract, wholly in accordance with paragraph 606-10-55-65. If the license, the memorabilia, and the advertising activities were separate performance obligations, the entity would allocate the sales-based royalties to each performance obligation.

Figure 8.5: Scope for the sales-based and usage-based royalties exception



As demonstrated in Example 60 above and discussed in ASC 606-10-55-65B, an entity should not split a single royalty into a portion subject to, and a portion not subject to, the royalties exception, regardless of whether the royalty relates to one or more promised goods and services in the contract.

ASC 606-10-55-65B

When the guidance in paragraph 606-10-55-65A is met, revenue from a sales-based or usage-based royalty should be recognized wholly in accordance with the guidance in paragraph 606-10-55-65. When the guidance in paragraph 606-10-55-65A is not met, the guidance on variable consideration in paragraphs 606-10-32-5 through 32-14 applies to the sales-based or usage-based royalty.

8.5.2 Contracts with minimum royalty guarantees

Sometimes license arrangements in which the consideration is in the form of a sales-based or usage-based royalty also include a minimum guaranteed royalty. For example, a contract may require the licensee to pay the licensor 5 percent of the licensee's gross sales with a minimum guarantee of $5 million. The guarantee establishes a minimum amount of consideration that the licensor will collect. In other words, the minimum ($5 million in this case) is fixed consideration.

In contracts that do not include a license of IP and that include variable consideration with a minimum guarantee, the minimum guarantee effectively establishes a floor for an entity's estimate of the transaction price and the entity would therefore include the estimated variable consideration (subject to the constraint guidance) in the transaction price. In contrast, for a license of IP, an entity is precluded from recognizing the variable consideration in the form of a sales-based or usage-based royalty before the customer's subsequent sales or usage occurs.

At its November 2016 meeting, the TRG discussed how guaranteed minimum payments would impact the recognition of sales-based or usage-based royalties provided in exchange for licenses of both functional and symbolic IP.

TRG area of general agreement: How does a minimum guarantee impact the recognition of sales-based or usage-based royalties promised in exchange for a license of symbolic IP?

At the November 2016 meeting,[78] the TRG discussed the following example, which illustrates the acceptable methods of recognizing sales-based or usage-based royalties for a symbolic IP license with a minimum guarantee:

> *Entity A enters into a five-year arrangement to license a trademark. The trademark is symbolic IP. The license requires the customer to pay a sales-based royalty of 5 percent of the customer's gross sales associated with the trademark; however, the contract includes a guarantee that the entity will receive a minimum of $5 million for the entire five-year contract period. Entity A expects that the royalties will exceed the minimum guarantee.*
>
> *The customer's actual gross sales associated with the trademark and the related royalties each year are as follows (of course, this information is not known at the beginning of the contract period):*

Year	Sales	Royalties
1	$15 million	$ 750,000
2	$30 million	$1.5 million
3	$40 million	$2.0 million
4	$20 million	$1.0 million
5	$60 million	$3.0 million
Total	$165 million	$8,250,000

For symbolic licenses of IP with a minimum guarantee, the TRG generally agreed that the following broad approaches are reasonable interpretations of the revenue standard, and that entities should apply judgment and consider the specific facts and circumstances of an arrangement to determine which measure of progress is appropriate:

- Recognize revenue from the royalties when the subsequent sales occur (Approach 1)
- Estimate the total transaction price and recognize revenue using an appropriate measure of progress subject to the royalties constraint (Approach 2)
- Recognize the minimum guarantee as fixed consideration using an appropriate measure of progress. Include only the royalties in excess of the minimum guarantee in the variable

[78] TRG Paper 58, *Sales-Based or Usage-Based Royalty with Minimum Guarantee*.

consideration and constrain the amounts until the customer's subsequent sale or usage occurs (Approach 3)

Approach 1

A prerequisite to appropriately applying Approach 1 is that the entity expects the total royalties to exceed the minimum guarantee. In this case, it may be appropriate for an entity to recognize revenue from the royalties when the subsequent sales occur. An appropriate measure of progress may be the practical expedient in ASC 606-10-55-18 (that is, the right to invoice approach as discussed in Section 7.1.3) when the royalties correlate directly with the value to the customer of the entity's performance to date.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Royalties received	$750	$1,500	$2,000	$1,000	$3,000	$8,250
Annual revenue	750	1,500	2,000	1,000	3,000	8,250
Cumulative revenue	750	2,250	4,250	5,250	8,250	

Approach 2

Entity A estimates the total transaction price (including both fixed and variable consideration) and recognizes revenue using an appropriate measure of progress subject to the royalties constraint. Entity A estimates the total transaction price to be $8,250. Under this method, because an element of the consideration is fixed, Entity A may recognize revenue in advance of the royalty from the customer's subsequent sales; however, once the minimum guarantee is met and there is no longer fixed consideration, the remaining consideration is variable, and the entity is precluded from recognizing revenue for sales-based royalties in advance of the underlying sales. As a result, year-four revenue is constrained to $0.3 million because cumulative revenue is constrained to $5.25 million.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Royalties received	$ 750	$1,500	$2,000	$1,000	$3,000	$8,250
Annual revenue	1,650	1,650	1,650	300	3,000	8,250
Cumulative revenue	1,650	3,300	4,950	5,250	8,250	

Approach 3

The variable consideration only includes the royalties in excess of the minimum guarantee, and those royalties are constrained from being recognized until the customer's subsequent sale or usage occurs. Entity A does not begin to recognize any variable consideration until the royalties received exceed $5 million on a cumulative basis because the variable consideration is only the amount in excess of the minimum guarantee of $5 million. In applying Approach 3, Entity A considers the symbolic license to be a series of distinct time periods and the variable consideration (the royalties in excess of the minimum guarantee) are allocated to the distinct time periods in which the subsequent sales entitling Entity A to the variable consideration occur.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Royalties received	$ 750	$1,500	$2,000	$1,000	$3,000	$8,250
Annual revenue	1,000	1,000	1,000	1,250	4,000	8,250
Cumulative revenue	1,000	2,000	3,000	4,250	8,250	

The TRG also discussed functional IP license arrangements with consideration in the form of a sales-based or usage-based royalty and a minimum guarantee. The TRG generally agreed that the licensor should recognize the minimum guaranteed amount as revenue at the point in time when it transfers control of the license to the customer. In this case, the guaranteed amount is not subject to the royalties exception. Royalties above the minimum guarantee, however, would be recognized in accordance with the royalties exception (in other words, generally as the sales or usage occurs).

9. Principal versus agent

In many revenue transactions, more than one party is involved in delivering the goods and services to the customer. In those situations, it is sometimes difficult for an entity to determine whether it is acting as a principal or as an agent, and an entity must often apply significant judgment to reach a conclusion. While the principal-agent guidance in ASC 606 does not eliminate the need for judgment, it is intended to make the principal versus agent assessment easier.

ASC 606 requires an entity to determine whether the nature of its promise is to provide the specified goods or services to the customer or to arrange for another party to provide the goods or services to the customer.

ASC 606-10-55-36 (excerpt)

When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by the other party (that is, the entity is an agent).

If the nature of the promise is to provide the specified goods or services directly to the customer, the entity is a principal and recognizes revenue on a gross basis at the amount of consideration to which it expects to be entitled. In contrast, if the nature of the promise is to arrange for another party to provide the goods or services to the customer, the entity is an agent and recognizes revenue in the net amount of the fee or commission it is entitled to for its agency services. In this case, the net amount might be the amount that the entity retains after paying the other party if the entity is responsible for collecting the full amount of consideration.

ASC 606-10-55-37B

When (or as) an entity that is a principal satisfies a performance obligation, the entity recognizes revenue in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred.

ASC 606-10-55-38

An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be

the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

To determine whether an entity is a principal or an agent in contracts involving more than one party delivering goods or providing services to customers, the entity should first identify the specified goods or services to be provided to the customer and then assess whether it controls the specified goods or services before they are transferred to the customer.

Under ASC 606, “control” of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (either inflows or savings in outflows) that might be obtained by using the asset to produce goods or provide services, to enhance the value of other assets, or to settle liabilities or reduce expenses; by selling or exchanging the asset; by pledging the asset to secure a loan; or by holding the asset.[79]

ASC 606-10-55-36A

To determine the nature of its promise (as described in paragraph 606-10-55-36), the entity should:

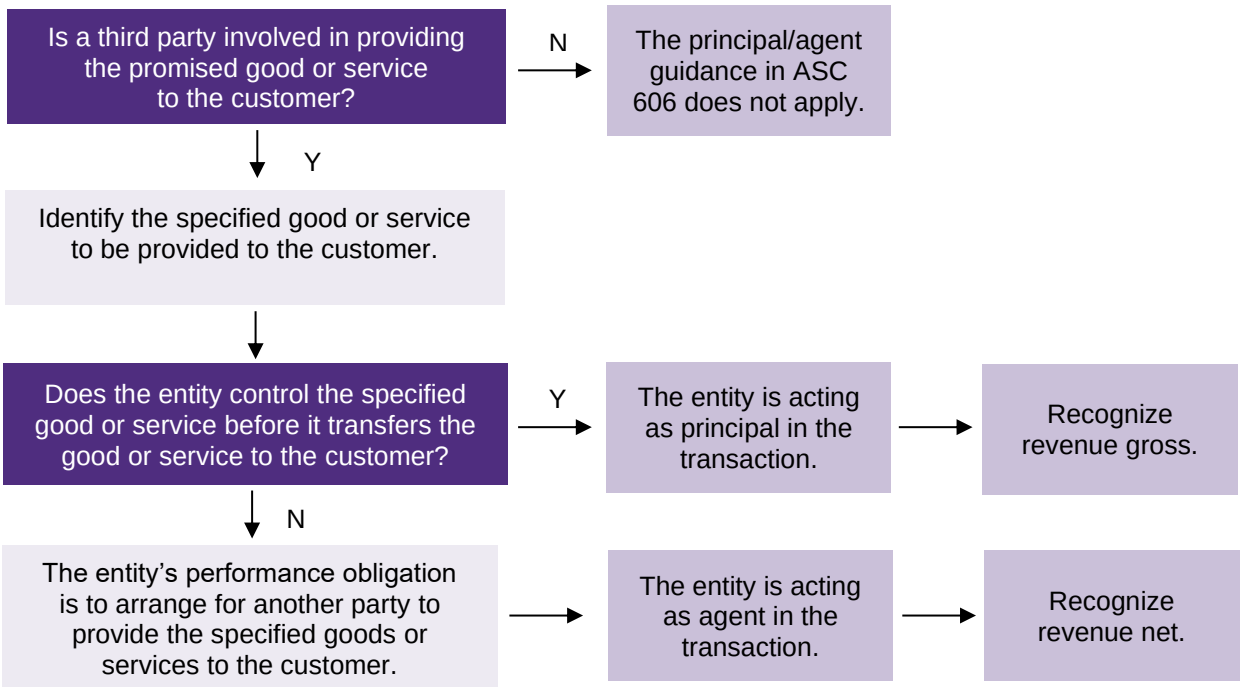
a. Identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party [see paragraph 606-10-25-18])

b. Assess whether it controls (as described in paragraph 606-10-25-25) each specified good or service before that good or service is transferred to the customer.

The following diagram summarizes the guidance in ASC 606 that an entity should consider when assessing whether it is acting as a principal or as an agent in a customer arrangement.

[79] ASC 606-10-25-25.

Figure 9.1: Principal versus agent considerations in ASC 606



Assessing whether the entity controls the specified good or service before it is transferred to the customer is the basis for determining the nature of the entity's promise.[80] To conclude that it is providing the specified good or service itself, the entity should first determine whether it controls the specified good or service before it is transferred to the customer.

9.1 Identifying the specified goods or services promised to the customer

The unit of account for the principal versus agent assessment is the specified good or service, which is defined in ASC 606-10-55-36.

ASC 606-10-55-36 (excerpt)

… An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 606-10-25-19 through 25-22). If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

A specified good or service is a "distinct" good or service or a "distinct" bundle of goods or services to be provided to the customer. ASC 606 defines "distinct" goods and services as those that are both capable of being distinct and are separately identifiable from other promises in the contract (see Section 4.2). If a

[80] BC11, ASU 2014-08.

contract contains more than one specified good or service, an entity should determine if it is principal or agent for each one and may be a principal for some goods or services and an agent for others.

Grant Thornton insight: Specified good or service – not performance obligation

The FASB decided to use the term "specified good or service" rather than "performance obligation" to describe the unit of account for purposes of the principal versus agent evaluation because using the term "performance obligation" would have been confusing when the entity is acting as an agent. An agent's promise (its performance obligation) is to arrange for another party to provide that party's goods or services to the customer. In that circumstance, the specified good or service itself is not the agent's performance obligation.[81]

While the identification of the specified good or service may be straightforward in many contracts, it may be more difficult when an entity attempts to determine whether the specified good or service promised to the customer is the underlying good or service itself or whether it is a right to that good or service.

The following excerpt from Example 46A in ASC 606 demonstrates when the specified good or service promised to the customer is the underlying good or service rather than the right to that good or service.

Example 46A—Promise to Provide Goods or Services (Entity is a Principal) (excerpt)

ASC 606-10-55-324A

An entity enters into a contract with a customer to provide office maintenance services. The entity and the customer define and agree on the scope of the services and negotiate the price. The entity is responsible for ensuring that the services are performed in accordance with the terms and conditions in the contract. The entity invoices the customer for the agreed-upon price on a monthly basis with 10-day payment terms.

ASC 606-10-55-324B

The entity regularly engages third-party service providers to provide office maintenance services to its customers. When the entity obtains a contract from a customer, the entity enters into a contract with one of those service providers, directing the service provider to perform office maintenance services for the customer. The payment terms in the contracts with the service providers generally are aligned with the payment terms in the entity's contracts with customers. However, the entity is obliged to pay the service provider even if the customer fails to pay.

ASC 606-10-55-324C

To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

ASC 606-10-55-324D

[81] BC10, ASU 2016-08.

The entity observes that the specified services to be provided to the customer are the office maintenance services for which the customer contracted and that no other goods or services are promised to the customer. While the entity obtains a right to office maintenance services from the service provider after entering into the contract with the customer, that right is not transferred to the customer. That is, the entity retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right. For example, the entity can decide whether to direct the service provider to provide the office maintenance services for that customer, or for another customer, or at its own facilities. The customer does not have a right to direct the service provider to perform services that the entity has not agreed to provide. Therefore, the right to office maintenance services obtained by the entity from the service provider is not the specified good or service in its contract with the customer.

Example 46A from ASC 606 continues with the evaluation of control in Section 9.2 below.

The following excerpt from Example 47 in ASC 606 demonstrates when the specified good or service promised to the customer is the right to the underlying good or service rather than the underlying good or service itself.

Example 47—Promise to Provide Goods or Services (Entity Is a Principal) (excerpt)

ASC 606-10-55-325

An entity negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public. The entity agrees to buy a specific number of tickets and must pay for those tickets regardless of whether it is able to resell them. The reduced rate paid by the entity for each ticket purchased is negotiated and agreed in advance.

ASC 606-10-55-326

The entity determines the prices at which the airline tickets will be sold to its customers. The entity sells the tickets and collects the consideration from customers when the tickets are purchased.

ASC 606-10-55-327

The entity also assists the customers in resolving complaints with the service provided by the airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

ASC 606-10-55-328

To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by another party (that is, the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

ASC 606-10-55-328A

The entity concludes that with each ticket that it commits itself to purchase from the airline, it obtains control of a right to fly on a specified flight (in the form of a ticket) that the entity then transfers to one of its customers (see paragraph 606-10-55-37A(a)). Consequently, the entity determines that the specified

good or service to be provided to its customer is that right (to a seat on a specific flight) that the entity controls. The entity observes that no other goods or services are promised to the customer.

Example 47 in ASC 606 continues with the evaluation of control in Section 9.2 below.

The proper identification of the specified good or service remains a critical step in determining whether an entity is acting as a principal or an agent in a customer arrangement. This step can be particularly challenging when two parties are involved in providing services to the customer, especially if some of the services can only be provided by a specific service provider.

Identifying the specified good or service when a third party is legally required to provide certain services in the contract

In many arrangements, an entity is engaged by the customer to perform an overall service in exchange for a fee but, due to legal or regulatory restrictions, the entity cannot provide certain sub-services in the contract. As noted in ASC 606-10-55-37A, a principal may obtain control of a service from a third party, which it may then combine with other goods or services, to provide the specified good or service to the customer. Determining whether an entity is a principal or an agent in a revenue transaction can be particularly challenging when two parties are involved in providing services to a customer, especially if some of the services can only be provided by a specific service provider (for example, a licensed physician. See “Identifying the specified good or service when a third party is legally required to provide certain services in the contract”).

At the 2019 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff[82] provided an example of how to evaluate these types of scenarios. First and foremost, the entity must appropriately identify the specified good or service in the arrangement. Further, the SEC clarified that an entity is not precluded from identifying itself as a principal solely because some of the services offered can legally only be provided by a third-party licensed provider. Rather, an entity is not precluded from concluding that it is acting as the principal in an arrangement if the entity (1) has the contractual ability to direct the other service provider to provide services to customers on its behalf, and (2) can demonstrate it is primarily responsible for fulfilling the overall promise to provide specified services.

Identifying the specified good or service when a third party is legally required to provide certain services in the contract

Wellness Company provides cancer patients with an overall specified service of a “cancer treatment and wellness program.” Wellness Company developed its proprietary wellness program that caters to all of a cancer patient’s needs throughout their cancer treatment and recovery journey. After completing a comprehensive intake form using the entity’s proprietary approach, each patient is assigned a “wellness leader,” who customizes the program for each patient, including program execution, chemotherapy treatments, physical and mental rehabilitation, and pharmacy needs. The chemotherapy treatments and

[82] 2019 AICPA Conference on Current SEC and PCAOB Developments, Speech by Lauren K. Alexander, Professional Accounting Fellow, Office of the Chief Accountant.

physical rehabilitation are provided by licensed physicians, and the mental rehabilitation is performed by licensed psychologists, all vetted and engaged separately by Wellness Company.

Wellness Company concludes that the specified good or service in the arrangement is its cancer treatment and wellness program. It determines that it is primarily responsible for providing this service to its customers and therefore is acting as the principal in the arrangement.

When considering the role of the licensed physicians and psychologists, Wellness Company observes that it obtains control of the services provided by these doctors through its contractual relationships, and that it then directs the doctors to treat the patients on its behalf. Further, Wellness Company notes that it integrates the individual services into a unique and comprehensive proprietary wellness program for each of its customers.

9.2 Evaluating control

Once an entity has identified the specified goods or services to be provided to the customer, it must evaluate whether it controls those goods or services before they are transferred to the customer, in which case, it is acting as a principal in the transaction.

An important aspect of the guidance is that a principal either provides the specified good or service to the customer or engages another party to provide some or all of the good or service on its behalf.

ASC 606-10-55-37

An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to the customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

The three instances in which a principal obtains control of a specified good or service are described in ASC 606-10-55-37A.

ASC 606-10-55-37A

When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

a. A good or another asset from the other party that it then transfers to the customer.

b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.

c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 606-10-25-21(a)) provided by

> another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

Determining whether an entity controls a tangible good before it is transferred to a customer is generally straightforward; however, determining whether an entity controls a service before it is transferred to a customer might be more challenging. As a result, the Board included guidance on applying the control principle to service transactions.

In a transaction with more than one party providing goods or services to the customer, a principal obtains control of any one of the following prior to its transfer to a customer:

- An asset from the other party
- A right to a service to be performed by the other party (that is, the entity directs the other party in providing the service to the customer on its behalf)
- An asset or a service from the other party that it then combines with other goods or services to provide the specified good or service to the customer

The first instance is generally straightforward to identify. For example, a car dealership purchases 10 vehicles from a used-car auction for resale to third-party customers. The car dealership assumes inventory risk for the 10 vehicles while they are in its possession.

The second case may be less straightforward to identify. Example 46A in ASC 606 (discussed earlier) illustrates a scenario where an entity engages a third-party service provider to provide office maintenance services to the entity's customers. The entity first obtains a contract with a customer and then enters into a contract with a service provider, directing the service provider to perform office maintenance services for the customer. The specified service is the office maintenance services. While the entity obtains a right to office maintenance services from the service provider after entering into the contract with the customer, that right is not transferred to the customer. In other words, the entity retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right.

An entity is also a principal when the entity obtains control of the third-party's good or service before it integrates the good or service with other goods or services that it provides to the customer as part of transferring control of the overall performance obligation. This situation is common in the engineering and construction industry where entities often engage third-party entities to perform pieces of an overall project (for example, to construct a building), but the entity retains overall responsibility for integrating all of the services into the combined output requested by the customer. The entity identifies a single performance obligation because it conducts a significant service by integrating the promises into the overall output for the customer. As a result, the entity would likely conclude that it is acting as principal.

A further excerpt from Example 46A in ASC 606 (started above in Section 9.1) adds the control evaluation to the analysis.

Example 46A—Promise to Provide Goods or Services (Entity is a Principal) (excerpt)

ASC 606-10-55-324E

The entity concludes that it controls the specified services before they are provided to the customer. The entity obtains control of a right to office maintenance services after entering into the contract with the customer but before those services are provided to the customer. The terms of the entity's contract with the service provider give the entity the ability to direct the service provider to provide the specified services on the entity's behalf (see paragraph 606-10-55-37A(b)).

The example continues in Section 9.3 below with a look at how the indicators support (or do not support) the control evaluation.

A further excerpt from Example 47 in ASC 606 (started above in Section 9.1) adds the control evaluation to the analysis.

Example 47—Promise to Provide Goods or Services (Entity Is a Principal) (excerpt)

ASC 606-10-55-328B

The entity controls the right to each flight before it transfers that specified right to one of its customers because the entity has the ability to direct the use of that right by deciding whether to use the ticket to fulfill a contract with a customer and, if so, which contract it will fulfill. The entity also has the ability to obtain the remaining benefits from that right by either reselling the ticket and obtaining all of the proceeds from the sale or, alternatively, using the ticket itself.

The example continues in Section 9.3 below with a look at how the indicators support (or do not support) the control evaluation.

9.3 Indicators of control

ASC 606 includes indicators that denote when an entity controls the specified good or service before it is transferred to a customer.

ASC 606-10-55-39

Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal [see paragraph 606-10-55-37]) include, but are not limited to, the following:

a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.

b. The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.

c. The entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

ASC 606-10-55-39A

The indicators in paragraph 606-10-55-39 may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

As noted in ASC 606-10-55-39, indicators that an entity controls the specified good or service before it is transferred to a customer include, but are not limited to, the following:

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service.
- The entity has inventory risk.
- The entity has discretion in establishing the price for the specified good or service.

These indicators, which are not all-inclusive, may be more or less relevant to the assessment of control depending on the facts and circumstances of each situation. An entity may determine that other indicators are more persuasive evidence based on the terms of the contract and the facts and circumstances of a particular situation.

The Boards[83] included these indicators to support an entity's assessment of whether it controls the specified good or service before it is transferred or provided to the customer. The indicators

- Do not override the assessment of control
- Do not constitute a separate or additional evaluation
- Are not a checklist of criteria to be met in all situations

[83] BC16, ASU 2016-08.

Grant Thornton insight: Indicators are not weighted

When an entity has an arrangement to provide goods and services to a customer that includes more than one party, it needs to perform an analysis under ASC 606 to determine whether it is acting as a principal or an agent. ASC 606 focuses on the transfer of control to determine how and when an entity is acting as a principal or an agent. In other words, the key question is this: Does the entity control the specified good or service *before* that good or service is transferred to a customer?

ASC 606 provides three indicators to *inform* the entity about its control assessment if that assessment is not determinative in itself. These three indicators are not weighted, and no single indicator alone is determinative of whether an entity is acting like a principal or agent. Rather, ASC 606 says that the indicators may be more or less relevant to the assessment of control, depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

The remaining excerpt from Example 46A in ASC 606, started above in Sections 9.1 and 9.2, demonstrates the entity's consideration of the indictors in ASC 606.

Example 46A—Promise to Provide Goods or Services (Entity is a Principal) (excerpt)

ASC 606-10-55-324E

The entity concludes that it controls the specified services before they are provided to the customer. The entity obtains control of a right to office maintenance services after entering into the contract with the customer but before those services are provided to the customer. The terms of the entity's contract with the service provider give the entity the ability to direct the service provider to provide the specified services on the entity's behalf (see paragraph 606-10-55-37A(b)). In addition, the entity concludes that the following indicators in paragraph 606-10-55-39 provide further evidence that the entity controls the office maintenance services before they are provided to the customer:

a. The entity is primarily responsible for fulfilling the promise to provide office maintenance services. Although the entity has hired a service provider to perform the services promised to the customer, it is the entity itself that is responsible for ensuring that the services are performed and are acceptable to the customer (that is, the entity is responsible for fulfilment of the promise in the contract, regardless of whether the entity performs the services itself or engages a third-party service provider to perform the services).

b. The entity has discretion in setting the price for the services to the customer.

ASC 606-10-55-324F

The entity observes that it does not commit itself to obtain the services from the service provider before obtaining the contract with the customer. Thus, the entity has mitigated its inventory risk with respect to the office maintenance services. Nonetheless, the entity concludes that it controls the office maintenance services before they are provided to the customer on the basis of the evidence in paragraph 606-10-55-324E.

ASC 606-10-55-324G

Thus, the entity is a principal in the transaction and recognizes revenue in the amount of consideration to which it is entitled from the customer in exchange for the office maintenance services.

The remaining excerpt from Example 47 in ASC 606, started above in Sections 9.1 and 9.2, demonstrates the entity's consideration of the indictors that the entity controls the specified good or service in ASC 606.

Example 47—Promise to Provide Goods or Services (Entity Is a Principal) (excerpt)

ASC 606-10-55-328C

The indicators in paragraph 606-10-55-39(b) through (c) also provide relevant evidence that the entity controls each specified right (ticket) before it is transferred to the customer. The entity has inventory risk with respect to the ticket because the entity committed itself to obtain the ticket from the airline before obtaining a contract with a customer to purchase the ticket. This is because the entity is obliged to pay the airline for that right regardless of whether it is able to obtain a customer to resell the ticket to or whether it can obtain a favorable price for the ticket. The entity also establishes the price that the customer will pay for the specified ticket.

ASC 606-10-55-329

Thus, the entity concludes that it is a principal in the transactions with customers. The entity recognizes revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred to the customers.

9.4 Examples of the principal versus agent assessment

ASC 606 includes the following comprehensive example where an entity concludes that it is acting as an agent. In its assessment, the entity identifies the specified good or service and then determines whether it controls the specified good or service before it is transferred to the customer. The entity considers the indicators to support the control assessment.

Example 45—Arranging for the Provision of Goods or Services (Entity Is an Agent)

ASC 606-10-55-317

An entity operates a website that enables customers to purchase goods from a range of suppliers who deliver the goods directly to the customers. Under the terms of the entity's contracts with suppliers, when a good is purchased via the website, the entity is entitled to a commission that is equal to 10 percent of the sales price. The entity's website facilitates payment between the supplier and the customer at prices that are set by the supplier. The entity requires payment from customers before orders are processed, and all orders are nonrefundable. The entity has no further obligations to the customer after arranging for the products to be provided to the customer.

ASC 606-10-55-318

To determine whether the entity's performance obligation is to provide the specified goods itself (that is, the entity is a principal) or to arrange for those goods to be provided by the supplier (that is, the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

ASC 606-10-55-318A

The website operated by the entity is a marketplace in which suppliers offer their goods and customers purchase the goods that are offered by the suppliers. Accordingly, the entity observes that the specified goods to be provided to customers that use the website are the goods provided by the suppliers, and no other goods or services are promised to customers by the entity.

ASC 606-10-55-318B

The entity concludes that it does not control the specified goods before they are transferred to customers that order goods using the website. The entity does not at any time have the ability to direct the use of the goods transferred to customers. For example, it cannot direct the goods to parties other than the customer or prevent the supplier from transferring those goods to the customer. The entity does not control the suppliers' inventory of goods used to fulfill the orders placed by customers using the website.

ASC 606-10-55-318C

As part of reaching that conclusion, the entity considers the following indicators in paragraph 606-10-55-39. The entity concludes that these indicators provide further evidence that it does not control the specified goods before they are transferred to the customers.

a. The supplier is primarily responsible for fulfilling the promise to provide the goods to the customer. The entity is neither obliged to provide the goods if the supplier fails to transfer the goods to the customer nor responsible for the acceptability of the goods.

b. The entity does not take inventory risk at any time before or after the goods are transferred to the customer. The entity does not commit to obtain the goods from the supplier before the goods are purchased by the customer and does not accept responsibility for any damaged or returned goods.

c. The entity does not have discretion in establishing prices for the supplier's goods. The sales price is set by the supplier.

ASC 606-10-55-319

Consequently, the entity concludes that it is an agent and its performance obligation is to arrange for the provision of goods by the supplier. When the entity satisfies its promise to arrange for the goods to be provided by the supplier to the customer (which, in this example, is when goods are purchased by the customer), the entity recognizes revenue in the amount of the commission to which it is entitled.

As noted above in Section 9.1, if a contract contains more than one specified good or service, an entity may be a principal for some goods or services and an agent for others. ASC 606 includes the following example where the entity concludes that it is acting as a principal and an agent in the same contract. In the assessment, the entity identifies the specified goods or services and then determines if it controls each specified good or service before they are transferred to the customer. The entity considers the indicators to support the control assessment.

Example 48A—Entity Is a Principal and an Agent in the Same Contract

ASC 606-10-55-334A

An entity sells services to assist its customers in more effectively targeting potential recruits for open job positions. The entity performs several services itself, such as interviewing candidates and performing background checks. As part of the contract with a customer, the customer agrees to obtain a license to access a third party's database of information on potential recruits. The entity arranges for this license with the third party, but the customer contracts directly with the database provider for the license. The entity collects payment on behalf of the third-party database provider as part of its overall invoicing to the customer. The database provider sets the price charged to the customer for the license and is responsible for providing technical support and credits to which the customer may be entitled for service down-time or other technical issues.

ASC 606-10-55-334B

To determine whether the entity is a principal or an agent, the entity identifies the specified goods or services to be provided to the customer and assesses whether it controls those goods or services before they are transferred to the customer.

ASC 606-10-55-334C

For the purpose of this Example, it is assumed that the entity concludes that its recruitment services and the database access license are each distinct on the basis of its assessment of the guidance in paragraphs 606-10-25-19 through 25-22. Accordingly, there are two specified goods or services to be provided to the customer—access to the third-party's database and recruitment services.

ASC 606-10-55-334D

The entity concludes that it does not control the access to the database before it is provided to the customer. The entity does not at any time have the ability to direct the use of the license because the customer contracts for the license directly with the database provider. The entity does not control access to the provider's database—it cannot, for example, grant access to the database to a party other than the customer or prevent the database provider from providing access to the customer.

ASC 606-10-55-334E

As part of reaching that conclusion, the entity also considers the indicators in paragraph 606-10-55-39. The entity concludes that these indicators provide further evidence that it does not control access to the database before that access is provided to the customer.

a. The entity is not responsible for fulfilling the promise to provide the database access service. The customer contracts for the license directly with the third-party database provider, and the database provider is responsible for the acceptability of the database access (for example, by providing technical support or service credits).

b. The entity does not have inventory risk because it does not purchase or commit to purchase the database access before the customer contracts for database access directly with the database provider.

c. The entity does not have discretion in setting the price for the database access with the customer because the database provider sets that price.

ASC 606-10-55-334F

Thus, the entity concludes that it is an agent in relation to the third-party's database service. In contrast, the entity concludes that it is the principal in relation to the recruitment services because the entity performs those services itself and no other party is involved in providing those services to the customer.

Identifying the customer in a distributor relationship

Supplier A manufactures and sells equipment. Supplier A sells directly to end customers and also sells through a distributor.

In transactions with distributors, the distributor identifies the end customer, agrees to a price with the end customer for the equipment, sends notification of the agreed upon sales price back to the supplier, and the supplier has three days to accept or reject the price offered. If the supplier agrees to the end-customer pricing, the supplier drop ships the equipment to the end customer. When the equipment is drop shipped, the distributor never takes control of the equipment (that is, the distributor does not have legal title, physical possession or risks and rewards of ownership related to the equipment). Inventory returns by the end customer are made to Supplier.

The invoice to the end customer is on Supplier A letterhead but Supplier A is paid by the distributor upon shipment to the end customer and there is no further credit risk to Supplier A. The distributor takes on credit extension including, in some situations, working with the end customer to set up an installment sale. Supplier A does not participate in any credit extension as it is paid by the distributor at shipment. The payment received by Supplier A from the distributor at the time of shipment is "net" of distributor commissions (for example, if the invoice to the customer is for $10,000 and the distributor commission is 5%, upon shipment, the distributor remits $9,500 ($10,000 - $10,000 x 5%) to Supplier A).

Supplier A considers whether the distributor or the end customer is its customer and determines that the end customer, not the distributor, is its customer because it is primarily responsible for fulfilling the equipment ordered by the end customer. Supplier A also considers whether it is acting as a principal and therefore would record revenue of $10,000, or if it is acting as an agent, in which case it would record revenue of $9,500.

Supplier A determines that it controls the equipment and therefore is acting as a principal for the following reasons:

- Supplier A has the ability to reject the transaction if it does not accept the price negotiated by the distributor.
- The end customer knows it is purchasing the equipment from Supplier A.
- Supplier A has primary responsibility for fulfilling the contract and Supplier A accepts returns from the end customer.
- The distributor never takes control of the equipment. Further, the distributor does not purchase the equipment until it has identified the end customer and, as a result, it has no inventory risk.

Supplier A records revenue at the gross amount of $10,000. The fees retained by the distributor are akin to a finder's fee or commission, and therefore the supplier should also consider whether the fees to the distributor are an incremental cost of obtaining the contract and whether the fee should be recorded

as a deferred commission asset. In this particular example, because the contract is completed at the time the equipment is shipped, the commission is expensed.

In some transactions involving a distributor, the supplier may not know the amount of the transaction price paid by the end customer to the distributor. In situations where the supplier concludes it is acting as a principal with respect to the underlying goods or services, but only knows the net amount it receives from the distributor, questions have arisen regarding the determination of the transaction price to be recorded by the supplier. Such situations are discussed at BC37 to BC38 of ASC 2016-08. In particular, the Board noted that entities may consider estimating the transaction price following the guidance for variable consideration; however, in order to apply the guidance regarding variable consideration, the uncertainty in the transaction price must ultimately be resolved at some point in the future. If such uncertainty is not expected to ever be resolved, the amount charged by the distributor to the end customer is not considered variable consideration and would not be part of the transaction price.

Estimating gross revenue as a principal

Continue with the above example, except assume that Supplier A does not know the transaction price paid by the end customer to the distributor. Supplier A only knows the amount of the payment it receives from the distributor and never obtains access to the details of the transaction price paid by the end customer.

In this situation, even if Supplier A concludes it is acting as a principal with respect to the equipment sold to the end customer, it would recognize revenue equal to the net amount it receives from the distributor. It would be inappropriate for Supplier A to estimate the transaction price paid by the end customer because the guidance regarding variable consideration does not apply when the uncertainty regarding the transaction price is not expected to be ultimately resolved.

Drop-ship or flash-title arrangements

The determination of whether an entity is acting as a principal or an agent can be especially challenging when the entity never obtains physical possession of a good prior to the customer's receipt of the good. For example, some goods are shipped directly from a manufacturer to the customer. These arrangements are often referred to as "drop-shipments" or "drop-ship arrangements." Further, an entity may only take title momentarily before a good is transferred on to the customer. Such an arrangement is often referred to as "flash title."

Grant Thornton insight: Considerations related to drop-ship or flash-title arrangements

The SEC staff[84] addressed drop-ship or flash-title arrangements at the 2018 AICPA Conference on Current SEC and PCAOB Developments, noting that an entity may appropriately conclude that it is acting as a principal in some cases and as an agent in other cases after considering all relevant facts

[84] 2018 AICPA Conference on Current SEC and PCAOB Developments, Speech by Sheri L. York, Professional Accounting Fellow, Office of the Chief Accountant.

and circumstances. The SEC staff reminded registrants to consider the definition of control as well as the indicators used to determine whether control of a good has transferred, of which inventory risk is only one of the possible indicators. In some circumstances, physical possession will not coincide with who controls a specified good.

In light of the SEC staff speech, we believe an entity needs to consider all facts and circumstances when determining whether it is acting as a principal or an agent for any drop-ship or flash-title arrangements. When determining if it takes control of the specified good prior to transferring that good to the customer, the entity should consider all relevant facts and circumstances, including the following:

- *If it has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods* – For example, can the entity redirect the shipment between the point of departure from the third-party facility to the point where it reaches the customer?
- *If it is primarily responsible for fulfillment* – For example, if the customer does not receive the good or the customer is dissatisfied with the good, who will the customer call and from whom will the customer seek recourse?
- *The reason for structuring the arrangement as a drop-ship or flash-title arrangement*.
- *If it has discretion is setting the price with the customer*

9.5 Reimbursement of out-of-pocket expenses

In order to correctly account for the reimbursement by a customer of out-of-pocket expenses incurred by an entity in connection with its performance under a contract with a customer, the entity will need to determine whether it is acting as a principal or an agent with respect to the related specified goods or services. In this determination, the entity should first identify the specified goods or services to be provided to the customer and then assess whether it controls the specified goods or services before they are transferred to the customer.

Reimbursable costs – entity is a principal

A professional services firm is reimbursed by its client for out-of-pocket expenses including meals, transportation, and lodging incurred by the engagement team for travel required in the execution of the client's consulting services engagement.

The professional services firm identifies the specified goods and services as the meals, airfare, and lodging consumed by its staff in the performance of the consulting engagement and concludes that it controls the specified goods or services as it is the entity that is primarily involved in selecting the nature of the specified goods and services and directly consumes the benefits from the meals, airfare, and lodging. The benefits of the specified services are not transferred to the customer; rather, the professional services firm controls the benefit of the meals, airfare, and lodging services, which it integrates into its performance of the consulting services for which the client has contracted.

Because the professional services firm concludes that it controls the specified goods or services, the customer's reimbursement of these items is included in the contract price.

Under ASC 606, if an entity is acting as a principal with respect to the reimbursable goods or services, out-of-pocket reimbursements from the entity's customer are included in the transaction price (Step 3), are allocated to the performance obligations (Step 4), and are recognized in revenue (Step 5) when those performance obligations are satisfied. The FASB staff addressed concerns raised by stakeholders regarding the application of ASC 606 to reimbursable expenses, particularly the following:

- The requirement to estimate variable consideration in cases where the amount of the expense reimbursement is not known at the inception of the contract
- The effect of timing differences between when expenses are incurred and the related reimbursements are recognized as revenue

Based on the outreach performed by the FASB staff, many public entities typically are not estimating out-of-pocket reimbursements. Those that do make such estimates develop those estimates at a portfolio level using historical information or other reliable available data. Others have implemented thresholds under which they do not estimate immaterial amounts or have implemented new accounting systems to comply with ASC 606.

The paper also identifies certain situations where the entity may not be required to estimate variable consideration with respect to reimbursement of out-of-pocket expenses, including

- The reimbursable expense is variable consideration that is constrained until the expense is incurred.
- The variable consideration relates specifically to a performance obligation or a distinct good or service in a series and the allocation guidance in ASC 606-10-32-40 applies, and the entity is able to allocate the out-of-pocket reimbursement entirely to that performance obligation or distinct good or service in the series.
- The entity is able to apply the "as invoiced" practical expedient.
- The entity recognizes revenue over time and applies a cost-to-cost measure of progress under previous GAAP and will apply such measure under ASC 606.

Materiality is also a consideration. If the reimbursable expenses are incurred consistently with the measure of progress selected for the performance obligation, there likely will not be a material difference between the amounts of revenue recognized under either method.

10. Modifications

Modifications that change the terms of a contract are common in many industries, including manufacturing, telecommunications, aerospace and defense, and construction. Depending upon the industry or jurisdiction, the modification may be better known as a change order, a variation, or an amendment. The Boards decided to prescribe specific guidance for contract modifications in ASC 606 to promote consistent accounting for modifications within and across all industries.

The modification guidance under ASC 606 requires an entity to

- Identify if a contract has been modified.
- Determine if the modification results in a separate contract, a termination of the existing contract and the creation of a new contract, or a continuation of the existing contract.
- Account for the contract modification accordingly.

The rest of this section discusses these steps in further detail.

10.1 Identifying a modification

A contract modification exists if three conditions are met:

- There is a change in the scope, price, or both in a contract.
- That change is approved by both the entity and the customer.
- The change is enforceable.

Similar to the criterion in Step 1 in ASC 606-10-25-1(a), the approval of a contract modification may be written, oral, or implied by customary business practice.

ASC 606-10-25-10

A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. In some industries and jurisdictions, a contract modification may be described as a change order, a variation, or an amendment. A contract modification exists when the parties to the contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement, or implied by customary business practices. If the parties to the contract have not approved a contract modification, an entity shall continue to apply the guidance in this Topic to the existing contract until the contract modification is approved.

Contract modifications may take many forms and the following list includes some common examples:

- Partially terminating the contract
- Extending the contract term with a corresponding increase in price

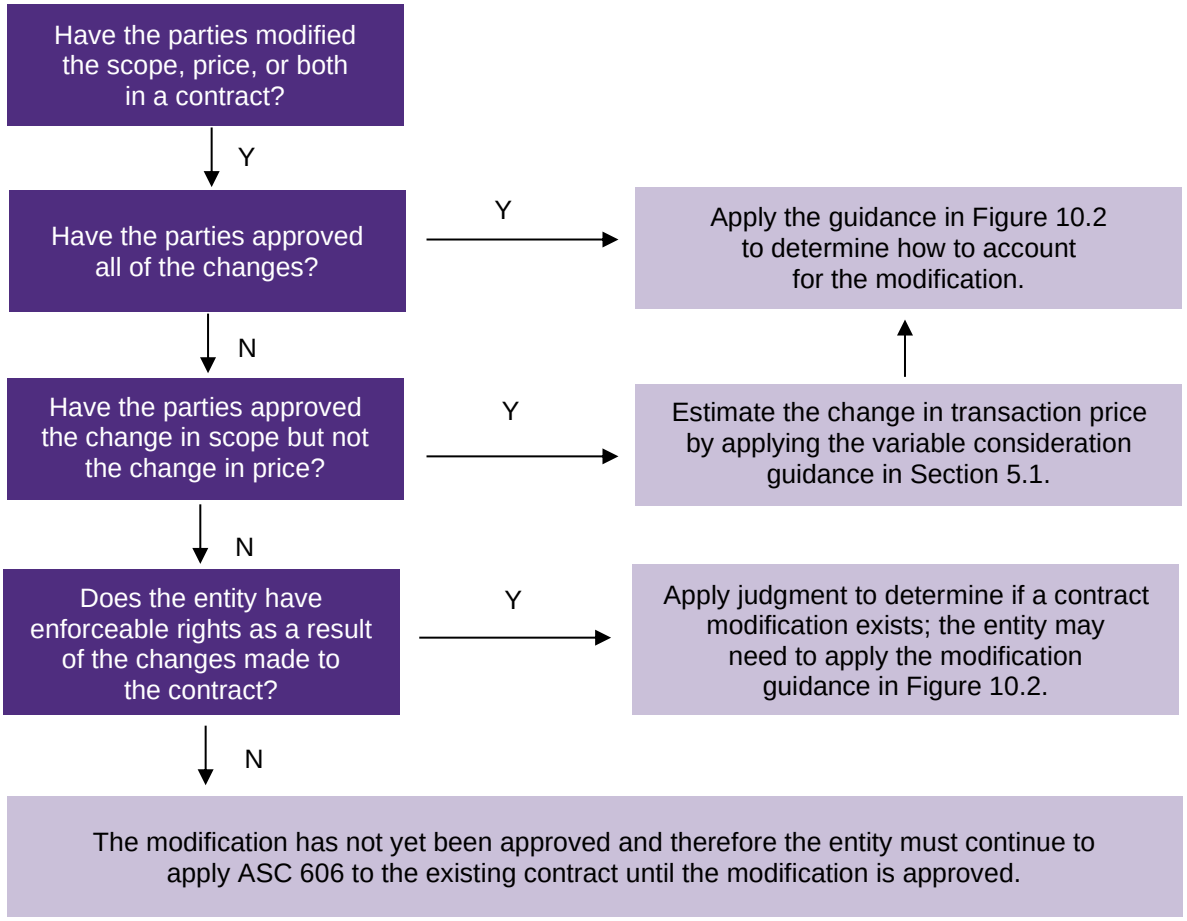
- Adding new goods and/or services to the contract, with or without a corresponding change in price
- Reducing the contract price without a change in goods or services promised

10.1.1 Unpriced change orders and claims

An entity may need to apply modification accounting, even if the details of the change are not yet finalized, when changes create new or modify existing rights and obligations in the contract.

If the entity and the customer agree to a change in the scope of the contract but have not yet agreed to a change in the price, the entity should estimate the change in transaction price using the guidance for variable consideration (see Section 5.1). The entity should then apply the guidance in Section 10.2 to determine if it should account for the modification as a separate contract. If on the other hand, the parties to a contract have not yet approved the change in scope, the entity should continue to apply the guidance in ASC 606 to the existing contract until the modification is approved.

Figure 10.1: Unpriced change orders and claims



ASC 606 provides the following guidance on unpriced change orders and claims.

ASC 606-10-25-11

A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence. If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the transaction price arising from the modification in accordance with paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

The following example in ASC 606 demonstrates the accounting for an unapproved change in scope and price.

Example 9—Unapproved Change in Scope and Price

ASC 606-10-55-134

An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including force majeure) in the entity's access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.

ASC 606-10-55-135

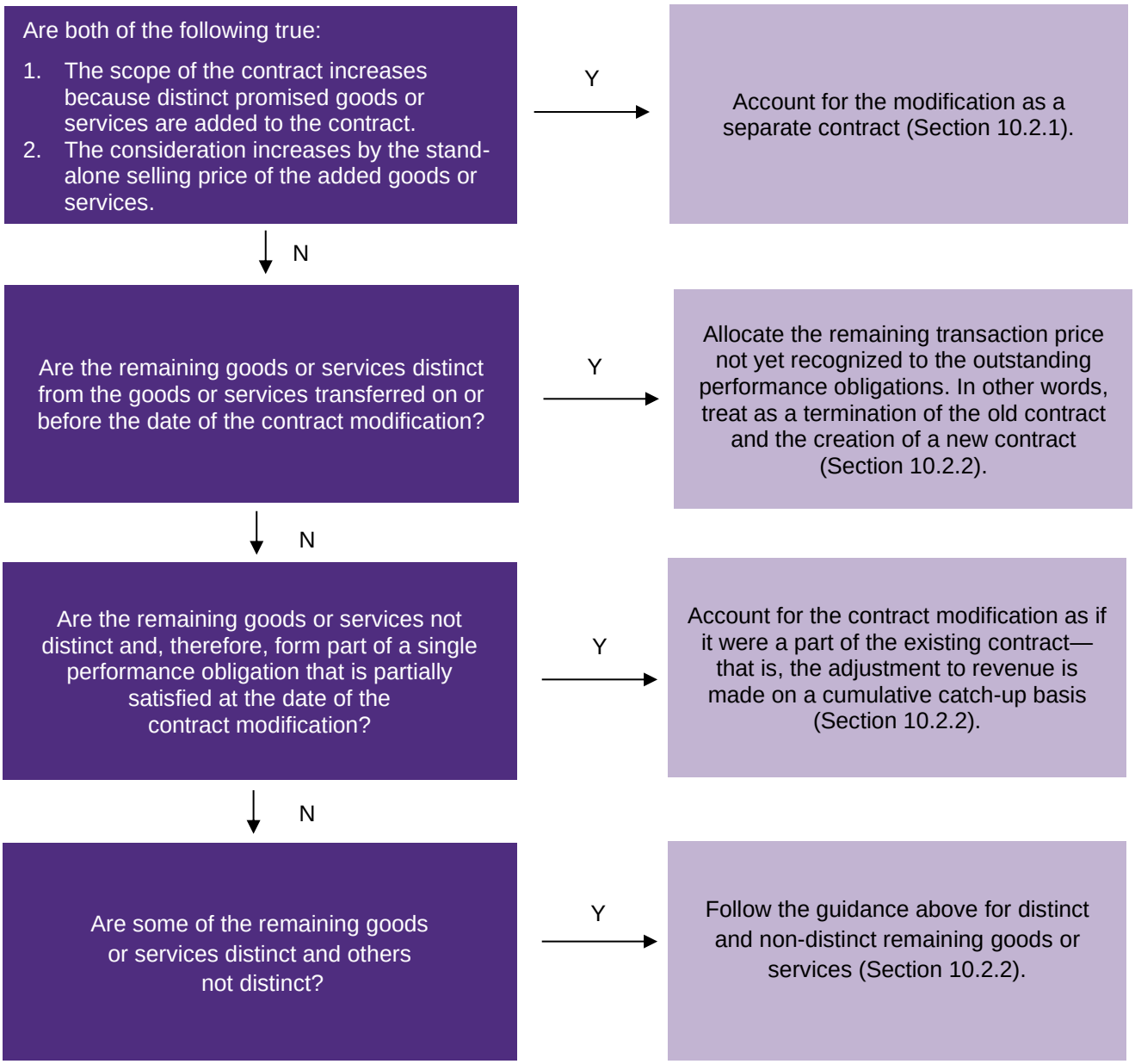
The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. The modification does not result in any additional goods or services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(b) by updating the transaction price and the measure of progress toward complete satisfaction of the performance obligation. The entity considers the constraint on estimates of variable consideration in paragraphs 606-10-32-11 through 32-13 when estimating the transaction price.

10.2 Accounting for the modification

Once an entity determines that a contract with a customer has been modified, it needs to determine whether the modification should be accounted for as a separate contract as discussed in Section 10.2.1. If the modification is not accounted for as a separate contract, it will be accounted for in one of the following three ways as discussed in Section 10.2.2:

- As a termination of the old contract and the creation of a new contract
- By making a cumulative catch-up adjustment to the original contract
- A combination of the two

Figure 10.2: Accounting for a contract modification



10.2.2 Modifications that constitute separate contracts

An entity accounts for a contract modification as a separate contract if the modification both (1) increases the scope of the work promised under the original contract by adding new promised goods or services that are considered distinct, and (2) the increase in the contract price reflects the stand-alone selling price of the additional goods or services. An entity determines if the additional promised goods or services are distinct using the guidance in ASC 606-10-25-18 through 25-22. The logic behind this guidance is that there is no economic difference between the entity entering into a separate contract or modifying an existing contract[85] for the additional goods or services.

When assessing whether the transaction price increases by an amount of consideration that reflects the stand-alone selling prices of the additional goods or services, an entity is allowed to adjust the stand-alone selling price for costs that it does not incur because it is contracting with a repeat customer. Therefore, if the stand-alone selling price in the original contract is $10 per unit, a modification that adds units for $9.50 per unit might reflect a stand-alone selling price of the additional units. For example, the selling effort and administration costs might be much lower when incremental units are added, in contrast to the effort and cost of the original quantity. The entity needs to exercise judgment to make that determination.

If a modification adds a distinct good or service to a series of distinct goods or services that is accounted for as a single performance obligation, the modification is accounted for as a separate contract as long as the transaction price increases by the stand-alone selling price for those added goods or services.

The following guidance from ASC 606 specifies when an entity should account for a modification as a separate contract.

ASC 606-10-25-12

An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

a. The scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 606-10-25-18 through 25-22).

b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

The following example from ASC 606 illustrates a contract modification that is accounted for as a separate contract.

[85] BC77, ASU 2014-09.

Example 5—Modification of a Contract for Goods (excerpt)

ASC 606-10-55-111

An entity promises to sell 120 products to a customer for $12,000 ($100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

Case A—Additional Products for a Price That Reflects the Standalone Selling Price

ASC 606-10-55-112

When the contract is modified, the price of the contract modification for the additional 30 products is an additional $2,850 or $95 per product. The pricing for the additional products reflects the standalone selling price of the products at the time of the contract modification, and the additional products are distinct (in accordance with paragraph 606-10-25-19) from the original products.

ASC 606-10-55-113

In accordance with paragraph 606-10-25-12, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract. The entity recognizes revenue of $100 per product for the 120 products in the original contract and $95 per product for the 30 products in the new contract.

10.2.3 Modifications that do not constitute separate contracts

If a contract modification is not accounted for as a separate contract in accordance with ASC 606-10-25-12, the guidance provides the following three methods to account for the modification:

- First, account for the modification prospectively as long as the goods or services to be provided after the modification are distinct from the goods or services that were already provided to the customer. The Boards' logic behind this guidance is that accounting for these types of modifications on a cumulative catch-up basis could be complex and may not faithfully depict the economics of the modification, since the modification is negotiated based on facts and circumstances that exist after the original contract's inception.[86]
- Second, when the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied, the entity recognizes the effect of the modification on a cumulative catch-up basis. This is the case in many construction contracts where a modification does not result in the transfer of additional distinct goods or services.
- Third, there may be cases where the remaining goods or services provided after a modification are a combination of both distinct and non-distinct goods or services. In this case, the entity accounts for those remaining goods or services that are distinct on a prospective basis and for those goods and services that are not distinct on a cumulative catch-up basis.

[86] BC78, ASU 2014-09.

ASC 606 contains the following guidance for when the modification is not accounted for as a separate contract.

ASC 606-10-25-13

If a contract modification is not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable:

a. An entity shall account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 606-10-25-14(b)) is the sum of:

    1. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue and

    2. The consideration promised as part of the contract modification.

b. An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (that is, the adjustment to revenue is made on a cumulative catch-up basis).

c. If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

Remaining goods or services are distinct

As noted above, if the contract modification is not accounted for as a separate contract in accordance with ASC 606-10-25-12, the modification should be accounted for prospectively when the goods or services to be provided after the modification are distinct from the goods or services that were already provided to the customer. Typically, this occurs when the distinct goods or services are not at their stand-alone selling prices.

The amount of consideration that the entity allocates to the remaining performance obligations (or the remaining distinct goods or services in a series) is the sum of

- The consideration promised by the customer that was part of the original transaction price, including any amounts already received from the customer that have not yet been recognized as revenue

- The consideration promised in the contract modification

Grant Thornton insight: Distinct goods or services in a modified contract

If the goods or services in a modified contract are consistent with those in the original contract, we believe that determining whether the goods or services in the modified contract are distinct should be consistent with the initial evaluation of the performance obligations in the original contract.

ASC 606 Example 5, Case B, demonstrates the accounting for contract modifications described in ASC 606-10-25-13(a)

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Example 5—Modification of a Contract for Goods (excerpt)

ASC 606-10-55-111

An entity promises to sell 120 products to a customer for $12,000 ($100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

Case B—Additional Products for a Price That Does Not Reflect the Standalone Selling Price

ASC 606-10-55-114

During the process of negotiating the purchase of an additional 30 products, the parties initially agree on a price of $80 per product. However, the customer discovers that the initial 60 products transferred to the customer contained minor defects that were unique to those delivered products. The entity promises a partial credit of $15 per product to compensate the customer for the poor quality of those products. The entity and the customer agree to incorporate the credit of $900 ($15 credit × 60 products) into the price that the entity charges for the additional 30 products. Consequently, the contract modification specifies that the price of the additional 30 products is $1,500 or $50 per product. That price comprises the agreed-upon price for the additional 30 products of $2,400, or $80 per product, less the credit of $900.

ASC 606-10-55-115

At the time of modification, the entity recognizes the $900 as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred. In accounting for the sale of the additional 30 products, the entity determines that the negotiated price of $80 per product does not reflect the standalone selling price of the additional products. Consequently, the contract modification does not meet the conditions in paragraph 606-10-25-12 to be accounted for as a separate contract. Because the remaining products to be delivered are distinct from those already transferred, the entity applies the guidance in paragraph 606-10-25-13(a) and accounts for the modification as a termination of the original contract and the creation of a new contract.

ASC 606-10-55-116

Consequently, the amount recognized as revenue for each of the remaining products is a blended price of $93.33 {[($100 × 60 products not yet transferred under the original contract) + ($80 × 30 products to be transferred under the contract modification)] ÷ 90 remaining products}.

ASC 606 Example 5, Case B, also demonstrates the appropriate accounting when an entity offers a partial credit to compensate the customer for poor quality of previously delivered products. Because the entity can isolate the quality issues to products already delivered (that is, past performance) in this example, the entity recognizes the credit as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred, even though the discount is incorporated into the modified terms on a prospective basis. Ultimately, an entity may need to exercise significant judgment and consider all of the relevant facts and circumstances to determine if a discount for additional goods and services in a modified contract relates to past performance.

Modification of a service agreement that is a series

Entity A enters into a contract with Customer B to provide janitorial services for three years for $10,000 a month, totaling $360,000. Entity A determines that the janitorial services represent a single performance obligation consisting of a series of distinct time periods, in this case, months.

Six months into the contract, after issues with the services provided, Entity A gives Customer B a $27,000 credit to use against future services. The service issues and resulting credit were not anticipated at contract inception, so Entity A recognized no variable consideration previously. Entity A determines that the credit is a change in the original transaction price and allocates the credit to the distinct services that form part of the single transaction price in accordance with ASC 606-10-32-44.

The $27,000 credit reduces the total transaction price of $360,000 resulting in an adjusted transaction price of $333,000, which is allocated to each of the 36 distinct months in the performance obligation at $9,250 per month. The amount allocated to the first six satisfied months, or $55,500 ($9,250 x 6 months), is less than the previously recognized amount of $60,000. As a result, Entity A recognizes the difference of $4,500 as a reduction in revenue as of the date of the modification.

Contract assets

ASC 606 requires entities to record a contract asset when a performance obligation has been satisfied or partially satisfied, but the amount of consideration has not yet been received because the receipt of the consideration is conditioned on something other than the passage of time. Stakeholders asked about the subsequent accounting for contract assets after a contract is modified in accordance with ASC 606-10-25-13(a). The TRG's discussion on this topic is summarized below.

TRG area of general agreement: How should an entity account for contract assets in a contract modification?

Stakeholders suggested two views on how to account for contract assets in a contract modification:

- View A: The contract asset should be written off to revenue because there is no longer a contract if the original contract is terminated.
- View B: The contract asset should be carried forward to the new modified contract and subsequently realized under the new contract as the receivables are recognized, which results in prospective accounting.

At the April 2016 meeting,[87] the TRG reached a general agreement that View B results in a financial reporting outcome that is consistent with the revenue guidance for contract modifications that are accounted for in accordance with ASC 606-10-25-13(a), since the objective is to account for these modifications prospectively. This view is also consistent with the guidance in BC78 of ASU 2014-09, which indicates that the intent of ASC 606-10-25-13(a) is to account for these types of modifications on a prospective basis and to avoid adjustments to revenue for satisfied performance obligations.

Modification of a series

The modification of a series of distinct goods or services accounted for as a single performance obligation that does not meet the criteria to be recognized as a separate contract should be accounted for as a termination of the old contract and the creation of a new contract, in accordance with ASC 606-10-25-13(a). In other words, an entity in this situation should apply the prospective accounting treatment.

Grant Thornton insight: Modifications and the series guidance

The guidance in ASC 606-10-25-13(a) makes it clear that the determination of whether a modification is accounted for prospectively depends on whether the remaining promises in the contract are for distinct goods or services. The Boards included this language to address concerns that an entity would be required to use a cumulative catch-up basis to account for any modification to a series.[88] Therefore, an entity should account for the modification as the termination of the old contract and the creation of a new contract (that is, prospective accounting treatment) even if an entity determines that it has a single performance obligation, provided that the performance obligation represents a series of distinct goods or services.

The following example demonstrates the accounting described in ASC 606-10-25-13(a) when an entity modifies a series of distinct goods or services and the modification is not accounted for as a separate contract.

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[87] Paper 51, *Contract Asset Treatment in Contract Modifications.*
[88] BC79, ASU 2014-09.

Example 7—Modification of a Services Contract

ASC 606-10-55-125

An entity enters into a three-year contract to clean a customer's offices on a weekly basis. The customer promises to pay $100,000 per year. The standalone selling price of the services at contract inception is $100,000 per year. The entity recognizes revenue of $100,000 per year during the first 2 years of providing services. At the end of the second year, the contract is modified and the fee for the third year is reduced to $80,000. In addition, the customer agrees to extend the contract for 3 additional years for consideration of $200,000 payable in 3 equal annual installments of $66,667 at the beginning of years 4, 5, and 6. The standalone selling price of the services for years 4 through 6 at the beginning of the third year is $80,000 per year. The entity's standalone selling price at the beginning of the third year, multiplied by the additional 3 years of services, is $240,000, which is deemed to be an appropriate estimate of the standalone selling price of the multiyear contract.

ASC 606-10-55-126

At contract inception, the entity assesses that each week of cleaning service is distinct in accordance with paragraph 606-10-25-19. Notwithstanding that each week of cleaning service is distinct, the entity accounts for the cleaning contract as a single performance obligation in accordance with paragraph 606-10-25-14(b). This is because the weekly cleaning services are a series of distinct services that are substantially the same and have the same pattern of transfer to the customer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

ASC 606-10-55-127

At the date of the modification, the entity assesses the additional services to be provided and concludes that they are distinct. However, the price change does not reflect the standalone selling price.

ASC 606-10-55-128

Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(a) as if it were a termination of the original contract and the creation of a new contract with consideration of $280,000 for 4 years of cleaning service. The entity recognizes revenue of $70,000 per year ($280,000 ÷ 4 years) as the services are provided over the remaining 4 years.

Remaining goods or services are not distinct

The accounting is different when the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied. In this case, the entity recognizes the effect of the modification on a cumulative catch-up basis. This accounting may apply to many construction contracts where a modification does not result in the transfer of additional distinct goods or services. The following example demonstrates the accounting described in ASC 606-10-25-13(b) when the remaining goods or services are not distinct and form part of a single performance obligation that is partially satisfied at the date of the contract modification.

Example 8—Modification Resulting in a Cumulative Catch-Up Adjustment to Revenue

ASC 606-10-55-129

An entity, a construction company, enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of $1 million and a bonus of $200,000 if the building is completed within 24 months. The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with paragraph 606-10-25-27(b) because the customer controls the building during construction. At the inception of the contract, the entity expects the following:

Transaction price	$ 1,000,000
Expected costs	700,000
Expected profit (30%)	$ 300,000

ASC 606-10-55-130

At contract inception, the entity excludes the $200,000 bonus from the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.

ASC 606-10-55-131

The entity determines that the input measure, on the basis of costs incurred, provides an appropriate measure of progress toward complete satisfaction of the performance obligation. By the end of the first year, the entity has satisfied 60 percent of its performance obligation on the basis of costs incurred to date ($420,000) relative to total expected costs ($700,000). The entity reassesses the variable consideration and concludes that the amount is still constrained in accordance with paragraphs 606-10-32-11 through 32-13. Consequently, the cumulative revenue and costs recognized for the first year are as follows:

Revenue	$ 600,000
Costs	420,000
Gross profit	$ 180,000

ASC 606-10-55-132

In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by $150,000 and $120,000, respectively. Total potential consideration after the modification is $1,350,000 ($1,150,000 fixed consideration + $200,000 completion bonus). In addition, the allowable time for achieving the $200,000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, on the basis of its experience and the remaining work to

be performed, which is primarily inside the building and not subject to weather conditions, the entity concludes that it is probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognized in accordance with paragraph 606-10-32-11 and includes the $200,000 in the transaction price. In assessing the contract modification, the entity evaluates paragraph 606-10-25-19(b) and concludes (on the basis of the factors in paragraph 606-10-25-21) that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation.

ASC 606-10-55-133

Consequently, the entity accounts for the contract modification as if it were part of the original contract (in accordance with paragraph 606-10-25-13(b)). The entity updates its measure of progress and estimates that it has satisfied 51.2 percent of its performance obligation ($420,000 actual costs incurred ÷ $820,000 total expected costs). The entity recognizes additional revenue of $91,200 [(51.2 percent complete × $1,350,000 modified transaction price) – $600,000 revenue recognized to date] at the date of the modification as a cumulative catch-up adjustment.

BC80 in ASU 2014-09 states that the Boards decided that an entity should recognize the effect of a contract modification on a cumulative catch-up basis if the remaining goods and services are not distinct and are part of a single performance obligation that is partially satisfied. The Boards further noted that this approach is particularly relevant to the construction industry where a modification to a contract typically does not result in the transfer of additional distinct goods or services.

In other words, the added goods or services may be capable of being distinct, but they are not distinct in the context of the contract. Accordingly, the entity accounts for such modifications on a cumulative catch-up basis.

Accounting for modifications that include goods or services that are distinct and other goods or services that are not distinct

Entity A enters into a contract with Customer B to build and deliver customized equipment for $2,000,000. The selling price is consistent with the stand-alone selling price of similar equipment sold by Entity A. Entity A determines that the customized equipment is one performance obligation, which will be recognized over time based on costs incurred. At the end of Year 1, Entity A has recognized 40 percent of the transaction price in revenue, or $800,000, based on the costs incurred to date relative to the total estimated costs.

At the beginning of Year 2, Entity A and Customer B modify the contract to revise the specifications of the customized equipment for an additional $500,000, as well as to add the delivery of 100 units of Widget C for $300,000, increasing the transaction price by $800,000.

Entity A considers whether the changes in the specifications of the customized equipment are distinct from the initial equipment, and concludes that the changes do not result in a distinct good and that the services are sold at stand-alone selling price.

Entity A then determines that Widget C is distinct and that the widgets are sold at the stand-alone selling price of $3,000 per unit. The widgets do not meet any of the over-time recognition criteria in

ASC 606-10-25-27; therefore, revenue is recognized at a point in time when control of the widgets transfers to Customer B.

The modification of the contract results in a combination of goods that are distinct from the goods transferred before the modification (Widget C) and goods that are not distinct from the goods transferred before the modification (the modifications to the customized equipment). In accordance with ASC 606-10-25-13.c, Entity A records a cumulative catch up adjustment for the customized equipment and will recognize revenue on Widget C as control transfers.

The cumulative catch-up adjustment for the modification to the customized equipment performance obligation is calculated as follows:

Total transaction price allocated to customized equipment (original transaction price of $2,000,000 + additional transaction price at modification of $500,000)	$2,500,000
Management's updated estimate of percent of contract completed	35%
Revenue that should be recognized to date	$875,000
Cumulative catch-up to be recorded ($875,000 revenue to date – $800,000 recognized before the modification)	$75,000

The remaining transaction price of $1,625,000 is recognized over time using the cost-incurred measure of progress as the construction of the customized equipment is satisfied.

Because each unit of Widget C is a distinct good, revenue is recognized at the point in time when control transfers for each unit ($3,000 per unit).

Reduction in contract scope or partial terminations

A reduction in a contract's scope or a partial termination of a contract meets the definition of a contract modification in ASC 606—that is, a change in the scope or price (or both) of a contract. That said, a reduction in a contract's scope or partial termination of a contract can never meet the separate contract criteria in ASC 606-10-25-12 because the scope of the contract must increase for a modification to be accounted for as a separate contract.

Therefore, when an entity and customer agree to a reduction in the scope of a contract or a partial termination, the entity applies the guidance in ASC 606-10-25-13. If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification, the entity accounts for the modification as if it were a termination of the existing contract and the creation of a new contract, in accordance with ASC 606-10-25-13(a). If the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification, the entity accounts for the modification as if it were a part of the existing contract (that is, an adjustment to revenue on a cumulative catch-up basis).

Grant Thornton insight: When a modification results in the reduction of goods or services provided

If a contract with a customer is modified and the promised goods or services have been reduced, we believe that companies should consider whether the goods or services remaining in the modified contract are distinct from those already delivered. When the remaining goods or services are distinct, the modification should be treated as a termination of the original contract and the creation of a new contract and accounted for prospectively. When the remaining goods and services are not distinct, the modification results in a change to the original contract and is accounted for as a cumulative catch-up.

Reduction in contract scope

On January 1, 20X8, Entity A enters into a contract with Customer B to provide a machine for $1 million and one year of maintenance services for $10,000 per month. Entity A determines that the machine is distinct and that the services constitute a series of distinct services that are substantially the same and have the same pattern of transfer to the customer in accordance with ASC 606-10-25-15. Therefore, Entity A accounts for the services as a single performance obligation that is satisfied over time. Entity A determines that both the machine and services are priced at stand-alone selling prices. Entity A delivers the machine on January 1, 20X8, transferring control of the machine at a point in time (when delivered to the customer).

On September 30, 20X8, Entity A and Customer B agree to modify the contract to reduce the amount of services that A will provide B for the rest of the contract, which results in a reduction of the contract price from $10,000 per month to $6,000 per month.

Because the final three months of services are distinct from the services provided in the first nine months of the contract, the modification is accounted for in accordance with ASC 606-10-25-13(a), and Entity A accounts for the contract modification as if it were a termination of the existing contract and the creation of a new contract. The amount of consideration allocated to the remaining performance obligation (that is, the final three months of service) is $18,000, which is the sum of

- The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and had not yet been recognized as revenue
- The consideration promised as part of the contract modification

Reduction to stated contractual minimum quantities

On January 1, 20X8, Entity A enters into a contract with Customer B to provide a minimum of 100,000 widgets per year for five years at $100/widget. Entity A determines that each widget is a distinct performance obligation and records revenue at the point in time when each widget is shipped (that is, when control transfers to Customer B).

On March 31, 20X9, due to an economic downturn, Entity A and Customer B modify the contract to reduce the minimum quantity from 100,000 widgets per year to 50,000 widgets per year at $100/widget

beginning with the year ended December 31, 20X9; 10,000 widgets had already been purchased during the first three months of 20X9.

Because the remaining promised widgets are distinct from the widgets provided in the first 15 months of the contract, the modification is prospectively accounted for as a termination of the prior contract and the creation of a new contract under ASC 606-10-25-13(a). The amount of consideration allocated to the remaining performance obligations (that is, the remaining 190,000 widgets) is $19,000,000 ($39,000,000 + (20,000,000)), which is the sum of the following amounts:

- The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and had not yet been recognized as revenue (390,000 remaining widgets per original contract x $100/widget = $39,000,000)
- The consideration promised as part of the contract modification; because the scope of the contract is reduced, this consideration is negative (50,000 reduced widgets/year x 4 remaining years x $100/widget = ($20,000,000))

11. Contract costs

ASC 340-40 addresses the accounting for costs incurred as part of obtaining or fulfilling a contract with a customer.

The guidance in this Subtopic applies to all costs to obtain a contract with a customer; however, before applying the guidance for fulfillment costs in ASC 340-40, an entity should first consider whether the costs are within the scope of another Topic or Subtopic within the Codification, including, but not limited to, the following:

a. Consideration payable to a customer (ASC 606-10-32-25 through 32-27)

b. Inventory (ASC 330)

c. Preproduction costs related to long-term supply arrangements (ASC 340-10-25-1 through 25-4)

d. Internal-use software (ASC 350-40)

e. Property, plant, and equipment (ASC 360)

f. Costs of software to be sold, leased, or otherwise marketed (ASC 985-20)

In other words, if the costs are within the scope of another Codification Topic or Subtopic, the entity would not look to ASC 340-40 to determine how to account for those costs.

ASC 340-40-15-2

The guidance in this Subtopic applies to the incremental costs of obtaining a contract with a customer within the scope of Topic 606 on revenue from contracts with customers (excluding any consideration payable to a customer, see paragraphs 606-10-32-25 through 32-27).

ASC 340-40-15-3

The guidance in this Subtopic applies to the costs incurred in fulfilling a contract with a customer within the scope of Topic 606 on revenue from contracts with customers, unless the costs are within the scope of another Topic or Subtopic, including, but not limited to, any of the following:

a. Topic 330 on inventory

b. Paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements

c. Subtopic 350-40 on internal-use software

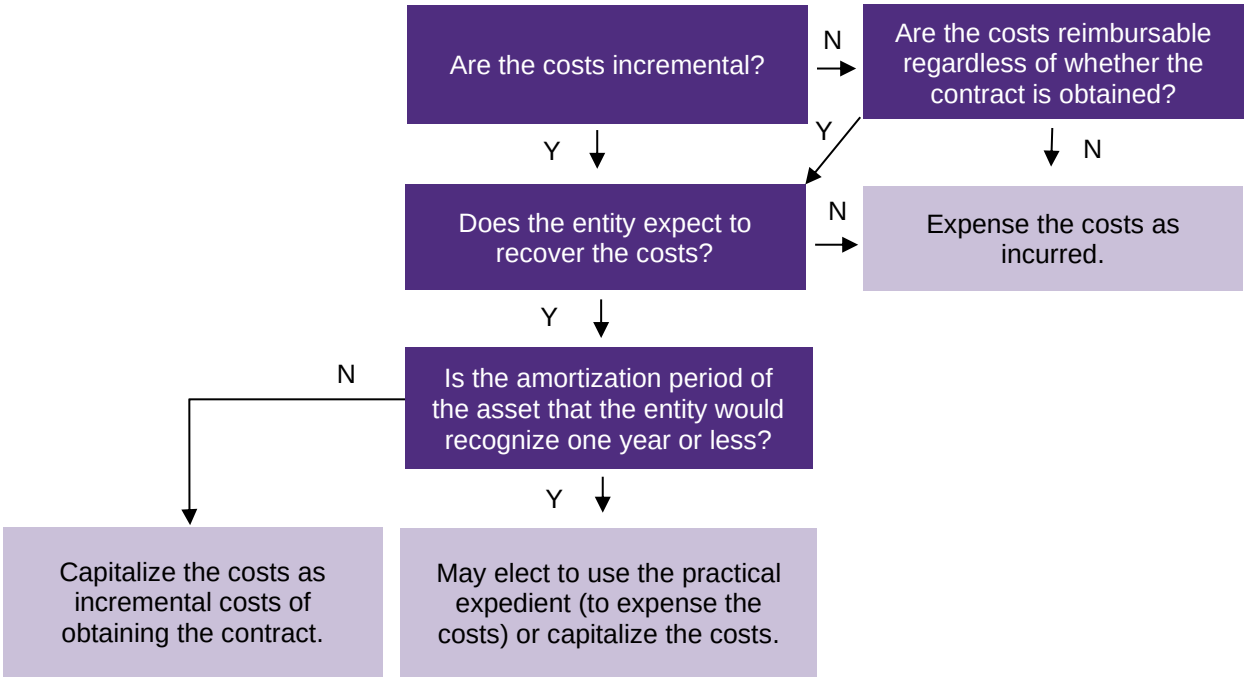
d. Topic 360 on property, plant, and equipment

e. Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed.

11.1 Costs to obtain a contract

If the requirements of ASC 340-40 to capitalize costs to obtain a contract are met, such accounting is not optional. In other words, the entity does not have an accounting policy election to capitalize or expense costs. The only exception is the practical expedient related to costs with an amortization period of one year or less as discussed below. The following diagram illustrates the guidance in ASC 340-40 on how to account for costs to obtain a contract.

Figure 11.1: Incremental costs to obtain a contract



Entities may incur various costs to obtain or acquire a contract with a customer, including, but not limited to, legal fees, advertising expenses, travel expenses, and salespersons' salaries and commissions. Once an entity has determined that costs incurred relate to a specific contract with a customer, it should then determine if the costs meet the conditions in ASC 340-40-25-1 through 25-3 for capitalization.

Incremental costs to obtain a contract that an entity expects to recover should be capitalized, while costs to obtain a contract that do not qualify for capitalization should be expensed as incurred.

ASC 340-40-25-1

An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

ASC 340-40-25-2

The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

ASC 340-40-25-3

Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

Under ASC 340-40, an entity capitalizes the incremental costs of obtaining a contract only if it expects to recover those costs. An entity can expect to recover the costs if they are either directly reimbursable under the contract or reimbursable through the expected margin included in the contract.

The test to determine if a cost is *incremental* is to ask whether the entity would have incurred the cost had one or both of the parties decided to walk away just before signing the arrangement. In this context, any legal costs (for example, to draft or negotiate the contract) or salaries for salespeople would be incurred regardless of whether the contract is finalized. Therefore, these costs are not incremental. On the other hand, a commission paid only upon the successful signing of the contract would be incremental and should be capitalized.

The following table examines common costs incurred when entering into a contract with a customer and the accounting treatment for those costs.

Figure 11.2: Evaluating costs to obtain a contract

Cost	Capitalize or expense	Reason
Commission paid only upon successful signing of a contract	Capitalize	Assuming the entity expects to recover the cost, the commission is incremental since it would not have been paid if the parties decided not to enter into the arrangement just before signing.
Travel expenses for salespersons pitching a new client contract	Expense	Because the costs are incurred regardless of whether the new contract is won or lost, the entity expenses the costs, unless they are expressly reimbursable.
Legal fees for drafting terms of arrangement for parties to approve and sign	Expense	If the parties walk away during negotiations, the costs would still be incurred and therefore are not incremental costs of obtaining the contract.
Salaries for salespeople working exclusively on obtaining new clients	Expense	The salaries are incurred regardless of whether contracts are won or lost and therefore are not incremental costs to obtain the contract.

Cost	Capitalize or expense	Reason
Bonus based on quarterly sales target	Capitalize	Bonuses based solely on sales are incremental costs to obtain a contract.
Commission paid to sales manager based on contracts obtained by the sales manager's local employees	Capitalize	The commissions are incremental costs that would not have been incurred had the entity not obtained the contract. ASC 340-40 does not differentiate costs based on the function or title of the employee that receives the commission.

Example 1 from ASC 340-40 evaluates various costs incurred by a consulting entity in winning a bid for a new customer.

Example 1—Incremental Costs of Obtaining a Contract

ASC 340-40-55-2

An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

External legal fees for due diligence	$15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	10,000
Total costs incurred	$50,000

ASC 340-40-55-3

In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity, and individual performance evaluations. In accordance with paragraph 340-40-25-1, the entity does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.

ASC 340-40-55-4

The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 340-40-25-3, those

costs are recognized as expenses when incurred, unless they are within the scope of another Topic, in which case, the guidance in that Topic applies.

Practical expedient

When capitalization is otherwise required under ASC 340-40, an entity may elect to use a practical expedient to expense the incremental costs of obtaining a contract if the amortization period of the asset that the entity would otherwise have recognized is one year or less.

ASC 340-40-25-4

As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

This does not mean, however, that an entity can default to the practical expedient if the initial contract term is one year or less. In some situations, the amortization period may be longer than the initial contract term. An entity needs to consider the impact of anticipated contract renewals and amendments when determining if the amortization period is one year or less.

The following example demonstrates a situation where an entity concludes that the practical expedient does not apply even though the initial contract term is only one year.

Initial contract term is one year but practical expedient does not apply

A professional services firm awards an employee with a 5 percent commission for obtaining a one-year contract with a customer and pays a commission on renewal of that contract that is not commensurate with the commission paid on the initial contract (say, only 2 percent). The entity determines that the amortization period for the original commission would be longer than the initial contract term because the customer is expected to renew and the renewal commission is not commensurate with the commission on the initial contract, thus, the contract does not qualify for the practical expedient.

For more information on determining the appropriate amortization period, including issues related to renewals, see Section 11.4.

11.1.1 Commissions

As illustrated in Example 1 in ASC 340-40 above, a sales commission is often cited as an example of an incremental cost to obtain a contract provided in the new cost guidance. The TRG discussed various aspects of commission arrangements in multiple meetings. At the TRG meeting in January 2015, rather than focusing on the specific questions submitted by stakeholders, the TRG focused on *when* an entity should apply the guidance in ASC 340-40.

TRG area of general agreement: A closer look at commission arrangements

At the January 2015 meeting,[89] the TRG focused on the cost capitalization principle in ASC 340-40 and reached general agreement that the appropriate time to evaluate the costs is when a related liability is incurred. TRG members also emphasized that the new revenue standard does not change the existing liability guidance, and that an entity should refer to other applicable standards to determine when to recognize the liability for the commission (for example, employee compensation guidance).

Once an entity concludes that it should recognize a liability for costs incurred in accordance with the applicable liability guidance, it should refer to the guidance in ASC 340-40 to determine whether to capitalize or expense the related cost.

While it may be rather straightforward to apply the guidance on incremental costs to obtain a contract for a fixed commission under a contract (say, $100 per new contract obtained) or a fixed percentage of the new contract's stated value (say, 5 percent of the sale), some entities have less straightforward commission terms. The U.S. members of the TRG discussed numerous questions about commission structures in 2016.

TRG area of general agreement: Evaluating various commission arrangements

At the November 2016 TRG meeting,[90] the U.S. members of the TRG discussed the following examples of evaluating different types of sales commissions in contracts with customers.

Example 1: Timing of the commission payment

> *An entity pays an employee a 4 percent sales commission on all of the employee's signed contracts with customers. For cash flow management, the entity pays the employee half of the commission (2 percent of the total contract value) upon completion of the sale, and the remaining half of the commission (2 percent of the total contract value) six months later. The employee is entitled to the unpaid commission, even if the employee is no longer employed by the entity when payment is due. An employee makes a sale of $50,000 at the beginning of year one.*

The entity capitalizes the entire commission of $2,000 because the commission is an incremental cost that relates specifically to the signed contract and the employee is entitled to the unpaid commission. The timing of the payment does not impact whether the costs would have been incurred if the contract had not been obtained.

Example 2: Commissions paid to different levels of employees

> *An entity's salesperson receives a 10 percent sales commission on each contract obtained. In addition, the following employees of the entity receive sales commissions on each signed contract negotiated by the salesperson: 5 percent to the manager and 3 percent to the regional manager.*

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[89] Paper 23, *Incremental costs of obtaining a contract.*
[90] Paper 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract.*

The entity capitalizes all of the commissions because the costs are incremental and would not have been incurred had the entity not obtained the contract. The guidance does not differentiate based on the function or title of the employee that receives the commission.

Example 3: Commission payments subject to a threshold

An entity has a commission program that increases the amount of commission a sales person receives based on how many contracts the salesperson has obtained during an annual period. The breakdown is as follows:

Contract number	Commission
0-9	0%
10-19	2% of value of contracts 1-19
20+	5% of value of contracts 1-20+

Even though the entity's program is based on a pool of contracts (and not directly attributable to a specific contract), the commissions would not have been incurred if the entity had not obtained the contracts with those customers. Therefore, when an entity recognizes a liability, it should also recognize a corresponding asset for the commissions. The entity should apply guidance other than ASC 606 and ASC 340-40 to determine when a liability for the commission payments should be recognized.

Some entities' compensation structures may condition commission or bonus payments on factors in addition to signing a new contract or meeting an overall threshold of new contracts. For example, an entity may retain half of a sales commission related to a new contract and delay the payment of the retained half until certain events have occurred, such as the salesperson's continued employment for a specified period of time. If the other factors are substantive inputs to the determination of whether the commission is paid, the commission may not be an incremental cost of obtaining a contract because the other conditions are required to be met in order for the amount to be paid.

Continuing with Example 1 in the TRG discussion above, consider an alternative fact pattern where the employee must be employed by the entity six months after the initial sale in order to be entitled to the second half of the sales commission. In this situation, the entity conditions the payment of the second half of the commission to encourage retention of its salesperson. Because the second payment is conditioned on an input other than the passage of time, the entity must determine whether the employment condition is substantive. If the entity concludes that the employment condition is substantive, the second half of the commission would not be an incremental cost of obtaining the contract.

Accounting for commissions when a contract modification is not accounted for as a new contract

Many entities also pay commissions when customer arrangements are expanded, for example, to include additional goods or services. Under ASC 606, not all contract modifications are considered new contracts for accounting purposes. Accordingly, some entities have questioned whether commissions related to a

contract modification that is not accounted for as a new contract should be capitalized given that the contract already existed and the commission is not a cost to obtain a new contract. The TRG addressed this issue in January 2015.

TRG area of general agreement: Commission earned when contract modification is not a new contract for accounting purposes

At the January 2015 meeting,[91] the TRG discussed the following example:

> *An entity pays a salesperson a commission based on the initial contract price. This initial commission is considered incremental and is capitalized.*
>
> *Later, the customer modifies the contract to purchase additional goods. This modification is not accounted for as a separate contract in accordance with ASC 606-10-25-12. The salesperson is paid an additional commission based on the increase in the contract price.*

The TRG noted that while the contract modification is not accounted for as a separate contract, the increase in the contract price results in a cost (the second commission), which is an incremental cost of obtaining the modified contract, and should be capitalized. The TRG noted that this would be true whether the contract modification is accounted for as if it were a termination of the existing contract and the creation of a new contract in accordance with ASC 606-10-25-13(a), or as if it were part of the existing contract in accordance with ASC 606-10-25-13(b).

11.2 Costs to fulfil a contract

In addition to guidance on accounting for costs to obtain a contract, ASC 340-40 also contains guidance on accounting for costs to fulfill a contract. Under that guidance, certain costs give rise to an asset while other costs are expensed as incurred. Before evaluating whether a cost incurred in fulfilling a contract with a customer gives rise to an asset under ASC 340-40, an entity should first evaluate whether the cost is within the scope of another ASC Topic or Subtopic, in which case, the entity would apply the guidance in that other Topic.

An entity does not have a policy election to expense or capitalize costs to fulfill a contract if the capitalization criteria are met, as discussed below.

ASC 340-40-25-6

For costs incurred in fulfilling a contract with a customer that are within the scope of another Topic (for example, Topic 330 on inventory; paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements; Subtopic 350-40 on internal-use software; Topic 360 on property, plant, and equipment; or Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed), an entity shall account for those costs in accordance with those other Topics or Subtopics.

[91] TRG Paper 23, *Incremental costs of obtaining a contract.*

Under ASC 340-40, an entity should recognize an asset for contract fulfillment costs if they meet all of the following conditions:

- Relate directly to a contract or to an anticipated contract
- Generate or enhance resources of the entity that will be used in satisfying performance obligations in the future
- Are expected to be recovered

ASC 340-40-25-5

An entity shall recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

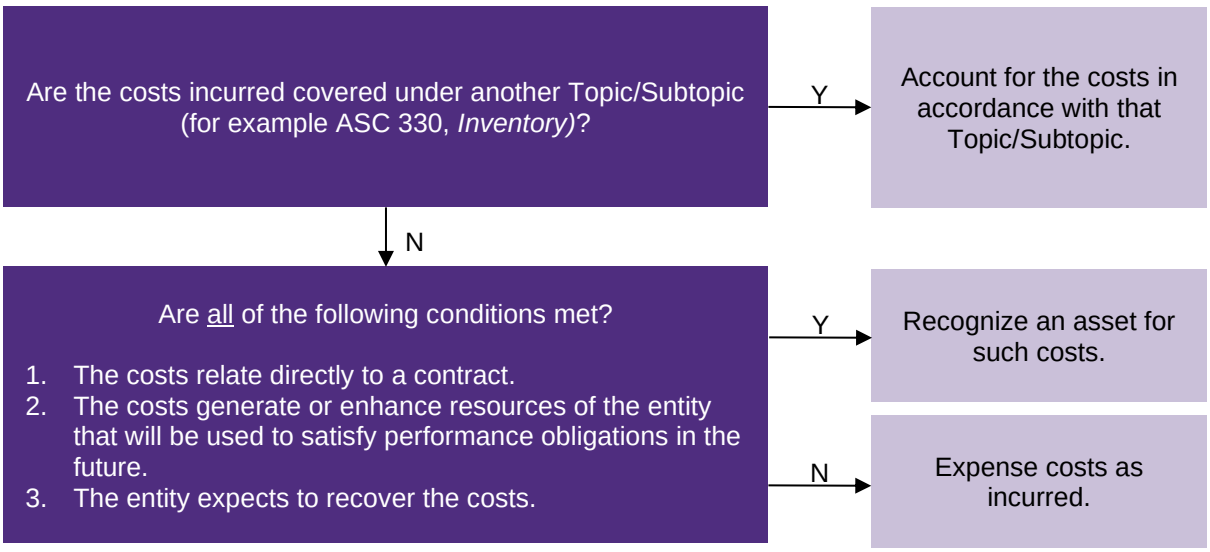
a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).

b. The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.

c. The costs are expected to be recovered.

The following diagram shows how to account for costs incurred in fulfilling a contract with a customer under ASC 340-40.

Figure 11.3: Costs to fulfill a contract



The guidance in ASC 340-40-25-7 and 25-8 provide examples of the types of costs that relate directly to a contract, as well as costs that should be expensed as incurred.

For instance, direct labor, direct materials, directly allocable costs, and reimbursable costs qualify as costs that directly relate to the contract and should therefore be evaluated under the guidance in ASC 340-40 to determine if they should be capitalized.

On the other hand, overhead, wasted resources, and costs that relate to satisfied or partially satisfied performance obligations must be expensed as incurred. In other words, costs that relate to past performance must be expensed. When an entity cannot determine whether costs relate to satisfied or unsatisfied performance obligations, it should expense those costs.

ASC 340-40-25-7

Costs that relate directly to a contract (or a specific anticipated contract) include any of the following:

a. Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer)

b. Direct materials (for example, supplies used in providing the promised services to a customer)

c. Allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract)

d. Costs that are explicitly chargeable to the customer under the contract

e. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

ASC 340-40-25-8

An entity shall recognize the following costs as expenses when incurred:

a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 340-40-25-7)

b. Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract

c. Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)

d. Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

Example 2 in ASC 340-40 evaluates both incremental costs to obtain a contract and costs to fulfill a contract.

Example 2—Costs That Give Rise to an Asset

ASC 340-40-55-5

An entity enters into a service contract to manage a customer's information technology data center for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity pays an employee a $10,000 sales commission upon the customer signing the contract. Before providing the services, the entity designs and builds a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer but will be used to deliver services to the customer.

Incremental Costs of Obtaining a Contract

ASC 340-40-55-6

In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract for the sales commission because the entity expects to recover those costs through future fees for the services to be provided. The entity amortizes the asset over seven years in accordance with paragraph 340-40-35-1 because the asset relates to the services transferred to the customer during the contract term of five years and the entity anticipates that the contract will be renewed for two subsequent one-year periods.

Costs to Fulfill a Contract

ASC 340-40-55-7

The initial costs incurred to set up the technology platform are as follows:

Design services	$ 40,000
Hardware	120,000
Software	90,000
Migration and testing of data center	100,000
Total costs	$ 350,000

ASC 340-40-55-8

The initial setup costs relate primarily to activities to fulfill the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

a. Hardware costs—accounted for in accordance with Topic 360 on property, plant, and equipment

b. Software costs—accounted for in accordance with Subtopic 350-40 on internal-use software

c. Costs of the design, migration, and testing of the data center—assessed in accordance with paragraph 340-40-25-5 to determine whether an asset can be recognized for the costs to fulfill the contract. Any resulting asset would be amortized on a systematic basis over the seven-year period (that is, the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data center.

ASC 340-40-55-9

In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity (see paragraph 340-40-25-5(b)). Therefore, the costs do not meet the criteria in paragraph 340-40-25-5 and cannot be recognized as an asset using this Topic. In accordance with paragraph 340-40-25-8, the entity recognizes the payroll expense for these two employees when incurred.

Loss leader sales

Sometimes an entity sells a good or service at a loss because it expects to make a profit on the subsequent sale of other goods or services to the same customer, resulting in an overall profitable contract. Questions have arisen as to how to account for the costs in a loss leader contract. In many cases, when a product has been delivered, the costs associated with the product are accounted for in accordance with ASC 330, and, accordingly, the costs would be included in cost of sales. Further, ASC 340-40-25-8(c) requires an entity to expense costs that relate to satisfied or partially satisfied performance obligations in the contract. Therefore, when an entity transfers control of a good or service that is distinct at a loss, the entity should recognize the loss. The TRG discussed loss contracts, as summarized below.

TRG area of general agreement: Loss contracts

The TRG discussed the following fact pattern at its November 2015 meeting[92]:

> *An entity enters into an exclusive contract with a customer to sell equipment and consumable parts for the equipment and determines that both the equipment and parts are distinct. The equipment does not function without the consumable part, but the customer could resell the equipment. The stand-alone selling price of the equipment is $10,000 and the stand-alone selling price of the part is $100. The cost of the equipment and each part is $8,000 and $60, respectively. The entity sells the equipment for $6,000 (a 40 percent discount from the stand-alone selling price), with a contractual option to purchase each part for $100. There are no contract minimums, but the entity is virtually certain that the customer will purchase 200 parts over the next two years.*

ASC 340-40-25-6 says that costs incurred in fulfilling a contract with a customer that are within the scope of another Topic should be accounted for in accordance with that Topic. In this case, ASC 330 on inventory applies, so the entity expenses the cost of the equipment when it sells the equipment. As discussed in Step 2, items that, as a matter of law, are optional from the customer's perspective are not promised goods or services in the contract. Therefore, it would not be appropriate for the entity to defer any element of the cost to reflect its expectation that the customer will purchase consumables in the future. In this example, the transaction price is $6,000, which is entirely attributable to the equipment, and the entity would recognize a loss of $2,000 when it transfers control of the equipment to the customer.

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[92] Paper 48, *Customer options for additional goods and services.*

11.3 Preproduction activities

Some long-term supply arrangements require an entity to undertake efforts up front to mobilize equipment or design new technology or equipment, which are referred to as preproduction activities. Preproduction activities are often necessary before delivering any units under a manufacturing contract.

11.3.1 Preproduction costs

An entity must first determine the scope of the preproduction costs. Legacy guidance now superseded in ASC 605-35 included prescriptive cost guidance for pre-contract costs associated with long-term construction and production-type contracts, such as mobilization costs, learning costs, and costs to purchase production equipment. Continuing guidance in ASC 340-10 provides guidance on preproduction costs related to long-term supply arrangements, such as design and development costs for molds, dies, and other tools.

The TRG discussed the scope of preproduction costs at the November 2015 meeting.[93] Generally, preproduction costs fall in one of the following three categories:

- Entities that previously applied the guidance in ASC 605-35 should instead apply ASC 340-40 to those costs because ASU 2014-09 supersedes the pre-contract guidance in ASC 605-35.
- Entities that previously applied the guidance in ASC 340-10 should continue to apply ASC 340-10 to costs within its scope because this guidance is not superseded by ASC 606.
- Entities that have been applying guidance in ASC 340-10 or other standards by analogy should revisit the scope of that guidance and determine if their accounting conclusions remain appropriate.

11.3.2 Determining the nature of preproduction activities

If preproduction activities are within the scope of ASC 606, the entity next must determine whether the preproduction activities are a promised good or service or a fulfillment activity, a determination that impacts the timing of revenue recognition. If the preproduction activities are a promised good or service in the contract and constitute a separate performance obligation, the entity would then determine the best measure of progress to reflect the transfer of control of that good or service to the customer, and would recognize revenue accordingly. If the preproduction activities are a promised good or service in the contract that are bundled with other promises into a single performance obligation, the entity would consider the activities when measuring its progress toward complete satisfaction of the performance obligation.

However, if a preproduction activity is not a promised good or service in a contract with a customer, then the costs should be accounted for as fulfillment costs (see Section 11.2).

ASC 606-10-25-17

Promised goods or services do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does

[93] Paper 46, *Pre-Production Activities.*

not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not promised goods or services in the contract with the customer.

TRG Paper 46, *Pre-Production Activities,* provides the following factors for an entity to consider when determining whether the activities constitute a promised good or service in the contract:

- *The nature of the promise to the customer:* In other words, are the preproduction activities a promised service, or are they activities that the entity must undertake to fulfill a contract to transfer the ultimate promised good or service?
- *Whether control is transferred:* Revenue should depict the transfer of promised goods and services. For example, if an entity performs engineering services as part of developing a new product for the customer and the customer will own the intellectual property that results from those activities, then the entity would likely conclude that it transfers control of the intellectual property to the customer.
- *Whether another entity would need to re-perform the work to date:* This can be a secondary criterion in assessing whether control is transferred during the preproduction period.

If preproduction activities transfer control of a good or service to the customer and are bundled with other promises into a single performance obligation that is satisfied over time, the entity would identify an appropriate measure of progress and recognize revenue accordingly.

Grant Thornton insight: Evaluating preproduction costs

When an entity considers which, if any, preproduction activities to include in the measure of progress to reflect the transfer of control in over-time revenue recognition, it should only include goods and services that transfer to the customer. An entity might determine that a preproduction cost should be included in the measure of progress, based on the circumstances of the arrangement. However, if the entity incurs a significant amount of costs near the start of the arrangement and the activities related to those costs do not transfer a good or a service to the customer, then the entity should consider the guidance on items to exclude from the measure of progress when using a cost-based input method (see Section 7.1.2). Application of that guidance requires an entity to consider whether the costs for certain activities should be excluded from the measure of progress (because their inclusion is not representative of progress toward satisfying a performance obligation) or whether an input method should be adjusted to recognize revenue only to the extent of the cost incurred.

11.3.3 Preproduction arrangements

Preproduction arrangements generally require an entity to undertake activities before production of a good, and the customer to pay for those activities through either an upfront payment or as part of the cost per unit when, or if, the goods are produced. Under ASC 605 these activities were typically considered either a service deliverable or a nonrevenue arrangement. In a 2017 speech, staff from the SEC's Office of the Chief Accountant (OCA) noted[94] these historical determinations could impact how an entity

[94] Refer to SEC staff's comments, Remarks before the 2017 AICPA Conference on Current SEC and PCAOB Developments.

approaches its accounting analysis of these arrangements under ASC 606, including whether any related consideration received is included in the transaction price.

At the crossroads: Preproduction arrangements

Registrants that have treated preproduction activities as a service deliverable under legacy GAAP must now evaluate the activities to determine whether they qualify as a performance obligation under ASC 606. OCA staff noted that this might result in a registrant concluding that a service deliverable under legacy GAAP is not considered a performance obligation under ASC 606. In one prefiling consultation evaluated by the OCA staff, a registrant determined that a preproduction arrangement for the design of a specialized good did not transfer control of a good or service to the customer. In arriving at this conclusion, the registrant considered that the information provided to the customer during the design process would not be sufficient to avoid reperformance of the completed design work if the customer were to select a different manufacturer, which indicates that the customer does not obtain control of the design work. The staff did not object to the registrant's determination that the preproduction design activities should be accounted for as research and development expenses and that the payments received should be considered an advance payment for the future sale of the specialized goods. The staff also noted that this would not be considered a voluntary change in accounting principle under ASC 250 and is instead an application of the transition guidance under ASC 606, because the registrant began its analysis under the revenue guidance, consistent with its policy under ASC 605, and applied reasonable judgment to reach its conclusion under ASC 606.

For registrants that had considered preproduction a nonrevenue arrangement (for example, research and development, fulfillment activities with the consideration received from the customer accounted for as an advance payment for goods, or a contra-expense under a cost reimbursement model), OCA staff noted that they would not object to those registrants continuing to apply their historical nonrevenue model when they transition to ASC 606. However, registrants applying a nonrevenue model that are considering making changes to that nonrevenue model or applying a revenue model under ASC 606 are encouraged to first consult with the staff. Private entities may also consider the OCA guidance in evaluating preproduction arrangements.

11.4 Amortization of contract costs

Under ASC 340-40, an entity amortizes capitalized contract costs on a systematic basis consistent with the pattern of transferring the goods or services related to those costs. If an entity identifies a significant change to the expected pattern of transfer, it should update the amortization to reflect that estimated change in accordance with ASC 250.

ASC 340-40-35-1

An asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in paragraph 340-40-25-5(a)).

ASC 340-40-35-2

An entity shall update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates. Such a change shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

Estimating the amortization period for capitalized incremental costs is analogous to estimating the amortization or depreciation period for other intangible and tangible assets. Both processes are subjective and require judgment. In some circumstances, the amortization period could be longer than the initial contract term if the costs also relate to an anticipated future contract.

In paragraph BC309 of ASU 2014-09, the Boards indicated that amortizing capitalized commissions over a period that is longer than the initial contract term is not appropriate if an entity pays a commission on renewing a contract that is commensurate with the commission paid when obtaining the original contract. The TRG discussed what the Boards meant by "commensurate with" at its November 2016 meeting, which has implications for determining the amortization period and for whether an entity can use the practical expedient discussed in Section 11.1.

TRG area of general agreement: Does 'commensurate with' mean level of effort, or is it a quantitative assessment only?

At the November 2016 meeting,[95] the U.S. TRG members generally agreed that capitalized commissions should be amortized over a period that is longer than the initial contract term if the contract includes a renewal option, if history supports that the contract will be renewed, and if there is no commission paid for the renewal or the renewal commission is not commensurate with the commission paid on the initial contract.

When evaluating whether a commission paid for renewing a contract is "commensurate with" the commission paid for obtaining the original contract, the TRG agreed that the assessment is not based on the level of effort required to obtain the initial contract and to renew it. Rather, an entity should determine if the commission relates only to the initial contract or if it also relates to goods or services to be provided under future anticipated contracts.

Paper 23, *Incremental costs of obtaining a contract,* indicates that it would be reasonable for an entity to conclude that a renewal commission is "commensurate with" an initial commission if the two commissions are reasonably proportional to the respective contract value (for example, 5 percent of the contract value is paid for both the initial and the renewal contract). Conversely, it would be reasonable to conclude that a renewal commission is not commensurate with an initial commission if it is disproportionate to the initial commission (for example, 6 percent of the contract value is paid on the initial contract and 2 percent is paid for renewals).

Therefore, if an entity pays a lower commission for contract renewals than it does for an initial contract, the amortization period would exceed one year and the practical expedient discussed in Section 11.1 would not apply to the contract.

[95] TRG Paper 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract.*

The TRG also discussed what the appropriate amortization period would be if an entity determines that the amortization period for capitalized incremental costs is longer than the initial contract term because the costs also relate to an anticipated future contract.

TRG area of general agreement: Should customer life be the default amortization period for costs to obtain a contract?

In November 2016,[96] the U.S. TRG members agreed that estimating the amortization period for capitalized incremental costs is analogous to estimating the amortization or depreciation period for other intangible and tangible assets, which is a subjective determination that requires judgment. While the particular facts and circumstances of the contract may indicate that an amortization period equal to the average customer life is a reasonable application of the guidance, the TRG agreed that the guidance does not require using, nor should entities default to using, the average customer life when determining the amortization period for costs to obtain a contract.

Grant Thornton insight: Determining the amortization period

When an entity determines that the commission on the renewal contract is not commensurate with the commission on the initial contract, it must evaluate the facts and circumstances and apply judgment to determine the amortization period. As noted above, the TRG generally agreed with the staff paper that the standard does not require an entity to amortize the asset over the average customer life, rather the entity should determine the goods or services to which the asset relates, which may include the goods or services in both the initial contract as well as anticipated renewal contracts. In some circumstances, this evaluation may lead an entity to conclude that the appropriate amortization period is the average customer life. However, in other cases, for example when an entity enjoys long-term relationships with its customers such that its average customer life is in excess of 15 years, the entity will need to look to other factors to determine the appropriate amortization period.

Under ASC 340-40-35-1, an asset recognized for costs of obtaining a contract is to be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. In circumstances such as the example of an entity whose average customer life exceeds 15 years, the entity might conclude that a commission paid 15 years ago has little to no relationship to the goods or services provided today. Said another way, one consideration in determining the amortization period is the expected life of the goods or services. This could include, for example, consideration of the product or service offering life cycle. That is, at what point in the future would the entity expect that product or service offerings have fundamentally changed based on technology or other attributes such that the commission paid in the past no longer reasonably relates to the customer's ongoing purchases, even if those future products or services continue to be of similar benefit to the customer.

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[96] Ibid.

The following example highlights factors an entity might consider to develop a methodology to amortize capitalized contract costs on a systematic basis consistent with the pattern of transferring the goods or services related to those costs.

Amortization of capitalized sales commission

Smith Company enters into a contract with a customer to provide Service A for five years. When the initial contract is executed, Smith Company pays its employee a 10 percent commission. Smith's current commission structure also includes a 5 percent commission upon contract renewal. Smith expects the customer to renew the services and considers that its average customer life exceeds 15 years.

Smith Company operates in an industry that is susceptible to changes in technology and consumer preferences, and anticipates that within the next five to eight years, Service A will be replaced by Smith Company's next generation offering. In addition, Smith Company also reviews its commission plans with an external compensation consultant every three years to ensure its compensation practices are competitive and in-line with the market. The next review will be completed in two years.

In determining the appropriate amortization period for the initial commission, Smith Company first considers whether the expected renewal commission is commensurate with the initial commission. While it is possible the renewal commission percentage will change as a result of the next compensation policy review, Smith Company concludes that the best information available at the time the contract is entered into is the current commission plan.

Smith Company also determines that under the current commission plan, the commission on the renewal contract is not commensurate with the commission on the initial contract because the two commissions are not reasonably proportional to the contract value: The initial 10 percent commission is twice the proportion of the contract value compared to the 5 percent renewal commission. Because the contract is expected to be renewed and the expected renewal commission is not commensurate with the initial commission, the initial commission relates to services that will be transferred to the customer over a period that is longer than the initial five-year term.

Although Smith Company's average customer life is 15 years, the service related to the commission is expected to have a remaining life of five to eight years. Therefore, selecting an amortization period equal to the average customer life would be inconsistent with the transfer of control of the SaaS service to the customer.

Smith Company selects an amortization period for the initial commission of 7.5 years, which is its best estimate of the period that the customer will benefit from Service A.

Entities will need to ensure they have the appropriate processes and controls in place to identify and account for changes in the expected pattern of transfer of the good or service to which capitalized contract costs relates. ASC 340-40-35-2 indicates that entities should update the amortization to reflect a significant change in the expected timing of transfer to the customer of the good or service to which the asset relates.

Change in amortization period for capitalized sales commission

Consider the same facts outlined in the previous example.

Two years after Smith Company enters into the initial contract with its customer for Service A, it completes the periodic review of its compensation practices and changes the commission on contract renewals so that it equals the 10 percent commission earned on initial contracts, consistent with industry practice.

Smith Company considers whether the increase in the expected renewal commission impacts the amortization period selected for the initial commission asset. Because the expected renewal commission and the initial commission are now both 10 percent of the contract price, Smith Company considers whether the initial and renewal commission are commensurate. Smith concludes that the initial contract asset does not relate to periods beyond the initial contract term and that it would be inappropriate to amortize the initial commission over a period that is longer than the initial contract term.

Smith Company follows the guidance in ASC 250 related to changes in accounting estimates to recognize an adjustment in the amortization to date.

The TRG also discussed[97] factors to consider to determine an appropriate method of amortization for a contract asset that relates to multiple performance obligations that an entity satisfies at or during different time periods.

Single commission for multiple performance obligations

Smith Company enters into a contract with a customer for Good A and Service B. Control of Good A is transferred to the customer on day one of the contract, while Service B will be performed over the two-year contract period. Smith Company pays its salesperson a commission for obtaining the contract and determines that the commission is an incremental cost to obtaining the contract under ASC 340-40. The commission relates to both Good A and Service B.

The transaction price is $1,000 and the commission is $100. Based on their respective stand-alone selling prices, Good A constitutes 75 percent of the overall transaction price in the contract and Service B constitutes 25 percent of the overall transaction price.

Smith Company allocates the commission asset to the individual performance obligations based on their respective stand-alone selling prices and recognizes the respective portion of the asset based on the pattern of performance for the related performance obligation. As a result, $75 of the contract asset is allocated to Good A ($100 x 75%) and is amortized on the first day of the contract and $25 of the contract asset is allocated to Service B ($100 x 25%) and is amortized over the two-year term.

In addition to the allocation methodology described above, the TRG also noted[98] at its January 2015 meeting that it may also be reasonable to amortize a single commission asset using one measure of performance that contemplates all of the performance obligations in the contract.

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[97] TRG Paper 23, *Incremental costs of obtaining a contract.*
[98] Ibid.

11.5 Impairment of contract costs

An entity should recognize an impairment loss in earnings if the carrying amount of an asset exceeds its recoverable amount. Under ASC 340-40, the recoverable amount equals the consideration the entity either expects to receive in the future or has received but has not yet recognized as revenue, minus the costs directly related to providing goods or services that have not yet been expensed.

ASC 340-40-35-3

An entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 exceeds:

a. The amount of consideration that the entity expects to receive in the future and that the entity has received but has not recognized as revenue, in exchange for the goods or services to which the asset relates ("the consideration"), less

b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses (see paragraphs 340-40-25-2 and 340-40-25-7).

ASC 340-40-35-4

For the purposes of applying paragraph 340-40-35-3 to determine the consideration, an entity shall use the principles for determining the transaction price (except for the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk. When determining the consideration for the purposes of paragraph 340-40-35-3, an entity also shall consider expected contract renewals and extensions (with the same customer).

As highlighted in ASC 340-40-35-4, an entity determines the consideration amount in ASC 340-40-35-3(a) by applying the same guidance for determining the transaction price in Step 3 of ASC 606, with the exception of two items: (1) the constraint guidance is not applied, and (2) the amount is adjusted to reflect the customer's credit risk.

As part of the technical corrections to ASC 606 issued in December 2016,[99] the FASB clarified that when determining the amount of consideration for purposes of impairment testing in ASC 340-40-35-3, an entity should include amounts that it has received but not yet recognized as revenue, as well as amounts related to expected renewals and extensions. In other words, if an entity expects the contract to be renewed, it would include the consideration associated with that renewal as well as the expected costs of renewal (for example, commissions).

The following figure summarizes how the guidance on determining the transaction price in ASC 606 differs from the guidance on assessing impairment in ASC 340.

[99] ASU 2016-20.

Figure 11.4: Transaction price versus consideration for impairment

ASC 606	ASC 340
In determining the transaction price, estimate variable consideration and consider the impact of the constraint guidance.	In determining the consideration for purposes of impairment testing, estimate variable consideration but ignore the constraint and reflect the customer's credit risk.
In determining the transaction price, do not anticipate that the contract will be cancelled, renewed, or modified.	Include expected contract renewals and extensions with the same customer.

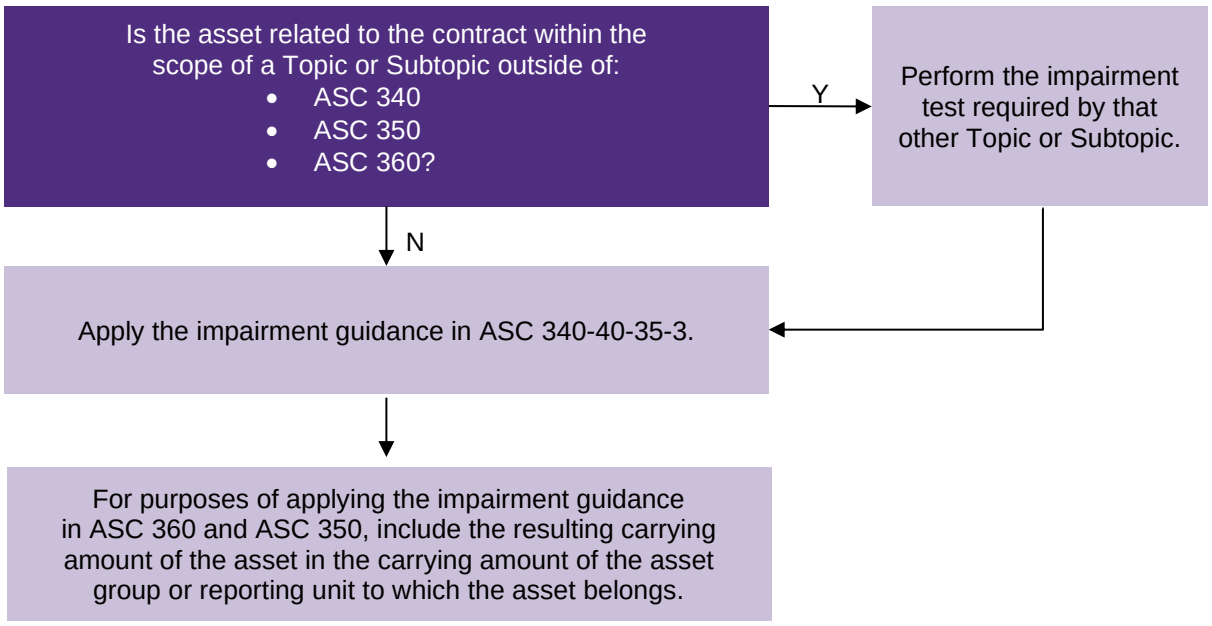
Impairment testing should first be performed on assets related to the contract that are recognized in accordance with guidance other than ASC 340, ASC 350, or ASC 360 (for example, inventory under ASC 330). Next, an entity applies the impairment guidance to assets related to the contract that are recognized in accordance with ASC 340.

After applying the impairment guidance in ASC 340-40-35-3, an entity includes the resulting carrying amount of the asset in the carrying amount of the asset group or reporting unit to which that asset belongs for purposes of applying the impairment guidance in ASC 350 and ASC 360.

Consistent with other U.S. GAAP impairment guidance, an entity is not permitted to reverse previously recognized impairment losses under ASC 340-40.

The following figure explains the sequence of the impairment testing guidance in ASC 340-40 and other Codification Topics for assets related to a contract with a customer.

Figure 11.5: Impairment testing



ASC 340-40-35-5

Before an entity recognizes an impairment loss for an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5, the entity shall recognize any impairment loss for assets related to the contract that are recognized in accordance with another Topic other than Topic 340 on other assets and deferred costs, Topic 350 on goodwill and other intangible assets, or Topic 360 on property, plant, and equipment (for example, Topic 330 on inventory and Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed). After applying the impairment test in paragraph 340-40-35-3, an entity shall include the resulting carrying amount of the asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 in the carrying amount of the asset group or reporting unit to which it belongs for the purpose of applying the guidance in Topics 360 and 350.

ASC 340-40-35-6

An entity shall not recognize a reversal of an impairment loss previously recognized.

11.5.1 Loss contracts

ASC 606 does not include guidance on loss contracts. However, the FASB retained the guidance on loss contracts in ASC 605-35 for construction-type and production-type contracts, updating the content to reflect ASC 606 terminology and clarifying that the loss is determined at the contract level. As an accounting policy election, an entity may consider the need for a loss provision at the performance obligation level.[100]

[100] ASU 2016-20.

12. Presentation

At the end of each reporting period, an entity presents a contract liability, a contract asset, or a receivable in the balance sheet, depending upon the relationship between the entity's performance and the customer's payment at that date, to reflect its rights and obligations under a contract with its customer. The guidance in ASC 606 uses the terms "contract asset" and "contract liability," but an entity can use alternative descriptions, provided that it gives sufficient information to enable financial statement users to distinguish between contract assets and receivables. An entity presents as a receivable any unconditional rights to consideration.

ASC 606-10-45-1

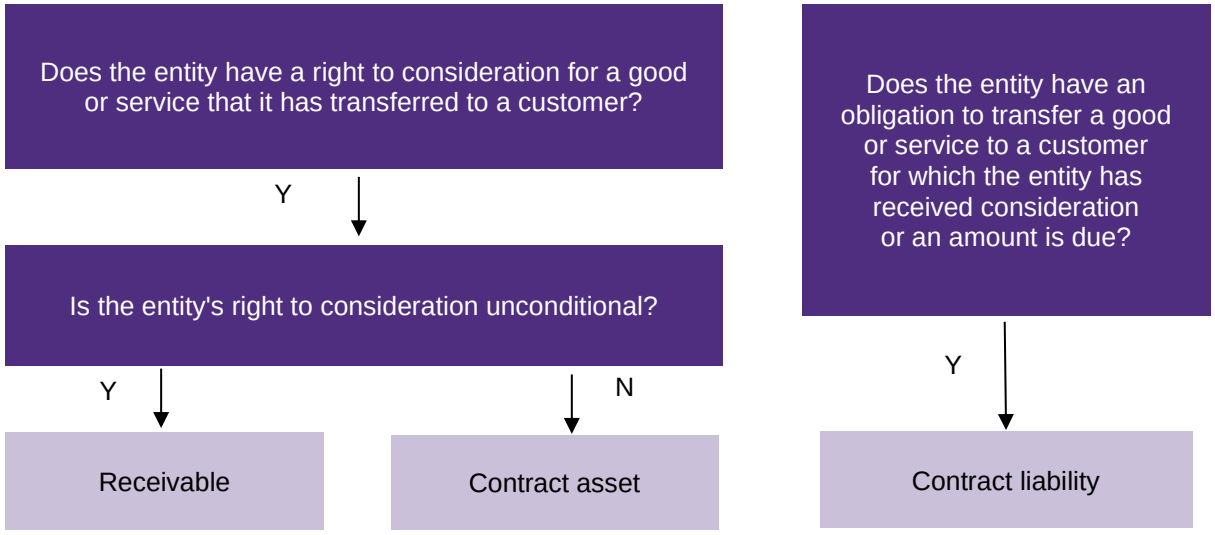
When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.

ASC 606-10-45-5

This guidance uses the terms *contract asset* and *contract liability* but does not prohibit an entity from using alternative descriptions in the statement of financial position for those items. If an entity uses an alternative description for a contract asset, the entity shall provide sufficient information for a user of the financial statements to distinguish between receivables and contract assets.

Figure 12.1 summarizes the presentation guidance on contract assets, receivables, and liabilities in ASC 606. The guidance is explained in detail in the sections that follow.

Figure 12.1: Presentation of contract assets, receivables, and liabilities



In addition to complying with the presentation guidance included in ASC 606, financial statements that are filed with the SEC should comply with the applicable presentation guidance included in Regulation S-X, including S-X Rule 5-03. For additional discussion of S-X Rule 5-03, see Section 12.5.

12.1 Contract assets and receivables

If the entity has transferred goods or services but the customer has not yet paid for them as of the reporting date, the entity should recognize either a contract asset or a receivable. An entity recognizes a contract asset if its right to consideration is conditioned on something other than the passage of time (for example, the entity still needs to transfer control of one or more of its performance obligations); otherwise, an entity recognizes a receivable. An entity presents contract assets separately from receivables in the balance sheet.

In BC323 of ASU 2014-09, the Boards emphasized that making a distinction between a contract asset and a receivable is important because doing so provides financial statement users with relevant information about the risks associated with the entity's rights in a contract. Both a receivable and a contract asset are subject to credit risk, but a contract asset is also subject to other risks, including performance risk.

In BC326 of ASU 2014-09, the Boards clarified that an entity's obligation to refund some or all of the consideration to the customer does not affect the entity's unconditional right to consideration. In this case, the entity may recognize a receivable and a refund liability.

Receivables and contract assets are subject to impairment testing under ASC 310 after initial recognition. An entity presents any impairment loss resulting from contracts with customers separately from losses from other contracts.

ASC 606-10-45-3

If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for impairment in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).

ASC 606-10-45-4

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognize a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with Topic 310 and Subtopic 326-20. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Subtopic 326-20 and the corresponding amount of revenue recognized shall be presented as a credit loss expense.

The following examples from ASC 606 illustrate when an entity should present a contract asset and a receivable.

Example 39—Contract Asset Recognized for the Entity's Performance

ASC 606-10-55-287

On January 1, 20X8, an entity enters into a contract to transfer Products A and B to a customer in exchange for $1,000. The contract requires Product A to be delivered first and states that payment for the delivery of Product A is conditional on the delivery of Product B. In other words, the consideration of $1,000 is due only after the entity has transferred both Products A and B to the customer. Consequently, the entity does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to the customer.

ASC 606-10-55-288

The entity identifies the promises to transfer Products A and B as performance obligations and allocates $400 to the performance obligation to transfer Product A and $600 to the performance obligation to transfer Product B on the basis of their relative standalone selling prices. The entity recognizes revenue for each respective performance obligation when control of the product transfers to the customer.

ASC 606-10-55-289

The entity satisfies the performance obligation to transfer Product A.

Contract asset	$400	
Revenue		$400

ASC 606-10-55-290

The entity satisfies the performance obligation to transfer Product B and to recognize the unconditional right to consideration.

Receivable	$1,000	
Contract asset		$400
Revenue		$600

Example 40—Receivable Recognized for the Entity's Performance

ASC 606-10-55-291

An entity enters into a contract with a customer on January 1, 20X9, to transfer products to the customer for $150 per product. If the customer purchases more than 1 million products in a calendar year, the contract indicates that the price per unit is retrospectively reduced to $125 per product.

ASC 606-10-55-292

Consideration is due when control of the products transfer to the customer. Therefore, the entity has an unconditional right to consideration (that is, a receivable) for $150 per product until the retrospective price reduction applies (that is, after 1 million products are shipped).

ASC 606-10-55-293

In determining the transaction price, the entity concludes at contract inception that the customer will meet the 1 million products threshold and therefore estimates that the transaction price is $125 per product. Consequently, upon the first shipment to the customer of 100 products the entity recognizes the following.

Receivable	$15,000 [(a)]	
Revenue		$12,500 [(b)]
Refund liability		$2,500

(a) $150 per product × 100 products
(b) $125 transaction price per product × 100 products

ASC 606-10-55-294

The refund liability (see paragraph 606-10-32-10) represents a refund of $25 per product, which is expected to be provided to the customer for the volume-based rebate (that is, the difference between the $150 price stated in the contract that the entity has an unconditional right to receive and the $125 estimated transaction price).

12.2 Contract liabilities

An entity presents a contract as a contract liability if the customer has paid consideration, or if payment is due as of the reporting date, but the entity has not yet satisfied its performance obligation by transferring a good or service.

ASC 606-10-45-2

If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

In addition to Example 40 above, the following example from ASC 606 illustrates when an entity should present a contract liability and receivable.

Example 38—Contract Liability and Receivable

Case A—Cancellable Contract

ASC 606-10-55-284

On January 1, 20X9, an entity enters into a cancellable contract to transfer a product to a customer on March 31, 20X9. The contract requires the customer to pay consideration of $1,000 in advance on January 31, 20X9. The customer pays the consideration on March 1, 20X9. The entity transfers the

product on March 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:

a. The entity receives cash of $1,000 on March 1, 20X9 (cash is received in advance of performance).

Cash	$1,000	
Contract liability		$1,000

b. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	$1,000	
Revenue		$1,000

Case B—Noncancellable Contract

ASC 606-10-55-285

The same facts as in Case A apply to Case B except that the contract becomes noncancellable on January 31, 20X9. The following journal entries illustrate how the entity accounts for the contract:

a. January 31, 20X9 is the date at which the entity recognizes a receivable because it has an unconditional right to consideration.

Receivable	$1,000	
Contract liability		$1,000

b. The entity receives the cash on March 1, 20X9.

Cash	$1,000	
Receivable		$1,000

c. The entity satisfies the performance obligation on March 31, 20X9.

Contract liability	$1,000	
Revenue		$1,000

ASC 606-10-55-286

If the entity issued the invoice before January 31, 20X9, the entity would not recognize the receivable and the contract liability in the statement of financial position because the entity does not yet have a right to consideration that is unconditional (the contract is cancellable before January 31, 20X9).

Grant Thornton insight: When should a contract asset or receivable be recognized for advance billings?

Example 38 in ASC 606 illustrates when to recognize a contract liability and receivable in the balance sheet. Entities may question whether advance billing to a customer should also be reflected as a contract asset or receivable. For example, an entity bills customers on December 1 for the next year's subscription. Customers may cancel prior to January 1; however, on January 1, the contract becomes noncancellable. Because of the cancellation terms, the amounts are not unconditionally due to the

entity until January 1. Neither a contract asset nor receivable should be recognized at December 31. As of January 1, the entity has an unconditional right to the uncollected amounts and recognizes a receivable.

Careful evaluation of the facts and circumstances is necessary to determine the appropriate point in time when advance billed amounts should be reflected as receivables.

12.3 Unit of account

Stakeholders asked the TRG if an entity should present a contract asset or liability for each performance obligation or aggregate all contract assets and liabilities at the contract level.

TRG area of general agreement: How should an entity present assets and liabilities if a contract contains multiple performance obligations?

Many aspects of the guidance in ASC 606 are applied at the performance obligation level. However, at the October 31, 2014 meeting,[101] the TRG generally agreed that an entity should determine if a contract asset or liability exists at the contract level, and not at the performance obligation level. The TRG looked to the guidance in BC317 of ASU 2014-09, which states:

> The Boards decided that the remaining rights and performance obligations in a contract should be accounted for and presented on a net basis, as either a contract asset or a contract liability. The Boards noted that the rights and obligations in a contract with a customer are interdependent—the right to receive consideration from a customer depends on the entity's performance and, similarly, the entity performs only as long as the customer continues to pay. The Boards decided that those interdependencies are best reflected by accounting and presenting on a net basis the remaining rights and obligations in the statement of financial position.

Presentation of contract assets and liabilities with more than one performance obligation

A SaaS provider enters into a contract to provide SaaS service for one year beginning on December 1, 20X1 along with 40 hours of training to be provided within the first three months. The entity has determined that the training and the SaaS services promises are distinct and, therefore, identifies two performance obligations.

The contract terms require an upfront payment of $8,000. The contract also includes an offer for the first six months of the SaaS service for free and then charges for the remaining six months of SaaS service at $4,000/month. The contract includes a substantive termination penalty. As a result, the entity determines that both parties are committed to the arrangement and that a contract exists for the purposes of applying ASC 606 as of December 1, 20X1 and begins recording revenue for the contract as the services under the contract are provided.

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[101] TRG Paper 7, *Presentation of a contract as a contract asset or a contract liability.*

The SaaS provider estimates a total transaction price of $32,000 and determines the SASP of the training and SaaS services are $8,000 and $24,000, respectively. As of December 31, 20X1, the entity has provided one month of SaaS services and 20 hours of training.

The entity recognizes a contract asset of $2,000 related to the one month of service provided ($24,000/12 months = $2,000 per month). The entity also recognizes a contract liability of $4,000 ($8,000 x 20 hours of training provided / 40 hours of total training promised). At December 31, 20X1, the entity presents a net contract liability of $2,000 ($4,000 contract liability - $2,000 contract asset).

12.4 Offsetting

Because ASC 606 does not contain offsetting guidance, the TRG agreed that entities should apply other relevant guidance to determine if offsetting other balance sheet items against a contract asset or liability is appropriate, based on the facts and circumstances of each arrangement.

TRG area of general agreement: Can an entity offset other balance sheet items (for example, receivables) against the contract asset or liability?

At the October 31, 2014 meeting,[102] the TRG discussed the following example:

> *Assume that in a single contract, the entity has invoiced the customer and recognized a receivable for that invoiced amount because it represents an unconditional right to consideration. Also, assume that the entity has collected previous billed receivables in advance of performance. Therefore, the entity has recognized a receivable for the recurrent amount billed and a contract liability for the prior amounts collected.*

The guidance in ASC 606 allows for net presentation of contract assets and liabilities at the contract level, as discussed in Section 12.3, but stakeholders specifically questioned whether a receivable and contract liability could be offset against each other in the balance sheet.

The TRG members generally agreed that entities must look to guidance outside ASC 606 to determine whether offsetting would be appropriate in this situation, since ASC 606 lacks specific offsetting guidance.

Grant Thornton insight: Offsetting receivables and contract liabilities

The guidance in ASC 210-20 is typically the starting point in evaluating whether it is appropriate to offset assets and liabilities. The guidance states that offsetting assets and liabilities is improper unless a right of setoff exists. Therefore, after considering the guidance about contract assets and liabilities in ASC 606, together with the TRG general agreement discussed above, entities typically would look to ASC 210-20 for guidance on offsetting. Often entities will conclude that offsetting (for example, a receivable and a contract liability) is inappropriate unless an explicit right of setoff exists, as discussed

[102] Ibid.

in ASC 210-20-45-1. That paragraph provides four conditions that must be met to offset an asset and a liability:

- The amounts due to and from must be determinable.
- The entity has the right to set off the amounts.
- The entity intends to set off the amounts.
- The right to set off is enforceable by law.

12.5 Interaction of ASC 606 with SEC Regulation S-X, Rule 5-03(b)

If revenue from more than one category specified in S-X Rule 5-03(b) is over 10 percent of total revenue, such categories of revenue should be presented separately on the face of the income statement. For example, if revenue from products and revenue from services represent 30 percent and 70 percent, respectively, of total revenue, both categories should be separately presented on the face of the income statement.

If an entity concludes under ASC 606 that it has a single performance obligation that includes both products and services, separate income statement presentation may be required for product and service revenue under S-X Rule 5-03(b). Similarly, S-X Rule 5-03(b) also requires separate presentation for each category of costs of sales for each category of revenue that is required to be presented separately.

In a 2007 SEC staff speech,[103] the staff indicated that they would not object to separate presentation of product and service revenue that could not be separated into more than one deliverable for recognition purposes, as long as the entity has a reasonable basis for developing a separation method and consistently applies and discloses the separation method.

Questions have arisen about how to apply the guidance in S-X Rule 5-03(b) when the transaction price is based on multiple fee structures. When the transaction price for a single performance obligation is determined using more than one fee structure, an entity should not presume there is more than one category of revenue for income statement presentation purposes. For example, a transportation contract may include a fixed rate per mile as well as a fuel surcharge per mile. In this example, only one product or service, the transportation service, is provided. Accordingly, this contract includes only one revenue category for income statement presentation purposes, the transportation service.

[103] https://www.sec.gov/news/speech/2007/spch121007mb.htm

13. Disclosure

The Boards designed the disclosure requirements within ASC 606 and ASC 340 using an overall disclosure objective to guide entities: to provide a clear, transparent, and consistent picture for financial statement users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Entities should keep this objective in mind as they evaluate which disclosures to provide and at what level. Entities should consider the particular characteristics of their business when deciding how much emphasis to place on each of the various requirements.

ASC 606-10-50-1

The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

- Its contracts with customers (see paragraphs 606-10-50-4 through 50-16)
- The significant judgments, and changes in the judgments, made in applying the guidance in this Topic to those contracts (see paragraphs 606-10-50-17 through 50-21)
- Any assets recognized from the costs to obtain or fulfill a contract with a customer in accordance with paragraph 340-40-25-1 or 340-40-25-5 (see paragraphs 340-40-50-1 through 50-6).

ASC 606-10-50-2

An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.

ASC 606-10-50-3

Amounts disclosed are for each reporting period for which a statement of comprehensive income (statement of activities) is presented and as of each reporting period for which a statement of financial position is presented. An entity need not disclose information in accordance with the guidance in this Topic if it has provided the information in accordance with another Topic.

An entity must distinguish the amount of revenue recognized from contracts with customers separately from other sources of revenue either in the notes or within the income statement. An entity is also required to disclose credit losses from contracts with customers separately from other credit losses if they are not separately presented in the income statement.

ASC 606-10-50-4

An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income (statement of activities) in accordance with other Topics:

a. Revenue recognized from contracts with customers, which the entity shall disclose separately from its other sources of revenue

b. Credit losses recorded (in accordance with Subtopic 326-20 on financial instruments measured at amortized cost) on any receivables or contract assets arising from an entity's contracts with customers, which the entity shall disclose separately from credit losses from other contracts.

Because the disclosure requirements differ for public and private business entities, the rest of this Section separately discusses the requirements and considerations applicable to each group.

13.1 Public business entity disclosures

The following table provides a summary of the disclosures required for a public business entity for each period that it presents an income statement and a balance sheet. The remainder of this section discusses each disclosure area in more detail.

Figure 13.1: Summary of disclosure requirements for public business entities

Disclosure area	Summary of requirements
Disaggregation of revenue	• Categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors • Sufficient information to enable users of financial statements to understand the relationship with revenue information disclosed for reportable segments under ASC 280
Contract balances	• Opening and closing balances of contract assets, contract liabilities, and receivables (if not otherwise separately presented or disclosed) • Revenue recognized in the period that was included in opening contract liabilities and from performance obligations either wholly or partially satisfied in prior periods • Explanation of relationship between timing of satisfying performance obligations and payment, and the related effect on contract assets and contract liabilities • Significant changes in the balances of contract assets and contract liabilities

Disclosure area	Summary of requirements
Performance obligations	• When the entity typically satisfies performance obligations • Significant payment terms • Nature of goods and services, including when the entity acts as an agent • Obligations for returns, refunds, and similar terms • Types of warranties and related obligations • Aggregate amount of transaction price allocated to remaining performance obligations at end of period, including partially satisfied performance obligations and when that amount is expected to be recognized as revenue
Significant judgments and changes in judgments	• Significant judgments and changes in judgments used to determine both of the following: – Timing of satisfying performance obligations – The transaction price and amounts allocated to performance obligations, including methods, inputs, and assumptions
Assets recognized from the costs to obtain or fulfill a contract	• Judgments made in determining costs capitalized • Amortization method used • Closing balances by main category • Amortization expense • Impairment losses

13.1.1 Disaggregation of revenue

The Boards explained in BC336 of ASU 2014-09 that they did not want to be overly specific in prescribing how entities should disaggregate their revenue from contracts with customers. The Boards instead provided a disclosure objective for entities to keep in mind as they consider their own business and determine which disaggregation categories make the most sense for financial statement users.

ASC 606-10-50-5

An entity shall disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. An entity shall apply the guidance in paragraphs 606-10-55-89 through 55-91 when selecting the categories to use to disaggregate revenue.

Some public business entities may need to use more than one type of disaggregation category to meet the objective. Other entities may meet the objective by using only one type of category. In BC337 of ASU 2014-09, the Boards suggest that an entity making this determination might consider how it communicates information about its revenue for other purposes, including earnings releases or segment disclosures.

An entity should provide enough information to allow financial statement users to understand the relationship between the revenue disclosures and the segment disclosures; however, the two disaggregation levels may be different because the objectives of the disclosures are different.

ASC 606-10-50-6 (excerpt)

[A]n entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with paragraph 606-10-50-5) and revenue information that is disclosed for each reportable segment, if the entity applies Topic 280 on segment reporting.

Grant Thornton insight: Interaction between disaggregated revenue information and segment reporting

The Boards decided[104] to require disaggregated revenue information for revenue from contracts with customers in ASC 606, despite some similarity between the disaggregation of revenue and segment reporting in ASC 280, because some entities may not be subject to the segment disclosures. Moreover, even if an entity is subject to the segment disclosures, the disclosures may not be disaggregated enough to achieve the objectives outlined for the disaggregation of revenue.

One notable difference between the guidance in ASC 280 and ASC 606 is that ASC 280 requires a certain level of detail to be disclosed unless it is “impracticable” to do so, whereas there is no “practicability out” in ASC 606. According to ASC 280-10, information would be “impractical to present” if the information is unavailable and the cost to develop it would be excessive.

ASC 606 does not include such language. Therefore, one can infer that the Boards expect companies to do the work necessary to provide the appropriate level of disaggregated revenue information to users.

An entity’s ultimate goal should be to tell a clear, transparent, and cohesive story about revenue across all of its communication elements, whether through the ASC 606 disclosures, MD&A, segment disclosures, investor presentations, or website summaries.

The new revenue guidance offers the following considerations and examples to help an entity determine the most appropriate level of disaggregation.

[104] BC340, ASU 2014-09.

ASC 606-10-55-89

Paragraph 606-10-50-5 requires an entity to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. Consequently, the extent to which an entity's revenue is disaggregated for the purposes of this disclosure depends on the facts and circumstances that pertain to the entity's contracts with customers. Some entities may need to use more than one type of category to meet the objective in paragraph 606-10-50-5 for disaggregating revenue. Other entities may meet the objective by using only one type of category to disaggregate revenue.

ASC 606-10-55-90

When selecting the type of category (or categories) to use to disaggregate revenue, an entity should consider how information about the entity's revenue has been presented for other purposes, including all of the following:

a. Disclosures presented outside the financial statements (for example, in earnings releases, annual reports, or investor presentations)

b. Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments

c. Other information that is similar to the types of information identified in (a) and (b) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.

ASC 606-10-55-91

Examples of categories that might be appropriate include, but are not limited to, all of the following:

a. Type of good or service (for example, major product lines)

b. Geographical region (for example, country or region)

c. Market or type of customer (for example, government and nongovernment customers)

d. Type of contract (for example, fixed-price and time-and-materials contracts)

e. Contract duration (for example, short-term and long-term contracts)

f. Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)

g. Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

Example 41 in ASC 606 illustrates how an entity may satisfy the disclosure requirements related to disaggregated revenue balances.

Example 41—Disaggregation of Revenue—Quantitative Disclosure

ASC 606-10-55-296

An entity reports the following segments: consumer products, transportation, and energy, in accordance with Topic 280 on segment reporting. When the entity prepares its investor presentations, it disaggregates revenue into primary geographical markets, major product lines, and timing of revenue recognition (that is, goods transferred at a point in time or services transferred over time).

ASC 606-10-55-297

The entity determines that the categories used in the investor presentations can be used to meet the objective of the disaggregation disclosure requirement in paragraph 606-10-50-5, which is to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. The following table illustrates the disaggregation disclosure by primary geographical market, major product line, and timing of revenue recognition, including a reconciliation of how the disaggregated revenue ties in with the consumer products, transportation, and energy segments in accordance with paragraphs 606-10-50-6.

Segments	Consumer Products	Transportation	Energy	Total
Primary Geographic Markets				
North America	$ 990	$ 2,250	$ 5,250	$ 8,490
Europe	300	750	1,000	2,050
Asia	700	260	-	960
	$ 1, 990	$ 3,260	$ 6,250	$ 11,500
Major Goods/Service Lines				
Office supplies	$ 600	-	-	$ 600
Appliances	990	-	-	990
Clothing	400	-	-	400
Motorcycles	-	500	-	500
Automobiles	-	2,760	-	2,760
Solar panels	-	-	1,000	1,000
Power plant	-	-	5,250	5,250
	$ 1, 990	$ 3,260	$ 6,250	$ 11,500
Timing of Revenue Recognition				
Goods transferred at a point in time	$ 1,990	$ 3,260	$ 1,000	$ 6,250

Services transferred over time	-	-	5,250	5,250
	$ 1, 990	$ 3,260	$ 6,250	$ 11,500

Grant Thornton insight: Disaggregating revenue

The guidance in ASC 606 provides overall objectives and some examples of how an entity might disaggregate revenue, but does not provide a checklist or detailed requirements. As a result, an entity should take a holistic approach to determine the level of disaggregation that best reflects its business. When determining the appropriate level of disaggregation, an entity should consider the breadth of information available that has already been utilized in stakeholder communications or in other information provided to stakeholders both inside and outside of the traditional financial statements, for example, investor calls, the entity's website, MD&A, and social media posts.

In Example 41 above, although the entity has identified only three reportable segments (consumer products, transportation, and energy) under ASC 280, in investor presentations it has historically disclosed revenue in more detail that that required by ASC 280, including disclosing revenue by major product line. Because the entity determines that the disclosures in the investor presentations meet the objective of the disaggregation of revenue disclosure requirement, it provides disaggregation of revenue disclosures in more detail than has historically been required under ASC 280.

13.1.2 Contract balances

The goal of the disclosure requirements about contract balances is to help financial statement users understand the relationship between the revenue recognized and changes in the overall contract balances (contract assets and liabilities) during the reporting period. Users want to know when contract assets will convert into accounts receivable or cash and when contract liabilities will convert into revenue. Public business entities can meet the disclosure requirements through a combination of tabular and narrative information.

ASC 606-10-50-8

An entity shall disclose all of the following:

a. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed

b. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period

ASC 606-10-50-9

An entity shall explain how the timing of satisfaction of its performance obligations (see paragraph 606-10-50-12(a)) relates to the typical timing of payment (see paragraph 606-10-50-12(b)) and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information.

ASC 606-10-50-10

An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

a. Changes due to business combinations

b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained), or a contract modification

c. Impairment of a contract asset

d. A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable)

e. A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability).

13.1.3 Performance obligations

The Boards decided to require public business entities to provide detailed information about their performance obligations and how their revenue recognition policies relate to the entity's existing contracts as prescribed below.

ASC 606-10-50-12

An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:

a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement

b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 606-10-32-11 through 32-13)

c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)

d. Obligations for returns, refunds, and other similar obligations

e. Types of warranties and related obligations.

Finally, the Boards decided to require that public business entities disclose the amount of revenue recognized during the period that is not a result of performance in the current period, but is related to

performance obligations satisfied (or partially satisfied) in prior periods. This may happen, for example, when the transaction price is variable and changes after performance is complete.

ASC 606-10-50-12A

An entity shall disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).

Financial statement users also requested additional information about an entity's remaining performance obligations and when the entity expects to recognize revenue related to those remaining performance obligations, specifically for long-term contracts since they usually have the most significant amounts of unrecognized revenue. Overall, the Boards agreed, reasoning that disclosures about remaining performance obligations would provide

- Additional information about trends relating to the amount and expected timing of revenue from the remaining performance obligations in the contract
- Risks associated with expected future revenue
- The effects of changes in judgments about or circumstances affecting an entity's revenue[105]

ASC 606-10-50-13

An entity shall disclose the following information about its remaining performance obligations:

a. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period

b. An explanation of when the entity expects to recognize as revenue the amount disclosed in accordance with paragraph 606-10-50-13(a), which the entity shall disclose in either of the following ways:

    1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations

    2. By using qualitative information.

As described in ASC 606-10-50-13(b), the disclosures about remaining performance obligations can be provided on either a quantitative basis (that is, amounts to be recognized in given time bands, such as within year one and year two and within year two and year three) or by disclosing qualitative information. Some entities might disclose a mix of quantitative and qualitative information.

The guidance includes some relief by allowing entities to avoid the disclosures about remaining performance obligations in the following cases:

[105] BC348-350, ASU 2014-09.

- The performance obligation is part of a contract that has an original expected duration of one year or less.
- The entity recognizes revenue by applying the "right to invoice" practical expedient (Section 7.1.3).
- Variable consideration is a sales-based or usage-based royalty promised in exchange for a license of intellectual property (Section 8.5).
- Variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation (Section 6.5).

When a public business entity elects to apply one of the optional exemptions noted above, it still needs to disclose the nature of its performance obligations, the remaining duration of the performance obligations, and a description of the variable consideration that has been excluded from the information disclosed.

Grant Thornton insight: Termination clauses and the RUPO disclosure

It is common for contracts in certain industries to contain termination clauses. For example, contracts with the federal government may be governed by the Federal Acquisition Regulation (FAR) and may contain a "termination for convenience" clause. Depending on the language in the contract, the customer may be able to terminate the contract with short notice. The customer's ability to terminate is taken into account when assessing a contract's term. If the customer can terminate the contract and avoid a substantive penalty for doing so, then the contract term for purposes of applying ASC 606 would not extend beyond the date when the customer can terminate the contract without incurring a substantive penalty (which may be month-to-month).

If a contract contains a termination clause that causes its term to be shorter than the term stated in the contract, any transaction price that extends beyond the contract term (taking into account the termination penalty) is not included in the remaining unsatisfied performance obligation disclosure. See Section 3.3.1 for a discussion on what constitutes a substantive termination penalty.

Grant Thornton insight: Backlog is not synonymous with 'remaining unsatisfied performance obligations'

Historically, SEC regulations[106] prescribed disclosures for "backlog"—that is, anticipated revenue from contracts with customers. Specifically, the regulations required disclosure of "the dollar amount of backlog orders believed to be firm, as of a recent date and as of a comparable date in the preceding fiscal year, together with an indication of the portion thereof not reasonably expected to be filled within the current fiscal year, and seasonal or other material aspects of the backlog…" Those historical SEC disclosure requirements have since been eliminated;[107] however, under the SEC's overall principles-based approach for disclosure, registrants may need to provide information to users of the financial statements about "backlog" if they are material to understanding the business and are not otherwise

[106] Regulation S-K, Item 101(c)(viii).
[107] Modernization of Regulation S-K Items 101, 103, and 105, August 26, 2020. SEC.gov | SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K.

disclosed. As a result, many registrants continue to disclose information about “backlog” as prescribed in historical SEC regulations.

ASC 606 introduced disclosure requirements for remaining, unsatisfied performance obligations (referred to as RUPO). Because ASC 606 prescribes guidance for determining performance obligations, the transaction price, and allocation to the identified performance obligation, there may be differences in RUPO disclosure and those disclosures about “backlog” in MD&A or outside the financial statements, because entities may have historically included contracts for “orders believed to be firm” in their backlog figures that would not pass the contract existence requirements in ASC 606’s Step 1 criteria.

As a result, we expect entities to follow ASC 606’s guidance in determining the quantitative amount disclosed as RUPO in ASC 606-10-50-13 and to consider explaining to the financial statement users any differences in calculating “backlog” versus “RUPO” to promote transparency about future expected revenue from contracts with customers.

ASC 606-10-50-14

An entity need not disclose the information in paragraph 606-10-50-13 for a performance obligation if either of the following conditions is met:

a. The performance obligation is part of a contract that has an original expected duration of one year or less.

b. The entity recognizes revenue from the satisfaction of the performance obligation in accordance with paragraph 606-10-55-18.

ASC 606-10-50-14A

An entity need not disclose the information in paragraph 606-10-50-13 for variable consideration for which either of the following conditions is met:

a. The variable consideration is a sales-based or usage-based royalty promised in exchange for a license of intellectual property accounted for in accordance with paragraphs 606-10-55-65 through 55-65B.

b. The variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b), for which the criteria in paragraph 606-10-32-40 have been met.

ASC 606-10-50-14B

The optional exemptions in paragraphs 606-10-50-14(b) and 606-10-50-14A shall not be applied to fixed consideration.

ASC 606-10-50-15

An entity shall disclose which optional exemptions in paragraphs 606-10-50-14 through 50-14A it is applying. In addition, an entity applying the optional exemptions in paragraphs 606-10-50-14 through 50-14A shall disclose the nature of the performance obligations, the remaining duration (see paragraph

606-10-25-3), and a description of the variable consideration (for example, the nature of the variability and how that variability will be resolved) that has been excluded from the information disclosed in accordance with paragraph 606-10-50-13. This information shall include sufficient detail to enable users of financial statements to understand the remaining performance obligations that the entity excluded from the information disclosed in accordance with paragraph 606-10-50-13. In addition, an entity shall explain whether any consideration from contracts with customers is not included in the transaction price and, therefore, not included in the information disclosed in accordance with paragraph 606-10-50-13. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see paragraphs 606-10-32-11 through 32-13).

ASC 606 illustrates the remaining performance obligations disclosure, using both a quantitative and qualitative approach, in Examples 42 and 43.

Example 42—Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations

ASC 606-10-55-298

On June 30, 20X7, an entity enters into three contracts (Contracts A, B, and C) with separate customers to provide services. Each contract has a two-year noncancellable term. The entity considers the guidance in paragraphs 606-10-50-13 through 50-15 in determining the information in each contract to be included in the disclosure of the transaction price allocated to the remaining performance obligations at December 31, 20X7.

Contract A

ASC 606-10-55-299

Cleaning services are to be provided over the next two years typically at least once per month. For services provided, the customer pays an hourly rate of $25.

ASC 606-10-55-300

Because the entity bills a fixed amount for each hour of service provided, the entity has a right to invoice the customer in the amount that corresponds directly with the value of the entity's performance completed to date in accordance with paragraph 606-10-55-18. Consequently, the entity could elect to apply the optional exemption in paragraph 606-10-50-14(b). If the entity elects not to disclose the transaction price allocated to remaining performance obligations for Contract A, the entity would disclose that it has applied the optional exemption in paragraph 606-10-50-14(b). The entity also would disclose the nature of the performance obligation, the remaining duration, and a description of the variable consideration that has been excluded from the disclosure of remaining performance obligations in accordance with paragraph 606-10-50-15.

Contract B

ASC 606-10-55-301

Cleaning services and lawn maintenance services are to be provided as and when needed with a maximum of four visits per month over the next two years. The customer pays a fixed price of $400 per

month for both services. The entity measures its progress toward complete satisfaction of the performance obligation using a time-based measure.

ASC 606-10-55-302

The entity discloses the amount of the transaction price that has not yet been recognized as revenue in a table with quantitative time bands that illustrates when the entity expects to recognize the amount as revenue. The information for Contract B included in the overall disclosure is as follows.

	20X8	20X9	Total
Revenue expected to be recognized on this contract as of December 31, 20X7	$4,800 [(a)]	$2,400 [(b)]	$7,200

(a) $4,800 = $400 × 12 months

(b) $2,400 = $400 × 6 months

Contract C

ASC 606-10-55-303

Cleaning services are to be provided as and when needed over the next two years. The customer pays fixed consideration of $100 per month plus a one-time variable consideration payment ranging from $0 – $1,000 corresponding to a one-time regulatory review and certification of the customer's facility (that is, a performance bonus). The entity estimates that it will be entitled to $750 of the variable consideration. On the basis of the entity's assessment of the factors in paragraph 606-10-32-12, the entity includes its estimate of $750 of variable consideration in the transaction price because it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. The entity measures its progress toward complete satisfaction of the performance obligation using a time-based measure.

ASC 606-10-55-304

The entity discloses the amount of the transaction price that has not yet been recognized as revenue in a table with quantitative time bands that illustrates when the entity expects to recognize the amount as revenue. The entity also includes a qualitative discussion about any significant variable consideration that is not included in the disclosure. The information for Contract C included in the overall disclosure is as follows.

	20X8	20X9	Total
Revenue expected to be recognized on this contract as of December 31, 20X7	$1,575 [(a)]	$788 [(b)]	$2,363

(a) Transaction price = $3,150 ($100 × 24 months + $750 variable consideration) recognized evenly over 24 months at $1,575 per year

(b) $1,575 ÷ 2 = $788 (that is, for 6 months of the year)

ASC 606-10-55-305

In addition, in accordance with paragraph 606-10-50-15, the entity discloses qualitatively that part of the performance bonus has been excluded from the disclosure because it was not included in the transaction price. That part of the performance bonus was excluded from the transaction price in accordance with the guidance on constraining estimates of variable consideration.

ASC 606-10-55-305A

The entity does not meet the criteria to apply the optional exemption in paragraph 606-10-50-14A because the monthly consideration is fixed and the variable consideration does not meet the condition in paragraph 606-10-50-14A(b).

Example 43—Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations—Qualitative Disclosure

ASC 606-10-55-306

On January 1, 20X2, an entity enters into a contract with a customer to construct a commercial building for fixed consideration of $10 million. The construction of the building is a single performance obligation that the entity satisfies over time. As of December 31, 20X2, the entity has recognized $3.2 million of revenue. The entity estimates that construction will be completed in 20X3 but it is possible that the project will be completed in the first half of 20X4.

ASC 606-10-55-307

At December 31, 20X2, the entity discloses the amount of the transaction price that has not yet been recognized as revenue in its disclosure of the transaction price allocated to the remaining performance obligations. The entity also discloses an explanation of when the entity expects to recognize that amount as revenue. The explanation can be disclosed either on a quantitative basis using time bands that are most appropriate for the duration of the remaining performance obligation or by providing a qualitative explanation. Because the entity is uncertain about the timing of revenue recognition, the entity discloses this information qualitatively as follows:

> As of December 31, 20X2, the aggregate amount of the transaction price allocated to the remaining performance obligation is $6.8 million, and the entity will recognize this revenue as the building is completed, which is expected to occur over the next 12–18 months.

Disclosure of remaining unrecognized performance obligations when customer can terminate for convenience

Background

On June 30, 20X7, an entity executes a contract with a two-year stated term to provide consulting services to the government up to four times per month for which the government pays $400 in fixed consideration every month. The contract can be cancelled by the government, without incurring penalties, on June 30, 20X8. Therefore, the contract term for accounting purposes is only one year. The entity uses a time-based measure of progress to recognize revenue.

Analysis

Because the customer has the ability to terminate the contract without incurring a penalty after June 30, 20X8, the term of the contract for accounting purposes is one year. The entity discloses the amount of the transaction price that has not yet been recognized as revenue in a table with quantitative time bands that illustrates when the entity expects to recognize the amount as revenue.

	20X8	20X9	Total
Revenue expected to be recognized on this contract as of December 31, 20X7	$2,400*	$0	$2,400

*Transaction price = $2,400 ($400 x 6 months)

The entity must update the disclosure at each reporting date.

Disclosure of remaining unrecognized performance obligations when contract includes a material right

Background

On June 30, 20X7, an entity executes a two-year noncancellable contract to provide consulting services to the government, as needed. The government agrees to pay $100 per month in fixed consideration every month. The entity uses a time-based measure of progress to recognize revenue. The government has the option to renew the contract for a third year of consulting services at a discounted price of $50 per month, which is accounted for as a material right.

Analysis

Under ASC 606, a renewal is only reflected in the remaining performance obligations disclosure when it is a material right that has been allocated a transaction price from the original contract. In contrast, additional consideration arising from exercising a renewal right is excluded from the disclosure. As a result, the entity discloses the amount of the transaction price that has not yet been recognized as revenue qualitatively, and

- Includes the transaction price of the current contract allocated to the material right within the disclosure (that is, the portion of $2,400 allocated to the material right).
- Excludes any future consideration from the contract that will be executed upon exercising the material right (that is, $50 each month that the government would pay if it elects to enter into consulting services for the third year).

13.1.4 Significant judgments

Because ASC 606 may require entities to exercise significant judgment and to make numerous estimates (specifically around the timing of satisfying performance obligations, determining the transaction price, and allocating the transaction price to the performance obligations) the Boards decided[108] to require specific disclosures around these judgments and estimates.

ASC 606-10-50-17

An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in this Topic that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, an entity shall explain the judgments, and changes in the judgments, used in determining both of the following:

a. The timing of satisfaction of performance obligations (see paragraphs 606-10-50-18 through 50-19)

b. The transaction price and the amounts allocated to performance obligations (see paragraph 606-10-50-20).

The requirements for disclosing significant judgments used in determining the timing of when a performance obligation is satisfied differ for performance obligations satisfied over time and those satisfied at a point in time.

Because the disclosures often require entities to make significant judgments, entities may be required to disclose extensive information under ASC 606 in order to meet the disclosure objectives.

ASC 606-10-50-18

For performance obligations that an entity satisfies over time, an entity shall disclose both of the following:

a. The methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied)

b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

ASC 606-10-50-19

For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when a customer obtains control of promised goods or services.

Specific disclosures are required for certain judgments made in Step 3 and Step 4 of ASC 606. These types of judgments are captured by the following disclosure requirements in ASC 606.

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[108] BC355, ASU 2014-09.

ASC 606-10-50-20

An entity shall disclose information about the methods, inputs, and assumptions used for all of the following:

a. Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration

b. Assessing whether an estimate of variable consideration is constrained

c. Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)

d. Measuring obligations for returns, refunds, and other similar obligations.

13.1.5 Assets recognized from costs to obtain or fulfill a contract

Public business entities are required to disclose information about significant judgments and contract balances related to any assets recognized for costs to obtain or fulfill a contract with a customer.

ASC 340-40-50-2

An entity shall describe both of the following:

a. The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5)

b. The method it uses to determine the amortization for each reporting period.

ASC 340-40-50-3

An entity shall disclose all of the following:

a. The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5), by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs)

b. The amount of amortization and any impairment losses recognized in the reporting period.

13.1.6 Practical expedients for measurement under ASC 606 and ASC 340-40

ASC 606 provides the following relief for entities:

- An entity does not have to adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when it transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

- An entity can elect not to recognize the incremental costs of obtaining a contract as an asset if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

An entity is, however, required to disclose that it has taken advantage of one or both of the above practical expedients if it chooses to do so.

ASC 606-10-50-22

If an entity elects to use the practical expedient in either paragraph 606-10-32-18 (about the existence of a significant financing component) or paragraph 340-40-25-4 (about the incremental costs of obtaining a contract), the entity shall disclose that fact.

13.1.7 Interim disclosure requirements

ASU 2014-09 expanded the interim disclosure requirements in ASC 270 to include information related to accounting for revenue under ASC 606.

The revenue guidance requires the following interim disclosures for

- Public business entities
- Not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- Employee benefit plans that file or furnish financial statements with or to the SEC.

ASC 270-10-50-1A

Consistent with paragraph 270-10-50-1, a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission, shall disclose all of the following information about revenue from contracts with customers consistent with the guidance in Topic 606:

a. A disaggregation of revenue for the period, see paragraphs 606-10-50-5 through 50-6 and paragraphs 606-10-55-89 through 55-91.

b. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers (if not otherwise separately presented or disclosed), see paragraph 606-10-50-8(a).

c. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period, see paragraph 606-10-50-8(b).

d. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price), see paragraph 606-10-50-12A.

e. Information about the entity's remaining performance obligations as of the end of the reporting

period, see paragraphs 606-10-50-13 through 50-15.

13.2 Nonpublic entity disclosures

Nonpublic entities are allowed to make all disclosures required for public business entities; however, they are provided certain relief, primarily because the costs of providing this information outweigh the benefits.[109] This section describes the revenue disclosures that are required for nonpublic entities.

13.2.1 Disaggregation of revenue

A nonpublic entity should distinguish the amount of revenue recognized from contracts with customers separately from other sources of revenue either in the notes to the financial statements or within the income statement. A nonpublic entity is also required to disclose credit losses from contracts with customers separately from other credit losses if they are not separately presented in the income statement.

ASC 606-10-50-4

An entity shall disclose all of the following amounts for the reporting period unless those amounts are presented separately in the statement of comprehensive income (statement of activities) in accordance with other Topics:

a. Revenue recognized from contracts with customers, which the entity shall disclose separately from its other sources of revenue

b. Credit losses recorded (in accordance with Subtopic 326-20 on financial instruments measured at amortized cost) on any receivables or contract assets arising from an entity's contracts with customers, which the entity shall disclose separately from credit losses from other contracts.

The Boards explained in BC336 of ASU 2014-09 that they did not want to be overly specific in prescribing how all entities should disaggregate their revenue from contracts with customers. Rather, the Boards provided a disclosure objective for entities to keep in mind as they consider their own businesses and determine what disaggregation categories make the most sense for users: to provide a clear, transparent, and consistent picture for financial statement users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

ASC 606-10-50-5

An entity shall disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. An entity shall apply the guidance in paragraphs 606-10-55-89 through 55-91 when selecting the categories to use to disaggregate revenue.

ASC 606-10-50-6

[109] BC506, ASU 2014-09.

In addition, an entity shall disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with paragraph 606-10-50-5) and revenue information that is disclosed for each reportable segment, if the entity applies Topic 280 on segment reporting.

The guidance offers the following considerations and examples to help entities determine the most appropriate level of disaggregation for their business.

ASC 606-10-55-89

Paragraph 606-10-50-5 requires an entity to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. Consequently, the extent to which an entity's revenue is disaggregated for the purposes of this disclosure depends on the facts and circumstances that pertain to the entity's contracts with customers. Some entities may need to use more than one type of category to meet the objective in paragraph 606-10-50-5 for disaggregating revenue. Other entities may meet the objective by using only one type of category to disaggregate revenue.

ASC 606-10-55-90

When selecting the type of category (or categories) to use to disaggregate revenue, an entity should consider how information about the entity's revenue has been presented for other purposes, including all of the following:

a. Disclosures presented outside the financial statements (for example, in earnings releases, annual reports, or investor presentations)

b. Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments

c. Other information that is similar to the types of information identified in (a) and (b) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.

ASC 606-10-55-91

Examples of categories that might be appropriate include, but are not limited to, all of the following:

a. Type of good or service (for example, major product lines)

b. Geographical region (for example, country or region)

c. Market or type of customer (for example, government and nongovernment customers)

d. Type of contract (for example, fixed-price and time-and-materials contracts)

e. Contract duration (for example, short-term and long-term contracts)

f. Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)

g. Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

A nonpublic entity is permitted to achieve the requirements in ASC 606-10-50-5 and 50-6 through qualitative disclosure, with limited quantitative information.

ASC 606-10-50-7

An entity, except for a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission (SEC), may elect not to apply the quantitative disaggregation disclosure guidance in paragraphs 606-10-50-5 through 50-6 and 606-10-55-89 through 55-91. If an entity elects not to provide those disclosures, the entity shall disclose, at a minimum, revenue disaggregated according to the timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred to customers over time) and qualitative information about how economic factors (such as type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows.

Example 41 in ASC 606 illustrates how the entity may satisfy the quantitative disclosure requirements related to disaggregated revenue balances for a nonpublic entity that does not make the election described above.

13.2.2 Contract balances

The goal of the disclosure requirements about contract balances is to help financial statement users understand the relationship between the revenue recognized and changes in the overall contract balances (contract assets and liabilities) during the reporting period. Users want to know when contract assets will convert into accounts receivable or cash and when contract liabilities will convert into revenue. Entities can meet the disclosure requirements through a combination of tabular and narrative information. Nonpublic business entities are exempt from the disclosures required in ASC 606-10-50-8 through 50-10 about contract balances, with the exception of those outlined in 606-10-50-8(a).

ASC 606-10-50-8 (excerpt)

An entity shall disclose…

a. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed.

13.2.3 Performance obligations

The Boards decided to require entities to provide detailed information about their performance obligations and how their policies relate to the entity's existing contracts as prescribed below.

ASC 606-10-50-12

An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:

a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement

b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 606-10-32-11 through 32-13)

c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)

d. Obligations for returns, refunds, and other similar obligations

e. Types of warranties and related obligations.

ASC 606-10-50-12A

An entity shall disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).

13.2.4 Significant judgments

Because ASC 606 may require entities to exercise significant judgment and to make numerous estimates (specifically around the timing of satisfying performance obligations, determining the transaction price, and allocating the transaction price to the performance obligations), the Boards decided[110] to require specific disclosures around these judgments and estimates.

ASC 606-10-50-17

An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in this Topic that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, an entity shall explain the judgments, and changes in the judgments, used in determining both of the following:

a. The timing of satisfaction of performance obligations (see paragraphs 606-10-50-18 through 50-19)

b. The transaction price and the amounts allocated to performance obligations (see paragraph 606-10-50-20).

[110] BC355, ASU 2014-09.

Nonpublic entities are required to disclose the significant judgments used in determining the timing of when a performance obligation is satisfied, which differs for performance obligations satisfied over time and for those satisfied at a point in time.

ASC 606-10-50-18 (excerpt)

For performance obligations that an entity satisfies over time, an entity shall disclose…

a. The methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied).

Nonpublic business entities are also required to disclose information about the methods, inputs, and assumptions used in assessing whether an estimate of variable consideration is constrained in ASC 606-10-50-20(b).

ASC 606-10-50-20 (excerpt)

An entity shall disclose information about the methods, inputs, and assumptions used for…

b. Assessing whether an estimate of variable consideration is constrained

14. U.S. GAAP and IFRS comparison

While the core revenue recognition principles, including the general 5 Step model, in ASC 606 and ASC 340-40 and IFRS 15 are largely converged, some differences exist.

Some of the differences exist due to the overall differences between U.S. GAAP and IFRS (for example, U.S. GAAP does not allow for reversals of impairment while IFRS does and U.S. GAAP differentiates between public business entities and non-public business entities while IFRS does not).

Other differences exist due to the amendments made by one or both Boards. When the TRG raised issues to the FASB and IASB, the FASB generally addressed the issues raised through standard setting, while the IASB made fewer amendments. As a result, ASC 606 and ASC 340-40 contain additional illustrative examples and clarifying guidance not found in IFRS 15.

The following table provides a summary of the main areas that may result in different accounting. Refer to our U.S. GAAP and IFRS comparison guide for more information.

Topic	ASC 606 and ASC 340-40	IFRS 15	Cross-reference
The definition of “probable” is different for purposes of the collectibility assessment in Step 1	Probable means the future event or events are likely to occur.	Probable means the future event or events are more likely than not to occur.	Section 3.1.5
Additional requirement for “cash basis”	When a contract with a customer does not meet the Step 1 criteria and the entity receives nonrefundable consideration from the customer, the entity recognizes the consideration as revenue when the entity has transferred control of the goods or services to which the consideration that has been received relates; has stopped transferring the goods or services to the customer; and	The IASB did not add this third event to its list of when an entity may recognize revenue for nonrefundable consideration received from the customer.	Section 3.2

Topic	ASC 606 and ASC 340-40	IFRS 15	Cross-reference
	has no obligation under the contract to transfer additional goods or services.		
Policy election for shipping and handling activities	ASC 606 provides an election to account for shipping and handling activities that occur after the customer has obtained control of a good as an activity to fulfill the promise to transfer the good, rather than as an additional promised service.	IFRS does not allow an entity to make the same policy election.	Section 4.1.2
Measurement date for noncash consideration	ASC 606 clarifies that noncash consideration should be measured at contract inception.	IFRS 15 does not specify a measurement date.	Section 5.3
Subsequent measurement of noncash consideration	If the fair value of the noncash consideration changes for reasons other than the form of the consideration, the entity is required to apply the guidance on variable consideration and the constraint only to the variability resulting from reasons other than the form of the consideration. For example, if an entity receives an additional 100 shares because its performance meets certain quality ratings, the entity would apply the guidance related to variable consideration only to the variability related to the increase in the number of shares related to the performance bonus.	There is no such clarification in IFRS 15.	Section 5.3.1
Policy election for sales and other similar taxes	ASC 606 provides a policy election to exclude all sales and other similar taxes from the transaction price.	IFRS 15 does not provide a similar policy election.	Section 5.6

Topic	ASC 606 and ASC 340-40	IFRS 15	Cross-reference
Bill-and-hold guidance for vaccine stockpiles	The SEC issued a release to update its 2005 Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile. The release states that manufacturers should recognize revenue for vaccines within the scope of the release when the vaccines are placed in the stockpile, because at that time, control has transferred to the customer and the bill-and-hold criteria in ASC 606 are met.	The IASB has not issued similar guidance to date.	Section 7.5
Enforceable right to payment	It is reasonable to presume[111] that an enforceable right to payment does not exist if a written contract is silent about whether there is an enforceable right to payment when a customer cancels the contract.	This conclusion may not be appropriate for entities reporting under IFRS 15 if well-known laws in certain jurisdictions could override silent contract terms.	Section 7.1.1
License renewals	Revenue related to a renewal or extension of a license of functional IP will result in revenue recognition at the beginning of the renewal period.	Revenue related to a renewal or extension of a license may be recognized either when the parties agree to the renewal or extension or when the renewal period begins, depending upon the facts and circumstances.	Section 8.4.1
Disclosure of remaining	ASC 606 provides optional exemptions from the requirement to disclose	IFRS 15 does not include the same disclosure relief.	Section 13.1.3

[111] Private Company Council Memo No. 3, *Definition of an Accounting Contract and Short Cycle Manufacturing (Right to Payment)*.

Topic	ASC 606 and ASC 340-40	IFRS 15	Cross-reference
performance obligations	remaining performance obligations in situations in which an entity does not need to estimate variable consideration to recognize revenue (for example, when consideration is in the form of a sales-based or usage-based royalty in exchange for a license, or variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a series).		
Interim disclosure requirements	ASC 270 is amended to require entities to disclose: • Disaggregated revenue balances • Opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers • Revenue recognized in the period that was included in the contract liability balance at the beginning of the period • Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in a previous period • Information about the entity's remaining performance obligations as of the end of the reporting period	IAS 34, *Interim Financial Reporting*, is amended to require entities to disclose information about disaggregated revenue balances.	Section 13.1.7

Topic	ASC 606 and ASC 340-40	IFRS 15	Cross-reference
	This guidance applies to public business entities, not-for-profit entities that have issued or are a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or employee benefit plans that file or furnish financial statements with or to the SEC.		
Impairment loss reversal	An entity is not permitted to reverse an impairment loss on an asset that is recognized in accordance with the guidance in ASC 340-40.	Consistent with IAS 36, *Impairment of Assets*, an entity must reverse an impairment loss when required by the guidance.	Not applicable
Guidance for non-public business entities	U.S. GAAP differentiates between public business entities and all other entities for purposes of disclosure requirements.	IFRS does not differentiate between public business entities and non-public business entities. *IFRS for Small and Medium-sized Entities* is available for entities that do not have public accountability.	Not applicable

Appendix A: Guidance abbreviations

Abbreviation	Title
ASC 210-20	*Balance Sheet: Offsetting*
ASC 250	*Accounting Changes and Error Corrections*
ASC 270	*Interim Reporting*
ASC 280	*Segment Reporting*
ASC 310	*Receivables*
ASC 320	*Investments – Debt and Equity Securities*
ASC 321	*Investments – Equity Securities*
ASC 323	*Investments – Equity Method and Joint Ventures*
ASC 325	*Investments – Other*
ASC 330	*Inventory*
ASC 340-10	*Other Assets and Deferred Costs: Overall*
ASC 340-40	*Other Assets and Deferred Costs: Contracts with Customers*
ASC 350	*Intangibles: Goodwill and Other*
ASC 360	*Property, Plant, and Equipment*
ASC 405	*Liabilities*
ASC 460	*Guarantees*
ASC 470	*Debt*
ASC 480	*Distinguishing Liabilities from Equity*

ASC 505-50	*Equity: Equity-Based Payments to Non-Employees*
ASC 605-35	*Revenue Recognition: Construction-Type and Production-Type Contracts*
ASC 605-45	*Revenue Recognition: Principal Agent Considerations*
ASC 606, ASU 2014-09, IFRS 15	*Revenue from Contracts with Customers*
ASC 610-20	*Other Income: Gains and Losses from the Derecognition of Nonfinancial Assets*
ASC 718	*Compensation – Stock Compensation*
ASC 808	*Collaborative Arrangements*
ASC 815	*Derivatives and Hedging*
ASC 825	*Financial Instruments*
ASC 835-30	*Interest: Imputation of Interest*
ASC 840, ASC 842	*Leases*
ASC 850	*Related Party Disclosures*.
ASC 860	*Transfers and Servicing*
ASC 924-815	*Entertainment – Casinos: Derivatives and Hedging*
ASC 944	*Financial Services – Insurance*
ASC 952-606	*Franchisors: Revenue from Contracts with Customers*
ASC 958-605	*Not-for-Profit Entities: Revenue Recognition*
ASU 2016-10	*Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*
ASU 2016-20	*Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*

ASU 2018-07	*Compensation – Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*
ASU 2018-08	*Not-For-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*
ASU 2018-18	*Collaborative Arrangements (Topic 808): Clarifying the Interaction between Topic 808 and Topic 606*
ASU 2019-08	*Compensation – Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Codification Improvements – Share-Based Consideration Payable to a Customer*
ASU 2021-02	*Franchisors – Revenue from Contracts with Customers (Subtopic 952-606): Practical Expedient*
EITF Issue 19-B	*Revenue Recognition – Contract Modifications of Licenses of Intellectual Property*
FASB Statement of Financial Accounting Concepts 6	*Elements of Financial Statements*
SEC Accounting and Auditing Enforcement Release 108	*In the Matter of Stewart Parness*
SEC Staff Accounting Bulletin Topic 13	*Revenue Recognition*
SEC Regulation S-X, Rule 5-03	*Statements of comprehensive income*

Appendix B: Changes in this edition

4th Edition of *Navigating the Guidance in ASC 606 and ASC 340-40* (as of January 2025)		
Section added/ modified	**Topic**	**Description of change**
2.2.2	Contributions received	Adds examples to distinguish between exchange and nonexchange transactions.
3.2.1	Reassessing Step 1	Adds insight regarding what constitutes a "significant change in facts and circumstances" necessitating a reassessment of the Step 1 criteria.
3.3.1	Termination provisions	Adds insight regarding evaluating government contracts to determine if they contain substantive termination penalties.
4.1	Identifying promises	Adds insights on evaluating if exclusivity is a promise to a customer and an example to illustrate the accounting.
4.2.2	Distinct within the context of the contract	Adds insights to consider when a good and service are "always sold together" and what perspective to consider (the customer's or entity's perspective) when performing the Step 2 analysis.
4.6	Warranties	Adds summary of TRG Paper 29, *Warranties,* which considers a lifetime warranty on luggage.
5.1.5	Minimum purchase commitments	Adds insight regarding when an entity does not expect the customer to meet its minimum purchase commitment in a take-or-pay arrangement and updates the example accordingly for when an entity expects the minimum commitment will not be met.
5.3	Noncash consideration	Updates recent FASB activity at the time of writing for scope clarifications for share-based payments received from a customer in a revenue contract.
5.4	Consideration payable to a customer	Updates recent FASB activity at the time of writing for clarifications regarding vesting conditions and accounting for share-based consideration payable to a customer that vests based on the customer's (or

4th Edition of *Navigating the Guidance in ASC 606 and ASC 340-40* (as of January 2025)		
Section added/ modified	**Topic**	**Description of change**
		customer's customers') purchases of the entity's goods or services.
6.1	Determining stand-alone selling price	Adds insight for determining if an entity has an observable stand-alone selling price for "bundled sales."
7.1.2	Methods to measure progress	Adds insight for selecting the best measure of progress.
9.3	Indicators of control	Adds insight to remind readers that the indicators are not weighted.
13.1.3	RUPO disclosures	Adds insights to remind readers that "backlog" is not synonymous with remaining unrecognized performance obligations (RUPO) and the implications of determining that a contract has a termination for convenience provision without a significant termination penalty. This section also includes two new examples illustrating RUPO disclosures when a customer has a right to terminate for convenience and when a contract includes a material right.

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