Revenue Recognition

An Updated Look at the Guidance

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Background & Summary

It is almost three years since the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which substantially replaces all existing guidance for recognizing revenue, including more than 200 pieces of industry-specific guidance. The adoption deadline is fast approaching—2018 for public entities, including conduit debt obligations and certain employee benefit plans, and 2019 for all other nonpublic entities. FASB created the Joint Transition Resource Group for Revenue Recognition (TRG) to aid transition to the new standard by soliciting, analyzing and discussing stakeholder issues arising from implementation of the new guidance. The TRG has met eight times and discussed a wide variety of issues on almost every aspect of the new standard. As a result of these meetings, several amendments to the revenue standard have been issued, as noted in the table below. The subsequent amendments do not change the new guidance's core principles, but are intended as clarification to reduce potential diversity in practice and cost and complexity both at transition and on an ongoing basis. This paper incorporates the subsequent ASUs, TRG clarifications that did not warrant specific amendments and U.S. Securities and Exchange Commission (SEC) views gathered from official speeches.

While the TRG members' views are nonauthoritative, entities should consider them as they implement the new standards. The SEC expects registrants to use the TRG discussions and meeting minutes to aid in their implementation of the standards. Registrants that want to use accounting that differs from the TRG views are strongly encouraged to discuss their accounting with the SEC staff.

ASU 2014-09
Revenue from Contracts with Customers (Topic 606)
↓
ASU 2015-14
Deferral of the Effective Date
↓
ASU 2016-08
Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)
↓
ASU 2016-10
Identifying Performance Obligations and Licensing
↓
ASU 2016-12
Narrow-Scope Improvements and Practical Expedients
↓
ASU 2016-20
Technical Corrections and Improvements to Topic 606

Scope

The new revenue standard applies to all contracts with customers, except for those within the scope of other standards, *e.g.*, lease contracts, insurance contracts, financing arrangements, financial instruments, guarantees (other than product or service warranties) and certain nonmonetary exchanges between vendors. A contract may be partially in the scope of the new standard and partially in the scope of other accounting guidance, *e.g.*, a contract for the lease of an asset and for maintenance services. If the other accounting guidance specifies how to separate and/or initially measure one or more parts of a contract, an entity first should apply those requirements before applying ASU 2014-09.

Subsequent amendments clarify the following items are excluded from Topic 606's scope:

- Insurance – All contracts, not only insurance contracts within Topic 944's scope, are excluded
- Guarantee fees – Guarantee fees within Topic 460's scope are excluded

TRG members generally agreed that servicing and subservicing income is covered by Topic 860; however, deposit-related fees would be covered by the new revenue rules. TRG members also concluded that credit card fees accounted for under Topic 310, *Receivables*, are excluded from the new guidance's scope. Fees that include ancillary services or reward programs also would be excluded if the facts and circumstances indicate the agreement's overall nature is a lending arrangement.

ASU 2014-09 will supersede Topic 924-605, *Entertainment—Casinos—Revenue Recognition.* Gaming entities questioned if fixed-odds wagers were covered by Topic 606 or should be considered derivatives. ASU 2016-20 amends the derivative guidance in Topic 815 and creates a scope exception for fixed-odds wagering, meaning such bets are covered by Topic 606.

Contributions

The new standard supersedes portions of the exchange guidance in Topic 958-605, *Not-for-Profit Entities—Revenue Recognition*, to account for contributions, *i.e.*, unconditional promises of cash or other assets in voluntary nonreciprocal transfer. TRG members generally agreed that contributions are not within Topic 606's scope because they are nonreciprocal transfers; however, this conclusion generated additional questions from not-for-profits (NFP) and higher education institutions as to whether grants and donations with restrictions would be considered an exchange transaction under the new guidance. Discussions revealed a diversity in practice even under current generally accepted accounting principles (GAAP). NFPs struggle to distinguish between a condition and a restriction, particularly when funds have a stipulation of a certain outcome but no return policy is specified. There also is diversity in practice in determining whether the likelihood of failing to meet a condition is remote, which can change when a contribution is recognized. The conclusions can affect the timing and net asset classification of the revenue recognized in such transactions. In August 2016, FASB issued an exposure draft clarifying the scope and accounting guidance for contributions made and received. A final standard is expected in early 2018.

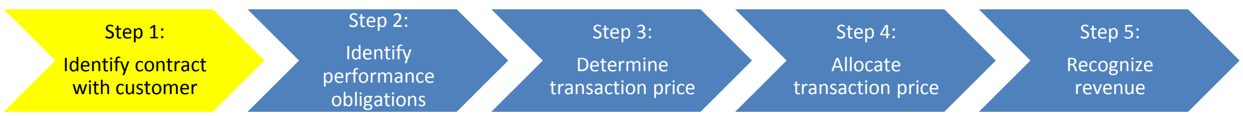
Collaborative Arrangements

The new revenue standard only applies to contracts with customers. The ASU defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." For some contracts, the counterparty may not be a customer but rather a collaborator or partner that shares with the entity the risks and benefits resulting from the activity and therefore would not be in the new standard's scope. These arrangements are most common in the pharmaceutical, energy and health care fields. Collaborative arrangements are covered by Topic 808; however, the existing guidance does not address recognition or measurement for transactions between collaborative partners, and diversity in practice has arisen. In November 2016, FASB added a project to its agenda to enhance guidance in Topic 808, *Collaborative Arrangements.* Progress has been slow and an exposure draft is not likely until 2018 at the earliest.

The Revenue Recognition Model

The model's core principle is that an entity would recognize revenue in the amount that reflects the consideration it expects to be entitled in exchange for goods or services when (or as) it transfers control to the customer. To achieve that core principle, an entity will apply a five-step model:

- Step 1: Identify the contract(s) with a customer
- Step 2: Identify performance obligations
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price to the performance obligations
- Step 5: Recognize revenue when (or as) a performance obligation is satisfied



Step 1 – Identify the Contract with a Customer

The standard defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." Contracts with customers should be accounted for only when all of the following criteria are met:

- Approval and commitment of all parties—this can be written, verbal or implied by an entity's customary business practices
- Identifiable rights, obligations and payment terms for each party to the contract
- Contract has commercial substance, defined as the expectation that the entity's future cash flows will change as a result of the contract
- Collectible, *i.e.*, probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

A contract would not exist if each party has the unilateral enforceable right to terminate a wholly unperformed contract without compensation.

Consideration received for a contract that does not meet the above criteria can only be recognized as revenue when the consideration is nonrefundable and one of the following has occurred:

- The entity has no remaining performance obligation and all consideration promised by the customer has been received.
- The contract has been terminated or canceled.
- The entity has transferred control of the goods or services, has stopped transferring goods or services and has no obligation to transfer additional goods or services.

Until revenue can be recognized, the consideration received should be recognized as a liability.

FASB's redeliberations reaffirm the cash basis method of revenue recognition is eliminated under the new standard.

SEC Observations

Can future anticipated contracts for the subsequent sale of goods or services be considered part of the existing revenue arrangement?

*Certain contracts may be executed as part of a loss leader strategy in which a good is sold at a loss with an expectation that future sales contracts will result in higher sales and/or profits. Sylvia Alicea, representing SEC's Office of the Chief Accountant, noted, "While a future contract might appear to be likely or even compelled economically or by regulation, in my view it would be inappropriate to account for a contract before the contract exists with both enforceable rights **and** obligations."*

Collectibility

Collectibility is an explicit threshold for determining contract existence and must be assessed before applying the five-step model. An entity must evaluate customer credit risk and conclude it is "probable" it will collect the consideration due in exchange for the customer's promised goods or services. The assessment is based on both the customer's ability and intent to pay as amounts become due. An entity will only consider credit risk and no other uncertainties, such as performance or measurement, as these are accounted for separately as part of determining the timing and measurement of revenue. Any subsequent negative adjustments related to customer credit risk will be recognized as expenses in the income statement.

ASU 2016-12 clarifies that the collectibility assessment is not based on collecting **all** the consideration promised in the contract. Instead, entities should consider the probability of collecting the consideration they will be **entitled** to in exchange for the goods or services they will transfer to the customer. An entity should take into account its ability to demand advance payments from customers or stop providing goods or services if the customer stops paying consideration when it is due.

Contract Termination

ASU 2016-12 clarifies the definition of "contract termination," which means an entity is allowed to stop—based on contract terms or by law—and has stopped transferring goods or services to the customer. The contract does not need to be legally terminated and the entity does not need to stop pursuing collection from the customer for the contract to be considered terminated for purposes of recognizing the cash collected as revenue.

Combining Contracts

Contracts entered into at or near the same time with the same customer (or related parties) should be combined if one or more of the following criteria are met:

- Contracts are negotiated together with a single commercial objective.
- Pricing interdependencies exist between contracts.
- Goods or services in the contracts represent a single performance obligation (see Step 2 – Identify Performance Obligations).

SEC Observations

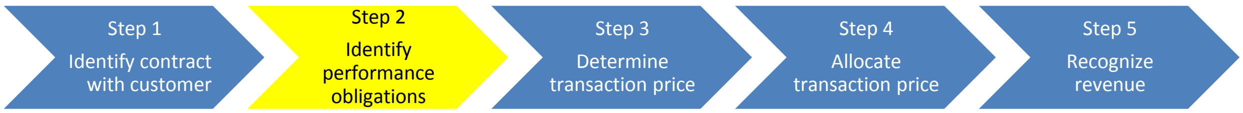
The combination guidance in Accounting Standards Codification (ASC) 606 explicitly limits which contracts may be combined to those with the same customer or related parties of the customer. The SEC staff objected to extending the contract combination guidance beyond those parties even though other criteria for combination were met.

Contract Modifications

Previous revenue guidance did not include an accounting framework contract modifications, except for certain industry-specific guidance. A contract modification occurs when both parties approve a change in a contract's scope or price that creates new enforceable rights and obligations or changes existing ones. Similar to a contract, a contract modification can be written, oral or implied by customary business practices. Contract claims, *e.g.*, additional consideration for customer-caused delays, changes or errors in specifications, would be accounted for like contract modifications. Unsettled claims and unpriced change orders would be accounted for similar to a modification only if the work's scope has been approved and the entity can estimate the change in the transaction price. Entities should estimate the change in the transaction price resulting from the modification in accordance with the guidance on estimating variable consideration and constraint on revenue recognition (see Step 3 – Determine the Transaction Price).

Accounting for contract modifications will depend on the type of modification. A contract modification would be recognized as a separate contract only if distinct goods or services are added for additional consideration that also reflects their standalone selling prices. If these two criteria are not met, the modification would be accounted for on a combined basis with the original contract, either prospectively or on a cumulative catch-up basis depending on whether the remaining goods or services are distinct from the goods or services transferred before the modification. If distinct, the modification is accounted for prospectively, with the unrecognized consideration allocated to the remaining performance obligations and revenue recognized as remaining performance obligations are satisfied. If the remaining goods or services are not distinct, the modification is accounted for as if it were part of the existing contract, forming part of a single partially satisfied performance obligation at the date of the modification. The modification's effect on the transaction price and on progress toward satisfaction of the performance obligation is recognized as an adjustment to revenue on a cumulative catch-up basis.

Separate Contract	Termination of Existing Contract	Part of Existing Contract
• Additional goods or services are distinct • At standalone selling price	• Remaining services are distinct • Not at standalone selling price • Prospective adjustment	• Remaining services are not distinct • Form part of a single partially complete performance obligation • Cumulative catch-up adjustment



Step 2 – Identify Performance Obligations

Once a customer contract has been identified, the next step is to identify the contract's separate, or distinct, performance obligations. A performance obligation is a promise to transfer goods or services to a customer that can be explicitly identified in a contract or implied by customary business practices, published policies or specific statements.

Both of the following criteria must be met for a promised good or service to be considered distinct and a separate performance obligation:

- Capable of being distinct because the customer can benefit from the good or service on its own or with other readily available resources
- Distinct within the contract's context—the good or service to the customer is separately identifiable from other promises in the contract; the following indicators would be used to evaluate if a good or service is distinct within the contract's context:
    - Significant integration services are not provided.
    - The goods are not highly interdependent or interrelated.
    - The good or service does not significantly modify or customize another good or service promised in the contract.

An entity would determine whether the nature of its promise in the contract is to transfer each of the goods or services or to transfer a combined item(s) to which the promised goods and/or services are inputs.

Immaterial Items

FASB did not expect entities to identify significantly more performance obligations than the deliverables identified under current guidance. However, concerns arose since the standard's basis for conclusions noted the current SEC guidance on inconsequential or perfunctory items was intentionally not carried forward into ASU 2014-09. ASU 2016-10 permits entities to disregard promises that are deemed to be immaterial in the contract's context. In addition, such items would not be required to be aggregated and assessed for materiality at the entity level for auditing purposes. If the revenue related to a performance obligation includes goods or services that are immaterial in the contract's context is recognized before those immaterial goods or services are transferred to the customer, an entity would accrue the related costs to transfer those goods or services.

Shipping & Handling

Under existing guidance, many entities do not account for shipping provided along with the sale of their goods as an additional deliverable. To reduce the cost and complexity of applying the new standard, ASU 2016-10 allows entities to elect to account for the cost of shipping and handling performed after control of a good has been transferred to the customer as a fulfillment cost, *i.e.*, an expense. Without such an election, an entity that has free on board shipping point arrangements might determine that the act of shipping is a performance obligation under the new standard and would be required to allocate a portion of the transaction price to the shipping service and recognize it when (or as) the shipping occurs.

Series Provision

The series provision is a concept introduced in ASU 2014-09 and does not exist in current GAAP. The series provision **requires** goods or services to be accounted for as a single performance obligation in certain instances, even though the underlying goods or services are distinct. A series of distinct goods or services should be accounted for as a single performance obligation if they are substantially the same, have the same pattern of transfer and both of the following criteria are met:

- Each distinct good or service in the series represents a performance obligation that will be satisfied over time.
- The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series.

Entities will need to determine whether a single performance obligation is created in this manner to appropriately allocate variable consideration and apply the guidance on contract modification and changes in transaction price. This provision prevents an entity from having to allocate the transaction price on a relative standalone selling price basis to each increment of a distinct service in repetitive service contracts.

TRG members agreed that a series of distinct goods or services need not be consecutively transferred. The series guidance also must be applied even when there is a gap or an overlap in an entity's transfer of goods or services if the other criteria are met.

Example A: A manufacturer has contracted to produce 1,000 units per month for a two-year period. The service will be performed evenly over the two-year period with no breaks in production. The units produced are substantially the same and manufactured to customer specifications. There are no significant upfront costs to develop the production process. Assume that its service of producing each unit is a distinct service and the service is accounted for as a performance obligation satisfied over time because the units are manufactured to customer specifications (no alternative use to the entity). If the contract were to be canceled, the entity has an enforceable right to payment (cost plus a reasonable profit margin).

Example B: Assume the same facts as the example above, except the entity does not plan to perform evenly over the two-year service period—the manufacturer could produce 2,000 units in some months and zero units in other months.

TRG Conclusion – Under both examples, the manufacturing service provided would be a single performance obligation. While an entity may consider the pattern of performance in determining the measure of progress toward satisfying a performance obligation, the pattern of performance is not an explicit criterion for the application of the series provision. TRG members agreed a consecutive performance pattern is not determinative in concluding if the series provision applies. FASB did not intend for the series provision to only apply to consecutive performance.

The TRG also addressed questions related to the application of the series provision to service contracts. If the nature of the promise is the delivery of a specified quantity of a service, then the evaluation should consider whether each service is distinct and substantially the same. 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 evaluation would likely focus on whether each time increment—rather than the underlying activities—are distinct and substantially the same. An example was included for a daily management service. TRG members noted the underlying activities may vary within a day and from day to day, but that should not prevent an entity from concluding that the service is distinct and substantially the same.

Material Rights

An option, such as a renewal option, would constitute a separate performance obligation only if the option gives the customer a material right it would not receive without entering into that contract. This topic generated a large number of implementation questions. TRG members generally agreed on the following:

- Entities should consider accumulating incentive programs, *e.g.*, loyalty rewards, when determining whether an option represented a material right.
- The material right evaluation should consider both qualitative and quantitative factors.
- It would be reasonable for an entity to apply contract modification guidance to the exercise of a material right, which also may be treated as a continuation of the existing contract. The decision will require management's judgment based on the facts and circumstances of each arrangement.
- Material rights also should be evaluated to determine if a significant financing component exists. TRG members noted if the customer can choose when to exercise the option, there likely is not a significant financing component.
- The nonrefundable upfront fee recognition period depends on whether the fee provides the customer with a material right to future contract renewals. If the entity concludes the upfront fee does not provide a material right, the fee would be recognized over the contract term.
- Usage-based fees will require judgment.

Distribution Networks

In distribution networks, manufacturers commonly transfer control of product to unrelated third-party intermediaries such as dealers or retailers. The manufacturer also may promise other goods or services as sales incentives to encourage product sales from the intermediary's inventory. In some cases those promises are made at contract inception; however, promises can be added later in response to changing market conditions—this is common in the automotive industry. If the promise to transfer additional goods or services to a dealer is made in the original contract, the promised goods or services would be treated as a single performance obligation. If the promise to transfer additional goods or services was made after the transfer of control of the product to the intermediary, the promise would be treated as a separate performance obligation.

Warranties

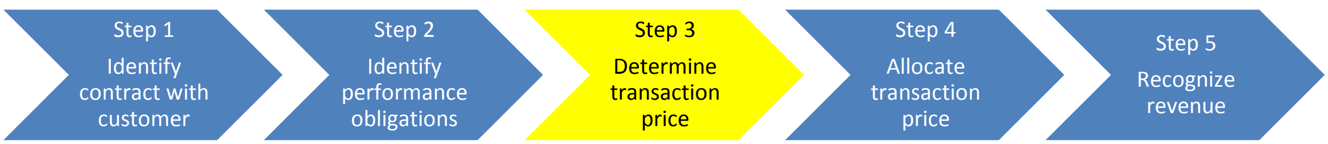
Entities must distinguish between warranties representing assurance of a product's performance and those representing a separate performance obligation. If a customer has the option to separately purchase a warranty, the entity has promised to provide a service to the customer in addition to the product or service and would account for that warranty as a separate performance obligation. If no separate purchase option exists, the entity would apply the cost-accrual guidance in ASC 460, *Guarantees*, unless the warranty provides an additional service to the customer along with the assurance that the product complies with agreed-upon specifications. If an entity promises both assurance and service-type warranties but cannot reasonably account for them separately, it would account for both together as a single performance obligation.

An entity should consider the following factors in determining whether a warranty provides a customer with an additional service:

- Legal requirement – If the intention is to protect the customer from purchasing a defective product, it likely does not represent a separate performance obligation.
- Warranty term – The shorter the coverage period, the less likely a warranty is a separate performance obligation.

- Tasks to be performed 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, *e.g.*, return shipping service for a defective product.

Entities may need to exercise significant judgment when determining whether a warranty is an assurance-type or service-type warranty. An entity's evaluation may be affected by several factors, including common warranty practices within its industry and the entity's business practices related to warranties. For example, consider an automotive manufacturer that provides a five-year warranty on a luxury vehicle and a three-year warranty on a standard vehicle. The manufacturer may conclude that the longer warranty period is not an additional service because it believes the materials used to construct the luxury vehicle are of a higher quality and latent defects would take longer to appear. In contrast, the manufacturer might compare the warranty with those offered by its competitors and conclude that the five-year warranty period—or some portion of it—is an additional service that should be accounted for as a service-type warranty.



Step 3 – 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. To determine the transaction price, an entity would consider the contract's terms, its customary business practices and the effects of the time value of money, noncash consideration and consideration payable to the customer. Consideration may include fixed or variable amounts or both. Customer credit risk would not be reflected in determining the transaction price.

Transaction Price				
Total Amount of Consideration to Which an Entity Expects to Be Entitled				
Variable consideration	Constraining estimates of variable consideration	Significant financing component in the contract	Noncash consideration	Consideration payable to a customer

Variable Consideration & Constraining Estimates

Variable consideration is anything that causes the amount of consideration to vary and could result from volume discounts, rebates, price concessions, refunds, performance bonuses, contingencies, royalties, penalties or other items. An estimate, including some or all of the variable consideration, could be included in the transaction price if it is "probable" the amount would not result in a significant revenue reversal. This constraint also would apply to a fixed-price contract if an entity's entitlement is contingent on the occurrence or nonoccurrence of a future event, *e.g.*, performance bonuses or sales with a right of return. Management's estimate of the transaction price will be reassessed each reporting period, and the transaction price should be updated for any changes in circumstances throughout the period.

Judgment often will be needed to determine if the amount of revenue recognized is subject to a significant reversal. The following indicators might suggest including an estimate of variable consideration in the transaction price could result in a significant reversal of revenue:

- The amount of consideration is highly susceptible to factors outside the influence of the entity.

- Resolution of the uncertainty about the amount of consideration is not expected for a long period of time.
- The entity has limited experience with similar types of contracts.
- The entity has a practice of offering a broad range of price concessions or changing the payment terms and conditions in similar circumstances for similar contracts.
- The contract has a large number and broad range of possible consideration amounts.

An entity would use the same method to estimate the transaction price throughout the life of the contract. The method selected to estimate the transaction price should be the method expected to most accurately predict the consideration to which the entity will be entitled. The estimate could be either of the following:

- Expected value – An entity would use a probability-weighted estimate for a large number of contracts with similar characteristics.
- Most likely amount – When a contract only has two possible outcomes

TRG members clarified that the constraint on variable consideration should be applied at the contract level as it is the unit of account for determining the transaction price.

In some cases it may be difficult to determine if an entity has implicitly offered a price concession or accepted the customer's risk of default on the contractually agreed consideration. FASB declined to develop detailed guidance for differentiating between a price concession and an impairment loss.

Sales with a Right of Return

ASU 2014-09 is consistent with current U.S. GAAP for sales with a right of return; however, entities now are required to present a liability for the refund obligation and an asset for the right to recover product on the balance sheet. The refund liability would be the amount of consideration for which the entity does not expect to be entitled, *i.e.*, the amount excluded from the transaction price, and would be updated each reporting period. The asset recognized is subject to impairment testing.

Example: Right of Return

A manufacturer sells 100 widgets for $100 each. The customary practice is to allow a customer to return an unsold widget within 30 days and receive a full refund. The cost of each widget is $60. The cost to recover the widget is immaterial and the returned widget can be resold at a profit. Previous predictive experience indicates that roughly three widgets will be returned. Upon transfer of the widgets, the manufacturer would not recognize revenue for the three widgets that it expects to be returned.

NEW MODEL

Cash	*10,000*	
Revenue (97 x $100)		*9,700*
Refund Liability (3 x $100)		*300*
Cost of sales (97 x $60)	*5,820*	
Inventory (100 x $60)		*6,000*
Right to Recover Products (3 x $60)	*180*	

Significant Financing Component

Contract terms may explicitly or implicitly provide the entity or the customer with favorable financing terms. The transaction price should be adjusted to reflect the time value of money if the financing component is significant. The transaction price should reflect a selling price as though the customer had paid cash at the time of transfer.

Entities should consider the following to determine if a contract contains a significant financing component:

- If the consideration would substantially differ if the customer promptly paid cash under typical credit terms
- Expected length of time between delivery of goods or services and receipt of payment
- The interest rate in the contract and prevailing market interest rates

As a practical expedient, an entity would not reflect the time value of money if the period between customer payment and transfer of goods or services is one year or less. This also would apply to contracts greater than one year if the period between performance and the corresponding payment for that performance is one year or less. If this expedient is elected, disclosure is required.

Prepayments for goods or services would not reflect the time value of money if the transfer of goods or services to a customer is at the customer's discretion, *e.g.*, while prepaid phone cards could have a significant timing difference between payment and performance, use of the cards is at the customer's discretion, so calculation of the transaction price should not include a time value of money component.

To adjust the transaction price for the time value of money, an entity would use the discount rate implied in a separate financing transaction between the entity and the customer at contract inception, reflecting the borrower's credit risk and any collateral or security provided. The rate may be calculated by discounting the nominal amount of the promised consideration to the cash selling price of the good or service. The rate cannot be adjusted for changes in circumstances or interest rates after contract inception.

Financing would be presented separately from revenue as interest expense or interest income in the income statement. An entity would not be precluded from presenting interest income recognized from contracts with a significant financing component as revenue if the entity generates interest income in the normal course of business similar to a financial services entity.

TRG members discussed several issues related to the assessment of a significant financing component and generally agreed on the following:

- Entities should not automatically assume there is no significant financing component if the promised consideration is equal to the cash price. This fact should be considered but is not determinative.
- Advance payments are not excluded from review for significant financing. Judgment is required. An entity should adjust for financing if the timing of payments specified provide the customer or the entity with a significant financing benefit.
- A financing component would be accreted as an interest expense for advanced payments or interest income for payment in arrears over the financing arrangement's term.
- Entities are not precluded from accounting for a financing component that is not significant. Entities with a contract portfolio including both significant and insignificant financing components can account for the financing component consistently across all its contracts instead of having to apply two methods of accounting.
- Entities will need to use judgment in allocating a significant financing component when there are multiple performance obligations in a contract. It might be possible to determine that a significant financing component relates specifically to one (or some) of the performance obligations in the contract.

Noncash Consideration

A contract may include consideration in a form other than cash, *e.g.*, equity, advertising, etc. Such noncash consideration would be measured at fair value (FV) to determine the transaction price. If a reasonable FV estimate cannot be made, the entity would use the estimated selling price of the promised goods or services, similar to current accounting standards. The original standard failed to specify a measurement date for noncash consideration; ASU 2016-12 clarifies noncash consideration would be measured at contract inception. Subsequent changes in the FV of the noncash consideration due to the form of the consideration would be recorded, if required, as a gain or loss in accordance with other accounting guidance—rather than as revenue.

For example, if GAAP related to the form of noncash consideration require the asset to be measured at FV, then an entity will recognize a gain or loss (outside of revenue) upon receipt of the asset if the FV of the noncash consideration increased or decreased since contract inception.

An entity enters into a contract 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 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). In exchange, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The contract terms require the shares to be paid upon the successful completion of each week of service.

To determine the transaction price (and the revenue to be recognized), the entity measures the estimated FV of 5,200 shares at contract inception (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 FV of the 5,200 shares after contract inception. 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 FV that occurred after contract inception should be recognized.

This is a significant change from existing U.S. GAAP related to equity instruments received in exchange for goods or services, whereby FV of an equity instrument typically is measured when the entity's performance is complete.

ASU 2016-12 also clarifies that when the variability of noncash consideration is due to both its form, such as shares of stock, and other reasons, *e.g.*, the entity's performance under the arrangement that affects the amount of consideration, the constraint on variable consideration applies only to the variability for reasons other than the form.

Consideration Payable to a Customer

Consideration payable to a customer includes amounts an entity pays—or expects to pay—to a customer in the form of cash or noncash items, *e.g.*, additional goods, a coupon or voucher, that the customer can apply against amounts owed to the entity. An entity would evaluate the consideration to determine if the amount represents a reduction of the transaction price, a payment for distinct goods or services or a combination of the two. An entity would reduce the transaction price by the amount it owes the customer, unless the consideration owed is in exchange for distinct goods or services transferred from the customer to the entity.

If the consideration owed to the customer is payment for distinct goods or services from the customer to the entity, the entity would account for the purchase of these goods or services similarly to purchases from suppliers. If the amount of consideration owed to the customer exceeds the FV of those goods or services, the entity would reduce the transaction price by the excess amount. If the entity cannot estimate the FV of the goods or services it receives from the customer, it would reduce the transaction price by the total consideration owed to the customer.

An entity would recognize the revenue reduction associated with adjusting the transaction price for consideration payable to a customer at the later of the following dates:

- When the entity recognizes revenue for the transfer of goods or services to the customer
- When the entity pays or promises to pay the consideration to the customer (this could be implied by customary business practices)

Upfront Payments to Potential Customers or on Anticipated Contracts

Under current guidance, there is diversity in the treatment of payments to potential customers and payments that relate to both current and anticipated contracts. Financial statement preparers questioned whether the accounting treatment for such payments would change under the new revenue standard. Some entities analogize to a 1998 SEC speech and capitalize upfront payments in cases where the payment does not meet the definition of an asset under FASB's Conceptual Framework.

The determination of asset versus expense is not an accounting policy election. Entities must understand the reason for the payment, the rights and obligations resulting from the payment, the nature of the promise and any other relevant facts and circumstances. An entity should be clear on whether and how it expects to obtain future benefit as a result of an upfront payment. A payment to a customer related to anticipated contracts could meet the "asset" definition. An entity's decision on which approach is appropriate may be a significant judgment in determining the transaction price that would require disclosure.

SEC Observations

SEC staff would consider the following questions when evaluating the accounting for payments made to a customer under ASC 606:

- *What are the underlying economic reasons for the transaction? Why is the payment being made?*
- *How did the company communicate and describe the nature of the customer payment to its investors?*
- *What do the relevant contracts governing the payment stipulate? Does the payment secure an exclusive relationship between the parties? Does the payment result in the customer committing to make a minimum level of purchases from the vendor?*
- *What is the accounting basis for recognizing an asset or an upfront payment immediately through earnings?*

Once a company has determined the substance of the payment, a company should account for the payment using an accounting model that is consistent with the identified substance of the payment and relevant accounting literature. In doing this, companies should carefully and impartially evaluate all of the facts and circumstances and establish accounting policies that are consistently applied. Matching the cost of the payment to the anticipated future revenue is not a determinative factor to support asset recognition for an upfront payment made to a customer.

Presentation of Sales Taxes

Step 3 of the standard, as originally issued, requires amounts collected on behalf of third parties, *e.g.*, some sales taxes, to be excluded from the transaction price. Entities would have to evaluate taxes collected in multiple jurisdictions to determine if a tax is levied on the entity or the customer; this analysis would include sales, use, excise and value-added taxes. ASU 2016-12 allows entities to make an accounting policy election to present sales taxes collected from customers on a net basis. An entity not making this accounting policy election would apply the new revenue standard—as originally issued—in determining if those taxes should be included in the transaction price.

Step 1	Step 2	Step 3	Step 4	Step 5
Identify contract with customer	Identify performance obligations	Determine transaction price	Allocate transaction price	Recognize revenue

Step 4 – Allocate Transaction Price to Separate Performance Obligations

An entity would allocate the transaction price to performance obligations based on the relative standalone selling price of separate performance obligations. The best evidence of a standalone selling price would be the observable price for which the entity sells goods or services separately. In the absence of separately observable sales, the standalone selling price would be estimated by using observable inputs and considering all information reasonably available to the entity. The objective would be to allocate the transaction price to each performance obligation in an amount that represents the consideration the entity expects to receive for its goods or services. Several approaches could be used:

- Adjusted market-assessment – An entity would evaluate the market and estimate the price customers would pay. Competitors' price information might be used and adjusted for an entity's cost and margins.
- Cost plus margin – An entity would forecast its expected cost to provide goods or services and add an appropriate margin to the estimated selling price.
- Residual value – An entity would subtract the sum of observable standalone selling prices for other goods and services promised in the contract from the total transaction price to find an estimated selling price for a performance obligation. The residual value approach would be appropriate only if the selling price is highly variable or uncertain, *e.g.*, intellectual property where there is little incremental cost or a new product where the price has not been set or the product has not been previously sold.

The use of the residual value approach is more limited within the ASU than under current accounting guidelines. The residual method becomes an estimation technique rather than an allocation methodology.

Where more than one good or service has a highly variable price or is uncertain, an entity could use a combination of techniques to estimate its standalone selling price. An entity first would apply the residual approach to estimate the aggregate price for all the goods and services with highly variable or uncertain standalone prices and then use another technique to allocate the aggregated estimated selling prices to the remaining goods or services.

Allocating Discounts

Discounts for a bundle of goods or services would be allocated to all performance obligations unless all of the following criteria are met, in which case the entire discount would be allocated to one or more (but not all) separate performance obligations:

- The entity regularly sells each good or service or each bundle of goods or services in the contract on a standalone basis.
- The entity regularly sells on a standalone basis bundles of distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.

- The observable selling prices from those standalone sales provide evidence of the performance obligations to which the entire discount belongs.

Changes in the Transaction Price

After contract inception, if the transaction price changes, an entity would allocate the change to the separate performance obligations in the same way it allocated the transaction price at contract inception. Any change in the transaction price allocated to a satisfied performance obligation would be recognized either as revenue or a reduction in revenue in the period the change occurs. An entity would allocate a change in transaction price to a single distinct good or service, or group of goods or services, using the same criteria applied to variable consideration noted below.

Variable Consideration

Variable consideration may be attributable to the entire contract or a specific part of it. Variable consideration (and any subsequent changes) would be allocated entirely to a distinct good or service only if both of the following criteria are met:

- The variable payment relates specifically to either of the following:
  - The entity's efforts to transfer that distinct good or service
  - A specific outcome of transferring that distinct good or service

- Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the general allocation principle that the transaction price should be allocated to each separate performance obligation in an amount depicting the consideration amount to which the entity expects to be entitled in exchange for satisfying each separate performance obligation, considering all of the performance obligations and payment terms in the contract

An entity can allocate variable consideration to more than one distinct good or service in the contract.

Incentive Purchase Options

An incentive that gives a customer the option to acquire additional goods (potentially at a discount), *e.g.*, customer award credits, contract renewal options or other sales incentives, may represent a separate performance obligation if it provides a material right to the customer that the customer otherwise would not have received without entering into the contract. If an incentive is deemed a separate performance obligation, an entity would need to allocate a portion of the transaction price—on a relative standalone basis—to the incentive and recognize revenue when control of the goods or services underlying the incentive is transferred to the customer or when the incentive expires. If a promise to transfer additional goods or services is made after a manufacturer transfers control of the contracted products or services to an intermediary, that promise would not be considered a separate performance obligation.

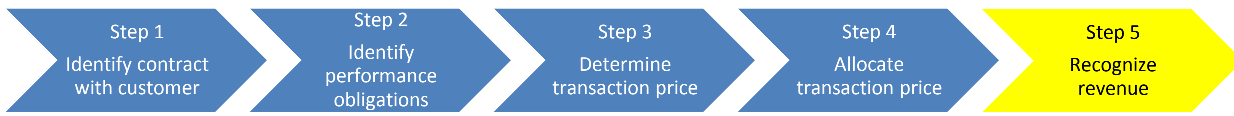
This topic generated a number of implementation questions. TRG members agreed on the following:

- Material rights that are performance obligations should be evaluated for the existence of a significant financing component. If a customer can choose when to exercise the option, there likely is not a significant financing component.

- Judgment will be required to determine how to account for the exercise of a material right. Depending on the facts and circumstances, it may be a contract modification or the continuation of an existing contract. Entities should determine an appropriate approach and consistently apply it.

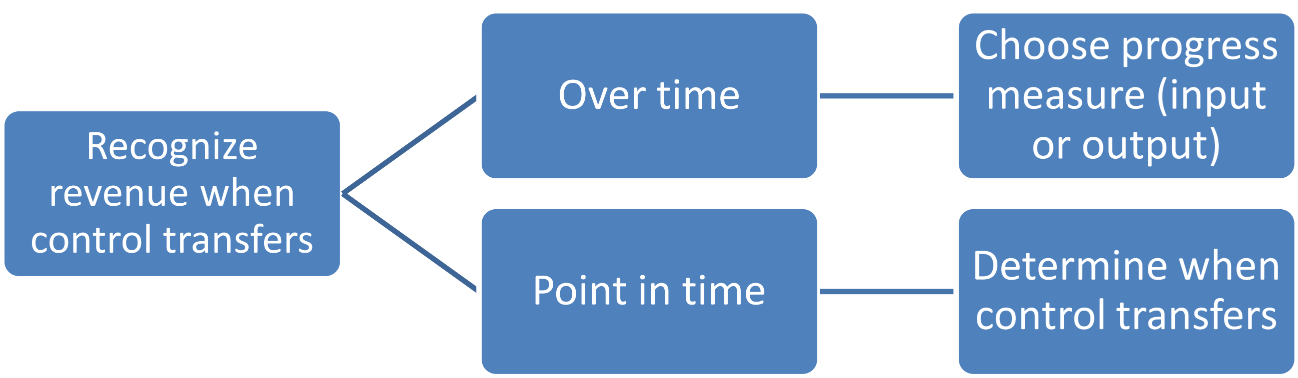
- Nonrefundable upfront fees should be recognized over the contract period if the fee does not provide a material right. If it includes a material right, the fee would be recognized over the expected period of benefit to the customer.

- In evaluating if a material right exists, entities should consider both quantitative and qualitative factors, for example:
  - An entity's historical renewal experience
  - Whether the customer could obtain substantially equivalent services from another provider without paying a similar upfront fee
  - Comparability of the renewal rate to the amount a new customer would be required to pay
  - Entities should consider all relevant transactions with the customer, not just the current transaction.



Step 5 – Recognize Revenue When (or as) Performance Obligations Are Satisfied

An entity would recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when the customer obtains control. For some industries such as real estate, this is a significant departure from the current risk and rewards criteria. Change in control would occur when the customer has the ability to direct the use of and receive the benefits from the transferred good or service. Control also includes the customer's ability to prevent other entities from directing the use of and obtaining benefit from the good or service. Revenue can be recognized over time or at a point in time.



Performance Obligations Satisfied over Time

An entity transfers control over time if **any** of the following criteria are met:

- The customer receives and consumes the benefits of the entity's performance as the entity performs, for example, a cleaning service.
- The customer controls the asset as it is created or enhanced by the entity's performance (could be tangible or intangible).

- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.
  - Alternative use – To determine if an asset has an alternative use, the entity considers at **contract inception** the effects of contractual and practical limitations on its ability to readily direct the asset to another customer. An asset would not have an alternative use if an entity is prohibited from transferring the asset to another customer or would incur significant costs to do so. TRG members agreed an entity should consider only the characteristics of the asset that will ultimately be transferred to the customer.
  - Enforceable right to payment – An entity has an enforceable right to payment for performance to date, if an entity is allowed to recover cost plus margin on goods and services transferred to date. The right to payment should be enforceable and management should consider contractual terms and any legislation or legal precedent that could override those contractual terms. The right to payment for performance completed to date does not need to be for a fixed amount. Application of this guidance will require judgment. An entity should consider whether it has an enforceable right to payment related to its performance completed to date. If the entity's performance obligation is to customize its standard goods for a customer, an entity would evaluate whether it has an enforceable right to payment at the point that the entity begins to satisfy the performance obligation to customize the goods for the customer.

Entities currently recognizing revenue at a point in time should not presume continued point-in-time recognition under the new revenue guidance. The assessment is made on a contract-by-contract basis and variances in contract terms could result in recognizing revenue at a "point in time" for some contracts and "over time" for others. TRG meeting materials included the following example when revenue recognition would change from point in time to over time.

A manufacturer produces goods designed to a customer's specifications. Because the goods are designed to unique specification, the entity concludes its performance does not create an asset with alternative use to the entity. The entity also has an enforceable right to payment for performance completed to date. Therefore, revenue will be recognized over time.

Measuring Progress Toward Complete Satisfaction of a Performance Obligation

For over-time revenue recognition, an entity must be able to reasonably measure its progress toward completion. In some cases, *e.g.*, a contract's early stages, an entity would be permitted to recognize revenue to the extent of costs incurred until it is reasonably able to measure its progress. Progress measures can either be output or input methods. An entity would be required to apply that method consistently to similar performance obligations in similar circumstances.

Output Methods

Under an output method, an entity would recognize revenue by directly measuring the value of the goods and services transferred to date to the customer (milestones reached or units produced). The output selected should faithfully depict the entity's progress toward satisfaction of a performance obligation. For example, units produced or delivered could only be used if the value of any work in progress and units produced but not delivered to the customer at the end of the reporting period is immaterial. As a practical expedient, an entity could recognize revenue in the amount it is entitled to invoice, if it directly corresponds with the value of the goods or services transferred to date. TRG members agreed that a contract does not need to have a fixed unit price for the contract's duration to qualify for the practical expedient, providing the changing rates directly correspond to changes in value to the customer, *e.g.*, a multiyear electricity contract that contemplates the forward market price of electricity. Upfront payments or retroactive adjustments would need to be considered when determining if the amount an entity has a right to bill for each incremental good or service directly corresponds to the customer value. The presence of an agreed-upon customer schedule payment does not mean that the amount an entity has a right to invoice directly corresponds to the customer value of performance completed to date. The existence of contract minimums would not always preclude the application of the practical expedient, if the clause is nonsubstantive.

Input Methods

Input measures use an entity's inputs, *e.g.*, costs incurred, machine hours used or time lapsed, relative to total expected inputs to satisfy a performance obligation. An entity must adjust if the inclusion of certain costs would distort the contract's performance, such as wasted materials. If inputs are incurred evenly over time, revenue would be recognized on a straight-line basis. If an entity, acting as a principal, procures goods from another vendor and does not design or manufacture those goods, and the cost of the goods is significant relative to the total cost to satisfy the performance obligation, and control of the goods is transferred to the customer significantly in advance of delivery or services related to those goods, the entity may recognize revenue in an amount equal to the cost of the goods, *i.e.*, zero-margin revenue on those specific goods.

Control Transferred at a Point in Time

Performance obligations that do not meet any of the three criteria for being satisfied over time should be accounted for at a point in time. When control over an asset is transferred at a single point in time, an entity would recognize revenue by evaluating when the customer obtains control. An entity would use judgment in determining when control has been transferred, considering the following indicators:

- The entity has a present right to payment.
- The customer has legal title.
- The customer has physical possession.
- The customer has the significant risks and rewards of ownership.
- The customer has accepted the asset.

Clauses that allow the customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed-upon specifications must be evaluated to determine if a customer has obtained control. For goods delivered for trial or evaluation, control of the product is not transferred until the customer accepts the product or the trial period lapses.

Consignment Sales

In consignment arrangements, the seller delivers goods to a customer but retains title to the goods. A consignee will not take title or pay for the goods until they are sold by the consignee to a third party or consumed by the consignee in production. Because control has not transferred, an entity should not recognize revenue upon delivery of consigned products.

Other Items

Principal Versus Agent Considerations

If other parties are involved in providing goods or services to an entity's customer, the entity would determine whether it is acting as a principal or an agent. Distinguishing between principal and agency roles requires significant judgment and is a challenge even under current guidance due to service industry growth and a rise in "virtual" transactions. This distinction is important because it determines if revenue is recognized on a gross or net basis.

If an entity obtains control of goods or services from another party before transfer to the customer, the entity's performance obligation is to provide the goods or services, meaning the entity is acting as a principal and would recognize revenue at the gross amount collected from the customer. If an entity obtains legal title of a good only momentarily before being transferred to a customer, the entity may not be acting as a principal. If an entity does not obtain control of the goods or services from another party before transfer to a customer, the entity is acting as an agent and would recognize revenue at the net amount, such as a fee or commission.

SEC Observations

The determination of whether a company is the principal or the agent could be challenging for evolving business models and could be different from the conclusion reached under current U.S. GAAP. In adopting ASC 606, companies should revisit their current principal versus agent conclusions based on whether they control the specified good or service before it is transferred to the customer.

Gross or net reporting should not be viewed as a default or a safe harbor. Instead, the specific facts and circumstances of an arrangement should drive the final accounting conclusion. Disclosures related to the principal versus agent determination are important because they allow investors to understand the registrant's role in the arrangement.

Unit of Account

ASU 2016-08 requires an entity to identify the specified good or service provided to the customer, *e.g.*, good, service or a right to a good or service. An entity then determines whether it is a principal or agent for each promised good or service. If a customer contract includes more than one good or service, an entity could be a principal for some items and an agent for others.

Control in Service Contract

ASU 2016-08 clarifies how the control principle applies to services performed by another party. A principal can control a service—even when another party actually performs the service—if it can direct that party to perform the service for the customer on its behalf, *e.g.*, an entity that provides office maintenance services, but subcontracts with another party to perform the services instead of using its own employees. In contracts where goods or services provided by another party are inputs to a combined item, an entity would be the principal if it controls the combined item before transfer to the customer, *e.g.*, integration services.

Indicators

ASU 2016-08 clarifies the indicators in the new revenue standard may be more or less relevant or persuasive to the control assessment, depending on the facts and circumstances. This ASU also eliminates the indicators related to credit risk and consideration in the form of commission. The control indicators in the original 2014 standard were drafted from an agent's point of view (when an entity did not control the goods/services before transfer). This ASU reframes the indicators from the principal's point of view (when an entity controls the goods/services before transfer), which is more intuitive for readers.

Customer's Unexercised Rights – "Breakage"

Some contracts require a customer to make an upfront, nonrefundable payment for future performance, but the customer does not demand full performance, *e.g.*, gift cards or prepaid phone cards. A contract liability should be recorded upfront. Revenue is recognized and liability is reduced as goods or services are delivered. The difference between the amount paid and the dollar value of performance received is referred to as "breakage." If an entity expects to be entitled to breakage, it would recognize the effects of the expected breakage as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, the entity would recognize the effects of the expected breakage when the likelihood of the customer exercising its remaining rights becomes remote. This is relatively consistent with current U.S. GAAP.

Nonrefundable Upfront Fees

Certain contracts charge a nonrefundable upfront fee to customers, such as health club memberships and cell phone activation fees. Such fees may cover costs incurred in setting up a contract or may represent a separate performance obligation. If the upfront fee is an advance payment for future goods or services, revenue would be recognized when those goods or services are delivered to the customer. If the fees are compensation for setup activities and do not transfer a service to a customer, they are not a performance obligation. Management would need to evaluate if these costs have resulted in an asset that should be recognized.

Licensing & Rights to Use Intellectual Property

Licensing refers to granting a customer the right to use—but not own—intellectual property (IP). Examples include patents, trademarks, software, franchises and motion pictures. Licensing arrangements have a variety of forms—term-based or perpetual, exclusive or nonexclusive—and payment terms can be fixed, variable, upfront or installment.

An entity must first determine if the license is distinct from other goods or services in the arrangement. For licenses that are not distinct, an entity would combine the license with other goods and services in the contract and recognize revenue when it satisfies the **combined** performance obligation.

If a license is distinct, an entity would assess the nature of the promise before applying the revenue recognition model to license arrangements. ASU 2016-10 requires entities to classify IP in one of two categories:

- Functional IP – This IP has standalone significant standalone functionality. Because functional IP has significant utility independent of the licensor's past or ongoing activities, and the functionality is not changing because of the licensor's ongoing activities, the license is satisfied at the point in time the IP is made available for the customer's use. If the functionality is expected to change, and the customer will be required or compelled to use the latest version of the IP, revenue for the license would be recognized over time.
- Symbolic IP – This IP is without significant standalone functionality. The benefit from licenses of symbolic IP depends on continuing support and maintenance of the IP. For example, a license to a sports team's name and logo typically would have limited residual value if the team stops playing games, *e.g.*, Hartford Whalers or Tampa Bay Devil Rays. Symbolic IP grants the customer an access right that is satisfied over time as the entity fulfills its promise to both:
    - Grant the customer's right to use and benefit from the IP
    - Continue to support and maintain the IP

Sales-Based or Usage-Based Royalties

FASB has provided a narrow exception to the variable consideration criteria for IP licenses when there is a sales-based or usage-based royalty. An entity should recognize revenue for such a transaction only when the later of the following events occurs:

- Subsequent sale or usage
- Satisfaction of performance obligation

ASU 2016-10 clarifies when the sales-based royalty constraint would apply. An entity would not be required to split a royalty into the portion that is subject to the royalty exception and the portion that is not. The sales-based royalty constraint would be applied to the overall royalty stream when the sole or predominant item within the arrangement is the license of IP. Otherwise, the general constraint on variable consideration would apply to the entire arrangement.

TRG members addressed how minimum guarantees would affect the recognition of sales- or usage-based royalties. General agreement was reached on the following:

- Functional IP – A minimum guaranteed amount of sales- or usage-based royalties should be recognized at the point in time the entity transfers control. Any royalties above the fixed minimum would be recognized at the later of when the sale or usage occurs or when the performance obligation is satisfied.
- Symbolic IP – Various recognition approaches could be acceptable for minimum guarantees in licenses of symbolic IP, which require revenue to be recognized over time.

Repurchase Arrangements

A contract with a repurchase agreement affects the customer's ability to control the asset and affects both the accounting and timing of revenue recognition. The accounting for repurchase arrangements depends on which party holds the obligation or right, as well as the relative purchase price as compared to the original selling price. If an entity sells an asset and promises—or has the right to repurchase the asset (or an asset that substantially is the same)—the accounting depends on the form of the promise, *i.e.*, forward contract or call or put option. For put options, an entity would evaluate the repurchase price and the expected market value at the repurchase date and the time to expiration to determine if there is a significant economic incentive (adjusting for the time value of money). If the repurchase price is expected to exceed the asset's market value, the customer would have a significant economic incentive to exercise the put option.

Agreement	Definition	Control?
Forward contract	Obligation to repurchase the asset	No – Customer has limited 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.
Call option	Right to repurchase the asset	No – Customer has limited 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.
Put option	Obligation to repurchase the asset at the customer's request	Yes – The customer has the ability to direct the asset's use.

Repurchase Agreement Type	Repurchase Price (RP) Original Sales Price (SP)	Significant Economic Incentive to Exercise	Accounting
Call option/forward	RP<SP	n/a	Lease, see ASC Topic 840
Call option/forward	RP>=SP	n/a	Financing
Put option	RP<SP	Yes	Lease, see ASC Topic 840

Repurchase Agreement Type	Repurchase Price (RP) Original Sales Price (SP)	Significant Economic Incentive to Exercise	Accounting
Put option	RP<SP	No	Sale with right of return
Put option	RP>=SP and RP>expected market value	Yes	Financing
Put option	RP>=SP and RP<expected market value	No	Sale with right of return

Sale Leasebacks

A call option that is part of a sale leaseback agreement would be treated as a financing arrangement if the repurchase amount is less than the original sales price. A put option with a repurchase price less than the original sales price that is included in a sale leaseback transaction would be accounted for as a financing arrangement if the customer has a significant economic incentive to exercise the put option.

The guidance on written put options is different from today's guidance because it requires an entity to determine whether the customer has a significant economic incentive to exercise its right. Under today's guidance, when an arrangement includes a written put option that is designed to compensate the customer for holding costs (including interest), the arrangement is accounted for as a financing arrangement, regardless of the likelihood that the customer will exercise that option. However, the new standard does not provide any guidance on determining whether "a significant economic incentive" exists, and judgment may be required to make this determination.

Because the standard treats all forwards and call options the same way and does not consider their likelihood of exercise, a significant change in practice may occur for some entities. In certain transactions, an entity may have an unconditional right to repurchase an asset at an amount equal to or greater than the original sales price. For example, some luxury designers have the right to repurchase their handbags at an amount equal to the original sales price. This call option serves as a protective right over the brand's reputation, but the designer is unlikely to exercise the option. The standard nevertheless would require the designer to account for all transactions, including this option, as financing arrangements.

Bill-and-Hold Arrangements

Bill-and-hold arrangements occur when an entity bills a customer for a product but retains physical possession until a future point in time, *e.g.*, due to a customer's space availability or delay in the production schedule. For these arrangements, the following conditions must be met for an entity to conclude control has been transferred to a customer and, therefore, revenue recognized:

- The reason for the bill-and-hold arrangement must be substantive.
- The product must be identified separately as belonging to the customer.
- The product currently must be ready for physical transfer to the customer.

- The entity cannot use the product or direct it to another customer.

Some of the transaction price would be allocated to the custodial service of storing the goods if such services are a separate performance obligation. There is no explicit requirement for a bill-and-hold arrangement to be at the request of the customer, although the reason for the arrangement must be substantive.

Some private companies may need to change their accounting for transactions involving bill-and-hold arrangements. The standard incorporates much of the SEC staff guidance on this topic that was not previously included in U.S. GAAP. Many nonpublic entities already apply this bill-and-hold guidance, but today it is only required for SEC registrants.

The criteria for determining whether a bill-and-hold transaction qualifies for revenue recognition under the new standard are similar to, but somewhat less detailed than, today's criteria in Staff Accounting Bulletin (SAB) Topic 13. SAB Topic 13 requires that the customer requests that the entity retain the completed product and that the arrangement include a fixed delivery schedule are not considerations under the standard. Most bill-and-hold transactions that qualify for revenue recognition under today's guidance also will qualify for revenue recognition under the new standard.

Conforming Amendments

Contract Costs

In conjunction with the new standard's release, FASB also amended ASC 340, *Other Assets and Deferred Costs*. Outside of guidance on accounting for long-term construction contracts and certain industry-specific guidance, U.S. GAAP previously did not address the accounting for the cost of obtaining and fulfilling customer contracts; an accounting policy election determined whether such costs were capitalized or expensed. Only SEC registrants are required to disclose their policy for capitalized costs.

Under current GAAP, cost must be both direct and incremental to be capitalized. Under the new standard, costs must only be incremental and companies may be required to capitalize more contract costs than they currently do.

Incremental Costs of Obtaining a Contract

An entity would capitalize incremental costs of obtaining a contract if the costs are recoverable. Incremental costs are those that would not have been incurred if the contract had not been obtained, *e.g.*, sales commissions. Cost an entity incurs regardless of whether it obtains a contract would be expensed as incurred. As a practical expedient, an entity can expense these incremental costs if the amortization period of those costs would be one year or less, *i.e.*, the contract term or earnings process is not greater than a year. An entity must disclose if this practical expedient is elected.

Advertising Costs

ASU 2014-09 superseded much of the guidance in Subtopic 340-20, *Other Assets and Deferred Costs—Capitalized Advertising Costs*, including when to recognize a liability. The technical corrections in ASU 2016-20 reinstate this guidance, "Expenditures for some advertising costs are made after recognizing revenues related to those costs. For example, some entities assume an obligation to reimburse their customers for some or all of the customers' advertising costs (cooperative advertising). Generally, revenues related to the transactions creating those obligations are recognized before the expenditures are made. For purposes of applying the guidance in this

Subtopic, those obligations shall be accrued and the advertising costs expensed when the related revenues are recognized."

Preproduction Activities

Some long-term supply arrangements require an entity to perform upfront engineering or design services or adopt new technology to meet customer needs. Under the new model, performance obligations do not include activities an entity must undertake to fulfill a contract unless it results in a transfer of goods or services to a customer.

Costs to Fulfill a Contract

If the costs incurred in fulfilling a contract are not within the scope of other guidance, *e.g.*, inventory, property, plant and equipment or capitalized software, an entity would recognize an asset only if the costs meet all of the following criteria:

- They directly relate to a contract or a specific anticipated contract, *e.g.*, direct labor or materials.
- They generate or enhance resources that would be used to satisfy performance obligations in the future.
- They are expected to be recovered.

Certain costs are expensed as incurred, such as most general and administrative costs and cost of wasted materials and labor not reflected in the contract price. If an entity cannot distinguish the fulfillment costs that relate to future performance obligations from the costs that relate to past performance obligations, the entity would expense these costs as incurred.

Amortization

Capitalized costs to obtain and fulfill contracts would be amortized on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates. An entity should update the amortization period to reflect significant changes in the expected timing of transferring goods or services to the customer. These changes should be accounted for as changes in accounting estimates. As a practical expedient, if the amortization period would be one year or less, an entity may elect to expense the costs. The asset may be amortized over more than one contract when the asset relates to goods or services that will be provided under an anticipated contract that the entity can specifically identify, *e.g.*, renewal options.

TRG meeting materials provided some factors to consider when estimating the amortization period of an asset arising from the incremental costs of obtaining a customer contract:

- Identify the contract(s) to which the commission relates – An entity must determine whether the capitalized incremental costs (such as sales commissions) relate to goods or services that only will be transferred as a part of the initial contract or if the costs also relate to goods or services that will be transferred as a part of a specific anticipated contract(s).
- Determine whether a commission on a renewal contract is commensurate with the commission on the initial contract – For commissions on renewal contracts, an entity must first determine if the "renewal" commission is commensurate with the "initial" commission. If commensurate, the asset would be amortized over the initial contract term, *i.e.*, the commission from the initial contract does not relate to the renewal contract. If not commensurate, the entity should assess the period to which the asset relates, potentially including specific anticipated contract(s).
- Evaluate facts and circumstances to determine an appropriate amortization period – TRG members think using an amortization period equal to the average customer term is a reasonable application of the new revenue standard unless facts and circumstances indicate otherwise.

Amortizing the asset over a longer period than the initial contract would not be appropriate in situations in which an entity pays a commission on a renewal contract that is commensurate with the commission paid on the initial contract. In that case, the acquisition costs from the initial contract do not relate to the subsequent contract.

Impairment

An impairment loss would be recognized if the carrying value of the capitalized costs exceeds its recoverable amount. The recoverable amount equals the remaining consideration to which the entity expects to be entitled, minus costs directly related to those goods or services. Reversals of these impairments would not be permitted.

ASU 2016-20 updates Topic 340-40 to clarify that contract renewals and extensions should be considered when measuring the remaining amount of consideration that the entity expects to receive. In assessing impairment, an entity should include both the amount of consideration it has already received—but not recognized as revenue—and the amount it expects to receive for goods and services to which the asset relates.

Presentation & Disclosures

Presentation

A contract asset or contract liability is generated when either party to a contract performs and is required to be reporting in the financial statements. When an entity satisfies a performance obligation by delivering promised goods or services, the entity has earned a right to consideration and has a contract asset. When the customer performs first, *e.g.*, prepayment, the entity has a contract liability.

These requirements will look familiar to entities with construction and production contracts; however, it is new for most other entities. Under existing guidance, when revenue is recognized but not yet billed, an entity records an asset for unbilled accounts receivable. After an invoice is sent to the customer, the related balance is reclassified as billed accounts receivable. Under Topic 606, reclassification from a contract asset to a receivable is contingent on fulfilling performance obligations—not on invoicing a client. As a result, the point at which a contract asset is reclassified as a receivable may be different than the time of invoicing.

This generated a number of questions to the TRG, and below are the general areas of agreement:

- Contract assets and liabilities should be determined at the contract level and not the performance level. An entity would not separately recognize an asset or liability for each performance obligation within a contract, but would aggregate into a single contract asset or liability.
- Contract assets or liabilities should be combined for different contracts with the same customer only when an entity is required to combine those contracts—when two or more contracts are entered into at or near the same time with the same customer (or related parties of the customer).
- Entities must look to other guidance, *i.e.*, ASC 210-20—*Offsetting*, to determine if it is appropriate to net contract assets and liabilities with other balance sheet items, *e.g.*, accounts receivable.

The TRG also addressed the question, "What is the accounting for an existing contract asset when the contract modification that is treated as if it were a termination of the existing contract and creation of a new contract, *i.e.*, remaining services are distinct but not offered at the standalone selling price?" The TRG concluded the existing contract asset related to a modified contract should be carried forward into the new contract if the modification is treated as a termination of an existing contract and the creation of a new contract. The following example was provided.

A vendor enters into a contract to provide a good and one year of service with a transaction price of $4,200. Assume the good and service are separate performance obligations and the service is considered a series. The good's standalone selling price is $3,000, and the service's standalone selling price is $100 per month ($1,200 for one year). Vendor allocates $3,000 to the good and $1,200 to the services. The contract does not have an upfront payment. Customer will pay 12 equal installments of $350. Vendor will invoice Customer each month-end. The contract requires Customer to pay the invoice within 30 days (or Vendor has the right to assess an agreed-upon late payment penalty and/or exercise its enforceable rights to demand payment). At the beginning of the first month, the good is transferred to Customer, and the revenue allocated to that performance obligation ($3,000) is recognized. Vendor also recognizes a contract asset for $3,000 because payment of that $3,000 is conditional upon Vendor performance of future services. At the end of the first month, Vendor recognizes revenue of $100 for progress toward complete satisfaction of the service performance obligation (assume the entity is using a time-based measure of progress). Vendor also recognizes accounts receivable of $350 because that amount is not conditional. The contract asset, which had a beginning balance of $3,000, would have an ending balance of $2,750.

After nine months, $3,900 of revenue has been recognized for the contract ($900 of service revenue and $3,000 for the good). At the end of nine months, Vendor has a receivable for $350 (assuming Customer already paid the first eight installments) and a contract asset for $750 (equal to $3,000 – (9 x ($350 - $100))).

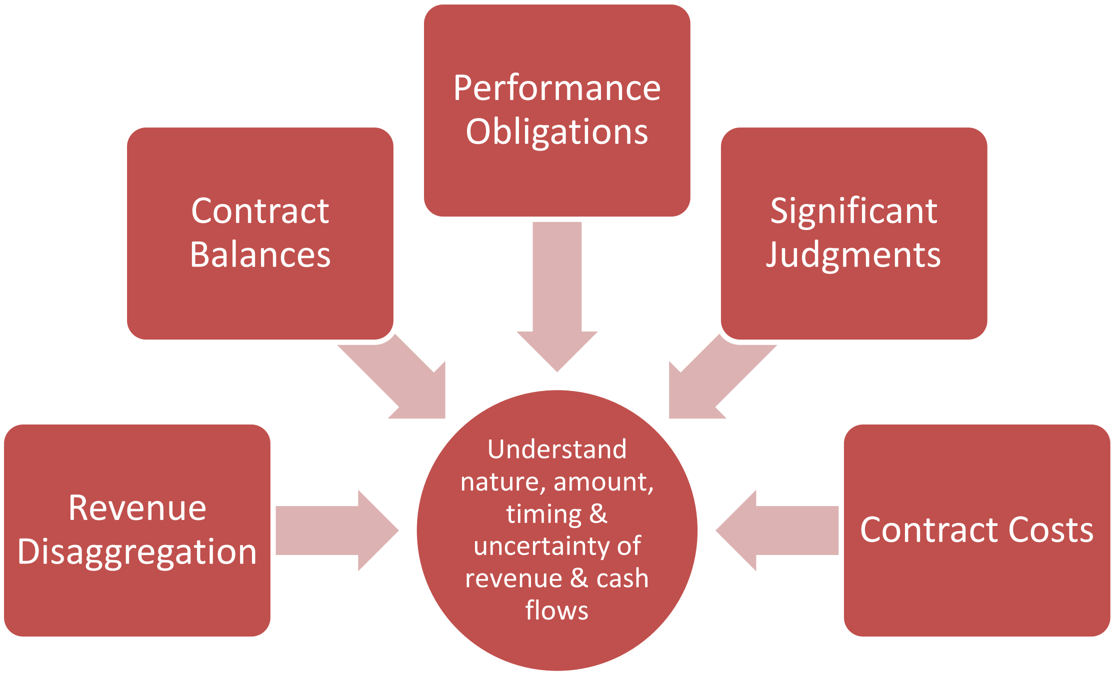
Vendor then negotiates with Customer to change the contract's scope and price. The contract is modified to include one additional year of service beyond the initial one-year service term. The fee for the last three months of the initial one-year contract is unchanged as a result of the modification. The agreed-upon fee for the additional one year of services is $50 per month, which is significantly below the standalone selling price of the services. Vendor determines that the additional promised services arising from the modification do not reflect the standalone selling price of the services to be provided. Because the remaining services are a series of distinct services, Vendor determines that the remaining services are distinct from the goods or services transferred prior to the modification and should be treated as a termination of the existing contract and the creation of a new contract.

TRG members agreed that the Vendor would retain the original contract asset at the modification date. That contract asset relates to revenue that was previously recognized but has not been paid by Customer and is not presented as a receivable. Vendor would perform an analysis to determine the total consideration to be allocated to the remaining performance obligations. Customers promised consideration included in the transaction price, but not yet recognized as revenue under the original contract, would be $300 (equal to $4,200 transaction price – $3,900 already recognized as revenue). The additional consideration promised as part of the contract modification is $600 (equal to 12 additional months × $50 per month).

The total consideration allocated to the remaining distinct services is $900 ($300 + $600). Vendor would allocate the $900 to the remaining performance obligations and recognize revenue over the remaining modified contract duration. Subsequent to the contract modification, the contract asset would be evaluated and accounted in the same manner as any other contract asset.

Entities are permitted to use different descriptions of contract assets, contract liabilities and receivables and could use additional line items to present those assets and liabilities if the entity also provides sufficient information for financial statement users to distinguish them.

Disclosures



The objective of the disclosure requirements is to enable financial statement users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Current disclosure requirements are included in industry-specific and general recognition standards but are limited and lack cohesion. The SEC also requires certain revenue disclosures for publicly traded companies. Current disclosure requirements include:

- General requirements – accounting policies, seasonal revenue, segments, related parties
- Specific requirements – multiple-element arrangements, nonmonetary revenue transactions, bill-and-hold, fees for services
- Industry requirements – construction contractors, franchisors

New disclosures for both public and private companies include the following:

- Revenue disaggregated according to the nature, amount, timing and uncertainty of revenue and cash flows. The disaggregated revenue would need to be reconciled to the revenues in the financial statements. Public companies would be required to provide a quantitative disclosure. Nonpublic entities would disclose qualitative information about how economic factors affect the nature, timing and uncertainty of revenue and cash flows. A nonpublic entity would disaggregate revenue in accordance with the timing or transfer of goods or services, *i.e.*, goods transferred at a point in time versus goods transferred over time.
- Information about performance obligations, including when the entity typically satisfies performance obligations, *e.g.*, upon shipment, upon delivery or as services are rendered
- Significant payment terms – when payment is due, variable consideration and significant financing components

- Nature of goods and services
- Obligations for returns, refunds and similar obligations
- Types of warranties and related obligations

Public companies would be required to disclose the following:

- Contract balances
    - Opening and closing balances of receivables, contract assets and contract liabilities (if not presented elsewhere) and quantitative and qualitative description of significant changes
    - Amount of revenue recognized that was included in the contract liability balance at the beginning of the period
    - Revenue recognized relating to performance obligations satisfied in a prior period, such as from contracts with variable consideration
- Remaining performance obligations – Required for contracts in excess of one year; renewals should be excluded. Entities are not precluded from including contracts with an original date of less than one year. Entities should include a qualitative discussion about any significant variable consideration not included in the discussion of remaining performance obligations. The disclosure should include the aggregate amount of the transaction price allocated to unsatisfied performance obligations as of period close as well as when the entity expects to recognize that revenue.
- Significant judgments, including the expected timing of satisfying performance obligations, the transaction price and the allocations to performance obligations – For obligations satisfied at a point in time, an entity should disclose significant judgments made in evaluating when a customer obtains control. For obligations satisfied over time, an entity would disclose the methods used to recognize revenue and why the method faithfully depicts the transfer of goods or services.
- Methods, inputs and assumptions used to determine the transaction price, assessing the constraint on variable consideration, allocation of the transaction price and measuring the obligations for returns and refunds
- Contract costs – Closing balances of capitalized contract costs by main category of asset (cost to obtain contract, setup costs, etc.), as well as the amount of amortization recognized in the period and a description of the assumptions used in capitalizing contract acquisition costs

Interim disclosures include most of the quantitative disclosures required in annual financial statements, including disaggregated revenue, contract balances and remaining performance obligations.

SEC Observations

SEC staff will look outside of the financial statements, e.g., investor presentations, earnings releases, financial information reviewed by the chief operating decision maker, to determine the adequacy of the disclosures of disaggregated revenue required by ASC 606, e.g., disaggregation by type of goods or services, geographical region, customer.

Effective Date

In July 2015, FASB granted an additional year for adoption of the revenue rules. So as not to penalize entities who started implementation, early adoption is permitted as of the original effective dates. FASB board members have made it clear that no further extensions should be expected.

<table>
<tr><th colspan="2">Public Business Entities</th></tr>
<tr><th>Mandatory Adoption Date</th><th>Early Adoption Date</th></tr>
<tr><td>Annual reporting period
Year ending December 31, 2018
Interim reporting period
Quarter ending March 31, 2018</td><td>Annual reporting period
Year ending December 31, 2017
Interim reporting period
Quarter ending March 31, 2017</td></tr>
<tr><th colspan="2">Nonpublic Entities</th></tr>
<tr><th>Mandatory Adoption Date</th><th>Early Adoption Date(s)</th></tr>
<tr><td rowspan="3">Annual reporting period
Year ending December 31, 2019
Interim reporting period
Quarter ending March 31, 2020
(Nonpublic entities are not required to apply the new revenue standard in interim periods within the year of adoption.)</td><td>Annual reporting period
Year ending December 31, 2017
Interim reporting period
Quarter ending March 31, 2017, OR quarter ending March 31, 2018</td></tr>
<tr><td>Annual reporting period
Year ending December 31, 2018
Interim reporting period
Quarter ending March 31, 2018, OR quarter ending March 31, 2019</td></tr>
<tr><td>Annual reporting period
Year ending December 31, 2019
Interim reporting period
Quarter ending March 31, 2019</td></tr>
</table>

Transition

Entities must retrospectively apply the new revenue standard using either a full or modified retrospective approach.

Full Retrospective

Under this approach, entities would apply the new guidance as if it had been in effect since the inception of all customer contracts. FASB provided several practical expedients:

- For completed contracts, an entity need not restate contracts that begin and end within the same annual reporting period.
- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.

- For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.
- ASU 2016-12 added an additional expedient for contract modifications, eliminating the need to separately evaluate the effects of each contract modification when determining the transaction price upon initial adoption of the standard. An entity could elect to perform a single standalone selling price allocation (with the benefit of hindsight) to all of the contract's satisfied and unsatisfied performance obligations.

Entities can elect any or all of these expedients, and would disclose that fact as well as a qualitative assessment of the estimated effects. Entities must apply each expedient selected consistently to all contracts for all periods presented.

Modified Retrospective

Under this approach, the cumulative effect of initially applying this ASU is recognized in opening retained earnings at the date of adoption. ASU 2016-12 permits an entity to elect to apply the modified retrospective transition approach either to all contracts as of the adoption date or only to uncompleted contracts. Entities are required to disclose how they applied the modified retrospective method.

Comparative year restatement is not required, but entities must disclose the following additional information in reporting periods that include the initial adoption date:

- For each financial statement line item, the amount affected in the current reporting period by the application of this ASU as compared to the guidance that was in effect before the change
- An explanation of the reasons for significant changes

Entities electing a modified retrospective approach can only use the practical expedient related to contract modifications.

As originally issued, the standard would have required an entity electing modified retrospective application to disclose the effect of the change on income from continuing operations, net income, any other affected financial statement line items and any affected per-share amounts for the current period and any prior periods retrospectively adjusted, substantially increasing transition costs. For companies applying the guidance using the modified retrospective application, ASU 2016-12 eliminates the requirement to disclose the effect of the accounting change for period of adoption. However, entities still would need to disclose the changes' effect on any prior periods retrospectively adjusted.

Completed Contracts

ASU 2016-12 clarifies that for a contract to be considered completed at transition, all—or substantially all—of the revenue must have been recognized under legacy GAAP before the date of initial application. Accounting for contract elements that do not affect revenue under legacy GAAP (historical cost accrual for loyalty points) would be irrelevant to the assessment of whether a contract is complete.

Management will need to carefully consider the cost and benefits of these two approaches, which will affect the start date and data requirements of implementation projects.

If you have questions about the revenue recognition rules, please contact your BKD advisor.

Contributor

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