

BLUEPRINT: A BDO SERIES

Revenue Recognition Under ASC 606

Updated October 2025

TABLE OF CONTENTS

Introduction 4
ASC 606 in a Nutshell: The Five-Step Revenue Recognition Model 5
Other Key Concepts 8
Presentation and Disclosures 9
Additional Topic 10
About the Blueprint 10
Acknowledgments 13
Chapter 1 — Scope 14
1.1 Overview: Scope 14
1.2 Scope and Scope Exceptions 14
1.3 Definition of a Customer 18
1.4 Contracts Partially Within the Scope of Other Standards 20
1.5 Interaction With Other Standards 22
1.6 Portfolio Approach 24
Chapter 2 — Step 1: Identify the Contract With a Customer 26
2.1 Overview — Step 1: Identify the Contract With a Customer 26
2.2 Definition of a Contract 27
2.3 Contract Enforceability and Termination Clauses 36
2.4 Contract Existence Criteria Are Not Met 41
2.5 Reassessment of Contract Existence Criteria 44
2.6 Combination of Contracts 45
Chapter 3 — Step 2: Identify the Performance Obligations in the Contract 49
3.1 Overview 3 — Step 2: Identify the Performance Obligations in the Contract 49
3.2 Promises in Contracts With Customers 52
3.3 Distinct Goods or Services 58
3.4 Series of Distinct Goods or Services 76
3.5 Warranties 84
3.6 Practical Expedient for Nonpublic Franchisors 87
Chapter 4 — Step 3: Determine the Transaction Price 89
4.1 Overview — Step 3: Determine the Transaction Price 89
4.2 Determining the Transaction Price 90
4.3 Variable Consideration 92
4.4 Significant Financing Component 106
4.5 Noncash Consideration 113
4.6 Consideration Payable to a Customer 117

4.7 Nonrefundable Upfront Fees 128
4.8 Changes in the Transaction Price 131
Chapter 5 — Step 4: Allocate the Transaction Price to the Performance Obligations 133
5.1 Overview — Step 4: Allocate the Transaction Price to the Performance Obligations 133
5.2 Allocation Objective 134
5.3 Allocation Based on Standalone Selling Price 135
5.4 Allocation of a Discount 142
5.5 Allocation of Variable Consideration 145
Chapter 6 — Step 5: Recognize Revenue When or as the Performance Obligation is Satisfied 152
6.1 Overview — Step 5: Recognize Revenue When or as the Performance Obligation is Satisfied 152
6.2 Satisfaction of Performance Obligations 154
6.3 Performance Obligations Satisfied Over Time 156
6.4 Measuring Progress Toward Complete Satisfaction of a Performance Obligation 174
6.5 Performance Obligations Satisfied at a Point in Time 185
6.6 Repurchase Agreements 187
6.7 Consignment Arrangements 194
6.8 Bill-and-Hold Arrangements 195
6.9 Customer Acceptance 197
Chapter 7 — Other Topics 199
7.1 Overview — Other Topics 199
7.2 Principal vs. Agent Considerations 199
7.3 Contract Modifications 214
7.4 Customer Options for Additional Goods or Services 222
7.5 Licensing 237
7.6 Onerous Contracts (Loss Contracts) 263
7.7 Contract Costs 268
Chapter 8 — Presentation and Disclosures 276
8.1 Overview — Presentation and Disclosures 276
8.2 Presentation 276
8.3 Disclosures 284
Appendix A — Gains and Losses from the Derecognition of Nonfinancial Assets 301
A.1 Overview of ASC 610-20 301
A.2 Scope and Scope Exceptions in ASC 610-20 302
A.3 Recognition and Measurement of Gain or Loss 309
A.4 Presentation and Disclosures required by ASC 610-20 318
Appendix B — Other BDO Blueprints 321
Appendix C — Summary of Significant Changes 322
Contacts 324



Introduction

In May 2014, the Financial Accounting Standards Board (FASB) issued new revenue recognition guidance in Accounting Standards Update (ASU 2014-09), *Revenue From Contracts With Customers* (ASC 606). ASC 606 sets out a comprehensive framework for revenue recognition and addresses virtually all industries, including those that previously followed industry-specific guidance, such as the real estate, construction, and software industries. The objective of ASC 606 is to establish the principles an entity should apply to report decision-useful information in its financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from its contracts with customers. ASC 606 includes an overall disclosure objective along with comprehensive, principles-based disclosure requirements, and entities must make several judgments and estimates in applying its requirements.

The revenue recognition project was one of several joint projects between the FASB and the International Accounting Standards Board (IASB) to converge U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS). The U.S. and international standard setters had observed inconsistencies and weaknesses in their respective accounting standards. Under U.S. GAAP, concepts for revenue recognition had been supplemented with a broad range of industry-specific guidance, which resulted in economically similar transactions being accounted for differently. In IFRS, there was significant diversity in practice because existing standards contained limited guidance on various topics such as accounting for contracts with multiple elements. Further, both the FASB and IASB determined the prior disclosure requirements were inadequate because they often resulted in insufficient information for users of financial statements to understand the sources of revenue and the key judgments and estimates made in its recognition. The information disclosed was also often boilerplate and uninformative.

The Boards achieved their goal of reaching the same conclusions on all major requirements for accounting for revenue from contracts with customers with the issuance of ASC 606 and IFRS 15, *Revenue From Contracts With Customers* in May 2014. They then formed the Joint Transition Resource Group for Revenue Recognition (TRG) to inform them about potential implementation issues and assist stakeholders in understanding specific aspects of the new guidance. Because of TRG deliberations, the FASB and IASB updated ASC 606 and IFRS 15, respectively, several times. While ASC 606 and IFRS 15 were converged upon issuance, the subsequent amendments introduced differences in the following areas:

- Revenue recognition for an arrangement that does not meet the criteria for a contract to exist under the revenue standards
- Promised goods or services that are immaterial in the context of a contract
- Determination of performance obligations by franchisors[1] that are not public business entities
- Shipping and handling activities
- Presentation of sales taxes
- Noncash consideration
- Consideration payable to a customer (equity instruments)
- In-substance sales of intellectual property (IP)
- Licensing:
  - Determining the nature of an entity's promise in granting a license of IP
  - Contractual restrictions in a license and identification of performance obligations
  - Renewals of licenses of IP
- Disclosures

While the two standards are no longer fully converged, the differences are still relatively minor. Additional information on revenue recognition for contracts with customers under IFRS 15 is available **here**.

[1] The Master Glossary defines a franchisor as "*the party who grants business rights (the franchise) to the party (the franchisee) who will operate the franchised business.*"

ASC 606 IN A NUTSHELL: THE FIVE-STEP REVENUE RECOGNITION MODEL

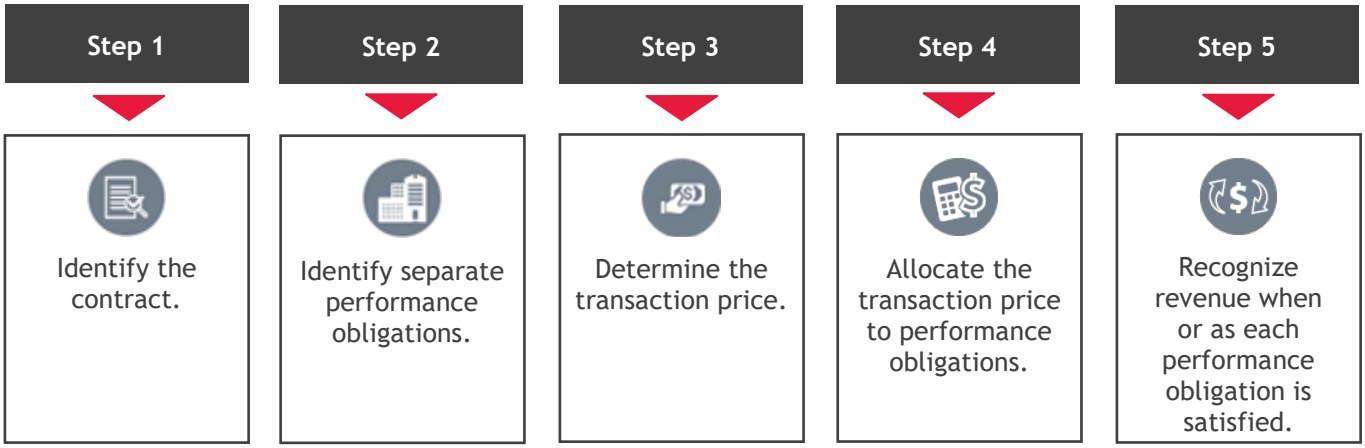
FASB REFERENCES

ASC 606-10-05-1 through 05-4

ASC 606 establishes a single, comprehensive framework to determine how much revenue to recognize and when. The core principle is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to receive in exchange for those goods or services. An entity recognizes revenue when or as control over the goods or services is transferred to the customer.

Recognition of revenue is linked to changes in an entity's assets and liabilities, which can be in the form of cash inflows, increases in receivable balances, or decreases in liabilities that represent deferred revenue. All changes in those assets and liabilities are recognized in profit or loss other than those relating to transactions with owners (for example, shareholders) in their capacity as such.

The core principle is applied in the following five steps (the five-step revenue recognition model):



Scope of ASC 606

ASC 606 applies to all entities and all contracts with customers to transfer goods or services arising from their ordinary activities, except for contracts or transactions that are excluded from its scope. The definitions of "contract" and "customer" establish the scope of ASC 606.

ASC 606 includes guidance for a contract that is partially within the scope of ASC 606 and partially within the scope of other U.S. GAAP. Additionally, ASC 606 specifies the interaction with certain other U.S. GAAP such as ASC 340-40, *Other Assets and Deferred Costs — Contracts With Customers*, and ASC 808, *Collaborative Arrangements*.

The Five-step Revenue Recognition Model

The diagram provides a high-level summary of the five-step revenue recognition model as discussed in detail in this Blueprint.

Step 1: **Identify the Contract.**	An entity identifies the contract with a customer for accounting purposes, which may not be the same as the contract for legal purposes. A contract is an agreement (written, oral, or implied by an entity's customary business practices) that creates enforceable rights and obligations between an entity and its customer. The term of a contract in which the parties to the contract have enforceable rights and obligations may be affected by termination clauses such as a customer's right to terminate a contract or termination penalty. Each of the five specified contract existence criteria must be met for a contract with a customer to exist, and the analysis to proceed to Steps 2 through 5. If any of the contract existence criteria are not met, revenue recognition is generally precluded until the contract existence criteria are met. Once the contract existence criteria are met, a subsequent reassessment is generally not performed except in certain rare circumstances. The contract combination guidance is applied to determine whether two or more contracts should be combined and accounted for as a single contract.
Step 2: **Identify Separate Performance Obligations.**	An entity identifies performance obligations in the contract by analyzing its promises to transfer goods or services to the customer. A performance obligation is a distinct good or service (or a bundle of goods or services). A good or service (either individually or in combination with each other in a bundle) is distinct if the customer can benefit from that good or service on its own or in combination with other readily available resources and that good or service is separately identifiable from other promises in the contract. In identifying performance obligations, an entity also considers: ▶ The applicability of the series guidance ▶ Whether a warranty is a performance obligation or within the scope of ASC 460, *Guarantees* ▶ A practical expedient for nonpublic franchisors.
Step 3: **Determine the Transaction Price.**	An entity determines the transaction price of the entire contract, including an estimate of variable consideration, if appropriate. The transaction price is the amount recognized in revenue in Step 5. Other key aspects of this step include identifying and adjusting the transaction price, if appropriate, for a significant financing component, noncash consideration, or consideration payable to a customer. ASC 606 includes specific guidance for nonrefundable upfront fees and subsequent changes in the transaction price.

Step 4: **Allocate the Transaction Price to Performance Obligations**	ASC 606 includes an allocation objective that generally results in an entity allocating the transaction price among the different performance obligations in the contract based on the relative standalone selling price of each performance obligation with exceptions for certain discounts and variable consideration. Determining the standalone selling price of each performance obligation is a key aspect of this step.
Step 5: **Recognize Revenue When or as Each Performance Obligation Is Satisfied.**	An entity assesses when it satisfies each performance obligation (which may be at a point in time or over time) by transferring a promised good or service to the customer and recognizes revenue allocated to each performance obligation when (or as) that performance obligation is satisfied. A good or service is transferred to the customer when (or as) the customer obtains control over that good or service. Control in the context of ASC 606 is the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. ASC 606 includes certain indicators to help apply the control principle. To assist in determining whether and when control transfers, ASC 606 also includes specific guidance on repurchase agreements, consignment arrangements, bill-and-hold arrangements and customer acceptance clauses. To determine whether a performance obligation is satisfied over time or at a point in time, an entity must first consider three specific criteria. If any one of those criteria is met, then the performance obligation is satisfied over time. If none of those criteria are met, then the performance obligation is satisfied at a point in time. For each performance obligation satisfied at a point in time, an entity considers the indicators of control to determine at what point in time the control transfers to the customer and recognizes revenue at that point in time. For each performance obligation satisfied over time, an entity recognizes revenue over time by measuring the progress toward complete satisfaction of that performance obligation.

Portfolio Approach

The five-step revenue recognition model applies to individual contracts. However, an entity can apply the model to a portfolio of contracts (or performance obligations) with similar characteristics if it reasonably expects that the effects would not differ materially if applied to individual contracts. For example, an entity may elect this practical expedient when it has many contracts affected by a particular issue and an estimate is more appropriately made for the population of contracts as a whole rather than for each contract individually. For example, for retail sales that give the customer a right of return, estimating the aggregate returns for a group of similar retail sale transactions may be more appropriate than assessing each retail sale for which a right of return is granted.

BDO INSIGHTS: INDUSTRY-AGNOSTIC REVENUE RECOGNITION MODEL REQUIRES JUDGMENT

ASC 606 is a comprehensive and industry-agnostic revenue recognition model. This approach is intended to result in similar accounting for similar transactions across industries. However, a model that applies to all entities requires broad principles. Because the guidance does not address specific industries, entities may need to apply significant judgment to determine the appropriate revenue recognition for their contracts.

OTHER KEY CONCEPTS

ASC 606 includes the following other key concepts that are critical in applying the five-step revenue recognition model:

Principal vs. Agent Considerations

ASC 606 provides guidance on assessments when a third party is involved in providing goods or services to a customer. An entity is a principal, and thus recognizes revenue on a gross basis, if it controls a good or service before transferring it to the customer. An entity is an agent, and thus recognizes revenue on a net basis, if it arranges for a good or service to be provided by another entity. ASC 606 contains indicators and examples to assist with the analysis.

ASC 606 clarifies the application of the principal versus agent guidance in the following areas:

- Unit of account at which the principal versus agent determination is made
- The control principle and principal versus agent indicators
- Applying the control principle to specific types of transactions

BDO INSIGHTS: PRINCIPAL VERSUS AGENT ANALYSIS IS BASED ON CONTROL

The principal versus agent guidance is based on the concept of control, which refers to an entity's ability to direct the use of, and derive substantially all the benefits from, an asset. The control concept in ASC 606 includes the elements of power and benefits.

Risks and rewards are merely indicators of control, and they are not solely conclusive of whether control has transferred.

Determining whether an entity controls a good or service before it is transferred to the customer requires the application of professional judgment based on the facts and circumstances.

Contract Modifications

ASC 606 includes a comprehensive model to account for modifications of customer contracts. A contract modification is a change in the contract's scope or price approved by parties to the contract and might be referred to as a "change order," "variation," or "amendment." Accounting adjustments are made for a contract modification only when new enforceable rights and obligations are created or existing ones are changed.

Depending on its nature, a contract modification may be accounted for under any one of the following approaches:

- A separate (and additional) contract with no adjustments to revenue recognized from the existing contract.
- A termination of the existing contract and the creation of a new contract with prospective adjustments to revenue recognized from the existing contract.
- A continuation of the existing contract with cumulative catch-up adjustments to revenue recognized to date from the existing contract.
- A combination of the approaches described in b and c.

Customer Options for Additional Goods or Services

Customer options to acquire additional goods or services for free or at a discount come in many forms, including sales incentives, customer award credits (or points), contract renewal options, and other discounts on future goods or services. ASC 606 provides guidance on accounting for a customer option to acquire additional goods or services that meet the definition of a material right.

Licensing

ASC 606 provides special rules for recognizing revenue from licenses of IP. It specifies that there are two types of IP licenses with different patterns for revenue recognition based on the nature of the license:

- **Symbolic IP license**: Provides the customer with a right to access an entity's IP throughout the license period. Its utility is derived from the entity's past or ongoing activities (for example, use of a brand). Revenue from symbolic IP is recognized over time.
- **Functional IP license**: Provides the customer with a right to use an entity's IP as it exists when the license is granted and has significant standalone functionality (for example, a drug compound, technology, or software product). Revenue from functional IP is generally recognized at a point in time.

Onerous Contracts (Loss Contracts)

ASC 606 does not provide guidance for onerous (loss) contracts with customers. However, prior revenue recognition guidance[2] continues to apply to certain onerous contracts with customers even after the adoption of ASC 606.

Contract Costs

ASC 340-40 was issued concurrently with ASC 606 and includes guidance on accounting for the incremental costs of obtaining and the costs incurred in fulfilling a contract with a customer within the scope of ASC 606. Certain contract costs are initially recognized as an asset (that is, deferred) and subsequently expensed on a systematic basis that is consistent with the pattern of transferring the good or service to which those costs relate to the customer.

PRESENTATION AND DISCLOSURES

Presentation

ASC 606 includes guidance on presenting contract assets, contract liabilities, and receivables in the balance sheet for contracts with customers. When either party to a contract has performed, an entity presents the contract in the balance sheet as either a contract asset or a contract liability depending on the relationship between the entity's performance and the customer's payment. An entity presents any unconditional rights to consideration separately as a receivable.

Disclosure Objective

ASC 606 includes an overall disclosure objective requiring an entity to disclose information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. This objective is accompanied by comprehensive and principles-based disclosure requirements about an entity's:

- Contracts with customers
- Significant judgments, and changes in the judgments, made in applying ASC 606 to those contracts
- Assets recognized for costs of obtaining and fulfilling those contracts.[3]

An entity must consider both:

- The level of detail necessary to satisfy the disclosure objective
- Emphasis to be placed on each disclosure requirement

The purpose of the disclosure objective is to make sure that:

- Information that users will find helpful is not obscured by a large amount of insignificant detail
- Items with sufficiently different characteristics are disaggregated and presented separately

---

[2] ASC 605-20, Revenue Recognition — Services; and ASC 605-35, Revenue Recognition — Construction-Type and Production-Type Contracts

[3] ASC 340-40 includes the disclosure requirements for assets recognized for costs of obtaining contracts with customers and fulfilling those contracts.

BDO INSIGHTS: SEC STAFF CONSULTATIONS ON ASC 606

Since the issuance of ASC 606, the SEC staff has consulted on multiple revenue recognition matters including identification of performance obligations, principal versus agent considerations, identification of a customer and accounting for consideration payable to a customer. The SEC staff will respect well-reasoned judgments grounded in facts and the relevant accounting principles.

ADDITIONAL TOPIC

Gains and Losses from the Derecognition of Nonfinancial Assets

ASC 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*, provides guidance on recognizing and presenting gains and losses on transfers of nonfinancial assets and in substance nonfinancial assets to counterparties that are not customers (noncustomers). Nonfinancial assets include, but are not limited to, intangible assets, land, buildings, and materials and supplies. An in substance nonfinancial asset is a financial asset promised to a counterparty in a contract if substantially all the fair value of the assets promised in that contract is concentrated in nonfinancial assets (for instance, a contract to sell a commercial real estate property and the related accounts receivable).

ASC 610-20 applies to all entities and includes guidance on transactions that fall within its scope. Transfers of nonfinancial assets and in substance nonfinancial assets to noncustomers that are specifically within the scope of other U.S. GAAP are excluded from the scope of ASC 610-20.

The determination of whether and when nonfinancial assets and in substance nonfinancial assets are derecognized is based on the principles of control in ASC 810, *Consolidation* and ASC 606. ASC 810 includes guidance on determining whether an entity has a controlling financial interest in another entity. ASC 606 includes the guidance on recognizing revenue from contracts with customers.

Even though ASC 610-20 applies to contracts with noncustomers, the revenue recognition principles in ASC 606, which apply to contracts with customers, are heavily leveraged for multiple key accounting concepts. Specifically, in accounting for a transaction within the scope of ASC 610-20, an entity considers the guidance in ASC 606 to determine whether a contract exists, identify the distinct nonfinancial and in substance nonfinancial assets, measure the transaction price, allocate the transaction price to the distinct assets and determine the point in time control of those assets transfers.

ASC 610-20 includes presentation and disclosure requirements for transactions within its scope.

ABOUT THE BLUEPRINT

This Blueprint reflects the key aspects of the following ASUs:

- ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*
- ASU 2015-14, *Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date*
- ASU 2016-08, *Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*
- ASU 2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing*
- ASU 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016, EITF Meeting (SEC Update)*
- ASU 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*
- ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers*
- ASU 2017-05, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20)*

- ASU 2017-13, *Revenue Recognition (Topic 605), Revenue From Contracts With Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017, EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments (SEC Update)*
- ASU 2017-14, *Income Statement — Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605) and Revenue From Contracts With Customers (Topic 606) (SEC Update)*
- ASU 2018-18, *Collaborative Arrangements (Topic 808): Clarifying the Interaction Between Topic 808 and Topic 606*
- *ASU 2019-08, Compensation — Stock Compensation (Topic 718) and Revenue From Contracts With Customers (Topic 606): Codification Improvements — Share-Based Consideration Payable to a Customer*
- ASU 2020-05, *Revenue From Contracts With Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*
- ASU 2021-02, *Franchisors — Revenue From Contracts With Customers (Subtopic 952-606): Practical Expedient*
- ASU 2025-04, *Compensation — Stock Compensation (Topic 718) and Revenue From Contracts With Customers (Topic 606): Clarifications to Share-Based Consideration Payable*

This Blueprint includes detailed guidance and diagrams on analyzing and accounting for contracts with customers under ASC 606. While it does not address all requirements of ASC 606, it summarizes key concepts that are commonly considered in applying ASC 606. It also includes practical examples and interpretive guidance to assist entities and practitioners in their continued application of ASC 606. The diagrams are provided to assist readers in understanding various aspects of ASC 606. Revenue recognition for contracts with customers varies based on the specific facts and circumstances of each contract and therefore may differ from the examples and insights herein.

The Blueprint is divided into chapters that address key aspects of the revenue recognition standard. The chapters are generally organized in the order in which an entity would apply ASC 606, and in the questions it would answer as it proceeds through the evaluation. For example, the first two chapters discuss whether a contract exists and is within the scope of ASC 606; if so, the reader moves to the next chapter, which addresses identification of the performance obligations in a contract with a customer. Other key ASC 606 concepts in applying the five-step revenue recognition model have been grouped into the chapter entitled “Other Topics” that includes principal versus agent considerations, contract modifications, customer options for additional goods and services, licensing, onerous contracts, and contract costs. The final chapter discusses the presentation and disclosure requirements in ASC 606.

The following diagram depicts the chapter organization.



Additionally, Appendix A includes a discussion on gains and losses from the derecognition of nonfinancial assets under ASC 610-20, which provides guidance on recognizing and presenting gains and losses on transfers of nonfinancial assets and in substance nonfinancial assets to counterparties that are not customers.

The Blueprint focuses on revenue recognition for contracts with customers under U.S. GAAP only. More information on revenue recognition for contracts with customers under IFRS is available **here**.

Use of the Terms "Public Entity" and "Nonpublic Entity"

ASC 606 includes modified requirements for an entity that does not meet the definition of a public business entity. This Blueprint uses the term "public entity" to refer to an entity that meets that definition and the term "nonpublic entity" to refer to an entity that does not meet that definition.



FASB REFERENCES

ASC 606-10-20: Public Business Entity

> *A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit [NFP] entity nor an employee benefit plan is a business entity.*
>
> > *a. It is required by the SEC to file or furnish financial statements or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).*
> >
> > *b. It is required by the Securities Exchange Act of 1934, as amended, or rules or regulations promulgated under that Act, to file or furnish financial statements with a regulatory agency other than the SEC.*
> >
> > *c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.*
> >
> > *d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.*
> >
> > *e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both conditions to meet this criterion.*
>
> *An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.*



CAREFULLY EVALUATE THE DEFINITION OF A PUBLIC BUSINESS ENTITY

The definition of the term "public business entity" is complex and encompasses more than just those entities whose stocks are listed on an exchange.

ACKNOWLEDGMENTS

This Blueprint, published by BDO's Professional Practice, is the culmination of efforts of many individuals, to whom we express our sincere appreciation.

- Bobbi Gwinn
- Iliyana Dale
- Lisa Edelman
- Jin Koo
- Laura Breech
- Meredith Taylor
- Smruthi M N

Chapter 1 — Scope



1.1 OVERVIEW: SCOPE

ASC 606 applies to all entities and all contracts with customers to transfer goods or services arising from their ordinary activities except for contracts and transactions that are explicitly accounted for under other guidance. The definitions of the terms "contract" and "customer" establish the scope of ACS 606. ASC 606 includes a practical expedient to apply the guidance to a portfolio of contracts (or performance obligations) rather than to an individual contract with a customer, if certain conditions are met.

ASC 606 includes guidance for a contract that is partially within the scope of ASC 606 and partially within the scope of other U.S. GAAP. Additionally, ASC 606 specifies the interaction with certain other U.S. GAAP such as ASC 340-40 and ASC 808.

1.2 SCOPE AND SCOPE EXCEPTIONS

FASB REFERENCES

ASC 606-10-15-2

The following contracts or transactions are excluded from the scope of ASC 606:

- Lease contracts within the scope of ASC 842, *Leases*[4]
- Contracts within the scope of ASC 944, *Insurance*
- Financial instruments and other contractual rights and obligations within the scope of ASC 320, *Investments — Debt Securities*; ASC 321, *Investments — Equity Securities*; ASC 323, *Investments — Equity Method and Joint Ventures*[5]; ASC 325, *Investments — Other*; ASC 405, *Liabilities*; ASC 460, *Guarantees* (except certain product warranties); ASC 470, *Debt*[6]; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*

[4] See our Blueprint, Accounting for Leases Under ASC 842, for guidance.
[5] See our Blueprint, Equity Method Investments Under ASC 323, for guidance.
[6] See our Blueprint, Issuer's Accounting for Complex Financial Instruments (Debt & Equity), for guidance.

- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

The scope exceptions in ASC 606 require that if specific guidance in other standards applies to a transaction, an entity applies that rather than ASC 606. For example, guarantees (other than product warranties) within the scope of ASC 460 are not within the scope of ASC 606 because ASC 460 provides specific guidance for recognizing and measuring a guarantee liability. In other words, ASC 606 is applied as the residual standard when a transaction is not within the scope of other U.S. GAAP.

BDO INSIGHTS: STREAMING ARRANGEMENTS IN THE MINING INDUSTRY

Streaming arrangements, whereby investors (or streamers) make advance payments to mining entities in return for part or all of the metal production from a specified mine (usually still under development) at predetermined prices, are common in the mining industry. The advance payments may consist of one or more fixed payments or multiple milestone payments. Mining entities generally use the advance payments to finance the development of the mines for which the streamers hold the mineral rights. Streaming arrangements allow mining entities to access funding by monetizing the metal to be produced from the mines and the streamers to receive the future production of metals without owning, developing, or operating the mines.

A question arises as to whether the advance payments received by a mining entity are accounted for as contract liabilities under ASC 606. We generally believe that if none of the scope exceptions (for example, sales of future revenues under ASC 470 and derivative accounting under ASC 815) apply and a mining entity must deliver an output of its ordinary activities to the streamer, the arrangement is within the scope of ASC 606, and the advance payments received from the streamer must be recognized as contract liabilities. Accounting for streaming arrangements requires the application of professional judgment based on the facts and circumstances.

For streaming arrangements within the scope of ASC 606, mining entities must also consider the guidance on significant financing components (Section 4.4).

1.2.1 Nonmonetary Exchanges Between Entities in the Same Line of Business

FASB REFERENCES

ASC 606-10-15-2(e)

In industries with homogeneous products, it is common for entities in the same line of business to exchange products to facilitate sales to customers or potential customers that may not be a party to that exchange. This may be done, for example, to reduce transport costs, meet immediate inventory needs, or otherwise facilitate a sale to the end customer.

ASC 606 includes an example of two oil companies agreeing to exchange oil (or inventory) to fulfill customer demand in different locations. Because the oil being exchanged is an output of each oil company's ordinary activities, the counterparty to the exchange meets the definition of a customer (see Section 1.3). Applying ASC 606 to the exchange would result in double revenue recognition for the same supplies of oil for each entity: once for the exchange of inventory between the two oil companies and again for the sale of the inventory to the end customer. To avoid such gross up of revenues and expenses, ASC 606 excludes nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

Such transactions may be within the scope of ASC 845, *Nonmonetary Transactions*. If so, the oil companies would apply the guidance in ASC 845 to account for the exchange of oil between them and ASC 606 to recognize revenue for the sale of oil to the end customer.

BDO INSIGHTS: LINE OF BUSINESS

ASC 606 does not include any further guidance on interpreting the term "line of business" when assessing exchange transactions; therefore, judgment may be needed. We believe the scope exception is quite strictly drawn.

For example, consider whether an entity involved in mining diamonds is in the same line of business as an entity mining rubies. Both operate in the same industry sub-sector (mining precious stones) but are in different lines of business (mining diamonds versus rubies). We believe that unlike in the oil example discussed above, the mining entities are not in the same line of business because rubies and diamonds are not acceptable substitutes for one another.

However, even if the transaction is within the scope of ASC 606, it is necessary to understand the commercial substance of an exchange transaction before concluding on the appropriate accounting treatment. For example, even if there is commercial substance to the exchange, each entity might be acting as an agent for the other in the ultimate sale to the other entity's end customer. This conclusion would affect the measurement of revenue, which would then be based on the provision of the agency services, not the gross value of the exchanged goods or services.

Concluding whether two entities are in the same line of business, whether an exchange between the entities has commercial substance, and whether an entity is acting as an agent for the other entity requires the application of professional judgment based on the facts and circumstances.

The TRG has clarified when certain transactions are subject to one of the scope exceptions during its deliberations:



TRG DISCUSSIONS: ARRANGEMENTS BETWEEN FINANCIAL INSTITUTIONS AND CREDIT CARDHOLDERS

At its July 2015 meeting, the TRG discussed whether specific arrangements between financial institutions and credit cardholders are within the scope of ASC 606. Although some income streams, such as interest charges on late payments, are not in scope, questions had been raised regarding periodic or annual fees that do not depend on the amount of credit available or the use of the credit card or ancillary services, such as access to airport lounges and reward programs.

The FASB staff concluded that entities should continue to account for services exchanged for credit card fees under ASC 310, *Receivables,* rather than ASC 606. Further, if the credit card arrangement is within the scope of ASC 310, the associated reward program would be as well. However, the FASB staff stated that ASC 310 would not apply if the issuance of a card is incidental to the arrangement.



TRG DISCUSSIONS: INCOME FROM SERVICING AND SUB-SERVICING ACTIVITIES

At its April 2016 meeting, the TRG discussed whether income from servicing and sub-servicing activities (for example, servicing mortgage loans) are within the scope of ASC 606. It said that while ASC 860 includes detailed guidance on the initial recognition and subsequent measurement of servicing assets and liabilities, it does not include explicit guidance describing the revenue recognition of servicing fees.

However, the FASB staff concluded that the subsequent measurement guidance in ASC 860 provides sufficient implicit guidance on accounting for servicing cash flows, so the accounting for servicing and sub-servicing revenues is within the scope of ASC 860 rather than ASC 606.

TRG DISCUSSIONS: DEPOSIT-RELATED FEES

At its April 2016 meeting, the TRG discussed whether deposit-related fees, such as monthly service fees, ATM usage fees, and foreign exchange fees, are within the scope of ASC 405, which governs the accounting for the related deposit liability. The FASB staff concluded that ASC 405 addresses only the accounting for the deposit liability and does not contain an accounting framework for recognizing revenue from deposit-related transactions. Therefore, deposit-related fees are within the scope of ASC 606.

TRG DISCUSSIONS: INCENTIVE-BASED CAPITAL ALLOCATIONS, SUCH AS CARRIED INTEREST

Also at the April 2016 meeting, the TRG discussed whether incentive-based performance fees through an allocation of capital (often referred to as a "carried interest") are within the scope of ASC 606. Some entities, particularly asset managers, receive incentive-based performance fees through an allocation of capital from investment funds under management as compensation for services and performance in managing the funds.

Multiple members of the TRG and the FASB and its staff concluded that those fees are within the scope of ASC 606 because they are compensation for services provided and hence form a revenue transaction.

However, some TRG members held an alternate view that a carried interest could be considered an equity arrangement outside the scope of ASC 606 because it is in form an ownership interest in an entity. Under that alternate view, an entity receiving a carried interest would apply the consolidation model in ASC 810, *Consolidation,* equity method of accounting in ASC 323, or other U.S. GAAP to determine the appropriate accounting treatment for the ownership interest held in another entity.

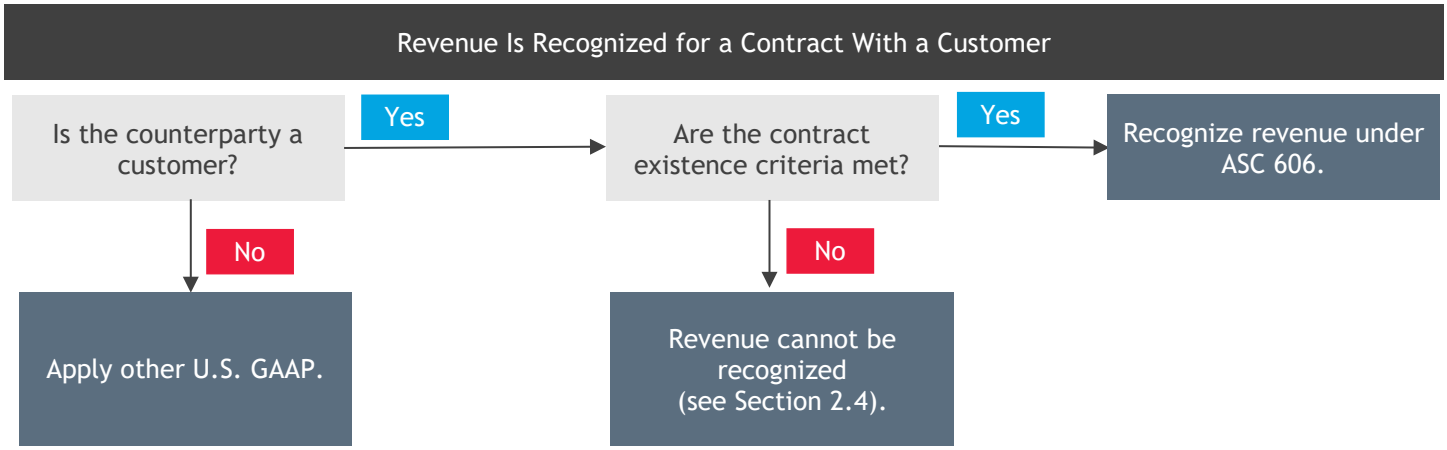
At the meeting, the SEC staff observer indicated that the SEC staff would accept treatment of carried interest as a revenue transaction within the scope of ASC 606. However, the SEC staff observer also stated that there could be a basis for applying an ownership model. If an entity were to apply an ownership model, the SEC staff would expect full application of the ownership model, including an analysis of the consolidation model under ASC 810, the equity method of accounting under ASC 323, or other relevant guidance. See our Blueprint, **Control and Consolidation Under ASC 810**, and **Equity Method Investments Under ASC 323**, for guidance on those standards.

BDO INSIGHTS: ACCOUNTING FOR CARRIED INTERESTS

We believe determining whether to account for a carried interest as a revenue transaction or an equity arrangement is an accounting policy election that must be consistently applied and fully disclosed. Accounting for carried interests requires the application of professional judgment based on the facts and circumstances.

1.2.2 Scope of ASC 606

The definitions of the terms "customer" and "contract" (see Sections 1.3 and 2.2, respectively) establish the scope of ASC 606, as illustrated in the following diagram:



1.3 DEFINITION OF A CUSTOMER

FASB REFERENCES

ASC 606-10-15-2A and 15-3

ASC 606-10-20: Customer

> *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.*

1.3.1 Ordinary Activities

ASC 606 does not define the term "ordinary activities," which was derived from the definitions of revenue in the FASB's conceptual framework. The definition of revenue in Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, refers to the notion of an entity's "*ongoing major or central operations*."

In December 2021, the FASB replaced that definition with a new definition in Statement of Financial Accounting Concepts No. 8, which removed the reference to the notion of an entity's "*ongoing major or central operations*." In making that change, the FASB concluded that delivering or producing goods and rendering services are primary factors in distinguishing revenue from gains, regardless of whether they are considered major or central to an entity's operations. Despite the change in the conceptual definition of revenue since the issuance of ASC 606, entities continue to consider the notion of ongoing major or central operations in defining the customer under that standard.

ASC 606 included the definition of a customer to enable entities to distinguish contracts for which revenue is recognized under ASC 606 (that is, contracts with customers) from contracts that are not within the standard's scope. Revenue from in-scope transactions is derived from contracts with customers an entity enters for the sale of goods or services arising from its ordinary activities.

Revenue from a transaction that does not arise from a contract with a customer is not within the scope of ASC 606. For example, receipts of dividends, sales of nonfinancial assets (such as excess properties), and nonexchange transactions (including receipts of government assistance or donations) are out of scope and are recognized in accordance with other U.S. GAAP.

BDO INSIGHTS: DETERMINING WHETHER INCOME IS FROM ORDINARY ACTIVITIES

Judgment may be required to determine whether an income-generating activity is an ordinary activity under ASC 606. For example, an entity that starts selling new products or services would need to determine whether and when the new offering becomes its ordinary activity or part of its ongoing major or central operations. Reaching a conclusion about whether an income generating activity is an ordinary activity requires the application of professional judgment based on the facts and circumstances.



FASB PROJECT: ACCOUNTING FOR GOVERNMENT GRANTS

U.S. GAAP does not include specific guidance on recognition and measurement of government grants received by for-profit entities. Entities can analogize to the guidance in IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*; ASC 450-30, *Gain Contingencies*; or ASC 958-605, *Not-for-Profit Entities — Revenue Recognition — Contributions*, on revenue recognition by NFP entities to determine the accounting for government grants received.

In November 2024, the FASB issued a Proposed Accounting Standards Update on the accounting for government grants received by business entities. The Proposed Accounting Standards Update would provide guidance on accounting for transfers of monetary and nonmonetary assets from a government to a business entity that leverages the accounting framework in IAS 20. As of the issuance date of this Blueprint, the proposed amendments had not been finalized, and they are not reflected in this publication.

ASC 610-20 includes guidance on recognition of gains or losses from derecognition of nonfinancial assets and in substance nonfinancial assets transferred to counterparties that are not customers, which typically results in a net presentation of the gain or loss outside revenue.[7] ASC 610-20 generally requires applying the revenue recognition principles in ASC 606 to contracts within the scope of ASC 610-20. See Appendix A for further discussion of ASC 610-20.

EXAMPLE 1-1: SALE TO A COUNTERPARTY THAT IS NOT A CUSTOMER

An entity generates revenue by manufacturing and selling containers. It enters a contract to transfer one of the machines from its manufacturing facility to a counterparty in exchange for $10,000.

The entity considers whether the sale of machinery is within the scope of ASC 606. It observes that it does not ordinarily generate revenue by selling machinery; rather, it uses the machinery (a fixed asset) in its facility to manufacture containers for sale. The entity concludes that the sale of machinery is not an output of its ordinary activities, so the counterparty in the contract for the sale of machinery is not a customer. Accordingly, ASC 606 does not apply to the transaction. In other words, the entity does not recognize or present the $10,000 it receives from the sale of the machinery as revenue.

The entity considers the guidance in ASC 610-20 on transfer of nonfinancial assets to determine the appropriate accounting and presentation of the sale of machinery.

[7] Based on a reference in ASC 610-20-45-1 to ASC 360-10-45-5 for presentation of a gain or loss recognized on the sale of a long-lived asset.

1.3.2 More Than One Customer in a Contract

A revenue transaction may have more than one customer such that an entity may be transferring goods or services that are an output of its ordinary activities to more than one party. For example, an entity that is acting as an agent may conclude that both the principal in the arrangement and the end customer are its customers for different aspects of the arrangement (see Section 7.2).

PRINCIPAL VERSUS AGENT ANALYSIS: IDENTIFICATION OF THE CUSTOMER(S)

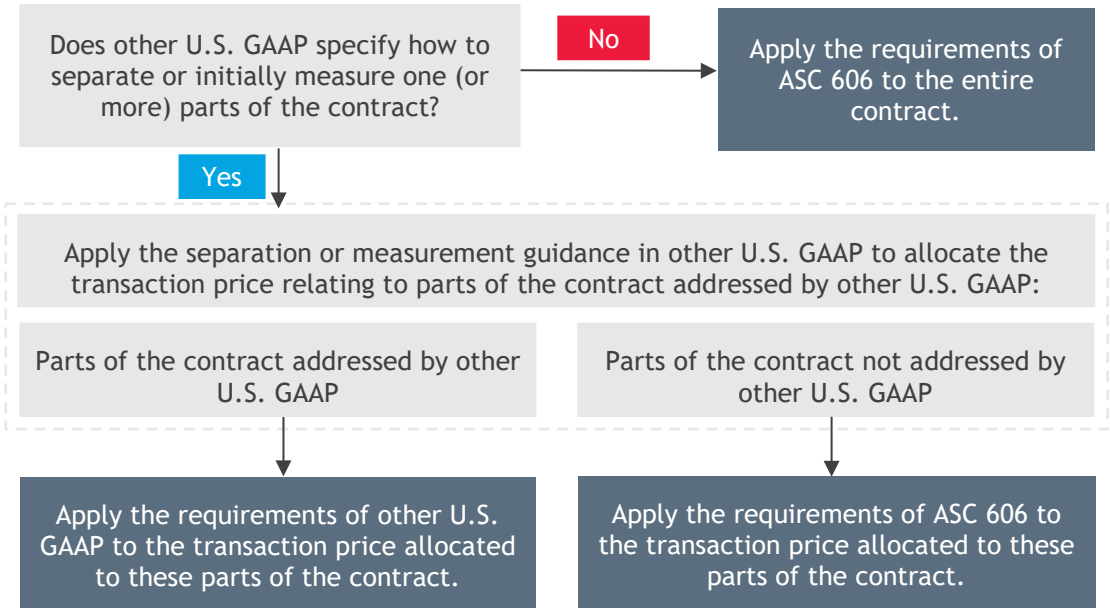
Careful analysis is required to identify an entity's customers in revenue transactions that include more than two parties. Correct identification of customers is important because it affects the identification of consideration payable to a customer which, under some conditions, is recognized as a reduction of revenue (see Section 4.6).

1.4 CONTRACTS PARTIALLY WITHIN THE SCOPE OF OTHER STANDARDS

FASB REFERENCES

ASC 606-10-15-4

An entity applies the approach summarized in the following diagram to account for a contract that is partially within the scope of ASC 606 and partially within the scope of other U.S. GAAP:



If any standards other than ASC 606 specify how to separate or measure the parts of a contract they address, an entity applies the separation and measurement guidance in those other standards to determine the portion of the transaction price that is excluded from ASC 606. If other standards do not address how to separate or measure the parts of the contract they address, the guidance in ASC 606 for separating and measuring parts of the contract (see Chapter 5) is used to determine how to allocate the transaction price between any elements subject to other standards and those subject to ASC 606.

EXAMPLE 1-2: CONTRACT PARTIALLY WITHIN THE SCOPE OF ASC 606 (ADAPTED FROM ASC 842-10-55-132 THROUGH 55-137): LEASE OF EQUIPMENT WITH MAINTENANCE SERVICE

An entity leases a bulldozer, a truck, and a crane to a customer for three years, which it agrees to maintain during the lease term. Assume that the leases meet the definition of a lease under ASC 842 and that the contract is therefore within the scope of ASC 842.

In accordance with ASC 842-10-15-31, the entity separates the lease and nonlease (maintenance services) components in the contract and applies the requirements in ASC 842 to the lease components. While nonlease components are not within its scope, ASC 842 includes guidance on allocating the consideration in a contract to

each separate lease and nonlease component. The entity applies ASC 606 only to the consideration received from the customer that is allocated to the maintenance services.[8]

BDO INSIGHTS: LITIGATION SETTLEMENT — PRESENTATION AS REVENUE OR LITIGATION GAIN

An entity may generate income by settling a litigation with a customer. Classifying the proceeds from a litigation settlement as revenue or gain in the income statement depends on the facts and circumstances. Consistent with a 2007 SEC staff speech[9], we believe that an entity must consider the various elements of the arrangement to determine the classification of the settlement amount as revenue or gain on litigation. Judgment may be required to identify and value the various elements and to allocate the settlement amount appropriately.

1.4.1 Contributions Received by Not-for-Profit Entities

FASB REFERENCES

ASC 606-10-20: Revenue and ASC 958-605-20: Contribution

ASC 606 requires an entity to consider the guidance in ASC 958-605 when determining whether a transaction is a contribution within the scope of ASC 958-605 or within the scope of ASC 606. ASC 606 does not specifically exclude contributions received from donors. However, in practice, those contributions are typically not in scope because ASC 606 defines revenue as "*inflows or other enhancement of assets of an entity or the settlement of its liabilities (or a combination of both) from delivering or producing goods, rendering services or other activities that constitute the entity's ongoing and major activities*." By contrast, ASC 958-605 defines a contribution as "*an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner*." In other words, revenue is derived from a reciprocal transfer in which the parties expect to exchange similar value, whereas a contribution is voluntary and nonreciprocal. Because of those differences in the nature of revenue and contributions, a contribution received by an NFP is outside the scope of ASC 606.

Even so, an NFP might engage in activities that are considered exchanges or revenue transactions with customers and thus are within the scope of ASC 606. An NFP must evaluate its contracts to determine if they include both

[8] See our Blueprint, Accounting for Leases Under ASC 842, for guidance on ASC 842, including a practical expedient that allows lessors to combine lease and nonlease components and account for the combined component under ASC 606 or ASC 842 based on whether the lease or nonlease component is predominant.

[9] Remarks before the *2007 AICPA National Conference on Current SEC and PCAOB Developments* by Eric C. West.

contributions and exchange transactions. A contribution component is outside the scope of ASC 606, so contracts that include both a contribution and an exchange transaction must be separated. For example, the following arrangements of an NFP may be partially or wholly within the scope of ASC 606:

- Memberships
- Sale of products and services
- Sponsorships
- Tuition
- Subscriptions
- Royalty agreements
- Conferences and seminars
- Advertising
- Licensing
- Federal and state grants and contracts

TRG DISCUSSIONS: CONTRACTS PARTIALLY WITHIN THE SCOPE OF ASC 606 — PAYMENT RECEIVED BY AN NFP

In some circumstances, a payment received by an NFP may represent both a contribution and a reciprocal transfer of goods or services. For example, a service organization may charge an annual membership fee that, in addition to providing funding to support the organization's programs, grants a member the right to receive a monthly or quarterly magazine.

At its March 2015 meeting, the TRG observed that because contributions represent nonreciprocal transfers, they do not represent the sale of goods or services and thus are not within the scope of ASC 606.

However, the FASB staff acknowledged that if an NFP transfers a good or service in a reciprocal transfer, that arrangement is accounted for under ASC 606. Therefore, the annual membership fee in this example represents a contract that is partially within the scope of ASC 606 and partially within the scope of ASC 958-605.

Also, because ASC 958-605-55 contains specific guidance for separating and initially measuring contribution and exchange portions of a payment, the NFP applies that guidance to allocate the payment received. Therefore, the NFP determines the fair value of the exchange portion of the transaction with the residual reported as contributions.

1.5 INTERACTION WITH OTHER STANDARDS

Consequential amendments were made to the existing requirements of other standards for the recognition of gain or loss on the transfer of some nonfinancial assets that are not an output of an entity's ordinary activities (such as property, plant, and equipment and intangible assets) to be consistent with the requirements in ASC 606. See Appendix A for a discussion of ASC 610-20.

ASC 606 also specifies the interaction with certain other standards, as discussed below.

1.5.1 Deferred Costs From Contracts With Customers

FASB REFERENCES

ASC 606-10-15-5

For contracts with customers that are within the scope of ASC 606, an entity applies ASC 340-40, which provides guidance on accounting for the costs incurred to obtain or fulfill a contract with a customer if those costs are not within the scope of other U.S. GAAP (see Section 7.7).

1.5.2 Collaborative Arrangements

FASB REFERENCES

ASC 606-10-15-3, ASC 808-10-15-5A through 15-5C

ASC 808-10-20: Collaborative arrangement

> *A contractual arrangement that involves a joint operating activity. These arrangements involve two (or more) parties that meet both of the following requirements:*
>
> *a. They are active participants in the activity.*
>
> *b. They are exposed to significant risks and rewards dependent on the commercial success of the activity.*

Transactions between collaborative arrangement participants are within the scope of ASC 606 when the collaborative arrangement participant is a customer in the context of a unit of account. In those situations, all ASC 606 guidance, including recognition, measurement, presentation, and disclosure requirements, is applied to those transactions.

ASC 808 includes guidance on unit of account (that is, whether an activity is a distinct good or service) that is aligned with the guidance in ASC 606. That guidance is used to determine whether the collaborative arrangement, or a part thereof, is within the scope of ASC 606.

An entity is precluded from presenting income from a collaborative arrangement in the same income statement caption as revenue recognized under ASC 606 unless:

- The collaborative arrangement participant is a customer.
- The transaction with a collaborative arrangement participant is directly related to sales to third parties.[10]

BDO INSIGHTS: DETERMINING WHETHER A RESEARCH AND DEVELOPMENT ARRANGEMENT IS WITHIN THE SCOPE OF ASC 606

For life sciences entities, research and development (R&D) arrangements are often complex, involve multiple deliverables and various types of consideration, and span several years. Determining whether a counterparty to an arrangement is a customer (as defined in ASC 606) is important when evaluating whether payments can be accounted for as revenue from a contract with a customer. In answering that question, an entity determines whether the payment relates to goods or services that are an output of its ordinary activities. If the entity's ordinary activities are performing R&D, it is likely the relationship between the entity and counterparty is an entity-customer relationship, and the consideration would be recognized as revenue under ASC 606. Reaching a conclusion about whether an R&D arrangement is within the scope of ASC 606 requires the application of professional judgment based on the facts and circumstances.

[10] ASC 808-10-55-11 through 55-14 includes a related example.

COLLABORATIVE ARRANGEMENT

A collaborative arrangement within the scope of ASC 808 is also within the scope of ASC 606 if the counterparty is a customer as defined in ASC 606. In that scenario, an entity applies the guidance in both ASC 606 and ASC 808 to the transaction. Specifically, an entity would apply the following guidance:

- Recognition, measurement, presentation, and disclosure requirements in ASC 606
- Disclosure requirements in ASC 808

1.6 PORTFOLIO APPROACH

FASB REFERENCES

ASC 606-10-10-4

ASC 606 specifies the accounting for an individual contract with a customer. Entities often have many similar contracts for which applying the standard on a contract-by-contract basis might be impractical. As a practical expedient, an entity may apply the guidance in ASC 606 to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying the guidance to the portfolio would not differ materially from applying the guidance to the individual contracts (or performance obligations) within that portfolio. See Chapter 3 for discussion of performance obligations.

When accounting for a portfolio of contracts with customers, an entity uses estimates and assumptions that reflect the size and composition of the portfolio. Entities often apply the portfolio approach when many contracts are affected by a particular issue (for example, when an estimate is more appropriately made for the population of contracts rather than for each contract individually). For example, for retail sales that give the customer a right of return, it may be more appropriate to estimate the aggregate returns for a group of similar retail sale transactions, rather than at the contract level (that is, rather than for each retail sale for which a right of return is granted).

1.6.1 Evaluation of Whether Portfolio Approach Results in a Materially Different Outcome

FASB REFERENCES

ASC 606-10-55

ASC 606 does not provide specific guidance on whether or when the application of the portfolio approach is appropriate or how to determine whether the effects of applying the portfolio approach would differ materially from applying ASC 606 contract by contract.

However, ASC 606 illustrates the portfolio approach in an example related to a right of return (see Section 4.3.8 for discussion of a sale with a right to return). That example includes a fact pattern in which an entity applies the portfolio approach to 100 contracts, each of which includes the sale of one product under the same terms. Further, paragraph 293 in the Background Information and Basis for Conclusions (BC) of ASU 2014-09 states that in some circumstances, using the portfolio approach could simplify the application of the guidance on allocation of transaction price (in Step 4) for a group of similar contracts. However, BC69 of ASU 2014-09 states that the FASB did not intend for an entity to quantitatively evaluate each outcome. Instead, an entity can use a reasonable approach to determine the portfolios that would be appropriate for its types of contracts.

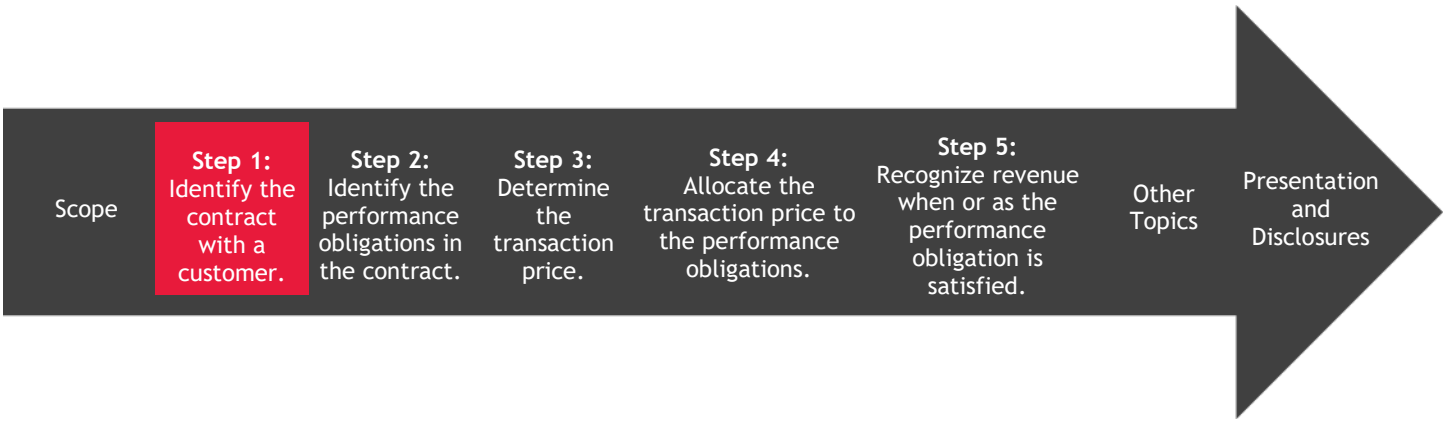
BDO INSIGHTS: PORTFOLIO APPROACH

While the portfolio approach is a more practical and cost-effective way to apply the standard, entities need appropriate processes and controls in place to do so. Entities also need to use judgment in:

- Selecting the size and composition of the portfolio and determining whether the contracts within a portfolio have similar characteristics. Contract characteristics to consider include:
  - Type of customer
  - Goods or services (or performance obligations) transferred
  - Pricing
  - Any other pertinent terms
- Evaluating qualitatively the effects on the financial statements of applying ASC 606 on a portfolio basis rather than contract by contract.
- Reassessing the appropriateness of the level of portfolio or use of portfolio approach for subsequent changes in the characteristics of contracts.

Reaching a conclusion about when and how to appropriately use the portfolio approach requires the application of professional judgment based on the facts and circumstances.

Chapter 2 — Step 1: Identify the Contract With a Customer



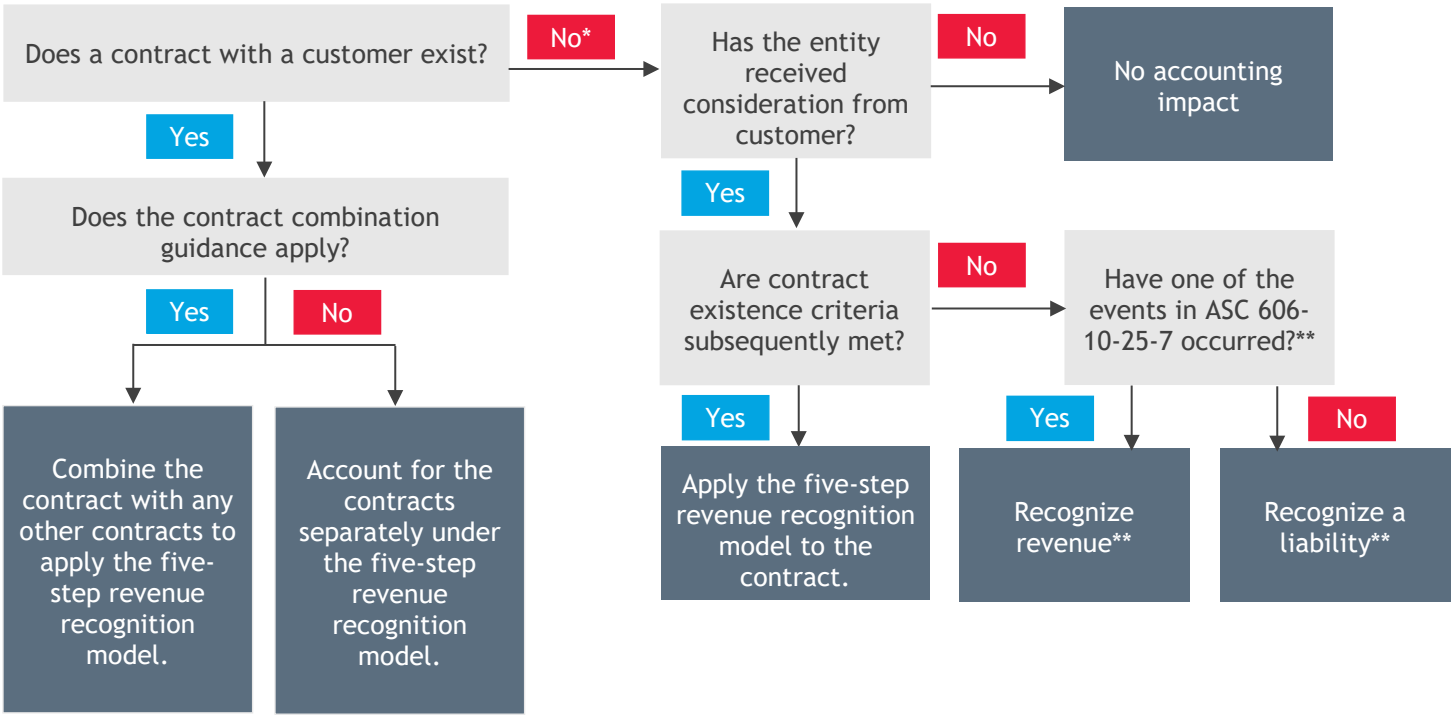
2.1 OVERVIEW — STEP 1: IDENTIFY THE CONTRACT WITH A CUSTOMER

Once an entity determines that it is transferring goods or services arising from its ordinary activities to a customer in a transaction within the scope of ASC 606, the first step in applying the five-step revenue recognition model is to identify the contracts with a customer. A contract is an agreement between two or more parties that creates enforceable rights and obligations.

The term of the contract in which the parties to the contract have enforceable rights and obligations may be affected by termination clauses such as a customer's right to terminate a contract or penalty payable upon termination.

ASC 606 includes five contract existence criteria, each of which must be met for a contract with a customer to exist. If the contract existence criteria are met, revenue from the contract is accounted for under the five-step revenue recognition model in ASC 606. If any one of the contract existence criteria is not met, ASC 606 includes guidance on reassessing whether the contract existence criteria are subsequently met and accounting for consideration received from a customer before the contract existence criteria are met. Additionally, ASC 606 includes guidance on subsequently reassessing contract existence criteria after the contract existence criteria are initially met. ASC 606 also includes contract combination guidance to determine when an entity must combine two or more contracts and account for them as a single contract.

The following diagram provides an overview of Step 1:



* Continuously reassess the arrangement to determine whether the contract existence criteria are subsequently met.

** See Section 2.4.2 for discussion on consideration received from customer before the contract existence criteria are met.

2.2 DEFINITION OF A CONTRACT

FASB REFERENCES

ASC 606-10-20: Contract

An agreement between two or more parties that creates enforceable rights and obligations.

2.2.1 Enforceable Rights and Obligations

FASB REFERENCES

ASC 606-10-25-2

An agreement does not need to be written to create legally enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Determining whether a contractual right or obligation is enforceable is considered within the context of the relevant legal (or equivalent) framework to make sure that the parties' rights and obligations are upheld. A contract with a customer for accounting under ASC 606 need not be the same as a contract for legal purposes.

The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. Further, business practices may vary within an entity; for example, depending on the class of customer or the nature of the goods or services. Written, oral, or implied contracts with customers could create enforceable rights and obligations depending on legal jurisdictions, industries, or customary business practices. An entity must consider those factors in determining whether and when an agreement with a customer creates enforceable rights and obligations.

In many cases, the contract that is accounted for separately under ASC 606 is the individual contract negotiated with the customer. However, the structure and scope of a contract can vary depending on how the parties record their agreement. For instance, there may be legal or commercial reasons for the parties to use more than one contract to document the sale of related goods or services or to use a single contract to document the sale of unrelated goods or services. See Section 2.6 for a discussion on when to combine contracts.

Although there must be legally enforceable rights and obligations between parties for a contract to exist under ASC 606, a promise within the contract does not necessarily have to be legally enforceable to be a performance obligation. A promise within the contract could arise from the customer having a valid expectation that the entity will transfer goods or services to the customer even though that promise is not enforceable. See Chapter 3 for discussion on identifying promises and performance obligations in a contract.

BDO INSIGHTS: FREE TRIAL PERIODS

An entity may offer certain services such as software-as-a-service, or SaaS, for free for a limited period during which a customer can try the services and decide whether to purchase them for a longer term. During the trial period, the customer can opt out of the free trial at any time or decide to accept the offer and purchase the services for a longer term.

Accounting for the services provided during the free trial period depends on whether and when the customer accepts the entity's offer and purchases the services for a longer term. A contract with a customer does not exist until the customer accepts the entity's offer to provide services after the free trial period in exchange for consideration.

- If the customer contracts for the services for a longer term during the trial period, then the services provided during the remainder of the free trial period and the term beginning after the end of the free trial period are considered in determining the performance obligations in that contract. The services provided in the free trial period before the customer accepts the offer are accounted for as sales incentives.
- If the customer does not contract for the services for a longer term, then the services provided during the free trial period are accounted for as sales incentives.

2.2.2 Contract Existence Criteria



FASB REFERENCES

ASC 606-10-25-1 and ASC 606-10-32-21

To determine whether enforceable rights and obligations exist in an arrangement with a customer, an entity evaluates the five contract existence criteria shown below. Contract inception is the date on which all five contract existence criteria are met. ASC 606 is applied to contracts with customers only when all five criteria are met.

Contract Existence Criteria				
The contract has been approved and the parties are committed to performing their obligations.	Each party's rights regarding the goods or services to be transferred can be identified.	The payment terms for the goods or services to be transferred can be identified.	The contract has commercial substance.	Collectibility of substantially all the consideration is considered probable.

BC33 of ASU 2014-09 states that in establishing the contract existence criteria to complement the definition of a contract, the FASB reasoned that when any of those criteria are not met, it is questionable whether the contract establishes enforceable rights and obligations between an entity and its customer.

In some instances, multiple legal agreements may need to be considered in combination in order to meet the definition of a contract, as illustrated in the following example:

EXAMPLE 2-1: MASTER SUPPLY AGREEMENT

An entity enters a master supply agreement (MSA) with a customer to supply a product according to the MSA's terms and conditions (for example, duration of the MSA, pricing information, payment terms, return rights). The MSA states that the customer will place a purchase order (PO) for the quantity of products needed throughout the term of the MSA, and that each PO will be subject to the MSA's terms and conditions. The MSA itself does not obligate the entity to transfer a specific number of products to the customer or the customer to purchase and pay for a specific number of products. One month after the execution of the MSA, the customer submits a PO specifying the number of products it wants to purchase.

The MSA and PO collectively create enforceable rights and obligations for the entity to transfer the products under the PO to the customer and the customer to purchase those products and pay according to the pricing information and payment terms in the MSA. Therefore, assuming the customer has the intent and ability to pay amounts due under the PO, the MSA and PO together meet the definition of a contract.

2.2.2.1 The Contract Has Been Approved and the Parties Are Committed to Performing Their Obligations



FASB REFERENCES

ASC 606-10-25-1(a)

For a contract to be enforceable, the parties to the contract must approve the contract and commit to performing their respective obligations thereunder. An entity considers all relevant facts and circumstances in assessing whether the parties intend to be bound by the contract's terms and conditions. The form of the contract does not, in and of itself, determine whether the parties have approved the contract. Depending on customary business practices, in some cases the parties to an oral or implied contract may have agreed to fulfill their respective obligations, while in other cases, a written contract may be required to determine whether the parties have approved the contract.

BDO INSIGHTS: WHETHER THE PARTIES ARE COMMITTED TO PERFORMING THEIR OBLIGATIONS

Determining whether an entity and its customer are committed to fulfilling their respective obligations may require judgment. For example, BC36 of ASU 2014-09 describes a contract requiring the customer to purchase a minimum quantity of goods from the entity each month, but the customer's past practice indicates that it is not committed to always doing so, and the entity does not enforce the requirement.

In the example, the first contract existence criterion — whether the contract has been approved and the parties are committed to performing their obligations — could still be satisfied if there is evidence demonstrating that the customer and entity are substantially committed to the contract. The FASB has said that for some contracts to which the parties are substantially committed, requiring all rights and obligations to be fulfilled would inappropriately result in no recognition of revenue.

Reaching a conclusion about whether the parties are committed to perform their obligations requires the application of professional judgment based on the facts and circumstances.

2.2.2.2 Each Party's Rights Regarding the Goods or Services Transferred Can Be Identified

FASB REFERENCES

ASC 606-10-25-1(b)

For a contract to be enforceable, an entity must be able to identify each party's rights regarding the goods or services transferred. This criterion was included because an entity would not be able to assess the transfer of goods or services for revenue recognition under the five-step revenue recognition model if it could not identify each party's rights regarding those goods or services in Step 2.

EXAMPLE 2-2: MSA WITH MINIMUM VOLUME GUARANTEE

An entity enters an MSA with a customer to supply a product according to the MSA's terms and conditions (for example, duration of the MSA, pricing information, payment terms, return rights). The MSA provides that the customer will place POs for the quantity of products needed throughout the term of the MSA, and that each PO will be subject to the MSA's terms and conditions. The MSA includes a minimum volume guarantee under which the entity guarantees the supply of the product, and the customer agrees to purchase a minimum volume of the product during the contract term. If the customer fails to purchase the minimum volume required, the entity has the right to charge a penalty equal to the price of the shortfall.

The MSA itself obligates the entity to transfer a specific number of products to the customer and the customer to purchase and pay for a specific number of products. Therefore, the MSA itself may create enforceable rights and obligations for the entity to transfer the minimum volume of the product to the customer and the customer to purchase the minimum volume of the product and pay for it according to the MSA's pricing information and payment terms.

Example 2-3 discusses the effects of an entity's past practice in determining whether a contractually specified minimum volume is substantive.

EXAMPLE 2-3: MSA WITH MINIMUM VOLUME GUARANTEE THAT HAS NOT BEEN ENFORCED IN THE PAST

Assume the same facts in Example 2-2 except that the entity's past practice indicates that if the customer does not purchase the specified minimum volume in the MSA, the entity may not enforce a purchase.

Even though the MSA includes a minimum volume guarantee, the past practice of not enforcing it may indicate that the entity and the customer are not committed to that minimum volume. In other words, the minimum guarantee may not be substantive in this fact pattern. As a result, the MSA might not create enforceable rights and obligations on its own, but when an MSA is combined with a PO the two would collectively create enforceable rights and obligations for the parties to the contract. Determining whether the minimum volume guarantee is no longer enforceable because of a lack of historical enforcement may require consultation with legal advisors.

2.2.2.3 The Payment Terms for the Goods or Services Transferred Can Be Identified



FASB REFERENCES

ASC 606-10-25-1(c)

For a contract to be enforceable, an entity must be able to identify the payment terms for the goods or services transferred. This criterion was included because an entity would not be able to determine the transaction price in Step 3 of the five-step revenue recognition model if it could not identify the payment terms in exchange for the promised goods or services.

In some industries, such as construction, it is common for parties to agree to unpriced change orders that specify the scope of work but not the consideration for that work. The amount of consideration may not be determined for some time. In BC39 of ASU 2014-09, the FASB clarified that it did not intend to preclude revenue recognition for unpriced change orders if the scope of the work has been approved and the entity expects that the price will be approved. In those cases, an entity considers the guidance on contract modifications (see Section 7.3) to determine the appropriate accounting for such change orders. Under the contract modification guidance, if enforceable rights and obligations are created by the parties' approval to the change in scope but not price, the change in price is considered variable consideration (see Section 4.3).

2.2.2.4 The Contract Has Commercial Substance



FASB REFERENCES

ASC 606-10-25-1(d)

For a contract to be enforceable, it must have commercial substance, meaning the risk, timing, or amount of the entity's future cash flows is expected to change because of the contract. This criterion was included because without commercial substance, it is questionable whether an entity has entered a transaction that has economic consequences. Commercial substance is based on the guidance for nonmonetary exchange transactions in ASC 845.

This criterion was developed when the FASB was considering whether an entity should recognize revenue from contracts with customers that include nonmonetary exchanges. To prevent scenarios in which entities might transfer goods or services back and forth between each other (often for little or no cash consideration) to artificially inflate their revenues, the FASB precluded an entity from recognizing revenue from a nonmonetary exchange if the exchange has no commercial substance. That decision was extended to all contracts (not only nonmonetary exchanges) to prevent an entity from recognizing revenue for transactions that do not have commercial substance or economic

consequences for the entity. This criterion prevents an entity from recognizing revenue for a contract with customer that serves no substantive business purpose for the entity.

2.2.2.5 Collectibility

FASB REFERENCES

ASC 606-10-25-1(e) and ASC 606-10-55-3A

For a contract to be enforceable, it must be probable that the entity will collect substantially all the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. The terms "probable" and "substantially all" are key thresholds in evaluating this criterion (see the diagram below). The consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity intends to provide a price concession to the customer (see Section 4.3).

The objective of this assessment is to determine whether the contract is valid and represents a substantive transaction between the entity and customer, which is a necessary condition for the contract to be accounted for under the revenue recognition model in ASC 606.

The following diagram illustrates the key concepts inherent in assessing the collectibility criterion:

Collectibility Criterion

Probable

ASC 606 defines probable as "*the future event or events are likely to occur,*" which is consistent with other U.S. GAAP.

Substantially All

ASC 606 does not define substantially all. The term is generally understood as approximately 90% in other U.S. GAAP (for example, ASC 842). However, ASC 606 does not specify a bright line percentage, and significant judgment may be required to determine an appropriate threshold.

Goods or Services That Will Be Transferred to the Customer

An entity assesses the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectibility of the consideration promised in the contract for all the promised goods or services. In other words, the collectibility assessment is based on a portion of the consideration promised in the contract: that to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer.

Price Concession

The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the entity intends to offer the customer a price concession.

In assessing the collectibility criterion, the focus is often on the price included in the contract between an entity and its customer. However, it is possible that the amount of consideration to which the entity ultimately expects to be entitled will be less because the entity expects to offer a price concession (or discount) to the customer, regardless of whether the entity has communicated that to the customer. In that case, the assessment of the customer's ability and intention to pay is made based on the lower amount. See Section 4.3 for discussion of variable consideration, including implicit price concessions.

BC12 of ASU 2016-12 states that if it is not probable that the customer will fulfill its obligations under the contract (that is, make payments as due), it will be questionable whether the contract is valid and the revenue-generating transaction is substantive, regardless of whether a legal contract exists. However, BC44 of ASU 2014-09 clarifies that

the FASB did not expect many arrangements to fail to meet the collectibility criterion because entities generally enter contracts only after concluding it is probable that they will be fairly compensated for their performance. In other words, in most instances, an entity would not enter a contract with a customer that posed a significant credit risk without also having adequate economic protection to collect the consideration.

2.2.2.5.1 Evaluating Whether Collectibility Is Probable

FASB REFERENCES

ASC 606-10-55-3A through 55-3C and ASC 606-10-55-99 through 55-105

In evaluating whether collectibility is probable, an entity evaluates the customer's financial ability and intention to pay consideration when due. The collectibility assessment is partly forward looking. It requires an entity to use judgment and consider all facts and circumstances, including the entity's customary business practices and its knowledge of the customer.

Also, as part of the collectibility assessment, an entity considers its exposure to credit risk and its ability to mitigate that risk. In assessing collectibility, an entity determines whether the contractual terms and its customary business practices indicate that its exposure to credit risk is less than the consideration promised in the contract because it can mitigate its credit risk. Examples of contractual terms or customary business practices that might mitigate the entity's credit risk include:

- **Advance payments:** An entity can mitigate all or a portion of its credit risk by requiring the customer to pay all or a portion of the consideration promised in the contract before the entity transfers the promised goods or services. The advance payments collected from the customer would not be subject to credit risk.
- **Ability to stop transferring goods or services to customers in default:** An entity can limit its exposure to credit risk if it has the right to stop transferring additional goods or services if a customer fails to pay consideration when due. If the customer fails to perform as promised (that is, pay consideration when due) and the entity consequently stops transferring additional goods or services, the entity will not consider the likelihood of payment for the promised goods or services that will not be transferred under the contract.
  - For example, an entity may have the ability and intent (evidenced by its customary business practice) to discontinue transfer of services in the third month of a 12-month contract if the customer does not pay as promised for any of the first three months of services. The entity evaluates whether the customer has the intent and ability to pay substantially all the consideration for the first three months of services only because the entity can manage its credit risk for the subsequent nine months by discontinuing the transfer of additional services to the customer if the customer defaults on payment for the first three months of services.

An entity's ability to repossess an asset transferred to a customer is not considered when assessing the entity's ability to mitigate its exposure to credit risk because the ability to repossess an asset does not mitigate an entity's exposure to its customer's credit risk for the consideration promised in the contract. However, an entity's ability to repossess an asset transferred to a customer might affect its assessment of when or whether control of the asset transfers to the customer in some arrangements. See Section 6.6 for discussion on repurchase rights.

2.2.2.5.2 Substantially All

The substantially all threshold in the collectibility criterion clarifies that a contract may represent a substantive transaction even if it is not probable the entity will collect 100% of the consideration to which it expects to be entitled. ASC 606 does not quantify the substantially all threshold with a bright line percentage, but the threshold is generally understood as approximately 90% in other U.S. GAAP (for example, ASC 842).

BDO INSIGHTS: SUBSTANTIALLY ALL THRESHOLD

We believe that because ASC 606 does not specify a bright line percentage, interpreting the term "substantially all" requires the application of professional judgment based on the facts and circumstances. We also believe the term must be interpreted consistently in each place it is used in U.S. GAAP.

2.2.2.5.3 Goods or Services That Will Be Transferred to the Customer

FASB REFERENCES

ASC 606-10-55-3C

The phrase "goods or services that will be transferred to the customer" is used only to evaluate the probability of whether an entity will collect substantially all the consideration to which it will be entitled as part of identifying the contract with the customer in Step 1. An entity considers whether a valid contract with a customer exists for purposes of applying the revenue recognition model in ASC 606 by considering the entity's exposure to nonpayment for goods or services that the entity's rights, obligations, and business practices suggest that the entity will transfer to the customer.

An entity cannot apply the notion of goods or services that will be transferred to the customer to other aspects of ASC 606, such as identifying the performance obligations, determining the transaction price, allocating the transaction price to performance obligations, or recognizing revenue. In other words, once a contract is determined to exist under ASC 606, the rest of the guidance in ASC 606 is applied to it.

BDO INSIGHTS: COLLECTIBILITY ASSESSMENT IN STEP 1

Under ASC 606, collectibility is assessed when determining whether a contract exists (Step 1) rather than when determining how much revenue to recognize. The collectibility assessment acts as a gating question to determine whether the five-step revenue recognition model can be applied to a contract. Thus, it precludes revenue recognition when collectibility is not probable; it does not affect the measurement of revenue recognized. The collectibility assessment requires the application of professional judgement based on the facts and circumstances.

EXAMPLE 2-4 (ADAPTED FROM ASC 606-10-55-99 THROUGH 55-101): IMPLICIT PRICE CONCESSION — CONSIDERATION IS NOT THE STATED FIXED PRICE

An entity sells a product to a customer in return for a contractually agreed amount of $1 million. This is the entity's first sale to a customer in a new geographic region. The region is experiencing significant economic difficulty, so the entity does not expect to collect the full contract price. However, even though it might not collect the full amount, the entity believes the region's economic conditions will improve and that establishing a trading relationship with this customer could help it open a new market with other potential customers in the region.

Based on the evaluation of economic difficulties in the region and the entity's desire to continue the contract with the customer to generate future revenue growth in that region, the entity determines that it will likely provide a price concession to the customer and accept an amount lower than $1 million. Accordingly, the entity concludes that the contract price is not fixed at $1 million; instead, the consideration in the contract is variable. The entity estimates the variable consideration to which it expects to be entitled is $400,000 (see Section 4.3).

The entity assesses the customer's intention and ability to pay $400,000 and concludes that despite the poor economic conditions, it is probable that it will collect $400,000 from the customer. Therefore, the collectibility criterion is met.

If the other four contract existence criteria are met, the entity concludes that it has entered a contract with the customer for the sale of the product in return for a variable consideration of $400,000, which will be accounted for under the five-step revenue recognition model in ASC 606.

EXAMPLE 2-5 (ADAPTED FROM ASC 606-10-55-102 THROUGH 55-105): IMPLICIT PRICE CONCESSION AND REASSESSMENT OF CONTRACT EXISTENCE CRITERIA — MEDICAL SERVICES TO UNINSURED PATIENT

A hospital provides emergency medical services to an uninsured patient it has not previously provided services to. Local law requires the hospital to provide medical services to all emergency room patients. Given the medical condition of the patient upon arrival, the hospital provided medical services immediately before determining whether the patient is committed to performing their obligations under the contract in exchange for the medical services provided (that is, pay the medical bill). Therefore, the contract existence criteria are not met, and the hospital will continue to assess its conclusion based on updated facts and circumstances (see Section 2.5).

After providing services, to assess the patient's ability and intention to pay for the services provided, the hospital reviews the information available about the patient and the services. It determines that:

- Its standard rate for the services provided in the emergency room is $10,000.
- According to its internal policies and the patient's income level, the services provided are not charity care.
- The patient does not qualify for government subsidies.

Before reassessing whether the contract existence criteria have been met, the hospital considers that although the standard rate for its services is $10,000 (the amount invoiced to the patient), it is willing to accept a lower amount. Accordingly, it concludes that the transaction price is lower than $10,000 and that the consideration is therefore variable. Upon reviewing its historical cash collections from this customer class and other relevant information about the patient, the hospital estimates the variable consideration and determines that it expects to be entitled to $1,000 (see Section 4.3).

In reassessing whether the collectibility criterion has been met, the hospital assesses the patient's ability and intention to pay $1,000. Based on its collection history from patients in this customer class, the hospital concludes that it will likely collect $1,000 (the estimated variable consideration). Therefore, the collectibility criterion is met.

If the other four contract existence criteria are met, the hospital concludes that it has entered a contract with the patient for the provision of emergency room services in return for a variable consideration of $1,000, which will be accounted for under the five-step revenue recognition model.

BDO INSIGHTS: IMPLICIT PRICE CONCESSION — VARIABLE CONSIDERATION VERSUS BAD DEBT EXPENSE

Determining whether an entity will give an implicit price concession to the customer by accepting a price lower than the contract price is a matter of significant professional judgment based on the facts and circumstances. Conceptually, an entity's decision to accept a lower price represents a concession, whereas a customer's default because of the customer's lack of ability and intent to pay reflects credit risk. Concessions are presented as a reduction of revenue, whereas expectations about amounts to be collected (or defaults) due to credit risk are relevant in determining the impairment of receivables under ASC 326, *Financial Instruments — Credit Losses*, and thus the measurement of bad debt expense.

An entity may have experience indicating that it will not collect all consideration from some customers in a portfolio of contracts. However, each contract in the portfolio might individually meet the collectibility criterion in Step 1 because the entity believes it is probable that the customers will pay substantially all the amounts owed based on credit checks and other procedures performed by the entity. For example, an entity may have a large volume of homogenous revenue-generating customer contracts for which historical evidence indicates that a small portion of the amounts billed will become uncollectible. However, in applying the collectibility assessment criterion at the individual contract level, the entity may determine that it is probable that each of the customers will pay substantially all the amounts owed under the relevant contracts. Questions about how an entity applies Step 1 to contracts in which the entity has historical experience that it will not collect consideration from some customers in a portfolio of contracts led the TRG to discuss the topic at its January 2015 meeting. The TRG concluded that revenue is recognized at the amount billed in this scenario, as illustrated in Example 2-6.

EXAMPLE 2-6: ASSESSING COLLECTIBILITY FOR A PORTFOLIO OF CONTRACTS

An entity has a large volume of homogenous revenue-generating customer contracts for which invoices are sent monthly in arrears. Before accepting a customer, the entity performs checks to ensure that it is probable the customer will pay the amounts owed. If, based on the results of those procedures, the entity concludes it is not probable the customer will pay the amounts owed, the entity will not accept that customer. Because the procedures are designed only to determine whether collection is probable (not certain), the entity anticipates that not all customers will pay their amounts owed. While the entity collects the entire amount due from most of its customers, on average, historical evidence (which is representative of its expectations for the future) indicates that the entity will collect only 97% of the amounts billed.

The entity bills $100 to its customers in a particular month, and there are no other issues that would preclude recognition of revenue for that amount in the month billed. The performance obligation related to the billing is satisfied as of the billing date.

The TRG considered whether the entity recognizes (a) revenue of $100 and a bad debt of $3 or (b) revenue of $97 because the historical evidence indicates that it will collect only 97% of the amount billed. It concluded that the entity recognizes $100 as revenue because each contract within the portfolio meets the collectibility criterion that collection of substantially all the consideration due under the contract is probable. The entity applies the subsequent steps in the five-step revenue recognition model to the entire contract rather than to the portion of the contract expected to be collected on a portfolio basis (97%). The fact that only 97% of the amounts invoiced are expected to be collected is relevant in determining the impairment of receivables under ASC 326.

2.3 CONTRACT ENFORCEABILITY AND TERMINATION CLAUSES



FASB REFERENCES

ASC 606-10-25-3

Sometimes a contract's term or duration may be readily determinable, but in other instances, determining the contract term may require judgment. For example, some contracts with customers could have a fixed duration but grant the customer renewal or termination rights, with or without an associated penalty payment. Some contracts might not have a fixed duration and can be terminated or modified by either party at any time, while others might automatically renew periodically. An entity applies ASC 606 to the terms of the contract under which the parties have enforceable rights and obligations.

2.3.1 Wholly Unperformed Contract

FASB REFERENCES

ASC 606-10-25-4

If the parties to the contract have the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party, a contract does not exist under ASC 606. A contract is wholly unperformed if **both** the following criteria are met:

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

ASC 606 does not explicitly explain how termination penalties are considered in determining the contractual period in which the parties have present enforceable rights and obligations. At its January 2015 meeting, the TRG discussed how termination provisions affect the duration of a contract (see Section 2.3.2).

2.3.2 Effect of a Termination Penalty on Contract Term

FASB REFERENCES

ASC 606-10-25-3

A contract exists if each party has the unilateral enforceable right to terminate the contract only by paying a substantive termination penalty to the other party. A contract continues to exist during the specified contractual period regardless of each party's unilateral and enforceable right to terminate at any time during the specified contractual period. In this scenario, enforceable rights and obligations exist throughout the contractual period, which is evidenced by the fact that compensation (a termination penalty) would be required to terminate the contract. In other words, on termination, the parties to the contract waive their enforceable rights and avoid their obligations by paying a termination penalty.

BDO INSIGHTS: EFFECT OF TERMINATION PROVISIONS ON ENFORCEABLE RIGHTS AND OBLIGATIONS

The revenue recognition model is applied to the period for which enforceable rights and obligations exist between an entity and its customer. An entity must evaluate substantive termination provisions (termination rights, termination penalties, or other payments) in a contract with a customer as well as customary business practices to determine whether the duration for which enforceable rights and obligations exist is shorter or longer than the contractually stated term.

To meet the definition of a contract, both parties must be committed to perform their obligations. Therefore, in determining the contract term, an entity does not assume that a breach of contract will occur, and termination provisions related to breach of contract or termination for cause are not considered. For example, a customer may have the unilateral right to cancel a contract if an entity fails to maintain specified service levels consecutively for three months. In that case, the termination for cause provision does not affect the determination of the contract term at contract inception.

If the customer has the unilateral right to terminate the contract without incurring a substantial penalty, for accounting purposes, the contract term is limited to the period before the date the termination right can be

exercised. Periods after that date are considered renewal options and must be evaluated when determining whether the contract includes a material right (see Section 7.4.2).

The term of a contract in which each party has the unilateral enforceable right to terminate without penalty does not extend beyond the then-current period. However, if only one party could terminate the contract without penalty, some enforceable rights and obligations may exist even if the contract term is limited to the then-current period. For example, if only the customer could terminate without penalty, the entity is obliged to stand ready to perform at the customer's discretion. In effect, the customer could extend the contract by not exercising its termination rights, which might represent a material right. See Chapter 3 and Section 7.4 for discussion on customer options and material rights.

EXAMPLE 2-7: MONTHLY TERMINATION RIGHTS IN AN ANNUAL CONTRACT — TERMINATION RIGHTS ARE HELD BY BOTH PARTIES

An entity enters a contract with a customer to provide cleaning services. The stated term is one year, the contract is cancelable at the end of each month by either party without penalty.

The parties' enforceable rights and obligations do not extend beyond the then-current month because either party can terminate the contract without penalty at the end of each month. The entity accounts for the contract as a month-to-month contract.

EXAMPLE 2-8: MONTHLY RENEWAL RIGHTS IN AN EVERGREEN (MONTH-TO-MONTH) CONTRACT — RENEWAL RIGHT HELD BY THE CUSTOMER

An entity enters a contract with a customer to provide cleaning services. The stated contract term is one month, and the contract automatically renews at the end of each month unless the customer elects not to renew.

When only the customer has a unilateral option to renew the contract for another month (by electing not to terminate at the end of a month), enforceable rights and obligations exist only for the then-current month.

Further, the customer has an enforceable right to receive, and the entity is obligated to provide, cleaning services in the subsequent months if the customer chooses to renew the contract by not exercising its termination rights. The unilateral renewal rights held by the customer effectively provide the customer 11 renewal options to extend the contract.

The entity evaluates whether the customer's renewal options are accounted for as material rights, which are separate performance obligations under Step 2. See Chapter 3 and Section 7.4 for discussion on performance obligations, customer options, and material rights.

If the contract does not include a material right, the entity disregards the customer's options to renew and applies the five-step revenue recognition model to the first month only.

If the contract includes a material right, the entity allocates a portion of the consideration received from the customer to the material right and defers recognizing it in revenue until the customer exercises the option or the option lapses.

The existence of a material right does not extend the contract term beyond the then-current month (that is, the contract term remains one month). However, the existence of a material right affects the amount and timing of revenue recognition for a contract because consideration allocated to the material right is deferred. See Section 7.4 for discussion on accounting for material rights, including the accounting policy election to account for a customer's exercise of a material right as the continuation of a contract or contract modification.

EXAMPLE 2-9: MONTHLY TERMINATION RIGHTS IN AN ANNUAL CONTRACT — TERMINATION RIGHT HELD BY THE CUSTOMER

An entity enters a contract with a customer to provide cleaning services. The stated contract term is one year, and the customer has a unilateral right to terminate the contract at the end of each month without penalty.

When only the customer has a unilateral option to terminate a period-to-period contract, enforceable rights and obligations exist only for the then-current month. The customer also has an enforceable right to receive, and the entity is obligated to provide, cleaning services in the subsequent months if the customer chooses not to exercise its termination right. The unilateral termination right held by the customer effectively provides the customer 11 renewal options to extend the contract by not exercising its termination rights. The entity evaluates whether the customer's options are accounted for as material rights (see Example 2-8).



TRG DISCUSSIONS: CONTRACT ENFORCEABILITY AND TERMINATION CLAUSES

Although ASC 606 contains guidance on when a contract exists, practitioners questioned how to assess whether a contract exists for accounting purposes (and, if so, how to determine the contract's duration) if the contract between an entity and its customer contains termination clauses. In deliberating how such clauses must be considered by an entity, the TRG generally agreed with the conclusions illustrated in the following examples:

Example A

An entity enters a contract with a customer to provide services until the contract is terminated. Each party can terminate the contract without compensating the other party for termination (that is, there is no termination penalty).

The duration of the contract does not extend beyond the services already provided.

Example B

An entity enters a contract with a customer to provide services for two years. Each party can terminate the contract at any time after 15 months from the start of the contract without compensating the other party for termination.

The duration of the contract is 15 months.

Example C

An entity enters a contract with a customer to provide services for two years. Either party can terminate the contract by compensating the other party.

The duration of the contract is the specified contractual period of two years.

Example D

An entity enters a contract with a customer to provide services for 24 months. Either party can terminate the contract by compensating the other party. The entity has a past practice of allowing customers to terminate the contract at the end of 12 months without enforcing collection of the termination penalty.

In this case, whether the contractual period is 24 months or 12 months depends on whether the past practice is considered by law to restrict the parties' enforceable rights and obligations, which can vary by jurisdiction. The entity's past practice of allowing customers to terminate the contract at the end of month 12 without enforcing collection of the termination penalty affects the contract term only if that practice changes the parties' legally enforceable rights and obligations. If that past practice does not change the parties' legally enforceable rights and obligations, the contract term is the stated period of 24 months.

BDO INSIGHTS: ANALYZING TERMINATION PENALTIES

ASC 606 does not define the terms "penalty" or "termination penalty," nor does it contain bright lines for determining whether a termination penalty is substantive. In analyzing whether either party must compensate the other to exercise a termination right, an entity evaluates any amount payable upon termination that is unrelated to the payments due for the goods or services transferred up to the termination date. Therefore, the analysis is not restricted only to payments explicitly characterized as termination penalties. Rather, it also includes the substance of the payments made to compensate the other party to terminate a contract before the end of the stated term.

The analysis of termination penalties is not restricted to cash payments. For example, requiring the customer to return an exclusive license to a drug compound upon early termination of a contract that includes R&D services in addition to the license could represent a substantive termination penalty. Conversely, requiring the customer to return a nonexclusive software license upon early termination of the license contract might not represent a substantive termination penalty.

Determining what constitutes a termination penalty and whether the termination penalty is substantive requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 2-9A: CANCELLABLE FOUR-YEAR CONTRACT FOR SOFTWARE LICENSE WITH SUBSTANTIVE TERMINATION PENALTY

A software entity enters a contract to grant a software license to a customer.

Following are the key terms of the contract:

- The contractually specified term is four years.
- The customer must pay $4 million, payable in four equal installments at the beginning of each year of the term.
- The customer has the right to unilaterally terminate the contract for convenience before the beginning of each year of the term by paying a termination penalty equal to 25% of the remaining fees, as follows:

	YEAR 1	YEAR 2	YEAR 3	YEAR 4
License fee	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000
Termination penalty	—	$ 750,000	$ 500,000	$ 250,000

Assume that the nature of the software entity's promise it to provide the customer with a right to use the software entity's IP, that is, the license is a functional IP for which revenue is recognized at a point in time.

The entity must first consider the effects of the termination clause and determine the contract term in Step 1 before moving to Step 2 to identify separate performance obligations.

The entity considers whether the penalty that the customer must pay to terminate the contract each year is substantive. The entity compares the termination penalty in each period to the remaining fees to be paid and concludes that the customer must pay a substantive termination penalty (25% of the remaining fees due under the contract) to terminate the contract. Therefore, the enforceable rights and conditions exist for the entire duration of the four-year term. We note that there may be other acceptable methods to determine whether the penalty in this scenario is significant.

The entity then determines that it has granted a software license with a four-year term (not four software licenses with one-year terms) to the customer. Assuming all revenue recognition criteria are met, the software entity would recognize $4 million in revenue at the beginning of Year 1.

EXAMPLE 2-9B: CANCELLABLE FOUR-YEAR CONTRACT FOR SOFTWARE LICENSE WITH NO TERMINATION PENALTY

Consider the same facts in Example 2-9A except that the customer is not required to pay any termination penalty.

The software entity determines that the contract term is one year because the customer has the unilateral right to terminate the contract at the beginning of each year without paying any termination penalty. The customer has three options to renew the contract annually by not exercising the termination right.

Assume that the options do not provide the customer with material rights.

The entity then determines that it has granted four software licenses with one-year terms (not a software license with a four-year term) to the customer. Assuming all revenue recognition criteria are met, the entity recognizes $1 million in revenue at the beginning of each of Years 1-4.

BDO INSIGHTS: SIGNIFICANCE OF THE CONTRACT TERM

An entity must first determine the duration of the contract (or contract term) to apply certain aspects of the five-step revenue recognition model (for example, identifying performance obligations, determining the transaction price, and recognizing revenue upon satisfaction of a performance obligation). The contract term is also important when determining whether a practical expedient can be elected. For example, an entity can elect the practical expedient on significant financing components in Step 3 for a short contract term (one year or less).

Determining the contract term is generally not complex when a contract has a stated duration and neither party has the unilateral right to cancel the contract. It also might not be particularly relevant to revenue recognition if the only promises are goods that are delivered at a point in time. However, determining the contract term can be more challenging when either party has cancellation rights. Analyzing cancellation rights to determine the contract term may require the application of professional judgment based on the facts and circumstances. In some cases, legal advice may be required to determine the duration for which enforceable rights and obligations exist.

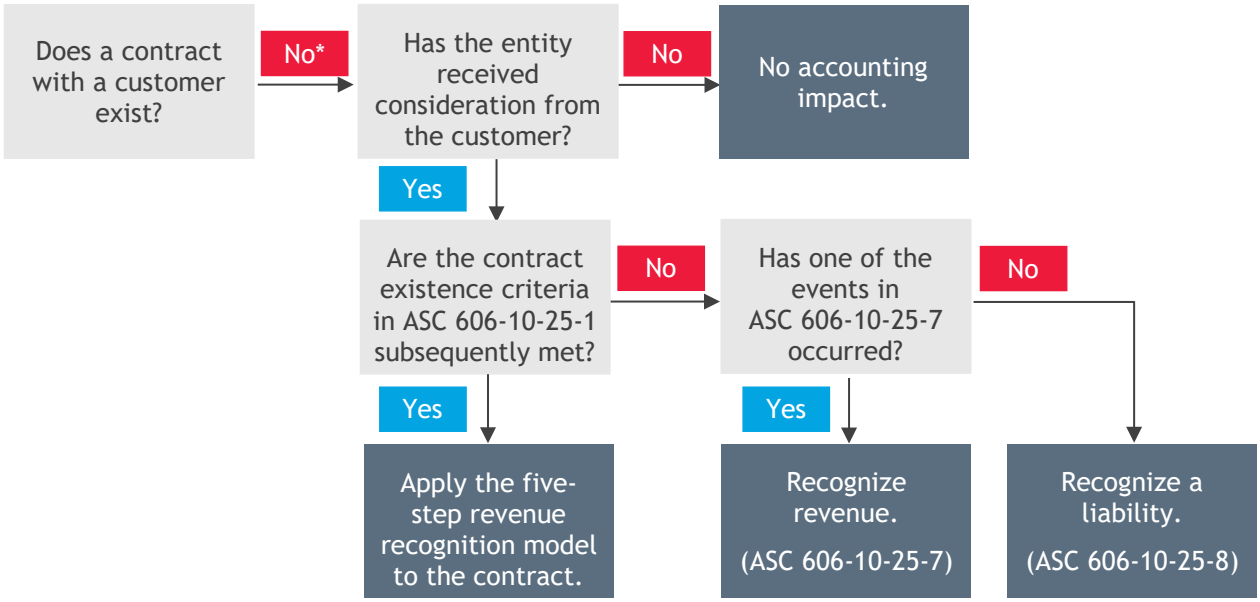
2.4 CONTRACT EXISTENCE CRITERIA ARE NOT MET



FASB REFERENCES

ASC 606-10-25-6 through 25-8

The following diagram provides an overview of the accounting requirements when the contract existence criteria are not met:



* Continuously reassess the contract to determine whether the contract existence criteria in ASC 606-10-25-1 are subsequently met.

If any of the five contract existence criteria are not met, a contract does not exist for revenue recognition purposes regardless of whether a legal contract exists. ASC 606 includes the following guidance, which is applied when an arrangement with a customer does not meet the contract existence criteria:

- Continuous reassessment of whether the contract existence criteria are subsequently met
- Accounting for consideration received from customer before contract existence criteria are met.

BDO INSIGHTS: ASSET TRANSFERRED BEFORE THERE IS A CONTRACT

In some arrangements, control of an asset might be transferred to the customer before the criteria for contract existence is met. In Example 1, Case A of ASC 606-10-55-95 through 55-98, an entity sells a building to a customer but concludes it is not probable that it will collect the consideration to which it is entitled in exchange for the transfer of the building. The example originally indicated that the building is not derecognized at the time of sale. That approach is consistent with ASC 360-10-40-C, which states that if an entity transfers a nonfinancial asset and the contract does not meet all the criteria in ASC 606-10-25-1, the entity does not derecognize the asset and instead continues to account for it as if it were still legally owned.

However, ASC 330, *Inventory*, does not include comparable guidance. Therefore, some stakeholders have questioned whether inventory that is transferred to a customer should be derecognized even if the definition of a contract is not met.

ASU 2016-12 added guidance to clarify when revenue would be recognized for a contract that fails to meet the criteria in Step 1 and amended Example 1, Case A, accordingly. In BC28 of ASU 2016-12, the FASB explained that it amended the example to focus on illustrating the collectibility criterion and not on the assessment of whether control of the building transfers to the customer. The FASB noted that the ASC 606 concept of control is directly linked to the concept of control of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*. The FASB also said an assessment of whether control of the building transfers to the customer before meeting the definition of a contract requires judgment and additional information.

Based on the foregoing discussion, we believe an entity should derecognize inventory when a buyer controls the asset, independent of the entity's conclusions about the existence of a contract. In some circumstances, that could result in an entity derecognizing the asset before revenue from the sale can be recognized if the criteria in

ASC 606-10-25-1 have not been met. We believe an entity in that situation should also consider whether to recognize a receivable for the return of the asset; for example, if the sales agreement grants it the right to require the return of the asset in the event of nonpayment. Determining whether to derecognize an asset and, if so, whether to recognize a receivable for the return of the asset, requires the application of professional judgment based on the facts and circumstances.

2.4.1 Continuous Reassessment of Contract Existence Criteria



FASB REFERENCES

ASC 606-10-25-6

An entity continuously reassesses arrangements with customers that do not meet all five of the contract existence criteria to determine whether and when those criteria are subsequently met. An entity applies the five-step revenue recognition model when the contract existence criteria are met.

2.4.2 Consideration Received From Customer Before Contract Existence Criteria Are Met



FASB REFERENCES

ASC 606-10-25-7 and 25-8

If the contract existence criteria are not met and an entity receives consideration from the customer, the amount received is recognized as revenue only when **any one** of the three following events (specified in ASC 606-10-25-7) has occurred:

- The entity has no remaining contractual obligations to transfer goods or services and all, or substantially all, of the consideration has been received and is nonrefundable.
- The contract has been terminated and the consideration received is nonrefundable.
- The entity has transferred control of the goods or services related to the consideration received, has stopped transferring goods or services to the customer (if applicable), and has no obligation under the contract to transfer additional goods or services; also, the consideration received from the customer is nonrefundable.

An entity cannot recognize revenue until the contract is complete or canceled or until a subsequent reassessment indicates that the contract meets all contract existence criteria. Any consideration received from the customer is recognized as a liability until either the criteria for a contract to exist are subsequently met or one of the three events in ASC 606-10-25-7 occurs. Depending on the specifics of the contract, the liability recognized represents the entity's obligation to transfer goods or services or to refund the consideration received. In either case, the liability is measured as the amount received from the customer.

The guidance on accounting for consideration received from a customer when the contract existence criteria are not met avoids revenue recognition related to contracts that might not be valid and do not represent genuine transactions; recognizing revenue for those contracts would not provide a faithful representation of an entity's business activities.

NONREFUNDABLE PAYMENTS RECEIVED FROM A CUSTOMER BEFORE THE CONTRACT EXISTENCE CRITERIA ARE MET

Regardless of whether the consideration received from the customer is nonrefundable, an entity cannot recognize revenue based on cash collected from the customer unless either the contract existence criteria are subsequently met (in which case the entity follows Steps 2 through 5 for recognizing revenue) or one of the three events in ASC 606-10-25-7 has occurred.

2.5 REASSESSMENT OF CONTRACT EXISTENCE CRITERIA

FASB REFERENCES

ASC 606-10-25-5 and ASC 606-10-55-106 through 55-109

If a contract with a customer meets the contract existence criteria at contract inception, an entity does not reassess those criteria unless there is an indication of a significant change in facts and circumstances. ASC 606 includes an example stating that if a customer's ability to pay the consideration deteriorates significantly, an entity must reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer.

When an entity determines that a previously identified contract no longer meets the contract existence criteria:

- No further revenue is recognized until either the entity can once again conclude that the contract existence criteria (including the collectibility criterion) are met or the revenue recognition requirements in ASC 606-10-25-7 are met (see Section 2.4.2 for discussion of the accounting for consideration received from customer when contract existence criteria are not met).
- Any revenue, receivable, or contract asset recognized to date is not reversed. Instead, the receivable or contract asset is subject to the impairment guidance in ASC 326.

EXAMPLE 2-10 (ADAPTED FROM ASC 606-10-55-106 THROUGH 55-109): REASSESSING THE CRITERIA FOR CONTRACT EXISTENCE

An entity and a customer enter a multiyear contract for the transfer of goods or services. The contract meets the contract existence criteria at inception, so the entity starts recognizing revenue from the contract according to the five-step revenue recognition model.

In the second year of the contract, the customer's financial condition declines and its access to credit and available cash on hand are limited. The entity continues to recognize revenue in the second year and evaluates any receivables recognized for impairment.

At the beginning of the third year of the contract, the entity becomes aware that the customer has lost access to credit and major customers. The entity thus determines that it is unlikely that the customer will be able to make any further payments for goods or services transferred.

Because of that significant change in facts and circumstances, the entity reevaluates the contract existence criteria and concludes that they are no longer met because collectibility is no longer probable. Based on that conclusion, the entity does not recognize revenue for that customer in the third year.

The entity does not reverse any revenue or existing receivables recognized during the first and second years of the contract. It accounts for the impairment of any existing receivables under ASC 326.

BDO INSIGHTS: REASSESSMENT OF CONTRACT EXISTENCE CRITERIA

Determining whether there is a significant change in facts or circumstances requiring a reassessment of contract existence criteria requires the application of professional judgment based on the facts and circumstances. Example 2-10 involves a severe deterioration in the customer's financial condition to demonstrate that ASC 606 does not intend to capture minor changes in facts and circumstances (that is, those that do not call into question the validity of the contract) that might reasonably fluctuate during a contract term, especially a long-term contract.

2.6 COMBINATION OF CONTRACTS

FASB REFERENCES

ASC 606-10-25-9

Two or more contracts entered into at or near the same time and with the same customer (or related parties of the customer, as defined in ASC 850, *Related Party Disclosures*) are accounted for as if they were a single contract, if **any** of the following criteria is met:



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



The consideration in one contract depends on the price or performance of any other contracts.



The goods or services (or some thereof) that are promised in the contracts represent a single performance obligation. (See Chapter 3.)

The guidance requiring the combination of two or more contracts was provided because in some cases, the amount and timing of revenue might differ depending on whether an entity accounts for two or more contracts separately or as one contract. A necessary condition for two or more contracts to be combined is that they must be executed at or near the same time with the same customer (or the customer's related parties).

Multiple contracts negotiated at or near the same time with the same customer or its related parties with a single commercial objective or by pricing one contract based on the price or performance of any other contract create pricing interdependencies between the separate contracts. Those contracts must be combined so that the combined consideration is allocated to the performance obligations in the combined contract, resulting in revenue recognition that faithfully depicts the value of the performance obligations transferred to the customer.

Some or all of the promised goods or services in separate contracts negotiated at or near the same time with the same customer or its related parties may represent a single performance obligation. Those contracts must be combined to preclude an entity from effectively bypassing the guidance for identifying performance obligations based on how contracts are legally structured. Rather, the contracts are combined and revenue for the single performance obligation is recognized when or as satisfied.

BDO INSIGHTS: COMBINING CONTRACTS REQUIRES JUDGMENT

Determining whether multiple contracts entered into with the same customer (or its related parties) at or near the same time must be combined requires the application of professional judgment based on the facts and circumstances. An entity considers the facts and circumstances surrounding those contracts, including the pricing and the nature of the goods or services being transferred, to evaluate the substance of the contracts and whether they must be combined.

The phrase "at or near the same time" is not defined under ASC 606, and entities may establish accounting policies to do so (for example, 90 days). Because ASC 606 does not include a bright line, determining whether any contracts executed shortly outside the defined time frame are within the scope of contract combination guidance requires the application of professional judgment based on the facts and circumstances, as illustrated in the following example.

EXAMPLE 2-11: ASSESSING "AT OR NEAR THE SAME TIME"

Company sells products and provides installation services to its customers. Because installation is customized to the customer's location and modifies the product based on the customer's requirements, Company concludes that the product and installation services are not distinct but instead represent a single combined performance obligation. As such, Company typically contracts with its customers for both the product and the installation services at the same time. When evaluating whether contracts should be assessed for combination, Company establishes an accounting policy defining the phrase "at or near the same time" as within a 45-day period.

Customer engaged with Company to purchase the product and installation. However, the contract for the product was executed before the contract for the installation. Company agreed to sign the contract for the product first because of the amount of time it would take to source materials for the product. 60 days after the product contract was signed, Company and Customer executed the installation contract.

Although the contract for installation services was executed outside Company's 45-day policy, the Company considers the following:

- Does one contract modify or change the service/goods being provided to the customer?
- Were the contracts negotiated with a single commercial objective?
- Were the same parties involved with both negotiations?
- Was there a business reason for the delay in executing the second contract?

Company notes the installation contract dictates how the products are to be customized to the size and layout of the customer's space. Further, the parties were in negotiations for both installation and products throughout the process. It was a business decision to agree to the products contract first to start sourcing the materials such that installation could begin immediately once the installation contract was finalized. Therefore, Company assesses the contracts for combination even though more than 45 days separate them.

BDO INSIGHTS: CONTRACT COMBINATION GUIDANCE — CUSTOMER'S RELATED PARTIES

ASC 606 requires an entity to consider whether the contract combination guidance applies to contracts that are entered into with two or more related parties because there could be interdependencies between or among those contracts. The amount and timing of revenue recognized might differ depending on whether those contracts are accounted for as separate contracts versus a single contract. The term "related parties" has the same meaning as the definition in ASC 850, *Related Party Disclosures*, which encompasses a wide range of entities and individuals, and careful analysis is required to ensure that all parties are considered.

Determining whether another entity is a related party of the customer and whether multiple contracts entered with the customer and the customer's related party (or parties) must be combined requires the application of professional judgment based on the facts and circumstances.

However, an entity cannot combine contracts with different counterparties who are not related parties, even if they are negotiated as a package with the same commercial objective, as discussed in the following SEC staff speech:

SEC STAFF GUIDANCE

Remarks before the 2016 Baruch College Financial Reporting Conference

Wesley R. Bricker, Deputy Chief Accountant, Office of the Chief Accountant

May 5, 2016

Contract Combination Guidance — Limited to a Customer and Its Related Parties

> *. . .[Office of the Chief Accountant] OCA also addressed the contract combination guidance, noting the guidance in Topic 606 explicitly limits what contracts may be combined. The staff objected to a registrant's proposal to extend the contract combination guidance beyond contracts with the same customer or related parties of the same customer.*

BDO INSIGHTS: CONTRACT COMBINATION GUIDANCE — DIFFERENT DEPARTMENTS OF AN ENTITY

An entity may enter into contracts with different departments or divisions of the customer entity. Regardless of whether the departments function independently within the entity, the contracts fall within the scope of contract combination guidance and must be combined if the contract combination requirements are met.

Similarly, when evaluating contracts with different departments of a government body (federal, state, local, or foreign), we believe different departments under the control of the same government body are generally considered part of a single entity. For example, separate contracts with different departments of the U.S. federal government may be combined if the contract combination requirements are met.

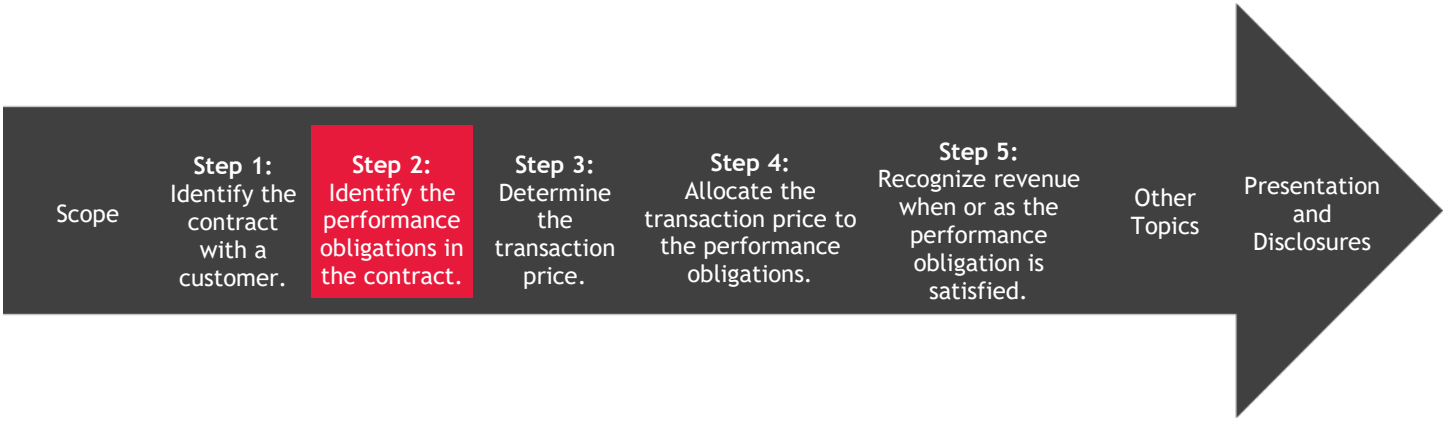
BDO INSIGHTS: INTERACTION BETWEEN THE GUIDANCE ON CONTRACT COMBINATION AND CONSIDERATION PAYABLE TO CUSTOMER

When evaluating multiple contracts with a customer or its related parties that require the entity to make cash or noncash payments to the customer or its related parties, an entity must carefully consider the applicability of the guidance on consideration payable to the customer and on contract combination. Consideration payable to the customer is recognized as a reduction in revenue if specific conditions are met (see Section 4.6 for related discussion).

For example, consider a biotechnology entity that sells R&D services and a functional IP license to a customer in exchange for a fee. The entity in-licenses technology from the customer's related party in exchange for a fee and uses that technology to provide the R&D services to the customer. If the two contracts were entered into at or near the same time, the biotechnology entity must evaluate whether they must be combined; for example, because they have a single commercial objective or pricing interdependencies. If the contracts are combined, the payments made by the biotechnology entity to the customer's related party for the in-license may be recognized as a reduction in revenue (rather than as an expense) under the guidance on consideration payable to customer.

Reaching a conclusion about whether to combine contracts and recognize payments to a customer or its related parties) as a reduction in revenue requires the application of professional judgment based on the facts and circumstances.

Chapter 3 — Step 2: Identify the Performance Obligations in the Contract



3.1 OVERVIEW 3 — STEP 2: IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

FASB REFERENCES

ASC 606-10-25-14

After identifying the contract for accounting purposes in Step 1, an entity must identify the promised goods and services within the contract and determine which of those goods and services are separate performance obligations.

A performance obligation is the unit of account for applying ASC 606 to recognize revenue from the transfer of goods and services promised to a customer. In Steps 3 through 5, the transaction price in a contract is allocated to each performance obligation in the contract, and the allocated transaction price is recognized in revenue when or as the performance obligation it relates to is satisfied. Correctly identifying the performance obligations in a contract is fundamental to the principle that the amount and timing of revenue recognized for the contract must faithfully depict an entity's performance in transferring the promised goods or services to the customer.

At contract inception, an entity assesses the promised goods and services in a contract and identifies separate performance obligations. A performance obligation is a promise to transfer to a customer **either**:

- A good or service (or a bundle of goods or services) that is distinct
- A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

BDO INSIGHTS: A PERFORMANCE OBLIGATION IS THE UNIT OF ACCOUNT FOR REVENUE RECOGNITION

Appropriate identification of the performance obligations in a contract is crucial because each performance obligation is a separate unit of account for determining when and how much revenue to recognize.

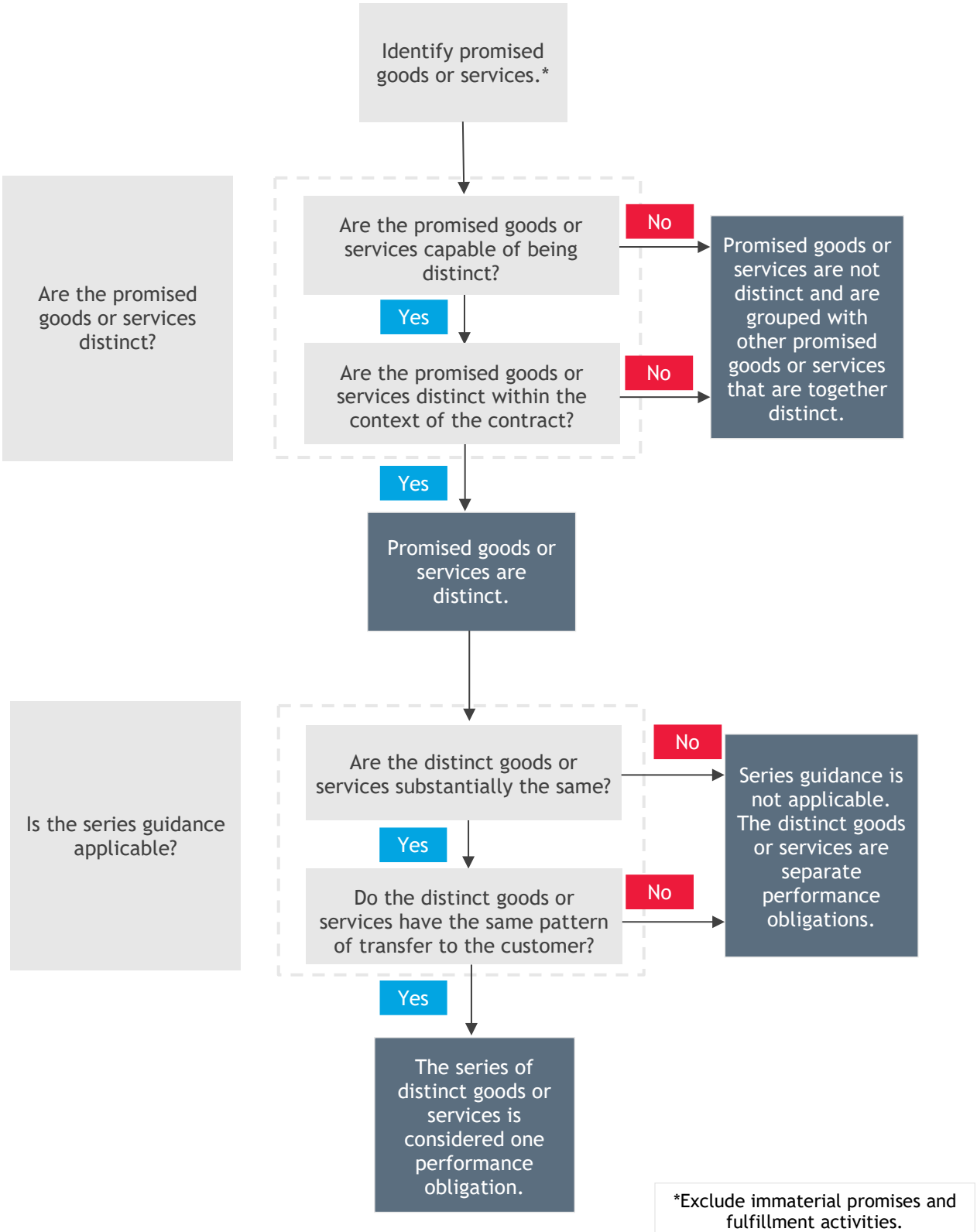
Further, the accounting for contract modifications (see Section 7.3) is based on, among other things, whether a promised good or service is distinct (and therefore a performance obligation) and whether a performance obligation in a contract has been satisfied before the modification date. Therefore, even if a contract includes multiple performance obligations that are satisfied concurrently and could practically be accounted for as a single performance obligation, an entity is required to correctly identify performance obligations in the original contract if that contract is modified.

BDO INSIGHTS: REASSESSING PERFORMANCE OBLIGATIONS

The performance obligations identified in a contract are not reassessed unless the contract is modified, and the modification is not accounted for separately from the existing contract (see Section 7.3).

ASC 606 also includes specific guidance for determining whether a warranty is a performance obligation (see Section 3.5) and a practical expedient for franchisors that are nonpublic entities when identifying performance obligations (see Section 3.6).

The following diagram provides an overview of Step 2:



3.2 PROMISES IN CONTRACTS WITH CUSTOMERS

FASB REFERENCES

ASC 606-10-25-16 through 25-18

To identify the performance obligations in a contract with a customer, an entity must first identify at contract inception all the promised goods or services in that contract. Generally, the contract explicitly identifies all goods or services an entity promises to transfer to a customer. Examples of promised goods or services include:

- Sale of goods
- Performing agreed tasks
- Standing ready to provide goods or services (such as unspecified software updates to software provided when and if available)
- Arranging for another party to transfer goods or services
- Constructing an asset on behalf of a customer
- Granting a license to intellectual property

3.2.1 Implied Promises in a Contract

FASB REFERENCES

ASC 606-10-25-16

Promised goods and services in a contract are not limited to the goods or services explicitly stated in the contract. In some cases, promises to provide goods or services might be implied by the entity's customary business practices; published policies; or specific statements if, at the time of entering the contract, the customer has a reasonable expectation that it will receive specified goods or services from the entity. If the customer has a reasonable expectation that it will receive goods or services not explicitly identified in the contract, it will likely view those promises as part of the negotiated exchange.

IMPLIED PROMISES: CONSIDERING CUSTOMER'S EXPECTATIONS

In identifying the implied promises in a contract, it is important for an entity to consider the customer's expectations (rather than only its own perspective) regarding which goods or services the customer expects to receive and for which it has paid or will pay under the contract.

Analyzing customer's expectations and identifying implied promises requires the application of professional judgment based on the facts and circumstances.

While a contract with a customer identified in Step 1 must be enforceable by law, implied promises in the contract do not need to be. If the customer has a valid expectation that the entity will transfer a good or service, it would view that promise as a part of the negotiated exchange. The FASB has said that absent that guidance, an entity might

recognize all the consideration in a contract as revenue even though it continues to have remaining implied promises related to the contract with the customer.[11]

3.2.2 Promises That Require Third-Party Involvement

FASB REFERENCES

ASC 606-10-25-18

Promised goods and services in a contract may include:

- Resale to a customer of rights to goods or services purchased by the entity. For example, ticket resellers purchase tickets from airlines and then sell them (or the right to the flight service) to customers.
- Providing a service of arranging for another party to transfer goods or services to a customer. For example, an entity may act as an agent of another party that will transfer goods or services to a customer.

In those types of arrangements, another party is involved in providing goods or services to the customer. Therefore, an entity needs to determine whether it is the principal or agent in that arrangement for revenue recognition purposes (see Section 7.2).

3.2.3 Promises to a Customer's Customer

FASB REFERENCES

ASC 606-10-25-18(g)

Granting a right to goods or services to be provided in the future that a customer can transfer to its customer (for example, when an entity makes a promise to provide goods or services to its customer's customer) is a promised good or service in a contract. Those types of promises exist in distribution networks in various industries, such as the automotive industry.

For example, when a manufacturer sells a motor vehicle to its customer, a motor vehicle dealer, it might promise to provide additional goods or services, such as maintenance, to the dealer's customer. An entity must identify all promises, both explicit and implicit, made to the customer as part of the contract with that customer. Consequently, the manufacturer's promise to provide a good or service that the dealer can pass on to its own customer would be a performance obligation for the manufacturer if that promise could be identified (explicitly or implicitly) in the manufacturer's contract with the dealer.

However, some promised goods or services that do not exist (explicitly or implicitly) when the parties agree to the contract may be added after contract inception. The entity must consider whether additional promised goods or services represent a future right granted to the customer that it can transfer to its customer, or new promises being provided to the customer's existing customers. Amendments that add future rights are assessed using the modification framework (see Section 7.3). However, new promises are instead treated as new contracts entered with a different counterparty (the customer's customer).

[11] ASU 2014-09, BC87.

3.2.4 Customer Options to Purchase Additional Goods or Services — Material Right

FASB REFERENCES

ASC 606-10-25-18(j)

Granting an option to a customer to purchase additional goods or services could be a promised good or service in a contract when that option provides the customer with a material right (see Sections 7.4). See Section 7.4.1.1 for a summary of the TRG discussions on whether a variable quantity of a good or service constitutes a customer's purchase options or variable consideration.

3.2.5 Exception for Immaterial Promises in a Contract

FASB REFERENCES

ASC 606-10-25-16A and 25-16B

If promised goods or services are immaterial in the context of the contract with the customer, an entity is not required to assess whether those goods or services are performance obligations (see Section 3.3). In other words, an entity is exempt from accounting for performance obligations it might consider perfunctory or inconsequential. Assessing whether a promised good or service is immaterial at the contract level requires judgment. BC12 of ASU 2016-10 states that in assessing immateriality, an entity considers both the quantitative and qualitative nature of the promised goods or services in the contract. An entity also considers the relative significance or importance of a promised good or service in the contract to the arrangement with the customer as a whole.

If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, the related costs to transfer those goods or services are accrued.

An entity cannot apply the exception for immaterial promises to a customer's option to acquire additional goods or services that provides the customer with a material right (see Section 7.4).

3.2.6 Fulfillment Activities

FASB REFERENCES

ASC 606-10-25-17

Activities performed to fulfill a contract that do not transfer goods or services to the customer are not considered promised goods or services in a contract, even though those activities are required to successfully transfer the goods or services for which the customer has contracted. Many contracts under which an entity performs separate activities that do not directly transfer goods or services to customers can include fulfillment activities. For example, a service provider may need to perform various administrative tasks to set up a contract (that is, set-up activities) before providing services to the customer. The performance of the administrative tasks does not transfer a service to the customer as the tasks are performed, so those activities are not promised goods or services in the contract.

See Section 7.7 for discussion on accounting for costs incurred to fulfil a contract with a customer.

BDO INSIGHTS: DISTINGUISHING SET-UP ACTIVITIES FROM PROMISED GOODS OR SERVICES

Administrative tasks are sometimes referred to as "set-up activities." Distinguishing set-up activities from promised goods or services in the contract can be challenging. We believe the following factors may be relevant when making the distinction:

- Does the customer continue to benefit from the activities after they are performed? Customers continue to benefit from promised goods and services after control of the promised goods or services has transferred to them. Conversely, customers do not benefit from set-up activities after an entity completes such activities. For example, an entity may perform tasks to provide customers with access to the promised goods or services. Such tasks are set-up activities because the tasks do not benefit the customer after the promised goods or services are transferred.
- Can other entities perform the services? If the activities cannot be performed by the customer or other entities, they may be set-up activities. Conversely, if the activities can be performed by the customer or other entities, they may be promised services.
- In performing the set-up activities, is the entity enhancing its own assets or the customer's? If performing the services enhances or improves the entity's assets, the activities are set-up activities because the entity retains control over any benefits derived therefrom. Conversely, if the customer's assets are being enhanced, the activities may be promised services.
- Does the customer simultaneously receive and benefit from the activities? When customers simultaneously receive and consume the services being performed, an asset is created, if only momentarily. That is, customers obtain control of an entity's outputs as it performs, and the activities being performed are promised services.

All factors must be holistically evaluated and no one factor is conclusive. Determining whether activities in the contract constitute set-up activities requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 3-1: EQUIPMENT INSTALLATION SERVICES — SET-UP SERVICES

Company A enters a contract with Company B to operate a distributed network that will amplify cell phone signals in in the customer's corporate headquarters building. To fulfill the contract,

- Company A will install and use its own equipment to operate the network. It concludes that the contract does not include a lease.
- The installation services are not complex and could be performed by Company B or a third party.
- Title to the equipment does not transfer to Company B upon installation or at the end of the contract.

In determining whether the equipment installation services are set-up activities or promised services, Company A considers the following factors:

- Company B cannot benefit from the distributed network until Company A has installed the equipment.
- The equipment installation services do not provide Company B with an incremental benefit beyond allowing it to access and benefit from the distributed network.
- Company A retains title to the equipment throughout the contract term.
- Company B could install the equipment in the building.
- The installation services do not enhance or improve Company A's assets.

Company A concludes that the equipment installation services are set-up activities because they do not transfer a good or service to the customer.

3.2.6.1 Tooling and Set-Up Activities

Manufacturing entities often incur significant costs at the inception of contracts for tooling, equipment, and engineering start-up activities, often referred to as "preproduction activities." Manufacturers need to consider whether preproduction activities are a promised good or service or are fulfillment activities, which requires judgment and consideration of the facts and circumstances. If a manufacturer has difficulty in determining whether a preproduction activity is a promised good or service in a contract, it evaluates whether control of that good or service is transferred to the customer (for example, whether the customer will own the results of the preproduction activity even if the contract is terminated). The transfer of control indicates that the preproduction activity is a promised good or service.

EXAMPLE 3-1A: TOOLING AND SET-UP ACTIVITIES

An entity manufactures parts for the automobile industry and has contracted with a customer to supply pistons. Each piston is determined to be a distinct performance obligation. To fulfill the contract, the entity must:

- Purchase a diamond-core cutting machine ($500,000) and tooling ($200,000).
- Incur engineering costs ($100,000) to configure the production line.

The entity receives $1 million from the customer at contract inception to compensate for the preproduction activities.

The entity retains title to the equipment, tooling, and any patents or other IP that results from the engineering activities. It is also responsible for maintaining and directing the use of the tooling and equipment.

The entity determines that the contract includes the promise to transfer pistons to the customer and that the preproduction activities do not result in control of additional goods or services being transferred to the customer. Therefore, the preproduction activities are not promised goods or services and cannot be a separate performance obligation within the contract.

The entity includes the upfront $1 million payment in the transaction price (see Chapter 4) and initially records it as a contract liability (deferred revenue). A portion of the contract liability is derecognized and credited to revenue as control over each piston is transferred to the customer (presuming the contract consists of multiple performance obligations — that is, each piston is a separate performance obligation). See Chapter 6 for discussion on recognizing revenue when or as a performance obligation is satisfied.

BDO INSIGHTS: PREPRODUCTION ACTIVITIES

If preproduction activities do not represent a separate performance obligation and are related to a performance obligation for which revenue is recognized over time (instead of a point in time, as in Example 3-1), the activities are not considered when measuring progress toward completion of that performance obligation because they do not result in control of a good or service being passed to the customer. In other words, the manufacturer does not recognize revenue as a result of incurring the $800,000 of preproduction activities. Instead, those costs are treated as costs to fulfill a contract. See Chapter 6 for discussion on recognizing revenue over time and measure of progress and Section 7.7 for discussion on accounting for the costs of contracts with customers.

In contrast, if the preproduction activities are determined to be a promised good or service, a portion of the transaction price is allocated to that good or service as either a single performance obligation or as part of a combined performance obligation that includes the preproduction activities with other goods and services.

BDO INSIGHTS: PREPRODUCTION ACTIVITIES FOR LONG-TERM SUPPLY CONTRACTS

ASC 340-10, *Other Assets and Deferred Costs — Overall*, includes guidance on accounting for the costs of designing and developing "*molds, dies, and other tools that will be used in producing*" products under a long-term supply agreement. ASC 606 did not amend or supersede the ASC 340-10 guidance on preproduction costs. Therefore, manufacturers that conclude that their preproduction costs are within the scope of ASC 340-10 continue to follow that guidance. Also, entities apply the guidance in ASC 340-40 to account for preproduction costs that are not within the scope of ASC 340-10. See Section 7.7 for discussion on accounting for the costs of contracts with customers.



TRG DISCUSSIONS: PREPRODUCTION ACTIVITIES — ANALYZING CONTROL

In November 2015, the TRG discussed whether preproduction activities are a promised good or service or are included in the measure of progress toward complete satisfaction of a performance obligation that is satisfied over time.

The TRG observed that entities may find it helpful to consider the core principle of ASC 606, which is *"that an entity shall recognize revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."*

Further, ASC 606 specifies that the good or service is transferred when or as the customer obtains control.

The FASB staff provided an example to illustrate an entity's assessment of whether control of a good or service is transferred to the customer when the entity is having difficulty determining whether preproduction activities are a promised good or service: An entity is performing engineering and development activities as part of developing a new product for a customer, and the customer will own the patents and other IP that results from those activities. The entity would likely conclude that it is transferring control of that IP to the customer and that the engineering and development activities therefore are promised goods or services in the contract.

The FASB staff used that straightforward example to illustrate a case in which it was clear that control transferred to the customer.

However, sometimes an entity needs to apply judgment to determine whether control of a good or service transfers to the customer. ASC 606 includes criteria for determining whether an entity transfers control of a good or service over time and therefore satisfies a performance obligation over time. The FASB staff indicated that whether the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs might apply to preproduction activities.

An entity might not always be able to readily identify whether this criterion is met. In those circumstances, an entity considers whether another entity would need to reperform the work the entity has completed to date if that other entity were to fulfill the remaining performance obligation. For example, consider a scenario in which an entity performs engineering and development activities as part of developing a new product for a customer. If the entity provides the customer with periodic progress reports (in a level of detail that would not require the customer to contract with another entity to reperform the work), or if the entity must provide the customer with the design information completed to date in the case of a termination of the contract, the entity likely would conclude that control of that service has transferred to the customer.

As another example, when a piece of equipment is transferred over time, an entity has determined that the customer has control over the asset because the entity has a right to payment for an asset with no alternative use. The entity might include labor costs in a cost-to-cost measure of progress for constructing the piece of equipment. The labor itself is not a separate promised good or service to the customer in the contract. However, each time the

worker turns a wrench, the asset (the equipment) is changed, and the customer obtains control of that changed asset.

Similarly, an entity might determine the preproduction cost should be included in the measure of progress depending on the circumstances of the arrangement. However, if the arrangement involves significant costs for the entity near the start of the arrangement, and the activities giving rise to those costs do not transfer a good or a service to the customer, the entity considers the guidance on adjustments to the measure of progress when using a cost-based input method. Application of that guidance requires an entity to consider whether the costs for some activities must be excluded from the measure of progress or whether the input method must be adjusted to recognize revenue only to the extent of that cost incurred.

See Chapter 6 for discussion on the notion of control, recognizing revenue over time or at a point in time, measure of progress, and adjustments to the measure of progress when using a cost-to-cost method.

3.2.6.2 Shipping and Handling Activities

FASB REFERENCES

ASC 606-10-55-18A through 55-18B

An entity that promises to transfer goods to a customer may perform shipping and handling activities related to those goods. If the shipping and handling activities are performed before the customer obtains control of the goods, the activities are not promised services to the customer but rather activities to fulfill the entity's promise to transfer goods.

If shipping and handling activities are performed after a customer obtains control of the good, the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good rather than as additional promised services.

If an entity opts for the accounting policy election:

- Shipping and handling activities are not identified as separate performance obligations and no revenue is allocated to them.
- If revenue for related goods is recognized before the shipping and handling activities occur, an entity must accrue the related costs of those activities.

If the accounting policy election is not made, the entity evaluates shipping and handling activities as promised services and potential performance obligations.

The accounting policy election must be applied consistently to similar types of transactions.

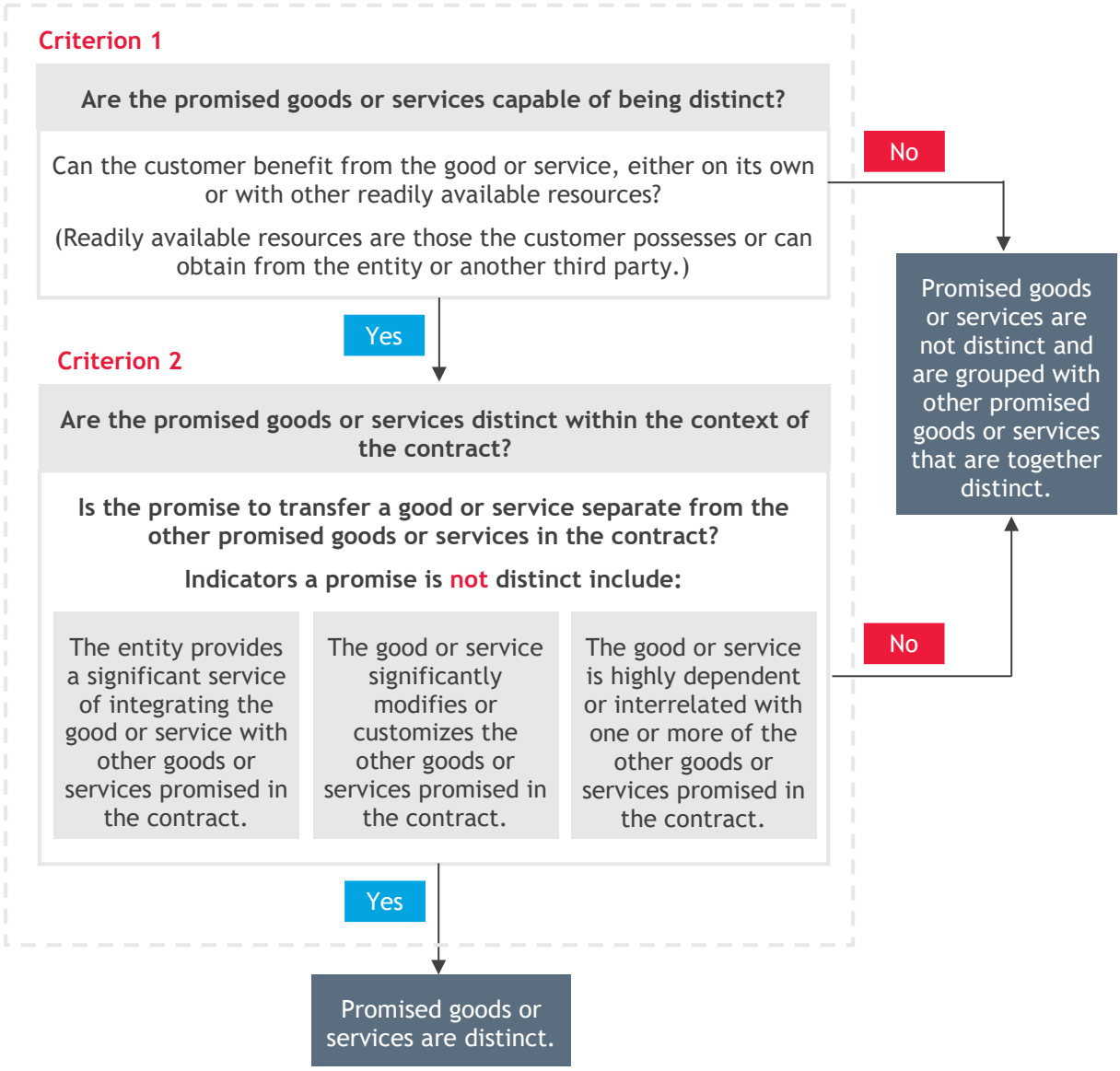
3.3 DISTINCT GOODS OR SERVICES

FASB REFERENCES

ASC 606-10-25-19 through 25-22

After identifying the promised goods or services in the contract, an entity determines which of those promised goods or services (or bundle of goods and services) are distinct and hence represent separate performance obligations. If a promised good or service is not distinct, the entity must combine it with other promised goods or services until a bundle of goods or services that is distinct can be identified.

The following diagram illustrates the guidance on determining whether a promised good or service is distinct and therefore a separate performance obligation:



As illustrated in the diagram, for a good or service to be distinct, **both** of the following criteria must be met:

- **The good or service is capable of being distinct:** The customer can benefit from the good or service either on its own or with other resources that are readily available to the customer.
- **The promise to transfer the good or service is distinct within the context of the contract:** The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

BDO INSIGHTS: ANALYZING WHETHER THE CONTRACT INCLUDES ONE OR MULTIPLE PROMISES

Although ASC 606 includes cleaning services as an example of a combined performance obligation, entities must carefully analyze this type of contract to appropriately identify distinct performance obligations and determine the pattern of satisfaction of the obligations identified. For example, consider a three-year cleaning contract of an office building in which the windows are cleaned every six months (which requires five days to complete), carpets are deep cleaned once a month (and takes place over a weekend), and trash disposal and vacuuming is done daily outside normal office working hours. Each cleaning activity may constitute a separate performance condition and, if so, it would be necessary to allocate the transaction price to each of the performance obligations. The transaction price allocated to window cleaning and the deep cleaning of carpets would be recognized as those activities take place (rather than ratably over the three-year contractual period).

Similarly, in some industries, such as the airline industry, an entity may provide ongoing maintenance for critical equipment such as airplane engines, as well as periodic overhaul services. While both the ongoing maintenance and overhaul services likely meet the criterion to be recognized over time (because the customer simultaneously receives and consumes the benefits provided by the entity), the entity would likely conclude that the ongoing maintenance and overhaul services are distinct performance obligations, each with different timing for revenue recognition. As such, the transaction price must be allocated to the ongoing maintenance activities and overhaul activities, and the allocated amounts are recognized in revenue as those separate activities take place.

3.3.1 Criterion 1: Good or Service Is Capable of Being Distinct

FASB REFERENCES

ASC 606-10-25-19(a) and ASC 606-10-25-20

A good or service is capable of being distinct if a customer can benefit from it either on its own or with other resources readily available to the customer. A customer can benefit from a good or service if the good or service can be used, consumed or sold (other than for scrap value), or held in any other way to generate economic benefits. While a customer may benefit from some goods or services on their own in other circumstances, it might be able to obtain benefits from goods or services only in conjunction with other readily available resources.

A readily available resource is **either**:

- A good or service that is sold separately (either by the entity or a third party)
- A resource the customer has already obtained from the entity, including a good or service the entity has already transferred to the customer under the contract or from other transactions or events.

Whether the customer can benefit from a good or service either on its own or in conjunction with other readily available resources can be corroborated by various factors, such as whether an entity regularly sells a good or service separately. If a good or service cannot be used on its own or with other resources, conceptually there would not be a market for an entity to provide that good or service on a standalone basis.

3.3.1.1 Customer Can Benefit From the Good or Service on Its Own

FASB REFERENCES

ASC 606-10-25-19(a) and ASC 606-10-55-150A through 55-150F

Whether the customer can benefit from the good or service on its own depends on the characteristics of the goods or services themselves rather than the way in which the customer contractually may use or obtain them. Therefore, an entity disregards any contractual limitations that might prevent the customer from obtaining readily available resources from a source other than the entity.

"Capable of being distinct" is the minimum characteristic that a promised good or service must possess to be considered for separate accounting in a contract with a customer. If that criterion is not met, the promised good or service is not distinct, and an evaluation of the second criterion is not necessary. Rather, that promised good or service is combined with other promised goods or services in the contract until a distinct bundle of goods or services is identified.

EXAMPLE 3-2 (ADAPTED FROM ASC 606-10-55-150A THROUGH 55-150D): GOODS AND SERVICES ARE CAPABLE OF BEING DISTINCT

An entity contracts with a customer to sell machinery and installation services. Installation of the machinery is not complex and can be provided by the entity or other entities. The entity identifies two promised goods and services in the contract: (a) machinery and (b) installation services. The customer can benefit from the machinery on its own by using or reselling it for an amount greater than scrap value, or with other readily available resources (that is, installation services available from other entities). The customer also can benefit from the installation service promised by the entity in combination with other resources it will already have obtained from the entity under the contract (that is, the machinery). Therefore, the entity determines that the machinery and installation services are capable of being distinct.

EXAMPLE 3-3 (ADAPTED FROM ASC 606-10-55-150A THROUGH 55-150F): GOODS AND SERVICES ARE CAPABLE OF BEING DISTINCT

Assume the same facts as in Example 3-2 except the customer is contractually required to purchase the installation service from the entity rather than other entities. The entity's promises to transfer the machinery and installation services to the customer are capable of being distinct for the reasons stated in Example 3-2, despite the contractual limitations that prevent the customer from purchasing the installation service from other entities. The assessment of whether a customer can benefit from a good or service (the machinery or installation service) on its own is based on the characteristics of the good or service (machinery or installation service) itself rather than any contractual limitations. The contractual requirement to use the entity's installation service does not change the characteristics of the machinery or installation service, nor does it change the entity's promise to the customer.

3.3.2 Criterion 2: Promise to Transfer Good or Service Is Distinct Within the Context of the Contract

FASB REFERENCES

ASC 606-10-25-19(b) and ASC 606-10-25-21

An entity's promise to transfer a good or service is distinct within the context of the contract if it is separately identifiable from other promises in the contract. The objective of assessing whether an entity's promise to transfer a good or service is separately identifiable from other promised goods or services in the contract is to determine whether the nature of the promise — within the context of the contract — is to transfer each of those goods or services individually or to transfer a combined item to which the promised goods or services are inputs.

In certain cases, even though the individual goods or services promised as a bundle of goods or services might be capable of being distinct, accounting for those goods or services separately may not result in a faithful depiction of the entity's performance in that contract. For example, many construction- and production-type contracts involve transferring many goods and services that are capable of being distinct (for example, various building materials, labor, and project management services) to the customer. However, identifying all those individual goods and services as separate performance obligations would be impractical. More importantly, it would not faithfully represent the nature of the entity's promise to the customer. Therefore, when identifying whether promised goods or services in a contract are distinct, an entity considers both the characteristics of an individual good or service (that is, whether the good or service is capable of being distinct) and whether the promise to transfer the good or service is separately identifiable (that is, distinct within the context of the contract).

Determining whether an entity's promise to transfer a good or service is separately identifiable in a contract requires significant judgment and consideration of all facts and circumstances for each individual contract with a customer.

ASC 606 specifies three factors to assist an entity in making that judgment. Those factors indicate that an entity's promise to transfer two or more goods or services to the customer are not separately identifiable:

- The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represents the combined output for which the customer has contracted.
- One or more of the goods or services significantly modifies or customizes, or is significantly modified or customized, by one or more of the other goods or services promised in the contract.
- The goods or services are highly interdependent or highly interrelated.

The "separately identifiable" principle is influenced by the notion of separable risks, which is whether the risk that an entity assumes to fulfill its obligation to transfer one of those promised goods or services to the customer is inseparable from the risk relating to the transfer of the other promised goods or services in the contract.

In BC29 of ASU 2016-10, the FASB said an entity must evaluate whether a contract is to deliver **either**:

- Multiple promised goods or services that are outputs themselves
- A combined item that consists of the multiple promised goods or services that are inputs to a combined item.

For multiple promised goods or services to be considered inputs to a combined item, an entity's promise to transfer the promised goods or services must result in a combined item that is greater than (or substantively different from) the sum of those promised goods and services.

Further, in BC32 of ASU 2016-10, the FASB clarified that the separately identifiable principle is intended to consider the level of integration, interrelation, or interdependence among promises to transfer goods or services. In other words, the separately identifiable principle is intended to evaluate when an entity's performance in transferring a bundle of goods or services in a contract is in substance fulfilling a single promise to a customer. Therefore, the entity evaluates whether two or more promised goods or services (for example, a delivered item and an undelivered item) each significantly affect the other (and therefore are highly interdependent or highly interrelated) in the contract. The entity cannot merely evaluate whether one item, by its nature, depends on the other (for example, an undelivered

item that would never be obtained by a customer absent the presence of the delivered item in the contract or the customer having obtained that item in a different contract).

Entities must consider the three factors with the separately identifiable principle. The three factors are not exhaustive, and not all of them must be met (or not met) to conclude that the entity's promises to transfer goods or services are not (or are) separately identifiable. Further, sometimes the factors are less relevant to the evaluation of the separately identifiable principle, so entities must consider the principle, not only the three factors.

Further, the three factors are not mutually exclusive. On the contrary, because the factors are based on the same underlying principle of inseparable risks, it is possible that more than one factor might apply to a contract with a customer. However, ASC 606 includes all three factors because each one may be more or less applicable for particular contracts or industries.

3.3.2.1 Significant Integration Service



FASB REFERENCES

ASC 606-10-25-21(a) and ASC 606-10-55-137 through 55-140

Two or more promises to transfer goods or services to a customer are not separately identifiable if an entity provides a significant service of integrating those goods or services with other goods or services promised in the contract into a bundle that represents the combined output or outputs for which the customer has contracted.

In other words, the entity is using the goods or services as inputs to produce or deliver the combined output specified by the customer. A combined output may include more than one phase, element, or unit. Therefore, as stated in BC107 of ASU 2014-09, when an entity provides an integration service, the risk of transferring the individual goods or services is inseparable because a substantial part of the entity's promise is to incorporate the individual goods and services into the combined output.

The factor on significant integration service may be relevant in many construction contracts in which the contractor provides an integration (or contract management) service to manage and coordinate the various construction tasks.

EXAMPLE 3-4 (ADAPTED FROM ASC 606-10-55-137 THROUGH 55-140): SIGNIFICANT INTEGRATION SERVICE IN CONSTRUCTION CONTRACT

A contractor enters a contract with a customer to construct a building. The contractor is responsible for the overall management of the project and has promised multiple goods and services including engineering, site clearance, foundation, procurement, construction, piping and wiring, equipment installation, and finishing.

Each of those goods and services are regularly sold separately by the contractor or its competitors, and the customer could generate economic benefit from the individual goods and services by using, consuming, selling, or holding them. Therefore, the contractor determines that the customer can benefit from each of the goods or services either on its own or with other readily available resources and that each good or service is capable of being distinct.

The contractor determines that the promises to transfer the goods and services are not separately identifiable because it is providing a significant service of integrating the goods and services (the inputs) into the building (the combined output) for which the customer has contracted.

Therefore, the individual goods and services in the contract are not distinct, and the contractor accounts for all of the goods and services in the contract as a single performance obligation.

3.3.2.2 Significant Modification or Customization

FASB REFERENCES

ASC 606-10-25-21(b) and ASC 606-10-55-146 through 55-150

Two or more promises to transfer goods or services to a customer are not separately identifiable if one or more of the goods or services significantly modifies or customizes, or is significantly modified or customized by, another good or service promised in the contract.

In some industries, the notion of inseparable risks (the concept that the risk an entity assumes to fulfill its obligation to transfer one of the promised goods or services to the customer is inseparable from the risk relating to the transfer of the other promised goods or services in the contract) is more clearly illustrated by assessing whether one good or service significantly modifies or customizes another good or service. If a good or service significantly modifies or customizes another good or service in the contract, each good or service is being assembled (as an input) to produce a combined output for which the customer has contracted (see Examples 3-10 and 3-11 from the software industry).

EXAMPLE 3-4A (ADAPTED FROM ASC 606-10-55-146 THROUGH 55-150): SIGNIFICANT CUSTOMIZATION IN A SOFTWARE CONTRACT

An entity, a software developer, executes a contract with a customer to transfer a software license and an installation service. As part of the installation service, the entity promises to substantially customize the software to add significant new functionality to enable the software to interface with other customized software applications used by the customer. The customized installation service can be provided by other entities.

The software license is delivered before it is installed and remains functional without the customization and installation. The customer can benefit from the customized installation service, which can be performed by other entities, in conjunction with the software license and the customized installation service. Therefore, the software developer concludes that the license and the customized installation service are both capable of being distinct.

However, the entity concludes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the customer's existing software system by performing a customized installation service. In other words, the entity is using the license and the customized installation service as inputs to produce a combined output (a functional and integrated software system). The software is significantly modified and customized by the installation service. Therefore, the entity concludes that the promise to transfer the license is not separately identifiable from the customized installation service and that the two promises are therefore not distinct. Instead, they are combined into a single performance obligation.

3.3.2.3 High Interdependency or Interrelation

FASB REFERENCES

ASC 606-10-25-21(c) and ASC 606-10-55-137 through 55-150J

Two or more promises to transfer goods or services to a customer are not separately identifiable if the goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, two or more goods or services may be significantly affected by each other because the entity would be unable to fulfill its promise by transferring each of the goods or services independently.

In some cases, whether an entity is providing an integration service or the goods or services are significantly modified or customized may be unclear. Even so, the individual goods and services in the contract may still not be separately identifiable from the other goods or services promised in the contract because they are highly dependent on, or highly interrelated with, other promised goods or services in the contract in such a way that the customer could not choose to purchase one good or service without significantly affecting the other promised goods or services in the contract.

When considering whether the promises in a contract are highly interdependent or interrelated, it is important for an entity to consider whether one promise in a contract has a transformative effect on another promise rather than having merely an additive effect. The fact that a good or service depends on a second good or service (that is, they have a functional relationship) does not necessarily mean the two promises are not distinct in the context of the contract.

For example, equipment and related consumables needed to operate the equipment are distinct even though the value of the consumables depends on access to the equipment because the supply of consumables does not result in any changes to the equipment. Instead, the dependency between the promises must be bidirectional (that is, they must each affect the other (see Examples 3-5 and 3-8)).

BDO INSIGHTS: IDENTIFYING DISTINCT GOODS OR SERVICES REQUIRES JUDGMENT

The identification of distinct goods or services in a contract requires the application of professional judgment based on the facts and circumstances. An entity may need to perform a detailed analysis of contractual terms and conditions, unique facts and circumstances, and customer expectations and apply significant judgment to determine whether a promise in a contract is a distinct good or service (and thus constitutes a performance obligation) or must be combined with other promises in the contract to create a single performance obligation. An entity may also consider other information, such as marketing materials, to assist in its determination of its performance obligations. However, all facts and circumstances should be considered because marketing descriptions are not determinative, as discussed by the SEC (excerpted below).

SEC STAFF GUIDANCE

Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments

Sheri L. York, Professional Accounting Fellow, Office of the Chief Accountant

December 10, 2018

Identification of Performance Obligations

. . . In a recent consultation with OCA, a registrant provided its customer with a commercial security monitoring service by integrating a variety of cameras and sensors (which I will refer to as "equipment") with the entity's technology platform. The equipment was integrated via a control panel that was installed at the customer's location and enabled communication between the equipment and the registrant's technology platform. The registrant's technology platform also incorporated an element of artificial intelligence that used data from the cameras and sensors to learn the patterns of the customer's behavior. It then used that information to create a "smart" security monitoring service. For example, motion detectors may identify an attempt to open a window while other sensors may simultaneously indicate, based on a lack of body temperature readings, that personnel are not currently located within the building. In this case, the control panel would route this information obtained from the equipment to the registrant's technology platform, which may alert the customer and/or the authorities about a potential issue.

The registrant concluded that each piece of equipment (including the control panel), the installation, and the monitoring services were capable of being distinct, but believed that these promises comprised a single performance obligation as they were not distinct in the context of the contract. The registrant believed it was providing a significant service of integrating the goods and services in the contract into a bundle that represented the combined output for which the customer had contracted. More specifically, the delivery of a "smart" security monitoring service would not be possible if the equipment were not integrated with the technology platform.

The [SEC] staff did not object to the registrant's conclusion and considered it reasonable to conclude that the nature of the promise is to transfer a combined item – the commercial security solution – to which each piece of equipment (including the control panel), the technology platform, and installation are inputs. In this fact pattern, the entity demonstrated reasonable judgment that they were providing a significant integration service that transformed the equipment and services into a combined output that provided the customer with an overall service offering that was greater than the customer could receive from each individual part.

SEC STAFF GUIDANCE

Remarks before the 2019 AICPA Conference on Current SEC and PCAOB Developments

Susan M. Mercier, Professional Accounting Fellow, Office of the Chief Accountant

December 9, 2019

A "Solution"

. . . While the majority of registrants that consult with us on the identification of performance obligations provide a robust analysis addressing the factors in Topic 606, we sometimes hear registrants support their conclusion in consultation submissions or responses to comment letters from the Division of Corporation Finance by simply stating that they are providing a "solution," that the customer wants a combined "solution," or that there is only one promise in the contract to provide a "solution."

While I understand that the term "solution" is commonly used nomenclature, I would observe that the staff is not persuaded that promises should be combined into a single performance obligation simply because an entity labels those promises as a "solution" that the "customer wants." Rather, a registrant must support its assertion that its promises to transfer goods or services are not separately identifiable based on the guidance in ASC 606-10-25-21, which describes the objective of the analysis and provides factors to consider.

In addition to the guidance in ASC 606, I think it is also helpful to remember the discussion in the Basis for Conclusions of ASU 2016-10. I think that the notion of considering if an entity's combined output is greater than or substantively different from the sum of the parts is helpful in many cases.

EXAMPLE 3-5 (ADAPTED FROM ASC 606-10-55-140A THROUGH 55-140C): SIGNIFICANT INTEGRATION SERVICE AND HIGH INTERDEPENDENCY AND INTERRELATION IN MANUFACTURING CONTRACT

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

Each unit of the device can function independently of the other units, so the customer can benefit from each device on its own. Therefore, the manufacturer determines that each unit of the device is capable of being distinct.

The manufacturer considers the nature of its promise in the contracts and observes that it has promised to establish and provide a service of producing the full complement of devices for which the customer has contracted. The manufacturer is responsible for overall contract management and for providing a significant service of integrating various goods and services (the inputs) into its overall service and the resulting devices (the combined output). Therefore, the manufacturer determines that the devices and various promised goods and services inherent in manufacturing those devices are not separately identifiable.

The manufacturer provides a manufacturing process specific to its contract with a customer. Also, the nature of the manufacturer's performance, particularly, the significant integration of various activities, means that a change in one of the manufacturer's activities to produce the highly complex, specialized devices has a significant effect on the other activities required to produce those devices, such that the entity's activities are highly interdependent and highly interrelated.

Therefore, the manufacturer concludes that the goods and services in the contract are not distinct, and it accounts for all the goods and services as a single performance obligation.

EXAMPLE 3-5A: HIGH INTERDEPENDENCY AND INTERRELATION IN SOLAR FARM DESIGN CONTRACT

An entity enters a contract with a customer to develop a solar farm that will generate a specified output of electricity. The contract requires the entity to deliver solar panels and related design and installation services. The design services determine how many solar panels are needed and in what configuration to maximize solar energy generation. The services are provided using proprietary software owned and developed by the entity. The design and installation services are customized to the customer's location and significantly enhance solar power generation from the solar panels. The design is updated as necessary based on conditions encountered during installation.

The entity determines that the promises to transfer the solar panels and related design and installation services are not separately identifiable because the services are highly interdependent on and interrelated with the solar panels and the output to be derived therefrom. Specifically, the design dictates the number and configuration of the solar panels and how the installation services are performed. Further, the installation services change the design as needed to optimize the electricity generated by the solar panels. The solar panels and the services together result in significantly different functionality such that they are inputs into a combined output. Also, the customer's ability to derive its intended benefit depends on the entity fulfilling all its promises to sell solar panels and design and installation services.

Therefore, the individual goods and services in the contract are not distinct, and the entity accounts for the promise to develop a solar farm as a single performance obligation.

TRG DISCUSSIONS: EFFECT OF CONTRACTUAL RESTRICTIONS ON IDENTIFYING PERFORMANCE OBLIGATIONS

After stakeholders raised questions about the effect of contractual restrictions on the identification of performance obligations, the FASB added an example to illustrate that a contract for the sale of specialized equipment and the installation of the equipment could be distinct within the context of the overall contract even if the entity requires the customer to buy installation services when it buys equipment. Other relevant factors might include:

- The extent to which the equipment could operate without the installation.
- Whether other entities would have been able to undertake the installation absent the contractual restriction.
- The extent to which the installation services significantly modify or customize the equipment being installed.
- Whether the customer could benefit economically from the machine if it did not receive the installation services.

EXAMPLE 3-6 (ADAPTED FROM ASC 606-10-55-150A THROUGH 55-150C): PROMISES ARE SEPARATELY IDENTIFIABLE — INSTALLATION

An entity contracts with a customer to sell machinery and installation services. Installation of the machinery is not complex and can be provided by the entity or other entities. The entity identifies two promised goods and services in the contract: (a) machinery and (b) installation service.

Capable of Being Distinct

The customer can benefit from the machinery on its own, by using it or reselling it for an amount greater than scrap value, or with other readily available resources (that is, installation services available from other entities). It also can benefit from the installation service promised by the entity with other resources it will already have obtained from the entity under the contract (that is, the machinery). Therefore, the entity determines that the machinery and installation services are capable of being distinct.

Distinct in the Context of the Contract

The entity then determines whether its promises to transfer the machinery and to provide the installation services are each separately identifiable. It considers the following to determine whether the machinery and the installation services are inputs to a combined item:

- The entity is not providing a significant integration service. In other words, the entity has promised to deliver the machinery and then install it; the entity would be able to fulfill its promise to transfer the equipment separately from its promise to subsequently install it. The entity has not promised to combine the machinery and the installation services in a way that would transform them into a combined output.
- The entity's installation services will not significantly customize or significantly modify the machinery.
- Although the customer can benefit from the installation services only after it has obtained control of the machinery, the installation services do not significantly affect the machinery because the entity would be able to fulfill its promise to transfer the machinery independently of its promise to provide the installation services. In other words, there is no two-way interdependency between the machinery and installation services. Because the machinery and the installation services do not significantly affect each other, they are not highly interdependent or highly interrelated.

Thus, the entity determines that the machinery and installation services are not inputs to a combined item and identifies two performance obligations (the machinery and installation services) in the contract. Each of the three factors contributes to, but is not individually determinative of, the conclusion that the equipment and the installation services are separately identifiable.

EXAMPLE 3-7 (ADAPTED FROM ASC 606-10-55-150A THROUGH 55-150F): PROMISES ARE SEPARATELY IDENTIFIABLE — INSTALLATION

Assume the same facts as in Example 3-6 except the customer is contractually required to purchase the installation service from the entity rather than from other entities.

Capable of Being Distinct

For the same reasons as in Example 3-6, the entity's promises to transfer the machinery and installation services to the customer are capable of being distinct, despite the contractual limitations preventing the customer from purchasing the installation service from other entities. That is because the assessment of whether a customer can benefit from a good or service on its own is based on the characteristics of the good or service itself (the machinery or installation service in this example) rather than any contractual limitations. The contractual requirement to use the entity's installation service does not change the characteristics of the machinery or installation service, nor does it change the entity's promise to the customer.

Distinct in the Context of the Contract

The entity performs the same analysis of whether the machinery and installation services are separately identifiable as in Example 3-6 and identifies two performance obligations (the machinery and installation services) in the contract.

EXAMPLE 3-8 (ADAPTED FROM ASC 606-10-55-150G THROUGH 55-150J): SEPARATELY IDENTIFIABLE — EQUIPMENT AND CONSUMABLES

An entity enters a contract with a customer to deliver a printer that is off-the-shelf and operational without any significant customization or modification and the specialized ink cartridges required to operate the printer. The entity is contractually required to provide replacement cartridges, which are specific to the printer and produced only by the entity, on specified dates over the next three years. The entity sells the cartridges separately to customers that have bought the printer from it or from other parties.

Capable of Being Distinct

The entity determines that the printer and the cartridges are each capable of being distinct because:

- The customer can benefit from the printer with the readily available cartridges. The cartridges are readily available because they are regularly sold separately by the entity (that is, through refill orders to customers that previously purchased the printer).
- The customer can benefit from the cartridges that will be delivered under the contract with the printer that will be delivered to the customer initially under the contract.

Therefore, the entity determines that the printer and the cartridges are each capable of being distinct.

Distinct in the Context of the Contract

The entity determines that its promises to transfer the printer and to provide cartridges over a three-year period are each separately identifiable because:

- The printer and the cartridges are not inputs to a combined item in the contract because the entity is not providing a significant integration service that transforms the printer and cartridges into a combined output.
- The printer and cartridges do not significantly customize or modify each other.
- The printer and the cartridges are not highly interdependent or highly interrelated because they do not significantly affect each other.

Although the customer can benefit from the cartridges only after it has obtained control of the printer (that is, the cartridges would have no use without the printer) and the cartridges are required for the printer to function, the printer and the cartridges do not each significantly affect the other because the entity would be able to fulfill each

of its promises in the contract independently of the other. In other words, the entity would be able to fulfill its promises to (a) transfer the printer even if the customer did not purchase any cartridges and (b) provide the cartridges even if the customer acquired the printer separately.

Therefore, the entity identifies two performance obligations in the contract: the printer and the cartridges.

3.3.2.4 Utility of Promised Good or Service — Customer's Perspective

FASB REFERENCES

ASC 606-10-55-140D through 55-150

In BC33 of ASU 2016-10, the FASB said that when evaluating whether two or more promises in a contract are separately identifiable, consideration is given to the utility of the promised goods or services (that is, the ability of each good or service to provide benefit or value) to the customer. While an entity might be able to fulfill its promise to transfer each good or service in a contract independently, each good or service could significantly affect the other's utility to the customer.

While the "capable of being distinct" criterion considers the utility of the promised good or service, it merely establishes the baseline level of economic substance a good or service must achieve. Utility also is relevant in evaluating whether two or more promises in a contract are separately identifiable because even if two or more goods or services are capable of being distinct because the customer can derive some economic benefit from each one, the customer's ability to derive its intended benefit from the contract may depend on the entity transferring each of those goods or services.

For example, in Example 3-9 below on anti-virus software license with updates, the entity's ability to transfer the initial license is not affected by its promise to transfer the updates (and vice versa), but the provision (or not) of the updates will significantly affect the utility of the licensed IP to the customer such that the license and the updates are not separately identifiable. They are, in effect, inputs to the combined solution for which the customer contracted.

EXAMPLE 3-9 (ADAPTED FROM ASC 606-10-55-140D THROUGH 55-140F): LICENSE TO ANTI-VIRUS SOFTWARE WITH WHEN-AND-IF AVAILABLE UPDATES

A software entity grants a customer a three-year term license to anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The entity often provides updates that are critical to the continued utility of the anti-virus software. Without those updates, the customer's ability to benefit from the software would decline significantly during the three-year term.

Capable of Being Distinct

The entity determines that the anti-virus software and the updates are each capable of being distinct because:

- The customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer).
- The customer can benefit from the updates with the software license transferred at the outset of the contract.

Distinct in the Context of the Contract

The entity determines that its promises to transfer the anti-virus software and the unspecified updates, when-and-if available, are not separately identifiable because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The unspecified updates will significantly modify the software's functionality (that is, they enable the software to protect the customer from numerous additional viruses the

software did not protect against previously) and are integral to maintaining the utility of the software license to the customer.

Consequently, the anti-virus license and periodic unspecified updates fulfill a single promise to the customer in the contract: a promise to provide protection from computer viruses for three years. Therefore, the entity accounts for the software license and the when-and-if available updates as a single performance obligation in the contract.

See Section 7.5 for additional discussion on licensing arrangements.

SEC STAFF GUIDANCE

Remarks before the 2019 AICPA Conference on Current SEC and PCAOB Developments

Susan M. Mercier, Professional Accounting Fellow, Office of the Chief Accountant

December 9, 2019

License to Software With Updates — Single Performance Obligation

. . . In this particular consultation, the registrant licenses software that allows its customers, application ("app") developers, to build and deploy, and therefore monetize, their own apps on various third-party platforms. The third-party platforms include phones and home entertainment systems, which, as you can imagine, are frequently undergoing their own updates. The registrant's software and updates ensure that the app built using the software is compatible with all platforms that it supports, both when the app is initially deployed on a platform and over time as that platform is updated. Therefore, the registrant partners with the third-party platforms to understand their timelines for internal updates so that the registrant can ensure compatibility by initiating corresponding updates to its software. Without these updates, the customer's ability to benefit from the software would be significantly limited over the contract term.

Ultimately, the [SEC] staff did not object to the registrant's conclusion that the software and updates represent a single performance obligation. In the [SEC] staff's view, the registrant's promise to the customer – that is, to continually be able to deploy and monetize content using third-party platforms of the customer's choice in a rapidly changing environment - and that the updates are integral to maintaining the utility of the software license. In other words, in this fact pattern, the [SEC] staff thinks that the combined output (whether or not you label it a "solution") is greater than, or substantively different than, the individual promises (that is, the software and the updates).

BDO INSIGHTS: DETERMINING WHETHER A SOFTWARE LICENSE AND UPDATES ARE A SINGLE PERFORMANCE OBLIGATION

In the fact pattern discussed above in the SEC staff speech and Example 3-9, the entity concluded that the software license and related updates are a single performance obligation. We believe it may be possible to reach the same conclusion in additional fact patterns, although we believe that will be rare.

Key factors we believe may be helpful in determining whether a software license and updates are a single performance obligation include:

- How frequently updates are available
- Whether the updates are driven by factors within the software entity's control
- How significantly the functionality of the software is affected by the upgrades
- How often, and how many, customers elect not to adopt an upgrade and continue to derive the intended benefit from the software license.

EXAMPLE 3-9A: IDENTIFYING PERFORMANCE OBLIGATIONS IN A CONTRACT FOR A HYBRID CLOUD-BASED SOLUTION

A software entity provides a cloud-based business productivity and collaboration solution to customers, which includes both cloud-based SaaS and on-premise software licenses for desktops and mobile devices.

The on-premise software and cloud-based SaaS each provide certain functionalities. However, certain significant functionalities are only available through the interaction of cloud-based features with the on-premise software.

In identifying the performance obligations in a contract with a customer for the cloud-based solution, the entity considers that the customer derives the expected benefits from the solution because of the interaction between the on-premise software and the cloud-based features of the solution. The customer cannot derive the intended benefits through the on-premise software alone because the cloud-based service includes significant features and functionalities that the customer can access only when connected to the cloud.

Therefore, the entity determines that the cloud-based features are integral to the promised solution and work together with the on-premise software to create significant features and functionalities promised to the customer.

The entity concludes that the contract includes one performance obligation.

The significant customization or modification factor may be relevant in a software development contract in which a software developer customizes a software product for a specific customer. ASC 606 includes two fact patterns to illustrate whether a significant customization service provided by a software developer in a contract with a customer is distinct from a software license, as illustrated in Examples 3-10 and 3-11 below.

EXAMPLE 3-10 (ADAPTED FROM ASC 606-10-55-141 THROUGH 55-145): SOFTWARE DEVELOPMENT CONTRACT — SIGNIFICANT CUSTOMIZATION OR MODIFICATION IS NOT PROVIDED

An entity, a software developer, contracts with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support for a specified period. The entity sells the license, installation service, and technical support separately. The installation service, which does not significantly modify the software, includes changing the web screen for each type of user (for example, marketing, inventory management, and IT). The entity's competitors routinely perform the installation service. The software remains functional without the updates and the technical support.

Capable of Being Distinct

The entity concludes that the promised goods and services are capable of being distinct because the customer can benefit from each of them on its own or with the other goods and services that are readily available. That is because:

- The software is delivered before the other goods and services and remains functional without the updates and the technical support.
- The customer can benefit from the updates with the software license transferred at the outset of the contract.

Distinct in the Context of the Contract

The entity determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (that is, the goods and services are distinct in the context of the contract) because:

- Although the entity integrates the software into the customer's system, the installation services do not significantly affect the customer's ability to use and benefit from the software license because they are routine and can be obtained from other providers.
- The software updates do not significantly affect the customer's ability to use and benefit from the software license because they are not necessary for the software to maintain a high level of utility to the customer during the license period.
- None of the promised goods or services significantly modify or customize one another.
- The entity is not providing a significant service of integrating the software and the services into a combined output.
- The software and the services do not significantly affect each other and therefore are not highly interdependent or highly interrelated. That is because the entity would be able to fulfill its promise to transfer the initial software license independently from its promise to subsequently provide the installation service, software updates, or technical support.

Thus, the entity concludes that there are four performance obligations in the contract:

- Software license
- Installation service
- Software updates
- Technical support

EXAMPLE 3-11 (ADAPTED FROM ASC 606-10-55-146 THROUGH 55-150): SOFTWARE DEVELOPMENT CONTRACT — SIGNIFICANT CUSTOMIZATION IS PROVIDED

Assume the same facts as in Example 3-10 except that the contract requires the entity, as part of the installation service, to substantially customize the software to add significant new functionality to enable the software to interface with other customized software applications used by the customer. Competitors can provide the customized installation service.

Capable of Being Distinct

For the same reasons as in Example 3-10, the entity concludes that the software license, installation service, software updates, and technical support are each capable of being distinct.

Distinct in the Context of the Contract

The entity then considers the following:

- The contractual terms result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) in accordance with the customer's specifications.
- The software is significantly modified and customized by the installation service.

Consequently, the entity determines that the promise to transfer the software license is not separately identifiable from the customized installation service and that those aspects are not distinct in the context of the contract. Therefore, the software license and the customized installation service are combined into a single performance obligation.

Based on the same analysis as in Example 3-10, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

Therefore, the entity concludes that there are three performance obligations in the contract:

- Software customization (comprising the software license and the customized installation service)
- Software updates
- Technical support

3.3.3 Firmware



FASB REFERENCES

ASC 606-10-55-56(a)

Many consumer products include firmware, which is embedded software required for the product to function as intended. A license that forms a component of a tangible good and is integral to the good's functionality is not distinct from the good. In that case, the tangible good and license are accounted for as a single performance obligation. As a result, firmware is typically combined with the related product and accounted for as a single performance obligation.

In a growing number of instances, an entity might also provide functionality related to a consumer product through a free mobile application (app). An entity needs to determine whether the app:

- Is integral to the functionality of the product and thus must be combined with the product and firmware as a single bundled performance obligation.
- Represents incremental functionality that is a distinct performance obligation.

Examples 3-12 and 3-13 illustrate the concept.

EXAMPLE 3-12: HARDWARE WITH EMBEDDED FIRMWARE AND MOBILE APP

A medical device entity sells a blood glucose monitor. A customer purchasing a monitor also receives a limited license to the firmware that is embedded on the monitor and without which the monitor cannot determine blood glucose levels as promised. The entity also makes available a free mobile app the customer can download to use with the monitor.

The blood glucose monitor includes a user interface that, when used properly, visually reports blood glucose levels of the user. The app provides more functionality, including wirelessly syncing to the monitor to receive and store measurements and using the stored history to predict when a user may experience high or low measures.

The embedded firmware is a component of the blood glucose monitor and integral to its functionality. As such, the license is not capable of being distinct.

The medical device entity then concludes that the app and blood glucose monitor are capable of being distinct because a user can obtain the promised benefit of determining blood glucose levels without downloading the app. Further, because the app can be used in conjunction with other resources a customer already owns (namely, the blood glucose monitor), it is capable of being distinct from the monitor.

The entity then determines whether the app is distinct in the context of the contract. It notes that while the app depends on the blood glucose monitor, the monitor does not depend on the app. In other words, the interdependency between the app and the monitor is not bidirectional. Also, neither the app nor the monitor modifies or customizes the other, and the entity does not perform a significant service of integrating the monitor and app into a combined output.

Therefore, the entity concludes that the app is distinct from the blood glucose monitor.

The entity must also evaluate whether the app is a functional IP license that is generally satisfied at a point in time (see Section 7.5).

EXAMPLE 3-13: HARDWARE WITH EMBEDDED FIRMWARE AND MOBILE APPLICATION

Assume the same fact pattern as in Example 3-13 except the blood glucose monitor does not include a user interface. Instead, it automatically delivers the measurements wirelessly to the app. A user must use the app to receive the blood glucose measurement taken by the monitor. The app also provides tracking and charting of historical measurements, as well as predictive analysis based on that history.

Consistent with Example 3-13, the medical device entity concludes that the firmware is not distinct from the blood glucose monitor.

However, in this example, the entity also concludes that the app is not capable of being distinct. Specifically, the blood glucose monitor cannot function as intended by a user without the app because the app is the only mechanism by which the user can obtain their blood glucose measurements. Therefore, the entity concludes that it has a single performance obligation consisting of the blood glucose monitor, the firmware, and the app.

The entity must also evaluate whether the app is a functional IP license that is generally satisfied at a point in time. If the app is a functional IP license that is always available on an application store for the customer to download, it is generally considered delivered at the same time as the hardware and firmware. See Section 7.5 for discussion on IP licenses and related revenue recognition considerations.

3.3.4 Combining a Good or Service with Other Promised Goods or Services

FASB REFERENCES

ASC 606-10-25-22

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

3.3.5 Application of Step 2 for Concurrently Satisfied Performance Obligations

ASC 606 does not specify the accounting for concurrently delivered distinct goods or services that have the same pattern of transfer. Based on the FASB's observation in BC116 of ASU 2014-09, an entity is not precluded from accounting for the goods or services in a contract that are delivered concurrently as if they were a single performance obligation if the outcome is the same as accounting for the goods and services as individual performance obligations. See Chapter 6 for discussion on the pattern of transfer of a good or service.

BDO INSIGHTS: MODIFICATION OF A CONTRACT THAT INCLUDES CONCURRENTLY SATISFIED PERFORMANCE OBLIGATIONS

Even if a contract includes multiple performance obligations that are satisfied concurrently and could practically be accounted for as a single performance obligation, an entity must correctly identify separate performance obligations in the original contract if that contract is modified. Accounting for a contract modification is based on, among other things, whether a promised good or service is distinct (and therefore a performance obligation) and whether a performance obligation in a contract has been satisfied before the modification date. Those considerations affect the amount and timing of revenue recognized at or after the modification date (see Section 7.3).

Identifying performance obligations and accounting for contract modifications requires the application of professional judgment based on the facts and circumstances.

3.4 SERIES OF DISTINCT GOODS OR SERVICES

FASB REFERENCES

ASC 606-10-25-14 through 25-15 and ASC 606-10-55-157B through 55-157E

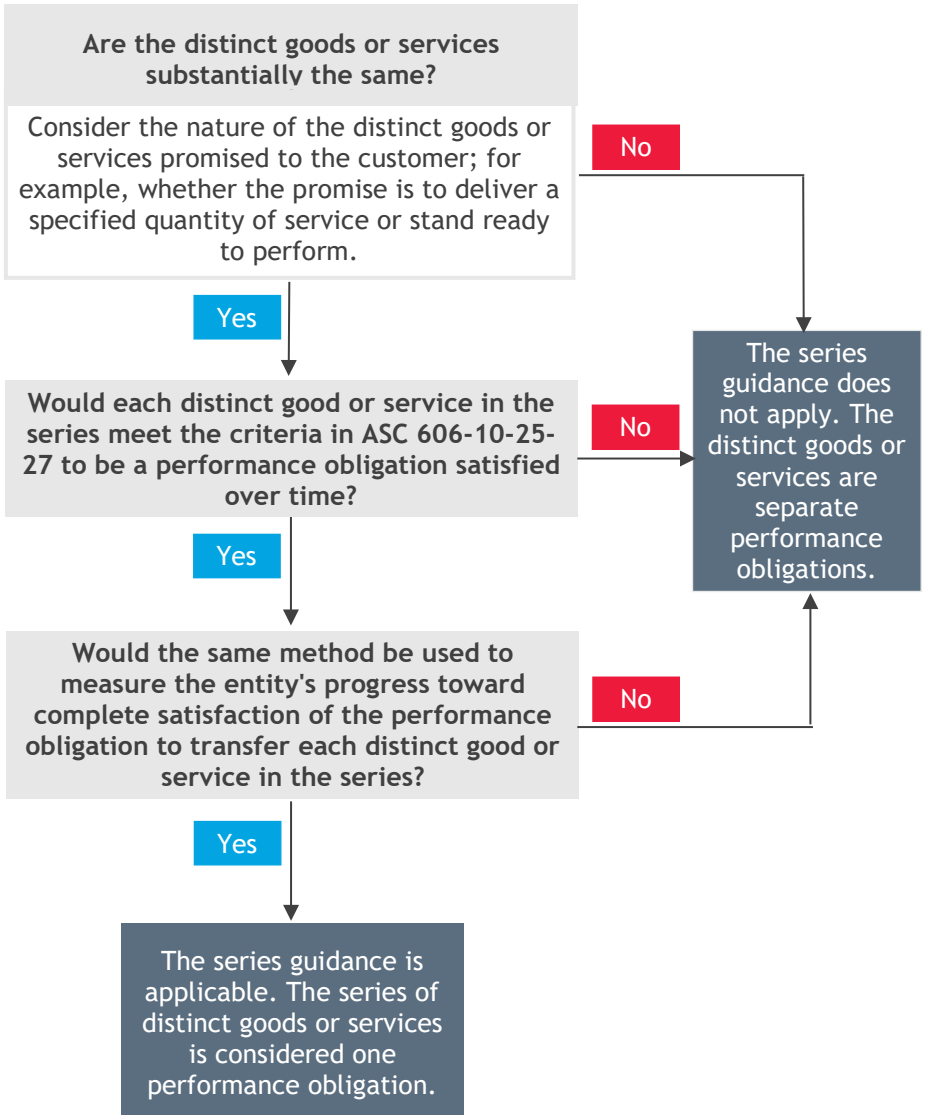
A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer are considered one performance obligation in the contract for applying the five-step revenue recognition model. A series of distinct goods or services has the same pattern of transfer to the customer if **both** the following criteria are met:

- Each distinct good or service in the series the entity promises to transfer to the customer would meet the criteria in ASC 606-10-25-27 to be a performance obligation satisfied over time.
- The same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

See Chapter 6 for discussion on whether a performance obligation is satisfied over time and measurement of an entity's progress toward satisfying its performance obligation.

In determining whether the series guidance applies, an entity must first determine the nature of the goods or services promised to the customer before assessing whether the promised services are distinct and substantially the same. In some cases, that analysis may include determining whether the promise is the actual delivery of a specified quantity of service or the act of standing ready to perform.

The following diagram outlines the process for determining whether the series guidance applies:



The series guidance was included as part of the definition of a performance obligation to simplify the application of the five-step revenue recognition model and promote consistency in the identification of performance obligations when the entity provides the same good or service repeatedly over a period of time. An entity may provide the same good or service repeatedly over a period; for example, in a repetitive service contract, such as a cleaning contract, transaction processing contract, or a contract to deliver electricity. If the series guidance had not been included in the definition of a performance obligation, an entity would be required to identify multiple distinct goods or services (or separate performance obligations), allocate the transaction price to each of the resulting performance obligations based on its standalone selling price (SSP), and recognize revenue when or as those performance obligations are satisfied. For example, an entity would be required to allocate the overall consideration to each incremental hour of cleaning in a cleaning contract. The series guidance was included to provide a cost-effective and more operable approach to applying the five-step revenue recognition model when an entity provides a series of distinct goods or services that are substantially the same.

When the contract includes a promise to transfer a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer, an entity identifies a single performance obligation and allocates the transaction price to that performance obligation. The entity then recognizes revenue by applying a single measure of progress to that performance obligation. See Chapter 6 for discussion on the pattern of transfer of a performance obligation (over time or at a point in time) and measure of progress when a performance obligation is satisfied over time.

In assessing whether multiple goods or services are treated as a series, it is not necessary that:

- The goods or services be transferred consecutively.
- The accounting result from applying the series guidance be substantially the same as would result from accounting for each promised good or service as a separate performance obligation.

EXAMPLE 3-14 (ADAPTED FROM ASC 606-10-55-157B THROUGH 55-157E): SERIES OF DISTINCT GOODS OR SERVICES — SUBSTANTIALLY THE SAME

An entity, a hotel manager, contracts with a customer to manage a customer-owned property for 20 years. The entity receives a monthly payment that is equal to 1% of the revenue from the customer-owned property.

The entity evaluates the nature of its promise to the customer and determines that it has promised to provide a hotel management service that consists of various activities, such as cleaning services and property maintenance, that may vary each day. However, those tasks are activities to fulfill the hotel management service and are not separate promises in the contract.

The entity concludes that each increment of the promised service (for example, each day of the hotel management service) is distinct for two reasons:

- The customer can benefit from each day of the hotel management service on its own (that is, each increment of service is capable of being distinct).
- Each increment of service is separately identifiable because:
  - No day of service significantly modifies or customizes another.
  - No day of service significantly affects either the entity's ability to fulfill another day of service or the benefit to the customer of another day of service.

Is each increment of service substantially the same?

The entity considers that although the underlying tasks or activities it performs to provide hotel management services may vary from day to day, the nature of its promise to its customer, which is to provide hotel management services, is the same each day. Therefore, the entity concludes that the hotel management services provided each day are substantially the same.

To determine whether the series guidance is applicable, the entity would determine whether each distinct increment of service is delivered over time using the same pattern of transfer. See Chapter 6 for discussion on whether a performance obligation is satisfied over time and measurement of an entity's progress toward satisfying its performance obligation.

EXAMPLE 3-15: R&D SERVICES — APPLICABILITY OF THE SERIES GUIDANCE

A biotechnology entity enters a contract with a customer to provide R&D services to develop a new drug compound. The R&D services are to be provided in various phases covering the initial development, trials, and regulatory approvals. Each subsequent phase is dependent on the successful completion of the prior phase.

The entity evaluates the nature of its promise to the customer to determine whether the R&D activities performed each day represent a series of distinct increments of time or service. It observes that:

- The nature of its promise is to provide R&D services, which comprise various activities that may vary, each day.
- Each day's research and related results are dependent on or interrelated with the prior day's research. Therefore, each day of R&D services builds on and is interrelated with the other days of services.

The entity determines that while the underlying activities may differ from day to day, its promise is the same for each day: to provide R&D services. Also, the nature of its promise is cumulative such that each increment of time or R&D service builds, and is dependent, on the preceding increments of time or R&D service. Therefore, the entity determines that an increment of time or service is not distinct, so the series guidance does not apply.



TRG DISCUSSIONS: SERIES GUIDANCE — SUBSTANTIALLY THE SAME

How should an entity evaluate whether the performance obligation consists of distinct goods or services that are substantially the same?

To be considered a series of goods or services, there must be two or more goods or services that are distinct, and each distinct good or service must also be considered substantially the same. The first step is to determine the nature of an entity's promise in providing the goods or services to the customer. In some cases, an entity would need to determine if the nature of the promise is the actual delivery of a specified quantity of service or the act of standing ready to perform, which will require significant judgment. See the related TRG discussions below.

The TRG considered the FASB's intention that a series could consist of distinct time increments (for example, an hour of cleaning) or the good or service delivered (for example, each unit of electricity), depending on the nature of the promise. Therefore, an entity should consider **both** questions below in applying the series guidance:

Is each time increment distinct?

- If the nature of the entity's promise is the act of standing ready or providing a single service for a period of time (that is, because there is an unspecified quantity delivered), the evaluation would likely focus on whether each time increment, rather than the underlying activities, are distinct and substantially the same.
  - For example, in Example 3-14, the nature of the hotel manager's promise is to provide a daily management service, not a specified quantity of services. The promised service could include accounting services, procurement, and managing, training, and hiring hotel employees. While the underlying activities could significantly vary within a day and from day to day, that would not be relevant to the evaluation of the nature of the promise. The hotel management performance obligation is a series of distinct days of service.

Is each unit of output distinct?

- If the nature of the promise is the delivery of a specified quantity of a service, the evaluation should consider whether each service is distinct and substantially the same.
  - ASC 606-10-55-160 describes an annual contract to provide monthly payroll processing services that are considered a series. In that contract, the nature of the promise is to deliver 12 distinct instances of the service, rather than a promise to stand ready to perform an undefined number of tasks.

TRG DISCUSSIONS: SERIES GUIDANCE — STAND-READY OBLIGATIONS

What is the nature of the promise to the customer in arrangements described as stand-ready obligations?

ASC 606-10-25-18 provides examples of promised goods or services, one of which is a service of standing ready to provide goods or services or of making goods or services available for a customer to use as and when the customer decides. If the goods or services provided meet the criteria in ASC 606-10-25-27 to be performance obligations that are satisfied over time and have the same pattern of transfer (see Chapter 6 for discussion on assessing timing and pattern of revenue recognition), a stand-ready obligation will generally meet the definition of a series and be accounted for as a single performance obligation. However, determining whether the promise to the customer is a stand-ready obligation can require significant judgment.

In January 2015, the TRG considered four types of promises (Types A-D) and discussing whether the nature of the good or service underlying the promises is the act of standing ready or the actual delivery of the underlying goods or services the entity stands ready to provide to the customer.

Type A: Obligations in which the delivery of the good, service, or IP underlying the obligation is within the entity's control, but the entity must still further develop its good, service, or IP (for example, a software entity's promise to transfer unspecified software upgrades at the entity's discretion, or a pharmaceutical entity's promise to provide when-and-if-available updates to previously licensed IP to a drug formula based on advances in R&D).

Type B: Obligations in which the delivery of the underlying good or service is outside the control of the entity or the customer (for example, an entity's promise to remove snow from an airport's runways in exchange for a fixed fee).

Type C: Obligations in which the delivery of the underlying good or service is within the customer's control (for example, an entity's promise to provide periodic maintenance, when and if needed, on a customer's equipment after a specified amount of use by the customer).

Type D: Making a good or service available to the customer continuously (for example, a health club membership).

In arrangements like those in Types B, C, and D in which an entity provides uncertain goods or services (for example, while the entity knows it will provide maintenance services, it does not know the number of service calls it will make or the parts it will be required to fix), the service the entity provides to the customer is standing ready to perform.

Promises like those in Type A (for example, to provide when-and-if available updates or upgrades in software or biotechnology IP licensing arrangements) may require additional analysis to determine the nature of the promise. That is because the entity itself, rather than the customer or external events, might unilaterally control when updates or upgrades become available for transfer to the customer. However, the nature of the entity's promise in Type A arrangements may be similar to those in Types B through D because an entity often will be unable to predetermine the timing, number, or specific functionality or features of major IP improvements that will be completed in the future and made available for transfer to a customer. For example, a biotechnology entity likely cannot unilaterally determine when its scientists will make an R&D advancement for a drug formula. Similarly, a software entity might have no major update or upgrade available for release during a contract period, especially if the contract period is relatively short (for example, one year). In those examples, an entity's performance in a Type A arrangement, such as a when-and-if available upgrade right, might depend on events or circumstances that are largely outside the entity's control. That is similar to the obligations in Types B through D arrangements.

Also, similar to the obligations in Types B through D arrangements, a Type A promise to unspecified when-and-if available upgrades is often about the customer obtaining assurance that it will have access to future improvements to the product it has obtained, thus providing the customer with a guarantee against product obsolescence or defects. In the software license example, the guarantee provides a benefit to the customer by protecting the customer's investment in the software (which may include, for example, an expensive implementation that would not be recovered economically if the customer had to implement new software in the near future) or the customer's related business interests (for example, a customer that embeds the software in its own products might

want assurance that it will have access to software upgrades so that its products remain competitive). Absent the right to unspecified upgrades, the entity might charge the customer exorbitant fees in a separate negotiation for the next version of the software or enter an exclusive arrangement with another customer that restricts the original customer's ability to obtain the upgrades.

In determining the nature of its promise to a customer in a Type A arrangement, an entity must carefully evaluate whether it has promised one or more specified upgrades to a customer even if the contract refers only to unspecified upgrades that will be transferred to the customer only when and if they become available. A promise to deliver a specified upgrade is accounted for in the same manner as any other specifically promised good or service. For example, a promise to deliver a specified upgrade to a software license is evaluated in the same manner as any other software license.

BDO INSIGHTS: SAAS WITH USAGE-BASED PRICING

As discussed above, a Type D promise is generally considered a series of distinct time increments because the nature of the promise is to stand ready to perform as the customer requests. This usually results in:

- Ratable recognition of any fixed consideration in revenue.
- Recognition of any variable consideration in the period to which it relates because of the application of the variable consideration allocation exception in ASC 606-10-32-39.

However, entities must not default to that revenue recognition pattern for contracts with usage-based pricing. Rather, an entity must carefully assess the nature of its promise to determine whether it has promised to deliver a specified volume of service (that is, a series of distinct service or usage) or stand ready to perform as the customer requests (that is, a series of distinct time increments).

To assess the nature of its promise, an entity may consider the following factors:

- Whether the customer benefits from the right to access the good or service in the amount and at the time as needed. In other words, whether the entity stands ready to perform throughout the contract duration.
- Whether the entity can predetermine the timing and volume of transactions, and its performance is dependent upon events or circumstances that are outside its control (for example, because the customer controls when and how much to use the good or service).
- Whether the entity stands ready to provide unlimited access or whether the entity's obligation to the customer diminishes as the customer uses the good or service.

See Example 3-16 for an illustrative fact pattern.

EXAMPLE 3-16: SOFTWARE-AS-A-SERVICE WITH USAGE-BASED PRICING

A technology entity enters a contract to provide a customer access to its software-as-a-service (SaaS) platform for two years. The customer will have the ability to process 100,000 transactions each year through the SaaS platform and it must make annual payments of $120,000. If needed, the customer is able to process transactions beyond the annual volume of 100,000 transactions but is charged for the incremental transactions at a higher rate. The entity does not expect the customer to exceed 100,000 transactions per year.

The entity evaluates the nature of its promise to determine whether it has an obligation to provide:

- A specified amount of services (that is, 100,000 transactions per year processed through the SaaS platform), with each transaction being distinct and substantially the same.
- A stand-ready obligation comprising distinct increments of time to provide access to the SaaS platform to process all transactions if and when required by the customer.

The entity determines that it has a stand-ready obligation to provide access to the SaaS platform for the entire contractual period, regardless of the amount of services specified in the contract or expected to be sold. In making that determination, the entity considers the following:

- The customer benefits from the right to access the SaaS platform and process transactions in the amount and at the time as needed. The entity stands ready to perform throughout the contract duration.
- The entity is unable to predetermine the timing and volume of transactions, and its performance depends on events or circumstances that are outside its control.
- The entity stands ready to process unlimited transactions. While transactions that exceed the annual volume are billed at a premium price, the customer does not have to separately contract for the right to transact those volumes. The entity's obligation to the customer does not diminish as transactions are processed. Selling a specified volume at a fixed price and overages on a variable basis is a pricing strategy rather than determinative of the entity's obligations to the customer.



TRG DISCUSSIONS: SERIES GUIDANCE — CONSECUTIVE DELIVERY OF GOODS OR SERVICES

To apply the series provision, must the goods be delivered, or services performed, consecutively?

No. In March 2015, the TRG considered whether the series guidance applies when there is a gap or overlap in the entity's delivery of goods or performance of services and generally agreed with the FASB staff that whether the goods or services are delivered or performed consecutively is not determinative in assessing whether the series guidance applies. While an entity may consider the pattern of performance in determining the measure of progress toward satisfying a performance obligation, the series guidance does not explicitly require the consideration of whether the pattern of performance is consecutive.

Both fact patterns below are accounted for as single performance obligations in accordance with the series guidance.

Case A: An entity contracts with a customer to provide a manufacturing service in which it will produce 10,000 units of a product every month for two years. The entity will perform the service evenly over the two-year period with no breaks in production. It does not incur any significant upfront costs to develop the production process. The units produced are substantially the same and manufactured to the customer's specifications.

The entity's manufacturing service of producing each unit is a distinct service. Further, the service is accounted for as a performance obligation satisfied over time (see Chapter 6) because:

- The units are manufactured specific to the customer's requirements (that is, the entity's performance does not create an asset with alternative use to the entity).
- If the contract is canceled, the entity has an enforceable right to payment (cost plus a reasonable profit margin).

Therefore, both criteria to apply the series guidance have been met.

Case B: Assume the same facts in Case A except that the entity does not plan to perform evenly over the two-year service period (that is, the entity will not produce 10,000 units each month). Instead, the entity plans to perform the manufacturing service over the two-year period, but in achieving the production targets, it will produce 20,000 units in some months and zero units in other months.

Despite the lag in manufacturing service, each unit is a series because ASC 606 does not require consecutive performance of a service.

TRG DISCUSSIONS: SERIES GUIDANCE — ASSESSING ACCOUNTING OUTCOME

To apply the series guidance (that is, to account for a series composed of multiple distinct goods or services as a single performance obligation), does the accounting result need to be the same as if the underlying distinct goods or services each were accounted for as separate performance obligations?

No. In March 2015, the TRG generally agreed that the series guidance does not include a requirement to assess whether the accounting outcome of applying that guidance would be the same as the outcome of accounting for each distinct good or service underlying the series as a separate performance obligation.

The TRG said that requiring entities to compare revenue recognition patterns in a "with and without" type manner would be onerous and negate the FASB's intent in establishing the series guidance, which was to simplify the accounting and make it more operational. A requirement to prove whether application of the series guidance results in a difference in the revenue recognition result would be counter to that objective. Therefore, the application of the series guidance does not require an entity's revenue recognition to be substantially the same with or without the series provision.

BDO INSIGHTS: IF APPLICABLE, SERIES GUIDANCE IS MANDATORY

Although the series guidance simplifies the application of ASC 606 in many situations, it is not a practical expedient that entities can choose to apply; rather, it is mandatory if the criteria for its application are met. Therefore, entities must carefully consider whether the series guidance applies, particularly to repetitive service contracts or contracts involving the delivery of a quantity of similar items that are delivered not at the same time but repeatedly over the contractual period. See Chapter 6 for discussion on the pattern of transfer of a performance obligation.

Determining whether the series guidance applies requires the application of professional judgment based on the facts and circumstances.

EFFECT OF THE SERIES GUIDANCE ON OTHER ASPECTS OF ASC 606

When a promise is a single performance obligation made up of a series of distinct goods or services rather than a single performance obligation made up of goods or services that are not distinct from each other, the accounting treatment can vary in three primary areas:

- **Changes in transaction price (see Section 4.8):** In some cases, ASC 606 requirements are applied differently to a single performance obligation comprising nondistinct goods or services than to a single performance obligation resulting from applying the series guidance.
- **Allocation of variable consideration (see Section 5.5):** The amount of the variable consideration recognized for each reporting period could be different because ASC 606 requires an entity to allocate variable consideration solely to one or more distinct goods or services even if those goods or services form a single performance obligation.
- **Contract modifications (see Section 7.3):** If the remaining undelivered goods or services are distinct (even if part of a single performance obligation under the series guidance), the entity will account for the modified

contract prospectively. If the remaining goods or services are not distinct from those already provided, the modification will result in a cumulative effect adjustment.

3.5 WARRANTIES

FASB REFERENCES

ASC 606-10-55-30 through 55-35

An entity may provide a warranty in connection with the sale of a good or service in accordance with the contract, the law or the entity's customary business practices. The nature of a warranty can vary significantly across industries and contracts.

BDO INSIGHTS: CASH WARRANTIES ARE CONSIDERED A RIGHT OF RETURN NOT A WARRANTY LIABILITY

In most cases, a warranty requires the seller to either repair or replace the defective product. However, some contracts require the seller to provide a cash payment (or a credit) to the customer. We believe that a warranty obligation that requires refunding the purchase price to the customer should be accounted for as a right of return (see Section 4.3.8) rather than a warranty. However, if the agreement requires the vendor to replace or remediate the defective product, the obligation should be accounted for as a warranty. Additional scenarios may require additional analysis. For example, an arrangement may require the seller to provide a cash payment to the customer in the amount of repairs obtained by the customer from a third party. Determining the appropriate accounting model for these situations requires judgment based on facts and circumstances.

ASC 606 differentiates between assurance- and service-type warranties:

Service-Type Warranty	A warranty that provides the customer with a service in addition to the assurance that the product will function in accordance with agreed specifications.	Account for as a distinct performance obligation under ASC 606	**Example:** A customer purchases an extended warranty that requires the original equipment manufacturer to repair the equipment if it fails after the standard warranty expires.
Assurance-Type Warranty	A warranty that provides a customer with the assurance that the product will function in accordance with agreed specifications.	Account for as a product warranty under ASC 460	**Example:** A manufacturer sells equipment with a standard warranty to cover any manufacturing defects for five years after purchase by the customer.

If a customer can purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a service-type warranty accounted for as a separate performance obligation. It represents a distinct service the entity promises to provide to the customer in addition to the product that has the functionality described in the contract.

Even if a warranty is not sold separately, an entity evaluates whether the warranty, or a part thereof, provides the customer with a service in addition to an assurance that the product complies with agreed specifications (that is, an assurance component). In assessing whether a warranty provides a customer with a service in addition to the assurance component, an entity considers factors such as:

 **Whether the Warranty Is Required by Law**	A law requiring an entity to provide a warranty indicates that the warranty is not a performance obligation because such laws typically exist to protect customers from the risk of purchasing defective products.
 **Length of the Warranty Coverage Period**	A longer coverage period indicates that it is more likely that the promised warranty is a performance obligation because an entity is more likely to provide a service in addition to the assurance that the product complies with agreed specifications.
 **Nature of the Tasks the Entity Promises to Perform**	If an entity must perform specified tasks to provide the assurance that a product will function in accordance with agreed specifications (for example, return shipping service for defective products), those tasks likely do not give rise to a performance obligation.

If a warranty, or a part thereof, does not provide a customer with a service in addition to the assurance that a product complies with agreed specifications, then an entity must account for that warranty in accordance with the guidance on product warranties in ASC 460. However, if a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed specifications, the promised service represents a service-type warranty that is a separate performance obligation from the product. Therefore, an entity must allocate the transaction price to the product and the service-type warranty (see Chapter 5). Further, if an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, it must account for both as a single performance obligation distinct from the related product.

A law that requires an entity to pay compensation if its products cause harm or damage does not create a performance obligation. For example, if a manufacturer sells laptops in a jurisdiction where the law holds the manufacturer liable for any damages that might be caused by a consumer using a product for its intended purpose, the legal requirements do not create a performance obligation. Similarly, an entity's promise to indemnify the customer for liabilities or damages arising from claims of patent, copyright, trademark, or other infringement by the entity's products does not create a separate performance obligation. Rather, an entity accounts for such obligations in accordance with ASC 450-20, *Contingencies — Loss Contingencies*.

EXAMPLE 3-17: LIFETIME WARRANTY

An entity manufactures high-end designer computer carrying cases. Each case comes with a lifetime warranty on parts and labor that covers any type of damage, no matter the cause.

Each contract likely includes both an assurance and service warranty because:

- There is no local law requiring the manufacturer to provide lifetime warranty on the cases.
- The length of time covered by the warranty is the lifetime of the case.
- The warranty covers damage beyond manufacturing defects.

The entity devises an accounting policy, controls, and processes to:

- Identify the implicit assurance warranty period and the likely period over which customers will benefit from the service warranty.
- Determine the portion of the transaction price allocable to the service warranty.
- Recognize the amount of revenue allocated to the service warranty over the anticipated period that customers will benefit from the implied service warranty.

Revenue recognition for the service warranty begins at the end of the assurance warranty period unless the manufacturer concludes that it cannot reasonably separate the assurance warranty and the service warranty, In that case, revenue recognition commences when control of the computer case transfers to the customer. See Chapter 6 for discussion on recognizing revenue when or as a performance obligation is satisfied.

TRG DISCUSSIONS: WARRANTIES

In March 2015, the TRG discussed a fact pattern that included a lifetime warranty similar to that in Example 3-17. In discussing the fact pattern, the FASB staff considered two aspects of the guidance on warranties:

- If an entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation.
- A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation.

The FASB staff said the two aspects of the guidance on warranties must not be applied by analogy to warranties that are not required by law. Such an analogy disregards the nature of the promise given to the customer, the three factors in ASC 606 for determining whether a warranty is a performance obligation, and the overall facts and circumstances of the arrangement.

The FASB staff stated that while not determinative in isolation, the length of the warranty is an important consideration under ASC 606. Overall, an entity must not focus its assessment on when the fault in the product arises. Rather, an entity must evaluate if the substance of the warranty reflects an additional service, considering the promises made and using the three factors in ASC 606 to assess whether the warranty is a performance obligation.

An evaluation of whether a warranty provides a service in addition to the assurance that the product complies with agreed specifications requires judgment and consideration of the facts and circumstances.

BDO INSIGHTS: WARRANTIES

An entity determines the amount of transaction price to be allocated to a separately priced extended warranty contract using a standalone selling price methodology, rather than simply using the contractually stated price (see Section 7.6.1). Also, regardless of whether a warranty is separately priced, an entity determines whether a portion of the warranty represents a service warranty that must be accounted for separately. Reaching a conclusion about whether an entity is providing a service warranty — and, if so, measuring the SSP of that service warranty — may require the application of professional judgment based on the facts and circumstances.

Further, entities accrue the costs related to assurance warranties under ASC 460.

3.6 PRACTICAL EXPEDIENT FOR NONPUBLIC FRANCHISORS

FASB REFERENCES

ASC 952-606-25-2 through 25-4

ASC 952-606-20: Franchisor

> *The party who grants business rights (the franchise) to the party (the franchisee) who will operate the franchised business.*

During the implementation of ASC 606, private entity stakeholders in the franchise industry raised concerns about the cost and complexity of identifying performance obligations related to pre-opening services provided in a franchise agreement and determining the amount and timing of revenue recognition for initial franchise fees. The initial franchise fee is an upfront payment typically paid in a lump sum to a franchisor in exchange for establishing a franchise relationship and the provision of varying levels of pre-opening services to the franchisee.

Under the prior industry-specific guidance in ASC 952, *Franchisors*, the initial franchise fee was recognized when the franchisor delivered the promised pre-opening services, which was typically when the franchise location opened. Under the five-step revenue recognition model in ASC 606, the franchisor must determine whether the pre-opening activities represent distinct performance obligations. If they are, the franchisor must evaluate the SSPs for those performance obligations to determine the timing and amount of revenue recognition.

The FASB issued ASU 2021-02 to provide nonpublic franchisors with a practical expedient to account for certain pre-opening services as distinct from the franchise licenses when identifying performance obligations under ASC 606. The practical expedient simplifies the evaluation of whether pre-opening activities are distinct from the related franchise right. Application of that guidance directly or by analogy is prohibited for all other entities.

As a practical expedient, a nonpublic franchisor can account for the following pre-opening services as distinct from the promise to grant the franchise license:

- Assisting in the selection of a site
- Assisting in obtaining and preparing the facilities for their intended use, including related financing, architectural, engineering, and lease negotiation services
- Training the franchisee or its personnel
- Preparing and distributing manuals and similar material about operations, administration, and recordkeeping
- Providing bookkeeping, IT, and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate, and other taxes or about regulations affecting the franchisee's business
- Inspecting, testing, and other quality control programs

A franchisor that elects to use the practical expedient can elect an accounting policy to account for the bundle of pre-opening services as a single performance obligation instead of evaluating whether each of the pre-opening services is distinct.

If a franchisor elects not to apply the practical expedient, or the pre-opening services in the arrangement do not qualify for the practical expedient, the franchisor applies the general guidance on identifying performance obligations (see discussion in Sections 3.2 through 3.5).

BDO INSIGHTS: PRACTICAL EXPEDIENT FOR NONPUBLIC FRANCHISORS MUST BE APPLIED CONSISTENTLY

If elected, the practical expedient for nonpublic franchisors must be applied consistently to contracts with similar characteristics and in similar circumstances.

Because the expedient is intended to simplify only the application of Step 2 of the model, franchisors must apply the general guidance in ASC 606 for the remaining aspects of accounting for revenue, including allocating the transaction price and recognizing revenue. Specifically, there is no relief from determining the standalone selling price of pre-opening services that are considered distinct. That assessment requires the application of professional judgment based on the facts and circumstances. A franchisor cannot assume that the SSP of the pre-opening services is equal to the amount of the initial franchise fee.

Further, although a franchisor can account for the distinct pre-opening services as a bundle, the determination of the SSP for the bundle might not be easier than the determination for each of the services separately.



BE CAREFUL BEFORE ELECTING AN EXPEDIENT FOR A NONPUBLIC ENTITY

There is no transition relief if a nonpublic entity becomes a public business entity (as defined in U.S. GAAP). Therefore, the entity accounts for such a change in accordance with ASC 250, *Accounting Changes and Error Corrections,* and restates its financial statements without applying the nonpublic entity practical expedient, which can be complex and time consuming. An entity should consider the likelihood of becoming a public business entity (including acquisition by an existing public business entity) before electing this alternative.

Chapter 4 — Step 3: Determine the Transaction Price



4.1 OVERVIEW — STEP 3: DETERMINE THE TRANSACTION PRICE

FASB REFERENCES

ASC 606-10-32-1 and 32-2

After identifying the performance obligations in a contract in Step 2, an entity determines the transaction price for the contract. Determining the transaction price is an especially important step in the five-step revenue recognition model because the transaction price is the amount an entity allocates to the performance obligations in a contract and ultimately recognizes as revenue when or as the performance obligations are satisfied.

The transaction price is the amount of consideration an entity expects to be entitled to in exchange for transferring goods or services to a customer. Consequently, the objective in determining the transaction price is to ascertain the total amount of consideration to which the entity will be entitled from the contract. The transaction price is often the amount specified in the contract, but determining that price is more challenging if the contracts include variable consideration. ASC 606 requires an entity to estimate variable consideration initially at contract inception and update that estimate at the end of each reporting period. The estimated amount of variable consideration is included in the transaction price only if it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty from the variable consideration is subsequently resolved.

Further, in determining the transaction price for a contract, an entity must consider:

- The contractual terms.
- The effect of customary business practices that may indicate the entity will accept a lower amount than stated in the contract.
- Noncash consideration.
- Consideration payable to the customer.
- Any significant financing component.

The following diagram illustrates the key concepts in determining the transaction price in Step 3:



BDO INSIGHTS: ESTIMATING VARIABLE CONSIDERATION

ASC 606 requires entities to estimate variable consideration with limited exceptions. While estimating revenue reflects the principle in ASC 606 that the amount recognized in revenue closely depicts the transfer of control, it introduces uncertainty in the measurement of revenue. Estimating variable consideration requires the application of professional judgment based on the facts and circumstances.

Additionally, ASC 606 includes specific guidance for evaluating nonrefundable upfront fees and accounting for subsequent changes in the transaction price.

4.2 DETERMINING THE TRANSACTION PRICE

FASB REFERENCES

ASC 606-10-32-2 through 32-4

The transaction price is the amount of consideration an entity expects to be entitled to in exchange for transferring promised goods or services to a customer. The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or consideration in a form other than cash. An entity considers the terms of the contract and its customary business practices to determine the transaction price.

The nature, timing, and amount of consideration promised by a customer affect the estimate of the transaction price, so, in addition to the fixed consideration in the contract, an entity must consider the effects of **all** the following:

- Variable consideration.
- Constraining estimates of variable consideration.
- The existence of a significant financing component in the contract.
- Noncash consideration (that is, an amount of consideration in a form other than cash).
- Consideration payable to a customer by the entity.

Although determining the transaction price requires several estimates about the future, the estimates are based on the goods and services to be transferred in accordance with the existing contract. Expectations about whether the contract will be canceled, renewed, or modified are not considered when estimating the transaction price.

BC186 of ASU 2014-09 clarifies that the transaction price includes only amounts (including variable amounts) an entity has rights to under the present contract. For example, the transaction price does not include an entity's estimates of consideration to be received from the future exercise of customer options for additional goods or services or from future change orders. That is because until the customer exercises the option or agrees to the change order, the entity does not have a right to the related consideration.

In BC187 of ASU 2014-09, the FASB clarified that the amounts the entity has rights to under the present contract can be paid by any party, not only by the customer. For example, in the healthcare industry, an entity might determine the transaction price based on amounts it will be entitled to receive from the patient, insurance entities, and governmental organizations. That situation can also occur in other industries; for example, when an entity receives a payment from a manufacturer because the manufacturer issues coupons or rebates directly to the entity's customer or when an entity acts as an agent on behalf of another entity but collects the consideration from the end consumer (see Section 7.2 for discussion on principal versus agent assessment).

Amounts collected on behalf of another party (for example, some sales taxes) are not included in the transaction price.

4.2.1 Accounting Policy Election for Taxes



FASB REFERENCES

ASC 606-10-32-2A

An entity can make an accounting policy election to exclude from the measurement of transaction price all taxes assessed by a taxing authority related to the specific transaction and collected from the customer. Examples include sales, use, value added, and some excise taxes. If an entity elects the policy, such tax amounts are presented net (that is, as reductions of the transaction price (or revenue) rather than as costs in the income statement). If an entity does not elect the policy, it must analyze each jurisdiction where it operates to determine whether such amounts are included in or excluded from the transaction price.

BDO INSIGHTS: TARIFFS AND THE ACCOUNTING POLICY ELECTION FOR TAXES

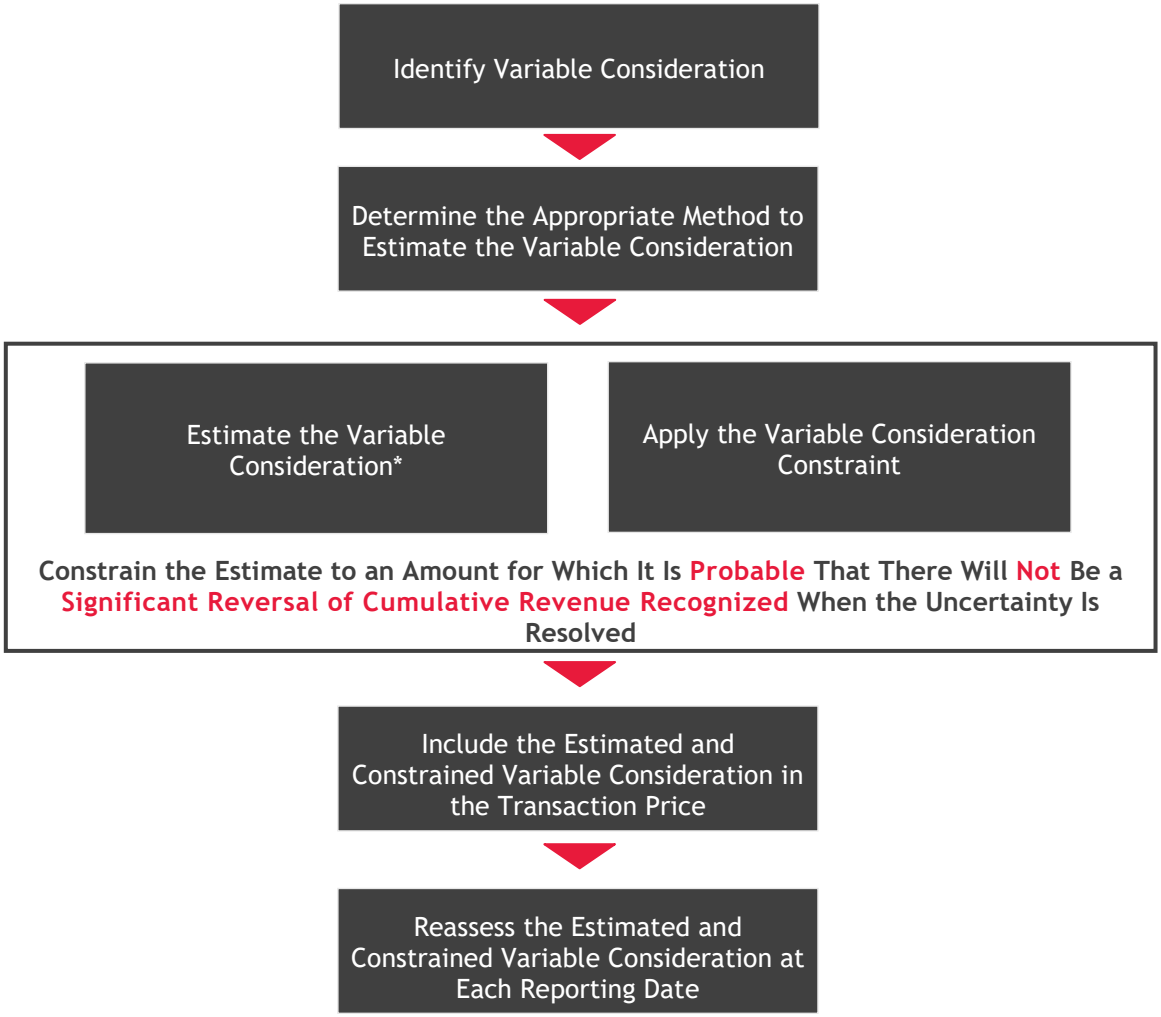
An entity that imports foreign goods might have to pay tariffs imposed by the government. The tariff is the importer's own cost of acquiring the goods and must be recognized when incurred. In other words, even if the entity is able to pass through some (or all) of the cost to its customers, the ability to do so is separate from its obligation to pay the government. The entity is not acting as the government's agent (which differs from when the entity collects sales taxes from its customers on behalf of the government). Therefore, tariffs are not sales taxes and are ineligible for the accounting policy election for taxes. Instead, any tariffs charged through to the entity's customers are additional consideration for the goods or services promised to the customer.

4.3 VARIABLE CONSIDERATION

FASB REFERENCES

ASC 606-10-32-5 through 32-9 and ASC 606-10-32-11 through 32-14

The following diagram provides an overview of the accounting considerations for variable consideration:



*See Section 4.3.2 for the limited exceptions from estimating variable consideration.

4.3.1 Identifying Variable Consideration

FASB REFERENCES

ASC 606-10-32-5 through 32-7 and ASC 606-10-55-194 through 55-195

Variable consideration can arise in any circumstance in which the amount of consideration the entity is entitled to varies. An entity must estimate the amount of consideration it expects to be entitled to in exchange for transferring the promised goods or services to a customer. Examples of common types of variable consideration that may exist in a contract with a customer include:

- Discounts
- Rebates
- Refunds
- Credits
- Price concessions
- Incentives
- Performance bonuses
- Penalties
- Other similar items
- Sales- or usage-based royalties

The consideration for a contract can vary if an entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event. For example, an amount of consideration is variable if a good is sold with a right of return or a fixed amount is promised as a performance bonus upon achievement of a specified milestone.

BC191 of ASU 2014-09 includes an example of a fixed-price service contract in which the customer pays upfront and the contract terms provide the customer with a full refund if the customer is dissatisfied with the service at any time. The consideration is variable because the entity might be entitled to all or none of the consideration if the customer exercises its right to a refund.

EXAMPLE 4-1 (ADAPTED FROM ASC 606-10-55-194 AND 55-195): VARIABLE CONSIDERATION — PENALTY

A construction entity enters a contract with a customer to build an asset for $2 million. The terms of the contract include a penalty of $200,000 if the construction is not completed within four months of a specified date. The entity concludes that the consideration promised in the contract includes a fixed amount of $1.8 million and a variable amount of $200,000 arising from the penalty.

BDO INSIGHTS: TREATMENT OF SERVICE LEVEL AGREEMENTS AS VARIABLE CONSIDERATION

In contracts to provide services, an entity often promises to maintain a specified level or timing of service, which if not achieved results in a refund or credit to the customer. For example, a service provider might give its customer a 2% discount on the services to be provided if does not arrive onsite within a promised one-hour time slot. Alternatively, a SaaS provider might provide escalating credits if required up-time metrics are not met.

Generally, credits or refunds of this nature are considered adjustments to the transaction price and are estimated as part of variable consideration. In arrangements that meet the definition of a series, any refund or credit may be related to a distinct time period and thus would meet the variable consideration allocation exception. As further discussed in Section 5.5, the refunds in that situation would not be estimated but rather recognized in the period incurred.

See Section 7.4.1.1 for a summary of the TRG discussions on whether a variable quantity of a good or service constitutes a customer's purchase option or variable consideration.

4.3.1.1 Implied Variable Consideration

Variability in consideration may be explicitly stated in a contract or implied based on an entity's customary business practices or other facts and circumstances surrounding the contract. In other words, an entity must look beyond the contract to identify all forms of variable consideration. Variable consideration may be implied if **either** of the following conditions are met:

- **Customary Business Practices:** The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the contractually stated price. In other words, the customer expects the entity to offer a price concession. Based on the jurisdiction, industry, or customer, this offer (or price concession) may be referred to as a discount, rebate, refund, or credit.
  - In BC192 of ASU 2014-09, the FASB stated that in many cases, entities grant price concessions to enhance customer relationships or to encourage future sales to customers. For example, a manufacturing entity may grant a price concession to a retailer customer for goods that were previously sold to that retailer to enable the retailer to discount the goods and therefore more easily sell them to a third-party end consumer.
- **Other Facts and Circumstances:** Other facts and circumstances indicate that the entity's intention when entering the contract with the customer is to offer a price concession to the customer by accepting a lower amount of consideration than contractually stated.
  - BC193 of ASU 2014-09 includes an example in which an entity enters a contract with a new customer with a strategy to develop the customer relationship. In that case, although there might not be past evidence that the entity will provide a price concession in future, there may be other factors that result in the entity concluding that it will accept a lower price than contractually stated.

BDO INSIGHTS: PRICE CONCESSION VERSUS CREDIT RISK

Sometimes it might be difficult to determine whether an entity has offered a price concession or chosen to accept the risk of the customer defaulting on the contractually agreed amount of consideration. In the development of ASC 606, the FASB said that judgment was already required in the prior revenue recognition guidance and decided not to include in ASC 606 detailed requirements for making the distinction between a price concession and an impairment of receivables.

When a customer does not pay the contractually stated amount, an entity must consider whether it is providing a price concession or has incurred bad debt expense. We believe that if the entity continues to provide goods or services to the customer despite not collecting the contractually stated price related to prior performance, the entity may have offered a price concession. However, that determination requires the application of significant judgment based on the facts and circumstances.

4.3.2 Estimating Variable Consideration

FASB REFERENCES

ASC 606-10-32-8 through 32-9 and ASC 606-10-55-197 through 55-199

When the consideration promised in a contract with a customer includes a variable amount, an entity estimates the amount of variable consideration it expects to be entitled to in exchange for promised goods or services in the contract by using **either** of the following two methods:

- **The expected value:** The sum of probability-weighted amounts in a range of possible consideration amounts. It may be an appropriate estimate of the variable consideration if a contract includes a large number of possible outcomes or if an entity has many contracts with similar characteristics.

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

SELECT A METHOD TO ESTIMATE VARIABLE CONSIDERATION

Selecting a method to estimate a variable consideration is not intended to be a free choice; rather, an entity must determine which method it expects to better predict the amount of consideration to which it will be entitled and apply that method consistently for similar types of contracts.

The expected value method (that is, the probability-weighted method) reflects all the uncertainties existing in the transaction price at the end of the reporting period and therefore best reflects the conditions present at the end of each reporting period. For instance, it reflects the possibility of receiving a greater amount of consideration, as well as the risk of receiving a lesser amount. The expected value method could be used to predict the amount of consideration to which an entity will be entitled if the entity has many contracts with similar characteristics.

However, an expected value may not always faithfully predict the consideration to which an entity will be entitled. BC200 of ASU 2014-09 includes an example in which an entity is certain to receive one of the only two possible consideration amounts in a single contract. In that case, the expected value would not be a possible outcome and therefore might not be relevant in predicting the amount of consideration to which the entity will be entitled. Rather, the most likely amount method identifies the individual amount of consideration in the range of possible consideration amounts that is more likely to occur than any other individual outcome.

Although an entity using the most likely amount method must consider all possible outcomes to identify the most likely one, the entity is not required to quantify the less probable outcomes. Similarly, estimating variable consideration under the expected value method (that is, probability-weighted method) does not require an entity to consider all possible outcomes using complex models and techniques even if it has extensive data and can identify many outcomes. In many cases, a limited number of discrete outcomes and probabilities can provide a reasonable estimate of the distribution of possible outcomes for variable consideration in a contract.

INFORMATION CONSIDERED IN ESTIMATING A VARIABLE CONSIDERATION

An entity must consider all the information (historical, current, and forecast) that is reasonably available to the entity to identify a reasonable number of possible amounts of variable consideration. Typically, that information would be similar to the information the entity's management used during the bid-and-proposal process and when it established prices for the promised goods or services.

CONSISTENT APPLICATION OF THE METHOD SELECTED TO ESTIMATE AN UNCERTAINTY

An entity applies one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which it expects to be entitled.

However, that does not mean that an entity would need to use one method to measure each uncertainty in a single contract. Rather, an entity may use different methods for different uncertainties in a single contract. Example 4-2 illustrates the concept.

EXAMPLE 4-2 (ADAPTED FROM ASC 606-10-55-197 THROUGH 55-199): VARIABLE CONSIDERATION — METHODS OF ESTIMATION

A construction entity enters a contract with a customer to build a customized asset. The contract includes the following terms related to pricing:

- The promised consideration is $4 million.
- For each day after a specified date that the asset is incomplete, the promised consideration decreases by $20,000.
- For each day before the specified date that the asset is complete, the promised consideration increases by $20,000.
- Upon completion of the asset, if the asset receives a specified rating from a third-party inspector based on contractually defined metrics, the construction entity will be entitled to a bonus of $300,000.

In determining the transaction price, the entity identifies two types of variable consideration in the contract:

- Variable consideration from the daily penalty or incentive for an amount of $20,000
- Variable consideration from the bonus for an amount of $300,000.

The entity concludes the following regarding the appropriate method of estimating the two types of variable consideration in the contract:

- The expected value method is appropriate for estimating the variable consideration from the daily penalty or incentive (that is, $4 million plus or minus $20,000 per day). The entity expects that method to better predict the amount of consideration to which it will be entitled because there is a range of possible outcomes that depend on how the variability is resolved.
- The most likely amount method is appropriate for estimating the variable consideration from the bonus because there are only two possible outcomes ($300,000 or $0). The entity expects the most likely amount method will better predict the amount of consideration to which it will be entitled because the outcome is binary and a probability-weighted amount will not reflect either of the possible outcomes.

BDO INSIGHTS: LIMITED EXCEPTIONS FROM ESTIMATING VARIABLE CONSIDERATION

While ASC 606 generally requires entities to estimate all variable consideration, there are a few exceptions:

- An entity does not estimate variable consideration in the form of sales- or usage-based royalties received in exchange for licenses of IP (in accordance with ASC 606-10-55-64 through 55-65B). That exception is explicitly limited to licenses of IP and cannot be applied to sales- or usage-based royalties in exchange for providing other goods or services, including SaaS (see Section 7.5.4).
- An entity does not estimate variable consideration if it applies the as-invoiced practical expedient to recognize revenue in accordance with ASC 606-10-55-18 (see Section 6.4.2.1.1).
- An entity does not estimate variable consideration if the variable consideration allocation exception in ASC 606-10-32-40 applies (see Section 5.5) as follows:
  - A performance obligation will be satisfied in future and the variable consideration is allocated entirely to that performance obligation.
  - A series of distinct services is determined to be a series of distinct time increments, and the variable consideration relates to the distinct services provided in the period when it is earned.

Reaching a conclusion on whether any of the exceptions from estimating variable consideration applies requires the application of professional judgment based on the facts and circumstances.

4.3.3 Constraining Estimates of Variable Consideration

FASB REFERENCES

ASC 606-10-32-11 and 32-12

Estimating the amount of variable consideration introduces uncertainty to the measurement of revenue. To reduce the possibility that variable consideration recognized in one reporting period is reversed in a subsequent period, the inclusion of an estimated amount of variable consideration in the transaction price is limited to the amount for which it is **probable** that there will **not** be a significant reversal of cumulative revenue recognized when the uncertainty from the variable consideration is subsequently resolved. That concept is known as the "variable consideration constraint," and it restricts revenue recognition by using measurement uncertainty as the basis for determining whether to recognize revenue (and if so, how much).

The term "probable" is widely used and understood in practice and is defined in ASC 450, *Contingencies*, as "*the future event or events are likely to occur*".

In assessing whether it is probable that a significant reversal of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity evaluates **both**:

Likelihood of a revenue reversal **AND** **Magnitude of the revenue reversal**

In BC212 of ASU 2014-09, the FASB said the analysis an entity would undertake to determine the likelihood of whether a significant revenue reversal could occur would still be largely qualitative and that it did not expect an entity to prepare a quantitative analysis each time it performed that analysis.

The FASB provided examples of five factors that may increase the likelihood or the magnitude of a revenue reversal:



In developing the variable consideration constraint guidance, the FASB's intention was not to eliminate the use of estimates, which are common and necessary in financial reporting, but rather to ensure that those estimates are robust and result in useful information.

The FASB decided to focus the variable consideration constraint on possible downward adjustments (that is, revenue reversals), rather than on all revenue adjustments (that is, both downward and upward adjustments) because users of financial statements indicated that revenue is more relevant if it is not expected to be subject to significant future reversals.

BDO INSIGHTS: CONSTRAINING ESTIMATES OF VARIABLE CONSIDERATION

When variable consideration has a wide range of potential outcomes (for example, from zero to $100,000 depending on number of website visits), it is highly unlikely that the transaction price will be constrained to zero.

Further, when an entity applies the portfolio practical expedient to multiple similar contracts or performance obligations, it would be rare for variable consideration included in the transaction price to be fully constrained because that would require an assumption that the outcome of every instance of uncertainty would be zero.

Regardless of whether an entity elects to use the portfolio practical expedient, we believe that an entity must consider its past experience with similar contracts with similar customers when determining the amount of variable consideration to be included in the transaction price unless the experience with those past contracts is not reflective of the expected outcome of the current contract, which would be unusual.

The constraint may reduce the amount of variable consideration included in the transaction price to zero when the outcome is binary (for example, a $100,000 bonus may be earned based on the achievement of a performance milestone) and significant uncertainty exists regarding the outcome.

Also, in some instances the requirement to limit the estimated variable consideration to an amount that is not probable of being reversed could result in recognizing revenue in an amount that is less than an entity's best estimate (see Example 4-4).

Reaching a conclusion on whether and how much to constrain the estimate of variable consideration requires the application of professional judgment based on the facts and circumstances.

BDO INSIGHTS: CONSTRAINING VARIABLE CONSIDERATION TIED TO REGULATORY APPROVALS

Life science entities frequently enter licensing arrangements that include milestone payments. Those payments might be contingent on regulatory approvals, such as those from the U.S. Food and Drug Administration (FDA). Because milestone payments are a form of variable consideration, a life science entity must estimate the amount of consideration and constrain the estimate. When estimating and constraining milestone payments related to the approval of a drug candidate, an entity should consider the following factors:

- Is the drug candidate using a novel or unproven drug compound?
- Has the drug compound already been approved for other indications?
- For generic drugs, are the regulatory approval criteria objective?
- Are there similar drugs in the market that have already been approved by the relevant regulatory body?
- Does the entity have prior experience with the regulatory approval process that is relevant to the current drug candidate?

For example, an entity that is entitled to a milestone payment upon FDA approval of a feline indication for a drug compound already approved for a canine indication may be able conclude that the most likely amount is the full payment. In that case, it may be probable that including the milestone payment in the transaction price will not result in a significant revenue reversal in the future.

However, we believe an entity should fully constrain a milestone payment tied to FDA approval for a drug candidate using a novel or unproven compound until FDA approval is obtained.

While those indicators focus on a drug candidate, similar analysis may be appropriate for other products subject to FDA approval, such as medical devices and food additives. Determining the amount of variable consideration to include in the transaction price requires professional judgment based on facts and circumstances.



TRG DISCUSSIONS: VARIABLE CONSIDERATION AND CONSTRAINING ESTIMATE — IS THE CONSTRAINT APPLIED AT THE CONTRACT OR PERFORMANCE OBLIGATION LEVEL?

Some contracts that include more than one performance obligation have both fixed and variable consideration.

In January 2015, the TRG considered whether the requirement to constrain the recognition of any variable consideration should apply at the contract level or performance obligation level when the variable consideration has not been allocated proportionately to all performance obligations in a contract. See Chapter 5 for discussion on allocation of consideration to performance obligations.

The TRG generally agreed that the constraint on variable consideration is applied at the contract level and not at the performance obligation level because the unit of account for determining the transaction price in Step 3 is the contract.



TRG DISCUSSIONS: PORTFOLIO PRACTICAL EXPEDIENT AND APPLICATION OF VARIABLE CONSIDERATION CONSTRAINT

In July 2015, the TRG discussed the application of the optional portfolio approach practical expedient (see Section 1.6) that allows entities to apply ASC 606 to a portfolio of contracts with similar characteristics instead of to individual contracts. TRG members agreed that estimating the transaction price using the evidence obtained from other similar contracts (that is, the portfolio of data) is different from applying the portfolio practical expedient.

One example of the practical effect of that distinction could be when an entity is developing an estimate of variable consideration for a single contract using the expected value method. The TRG conclusion means the entity is not necessarily applying the portfolio practical expedient when considering historical data for other similar contracts. Therefore, there is no need to comply with the restriction on the use of the portfolio practical expedient, which is to conclude that there is a reasonable expectation that the effects on the financial statements from applying the guidance to a portfolio of contracts would not differ materially from applying the guidance to individual contracts within the portfolio.

The TRG also discussed the application of the variable consideration constraint, which limits revenue recognition to the amount for which it is probable that there will not be a significant reversal of revenue previously recognized when the uncertainty over the amount of revenue is resolved. TRG members discussed whether ASC 606 requires applying the constraint to a portfolio of contracts when a portfolio of data was used to estimate variable consideration or whether the constraint can be applied at an individual contract level. The TRG concluded that the approach followed is linked to whether the entity concludes that it should use the expected value approach or the most likely amount method when it estimates the transaction price. If an entity uses the expected value approach, it would be consistent and appropriate to use the portfolio of data to estimate variable consideration. If the most likely amount method is followed, a portfolio approach should not be used.

4.3.4 Is Estimating Variable Consideration and Applying the Constraint a Two-Step Process?

FASB REFERENCES

ASC 606-10-32-8 and ASC 606-10-32-11

The variable consideration constraint guidance first requires an entity to estimate the consideration to which the entity will be entitled. The entity then assesses whether the objective of the variable consideration constraint guidance can be met by determining whether it is probable that a significant revenue reversal will not occur when the uncertainty from the variable consideration is subsequently resolved. If the entity determines that it is probable that the inclusion of its estimate will not result in a significant revenue reversal, that amount is included in the transaction price.

In BC215 of ASU 2014-09, the FASB said an entity would not be required to strictly follow those two steps if its process for estimating variable consideration already incorporates the principles on which the guidance for constraining estimates of variable consideration is based. For example, an entity might estimate revenue from sales of goods with a right of return; a sale with a right of return creates variability in the transaction price (see Section 4.3.8). In that case, the entity might not practically need to estimate the expected revenue and then apply the constraint guidance to that estimate in a two-step process if its calculation of the estimated revenue incorporates its expectations of returns at a level at which it is probable that the cumulative amount of revenue recognized would not result in a significant revenue reversal.

4.3.5 Sales- or Usage-Based Royalty for Licenses of IP

ASC 606 includes an exception from estimating and constraining variable consideration for variable consideration in the form of a sales- or usage-based royalty that is promised in exchange for a license of IP (see Section 7.7).

4.3.6 Reassessment of Variable Consideration

FASB REFERENCES

ASC 606-10-32-14

An entity must update the estimated transaction price (including its assessment of whether an estimate of variable consideration is constrained) at the end of each reporting period to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The estimated amount of variable consideration may change at each reporting date as more information becomes available and there is greater certainty about the expected amount of consideration. See Section 4.8 for discussion on accounting for changes in the transaction price.

EXAMPLE 4-3 (ADAPTED FROM ASC 606-10-55-208 THROUGH 55-212): PRICE CONCESSIONS — ESTIMATE OF VARIABLE CONSIDERATION IS NOT CONSTRAINED

An entity enters a contract with a customer, a retailer, on December 1, 20X1. The entity transfers 10,000 products at contract inception. The pricing terms are:

- The contractually stated price per product is $20 (that is, the total contractually stated price is $200,000).
- The customer is obligated to make payments when it sells the products to the end customers.

The entity has past experience that the customer generally sells the products within 60 days of receiving them.

Based on its past practices and to maintain its customer relationship, the entity anticipates granting a price concession to the customer to enable the customer to discount the product and move it quickly through the distribution chain. Therefore, the entity determines that the consideration in the contract is variable even though the contract stipulates a fixed price.

The entity considers the following:

- It has significant experience selling this and similar products
- The observable historical data indicates that the entity grants an average price concession of 25% of the sales price for these products
- Current market information indicates that a 25% price concession will be sufficient to quickly move the products through the distribution chain
- The entity has not granted a price concession significantly greater than 25% in many years.

The entity decides to use the expected value method to estimate the variable consideration because it expects that method to better predict the amount of consideration to which it will be entitled because there is a range of possible outcomes for how the variability in pricing will be resolved. The entity estimates the transaction price to be $150,000 ($15 * 10,000 products) under the expected value method.

To determine whether the estimated amount of variable consideration of $150,000 can be included in the transaction price or must be constrained, the entity notes:

- It has significant previous experience with this product and current market information that supports its estimate.
- Despite some uncertainty resulting from factors outside its influence, the entity expects the price to be resolved within a short time based on its current market estimates.

Therefore, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $150,000) will not occur when the uncertainty regarding the total amount of price concessions is resolved. Consequently, the entity includes $150,000 in the transaction price, recognizes revenue of $150,000 when the products are transferred on December 1, 20X1 (see Chapter 6 for discussion on Step 5 on recognizing revenue), and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved.

EXAMPLE 4-4 (ADAPTED FROM ASC 606-10-55-208 THROUGH 55-215): PRICE CONCESSIONS — ESTIMATE OF VARIABLE CONSIDERATION IS CONSTRAINED

Consider the same fact pattern as in Example 4-3, with the following differences:

- While the entity has experience selling similar products:
  - The products have a high risk of obsolescence.
  - The entity is experiencing high volatility in the pricing of its products.
- The observable historical data indicates that the entity grants a broad range of price concessions ranging from 20% to 60% of the sales price for similar products.
- Current market information also suggests that a 15% to 50% reduction in price may be necessary to move the products through the distribution chain.

The entity decides to use the expected value method for the same reasons stated in Example 4-3. It estimates that a discount of 40% will be provided. Therefore, the estimated variable consideration is $120,000 ($12 * 10,000 products).

The entity considers the following to determine whether the estimated amount of variable consideration of $120,000 can be included in the transaction price or must be constrained:

- The amount of consideration is highly susceptible to factors outside the entity's influence because of the risk of obsolescence.
- It is likely that the entity will be required to provide a broad range of price concessions to move the products quickly through the distribution chain.

As a result, the entity cannot conclude that it is probable that a significant reversal of cumulative revenue recognized will not occur if $120,000 (that is, 40% discount on the sale price) is included in the transaction price. Therefore, the entity cannot include its estimate of $120,000 in the transaction price. It considers the following:

- While the entity's historical price concessions have ranged from 20% to 60%, current market information suggests that a price concession of 15% to 50% will be necessary.
- An analysis shows that actual results have been consistent with then-current market information in previous similar transactions.

Consequently, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur if the entity includes $100,000 in the transaction price (that is, 50% discount on the sale price). Therefore, the entity includes $100,000 in the transaction price, recognizes revenue of $100,000 when the products are transferred on December 1, 20X1 (see Chapter 6 for discussion on Step 5 on recognizing revenue), and reassesses the estimates of the transaction price at each reporting date until the uncertainty is resolved.

BDO INSIGHTS: CONSTRAINING ESTIMATES OF VARIABLE CONSIDERATION IN EXAMPLE 4-4

In Example 4-4, although the amount of revenue recognized when the products were transferred to the retailer was restricted because of the identified uncertainties, there was sufficient evidence to support the immediate recognition of a portion of the estimated transaction price. For entities in the early stages of their operations, particularly those operating in relatively new sectors, it is possible that application of the constraint will result in little or no revenue being recognized on the date control over goods or services transfers to customers, with revenue recognition being postponed until a later date. However, in those circumstances, the inventory transferred to customers would be derecognized, with an associated cost of sales when control passes to the customers. The estimate of variable consideration and appropriate constraint would then be reassessed at each reporting date, with a corresponding amount of revenue being recognized as appropriate in each period.

EXAMPLE 4-5 (ADAPTED FROM ASC 606-10-55-216 THROUGH 55-220): VOLUME DISCOUNT INCENTIVE — RETROSPECTIVE REDUCTION

An entity enters a contract with a customer on January 1, 20X1, to sell a product for $10 per unit. The price per unit is retrospectively reduced to $9 per unit if the customer purchases more than 10,000 units of the product in a calendar year.

The entity determines that the consideration in the contract is variable because of the retrospective reduction in price per unit of the products sold to the customer.

Constraining Estimates of Variable Consideration

The entity sells 100 units of the product to the customer in the first quarter ended March 31, 20X1. On that date, the entity estimates that the customer's purchases will not exceed the 10,000 unit threshold required for the volume discount in the calendar year. The entity has significant experience with this product and this customer's purchasing pattern, so it concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $10 per unit) will not occur when the uncertainty regarding the total number of products purchased in that calendar year is resolved.

Therefore, the entity recognizes revenue of $1,000 (100 units * $10 per unit) for the quarter ended March 31, 20X1.

Reassessment of Variable Consideration

In April 20X1, the entity's customer acquires another entity, and in the second quarter ended June 30, 20X1, it purchases an additional 5,000 products. Considering that new fact, the entity estimates that the customer's purchases will exceed the 10,000 unit threshold for the calendar year and that it will therefore be required to retrospectively reduce the price per unit to $9.

Therefore, the entity updates its transaction price (and cumulative revenue recognized) to $45,900 (5,100 units * $9 per unit) to reflect the reduced price per unit of $9 for the sale of 5,100 units.

The entity recognizes $44,900 in the quarter ended June 30, 20X1. The amount is calculated as $45,000 for the sale of the 5,000 units (5,000 units * $9 per unit) less the change in transaction price of $100 (100 units * $1 price reduction per unit). See Section 4.8 for a discussion of changes in the transaction price.

EXAMPLE 4-6 (ADAPTED FROM ASC 606-10-55-221 THROUGH 55-225): MANAGEMENT FEES SUBJECT TO THE CONSTRAINT

An entity enters a contract with a customer to provide asset management services for four years in exchange for:

- A 2.5% quarterly management fee based on the customer's assets under management at the end of each quarter
- A performance-based incentive fee of 18% of the fund's return in excess of the return of an observable market index over the past four-year period.

The entity determines that both the management fee and the performance fee are variable consideration in the contract.

At contract inception, the entity observes that:

- The promised consideration in the contract is dependent on the market and thus is highly susceptible to factors outside the entity's influence.
- The incentive fee has many possible consideration amounts.
- Although the entity has experience with similar contracts, that experience is of little predictive value in determining the future performance of the market.

Therefore, at contract inception, the entity determines that it cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the management or incentive fee in the transaction price.

At each reporting date, the entity updates its estimate of the transaction price and concludes that:

- It can include the actual amount of the quarterly management fee in the transaction price because the uncertainty related to the market is resolved.
- It cannot include its estimate of the incentive fee for future periods in the transaction price at those dates because there has been no change in its assessment of the likelihood of significant revenue reversal since contract inception. In other words, the variability of the fee based on the market index indicates that the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the incentive fee in the transaction price.

The entity recognizes the quarterly management fee at the end of each quarter to which the fee relates (rather than over the four-year term) because the quarterly management fee relates to the distinct services provided during the corresponding quarter, and the requirements in ASC 606-10-32-40 regarding an exception in allocating variable consideration are met (see Section 5.5).

4.3.7 Refund Liability

FASB REFERENCES

ASC 606-10-32-10

An entity must recognize a refund liability if it receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (that is, those amounts are not included in the transaction price). The refund liability and corresponding change in the transaction price is updated at the end of each reporting period for changes in circumstances. An entity applies the guidance in Section 4.3.8 to account for a refund liability relating to a sale with a right of return.

4.3.8 Sale With a Right of Return

FASB REFERENCES

ASC 606-10-55-22 through 55-29

An entity may transfer control of a product to a customer and also grant the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive a full or partial refund of any consideration paid; another product in exchange; or a credit that can be applied against amounts owed, or that will be owed, to the entity.

An entity's promise to stand ready to accept a returned product during the return period is not accounted for as a performance obligation in Step 2. Rather, a sale with a right of return creates variability in the transaction price, and an entity must apply the guidance on estimating variable consideration (including the guidance on constraining estimates of variable consideration) to determine the amount of consideration to which the entity expects to be entitled (that is, excluding the products expected to be returned).

Exchanges by customers of one product for another of the same type, quality, condition, and price (for example, one color or size for another) are not considered returns for the purposes of applying the guidance on sales with a right of return.

Further, contracts in which a customer may return a defective product in exchange for a functioning product are evaluated in accordance with the guidance on warranties. However, a warranty that requires a cash payment is treated as a right of return (see Sections 3.5).

For any amounts received (or receivable) to which it does not expect to be entitled, the entity does not recognize revenue when it transfers products to customers. Instead, it recognizes those amounts received (or receivable) as a refund liability. Recognition of revenue is limited to the amount of consideration to which the entity expects to be entitled, so amounts received for products expected to be returned are not recognized in revenue. The entity also recognizes an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

Subsequently, at the end of each reporting period, the entity must update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the transaction price — and, therefore, of revenue recognized. An entity must also update the asset and adjustment to cost of sales representing its right to recover products upon settling the refund liability.

EXAMPLE 4-7 (ADAPTED FROM ASC 606-10-55-202 THROUGH 55-207): RIGHT OF RETURN

An entity enters 100 contracts with customers. Each contract includes the sale of one product for $10 for a total consideration of $1,000 (100 total products * $10). Customers pay cash when control of products transfers to them. The entity's customary business practice is to allow customers to return any unused product within 30 days for a full refund. The entity's cost of each product is $6.

The entity applies the portfolio approach to the 100 contracts because it reasonably expects that the effects on the financial statements from applying a portfolio approach would not differ materially from applying the guidance to the individual contracts within the portfolio.

The entity determines that the consideration received from the customers is variable because the contracts allow customers to return the products.

The entity decides to use the expected value method to estimate the variable consideration, which is the method it expects to better predict the amount of consideration to which it will be entitled because there is a range of possible outcomes for how the variability will be resolved. Using the expected value method, the entity estimates that three products will be returned (that is, 97 products will not be returned).

The entity also applies the guidance on constraining variable consideration to determine whether the estimated amount of variable consideration of $970 ($10 * 97 products) can be included in the transaction price. It determines that:

- Although the returns are outside its influence, the entity has significant experience in estimating returns for this product and customer class.
- The uncertainty will be resolved within a short time because the return period is 30 days.

Therefore, the entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $970) will not occur because the uncertainty is subsequently resolved over the return period.

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

Upon transfer of control of the 100 products, the entity recognizes revenue of $970 and does not recognize revenue for the three products that it expects to be returned (see Chapter 6). The entity records the following journal entries:

Debit	Cash	$ 1,000		$10 * 100 products transferred to customers
Credit	Revenue		$ 970	$10 * 97 products not expected to be returned
Credit	Refund Liability		30	$10 * 3 products expected to be returned

(Recognition of revenue and a refund liability for the payment received)

Debit	Cost of Sales	$ 582		$6 * 97 products not expected to be returned
Credit	Asset	18		$6 * 3 products the entity has the right to recover upon settling refund liability
Credit	Inventory		$ 600	$6 * 100 products transferred to customers

(Recognition of cost of sales for products not expected to be returned and an asset for the products expected to be returned.)

4.4 SIGNIFICANT FINANCING COMPONENT



FASB REFERENCES

ASC 606-10-32-15 and 32-16

Some contracts with customers include a financing component, which may be explicitly identified in the contract or implied by the contractual payment terms. A contract that has a financing component conceptually includes two transactions: one for the sale of goods or services and one for the financing. The objective of adjusting the promised amount of consideration in a contract for a significant financing component is for an entity to recognize revenue at an amount that reflects the price a customer would pay for the promised goods or services if the customer pays cash for those goods or services when or as they transfer to the customer (that is, the cash selling price).

For example, a construction entity may require a customer to pay in advance for a long-term construction contract because it needs funds to obtain materials to carry out the contract. In the absence of the advance payment from the customer, the construction entity would typically need to borrow the funds from another party (for example, a bank). The construction entity would need to pay finance charges on those borrowings and would therefore be likely to recoup those borrowing costs from the customer through a higher transaction price. However, the fair value of the goods and services transferred to the customer would be the same, with the only difference being the party extending the financing to the construction entity. The amount of the construction entity's revenue must not vary based on whether it receives financing from the customer or a third party.

Therefore, the transaction price is adjusted for the effects of the time value of money if the timing of payments provides the customer or the entity with a significant benefit of financing the transfer of goods or services. In those circumstances, the contract contains a significant financing component, and adjustment to the transaction price is made in the contract to reflect that financing component.

4.4.1 Identifying a Significant Financing Component

FASB REFERENCES

ASC 606-10-32-16 and 32-17

An entity must consider all relevant facts and circumstances in assessing whether a financing component exists in a contract and whether that financing component is significant to the contract, including:

- Any difference between the amount of consideration and the cash selling price of the goods or services
- The combined effect of the expected length of time between when the entity transfers the goods or services to the customer and when the customer pays for those goods or services **and** the prevailing interest rates in the relevant market.

Despite the above assessment, a contract with a customer does not include a significant financing component if **any** of the following factors exist:

- The customer has made advance payment for the goods or services and the timing of the transfer of those goods or services is at its discretion.
- A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that variable consideration varies based on the occurrence or nonoccurrence of a future event that is not substantially within the control of either the customer or the entity (for example, if the variable consideration is a sales-based royalty).
- The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately perform under the contract.

BDO INSIGHTS: EXISTENCE OF A SIGNIFICANT FINANCING COMPONENT

The time between an entity's delivery of a good or service to its customer and the customer's payment for that good or service could result in a financing component. Some contracts may include an explicit financing component. For example, an entity may allow its customers to choose whether to pay a lower amount at the time of sale or a higher amount at some point in the future.

In other instances, the contract terms may result in a financing component without providing the customer with an option or explicitly stating the impact of a difference in timing. For example, in many SaaS arrangements, the contract may require the customer to pay in advance for the service. Conversely, an entity may allow its customer to pay for a three-year term license in 12 quarterly payments. In many cases, the seller may have a substantive business reason for the difference between the timing of transfer of control of the good or service and payment. Determining whether a significant financing component exists in a contract requires judgment based on the facts and circumstances.

4.4.1.1 Practical Expedient for Significant Financing Components

FASB REFERENCES

ASC 606-10-32-18

An entity may elect a practical expedient not to make adjustments for the effects of a significant financing component if at contract inception the entity expects that the period between when revenue is recognized for the transfer of the goods or services and the date of payment from the customer will be one year or less.

BDO INSIGHTS: SIGNIFICANT FINANCING COMPONENT — PRACTICAL EXPEDIENT

In some cases, an entity may be eligible to elect the practical expedient even if providing financing to its customers is a significant component of its revenue transactions. For example, consider a scenario in which an entity resells consumer products to low-credit quality customers at a high interest rate using extended payment terms that do not exceed one year. Even if the customer must make all payments within one year from the date revenue is recognized, and the entity is thus eligible to elect the practical expedient, we believe the entity must consider whether the resulting financial reporting would provide the most relevant and useful information to users of its financial statements before electing the practical expedient. Entities must also consider the disclosure objective in ASC 606-10-50-1 and provide sufficient footnote disclosures about such arrangements (see Chapter 8).

EXAMPLE 4-8 (ADAPTED FROM ASC 606-10-55-227 THROUGH 55-232): SIGNIFICANT FINANCING COMPONENT AND RIGHT OF RETURN

An entity sells a product to a customer for $125, payable 25 months after delivery. The customer obtains control of the product at contract inception and has the right to return the product within 90 days of delivery.

The cash selling price of the product is $99 and the entity's cost of the product is $75.

The entity observes the difference between the amount of promised consideration of $125 and the cash selling price of $99 at the date the goods are transferred to the customer. It thus determines that the contract includes a significant financing component because the cash selling price differs from the promised consideration and no other factors indicate that the difference arises for reasons other than financing.

EXAMPLE 4-9 (ADAPTED FROM ASC 606-10-55-233 AND 55-234): WITHHELD PAYMENTS ON A LONG-TERM CONTRACT

A construction entity enters a contract for the construction of a building. The performance obligation will be satisfied over time (see Chapter 6). The contract includes the following payment terms:

- The entity will receive scheduled milestone payments based on its performance throughout the contract term of two years.
- The milestone payments are scheduled to coincide with the entity's expected performance over the two-year contract term.
- A specified percentage of each milestone payment is withheld by the customer throughout the contract term and paid to the entity only when the building is complete. The withheld amounts are commonly known as retainage.

The construction entity concludes that the contract does not include a significant financing component because:

- The milestone payments coincide with the entity's performance.
- The contract requires retainage for reasons other than the provision of finance because the withholding of retainage is intended to protect the customer from the entity failing to adequately complete its contract obligations.



TRG DISCUSSIONS: ANALYZING FINANCING COMPONENT WHEN THE PROMISED CONSIDERATION IS EQUAL TO THE CASH SELLING PRICE

In March 2015, the TRG discussed whether the guidance that includes the objective for adjusting the promised amount of consideration for a significant financing component (ASC 606-10-32-16) implies that there is never a significant financing component when the amount of promised consideration is equal to the cash selling price. In some industries, it may be common for the promised consideration and cash selling price to be equal. The TRG considered the following examples:

- **Example 1:** A customer can purchase a piece of equipment for $1,200 and then be eligible to purchase service for the equipment for $100 each month under a month-to-month service contract. However, the customer could choose to pay zero for the equipment on day one and have the option to sign a note to pay $1,200 over a 24-month period without an additional charge for interest and still pay $100 each month for service.
- **Example 2:** A furniture retailer offers a promotion for a $2,000 dining set. Customers have the option to obtain 0% financing for three years as part of the promotion or to pay the entire amount at the time of purchase.

While the list price of the goods is equal to the promised consideration in the contracts, the list price might not always equal the cash selling price and a contract might have an implied interest rate that is different from a stated interest rate. For example, if a customer offers to pay cash upfront when the entity is offering free financing, the customer might be able to pay less than the list price. In other words, the true cash selling price might be less than the list price. That is consistent in concept with the guidance in ASC 606-10-32-32, which states that a contractually stated price or a list price for a good or service may, but should not, be presumed to be the SSP of that good or service.

If the list price, cash selling price, and promised consideration are all equal, an entity should not automatically assume there is no significant financing component. Any difference between the amount of promised consideration and the cash selling price is a factor (that is, one of two factors in ASC 606-10-32-16), not a presumption, in determining whether a significant financing component exists. An entity must consider all relevant facts and circumstances. Therefore, the one fact that the cash selling price is equal to the selling price in the contract would not be the totality of the assessment.

An entity must carefully evaluate whether the list price, cash selling price, and promised consideration are actually equal. If they are, that might indicate that the contract does not include a significant financing component. However, that does not imply that a financing component cannot exist.

Determining the cash selling price may require judgment. The fact that an entity provides 0% financing does not necessarily mean the cash selling price is the same as the price another customer will pay over time. An entity must consider the cash selling price as compared to the promised consideration based on the overall facts and circumstances of the arrangement.

It is also possible that a financing component exists but is not significant, and an entity must apply judgment in determining that.

TRG DISCUSSIONS: FINANCING COMPONENT — OTHER ISSUES

In January and March 2015, the TRG discussed several questions about whether a contract includes a significant financing component.

TRG members agreed there is no presumption in ASC 606 that a significant financing component exists when there is a difference in timing between when goods and services are transferred and when the promised consideration is paid. An entity needs to apply judgment to determine whether the payment terms provide financing or are for another reason. Many TRG members said judgment will be required in some circumstances to determine whether a transaction includes a significant financing component.

The TRG said ASC 606 does not preclude accounting for financing components that are not significant in the context of the contract.

The TRG also stated that it might not always be clear if cash collected relates to a specific performance obligation. Therefore, judgment is needed to determine if the practical expedient related to significant financing components can be applied when there is a single payment stream for multiple performance obligations.

4.4.2 Accounting for a Significant Financing Component

FASB REFERENCES

ASC 606-10-32-19 and 32-20

When a significant financing component is identified, an entity determines the discount rate. To adjust the consideration in a contract for a significant financing component so that an entity recognizes in revenue the cash selling price of a good or service transferred, the entity uses the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral (which may include assets transferred in the contract) or security provided by the customer or the entity.

The discount rate may be determined by identifying the rate that discounts the nominal amount of the promised consideration to the price the customer would pay in cash for the goods or services when or as they transfer to the customer. However, in some situations, discounting the promised consideration to the price the customer would pay in cash results in a rate that is inconsistent with the discount rate that would apply in a separate financing transaction between the two parties. For example:

- An entity might grant a below-market interest rate as a sales incentive rather than because of the customer's creditworthiness.
- An entity might charge a lower cash price to incentivize its customer to pay in advance, which effectively provides financing to the entity and allows it to avoid internal costs associated with originating a new loan. That results in an implied discount rate that exceeds the market rate based on the entity's creditworthiness.

In those situations, the entity must use the discount rate that would be reflected in a separate borrowing transaction rather than the rate implied by the contract terms.

BDO INSIGHTS: DETERMINING AN APPROPRIATE DISCOUNT RATE

As noted above, an entity must utilize the discount rate that would be reflected in a separate borrowing transaction. In some cases, an entity's borrowing rate may not be readily determinable. For example, an early-stage company may not be able to access traditional credit markets such as bank lending. In those situations, determining an appropriate discount rate may require judgment, and an entity may need to engage a valuation specialist.

After contract inception, an entity does not update the discount rate for changes in interest rates or other circumstances (for example, a change in the assessment of the customer's credit risk). In BC243 of ASU 2014-09, the FASB said an entity should not update the discount rate for a subsequent change in circumstances because in the measurement of the transaction price, an entity should reflect only the discount rate determined at contract inception. That approach is consistent with valuing noncash consideration at contract inception (see Section 4.5).

EXAMPLE 4-10: ACCOUNTING FOR A SIGNIFICANT FINANCING COMPONENT

An entity enters a contract with a customer to build and supply a new machine. Control over the completed machine will pass to the customer after two years (that is, the entity's performance obligation will be satisfied at a point in time after two years). The contract contains two payment options: The customer can pay $5 million after two years when it obtains control of the machine or pay $4 million at contract inception.

The customer pays $4 million at contract inception.

The entity considers the significant period of time between the date of the customer's payment and the transfer of the machine to the customer, as well as the effect of prevailing market rates of interest. The entity concludes that there is a financing component, which is significant to the contract.

The interest rate implicit in the transaction is 11.8%. However, because it is effectively borrowing from its customer, the entity must also consider its own incremental borrowing rate, which is determined to be 6%.

The journal entries required are:

At contract inception:

Debit	Cash	$ 4,000,000	
Credit	Contract Liability		$ 4,000,000

(Recognition of a contract liability for the payment in advance.)

Over the two-year construction period:

Debit	Interest expense	$ 494,000	
Credit	Contract Liability		$ 494,000

(Accretion of the contract liability at a rate of 6%.)

At the date of transfer of the machine to the customer:

Debit	Contract Liability	$ 4,494,000	
Credit	Revenue		$ 4,494,000

(Recognition of revenue upon the transfer of the machine to the customer.)

BDO INSIGHTS: SIGNIFICANT FINANCING COMPONENT

To identify whether a contract includes a significant financing component, an entity compares the timing of payment and the timing of transfer of control of the related goods or services. How and when the activities related to satisfying any performance obligations are carried out is irrelevant.

For example, when activities related to satisfying a performance obligation are performed over time, but the revenue related to that performance obligation is recognized at a point in time (such as in Example 4-10), accounting for a significant financing component may be required. In other words, the fact that the activities are carried out over time is not relevant when comparing the timing of payment to the point in time at which the good or service is transferred to the customer to determine whether a significant financing component exists (see Chapter 6).

An entity presents the effects of financing (interest income or interest expense) separately from revenue from contracts with customers in the income statement. Interest income or expense is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer (see Chapter 8).

Also, in accounting for the effects of the time value of money, an entity must consider the subsequent measurement guidance in ASC 835-30, *Interest — Imputation of Interest*:

- Presentation of the discount and premium in the financial statements in accordance with ASC 835-30-45-1A through 45-3
- Application of the effective interest method in accordance with ASC 835-30-55-2 and 55-3.

However, interest expense arising from adjusting the transaction price in a revenue contract for the effect of a significant financing component is not in the scope of ASC 835-20, *Interest — Capitalization of Interest* Therefore, an entity cannot capitalize the interest imputed from a significant financing component in a revenue contract as a cost to acquire a qualifying asset.



TRG DISCUSSIONS: FINANCING COMPONENT — CONTRACT INCLUDES MULTIPLE PERFORMANCE OBLIGATIONS

In March 2015, the TRG acknowledged that calculating the adjustment of revenue in arrangements that contain significant financing components and determining how to apply the significant financing component guidance when there are multiple performance obligations can be complex. However, in calculating the impact of a significant financing component, ASC 606 provides guidance on selecting a discount rate and other U.S. GAAP provides guidance on subsequent accounting.

The TRG agreed that it might be appropriate in some circumstances to attribute a significant financing component to some, but not all, of the performance obligations in the contract. Practically, that might be in a manner analogous to the guidance on allocating variable consideration or allocating a discount (see Chapter 5).

4.5 NONCASH CONSIDERATION

FASB REFERENCES

ASC 606-10-32-21 through 32-24

In some cases, an entity might enter a contract with a customer under which the payment is in a form other than cash. The noncash consideration could be in the form of goods or services; a financial instrument (such as stock or warrants); or property, plant, and equipment; or cryptocurrencies (such as Bitcoin).

BDO INSIGHTS: NONCASH CONSIDERATION IN THE FORM OF CRYPTOCURRENCIES

An entity may receive cryptocurrencies as a form of noncash consideration in exchange for selling goods or services to another party. Such a transaction typically is in the scope of ASC 606 if the counterparty is a customer (see Section 1.3), or in the scope of ASC 610-20 if the counterparty is not a customer (see Section A.2). ASC 606-10-32-21 explains that an entity must measure "the estimated fair value of the noncash consideration at contract inception." Any changes in the fair value of the noncash consideration after contract inception caused by the form of the consideration are excluded from the transaction price and accounted for under other guidance. Accordingly, cryptocurrencies are initially measured at fair value at contract inception, and that value is included in the contract's transaction price. The cryptocurrencies are subsequently measured at fair value under ASC 350-60, *Intangibles — Goodwill and Other — Crypto Assets*. with changes in fair value excluded from the contract's transaction price. Those changes in fair value must be reported outside revenue from customers. If the changes are the result of other than the form of the consideration, they are reflected in the transaction price and subject to the guidance on constraining variable consideration in ASC 606. See **Accounting for Cryptocurrencies** for more guidance on cryptocurrencies.

If an entity provides goods or services in exchange for a future right to receive cryptocurrencies, it must evaluate whether the receivable contains an embedded derivative that must be bifurcated, which typically depends on whether the cryptocurrencies are readily convertible to cash. Refer to Question 24 in the **AICPA Practice Aid on the Accounting For and Auditing of Digital Assets** for more guidance.

ASU 2025-07 — SCOPE CLARIFICATION FOR A SHARE-BASED PAYMENT FROM A CUSTOMER

In some contracts, the consideration may include equity instruments such as warrants with vesting terms (for example, the right to receive additional shares as the customer purchases additional goods or services). Questions have arisen about whether the recipient should recognize those instruments at contract inception based on the guidance in ASC 321, in ASC 815, or only as the recipient satisfies its performance obligations under ASC 606.

In September 2025, the FASB issued ASU 2025-07 to clarify that an entity applies the guidance in ASC 606, including the guidance on noncash consideration, to a share-based payment from a customer. The ASU also clarifies that the guidance in ASC 321 and ASC 815 does not apply unless and until the entity's right to receive or retain the share-based noncash consideration is unconditional under ASC 606.

The amendments in ASU 2025-07 are effective for all entities for annual reporting periods beginning after December 15, 2026, and interim reporting periods within those annual reporting periods. Early adoption is permitted.

An entity must measure noncash consideration at its estimated fair value at contract inception (that is, when the five contract existence criteria in Step 1 are met) to determine the transaction price for contracts in which a customer promises noncash consideration. If an entity cannot reasonably estimate the fair value of the noncash consideration, it must measure the noncash consideration indirectly by reference to the SSP of the goods or services promised to the customer (or class of customer) in exchange for the consideration.

BDO INSIGHTS: ESTIMATING FAIR VALUE OF NONCASH CONSIDERATION

Estimating the fair value of the noncash consideration received in exchange for transferring goods or services can be challenging in some circumstances (for example, when an entity receives shares in a private entity that is in a start-up stage). However, we believe it would be unusual for an entity to assert that it cannot reasonably estimate the fair value of the noncash consideration, especially if the consideration is in the form of a financial instrument (for example, shares).

Once recognized, any asset arising from the noncash consideration is measured and accounted for in accordance with other relevant U.S. GAAP.

The fair value of noncash consideration may vary after contract inception because of the form of the consideration. For example, the price of a share received by an entity from a customer in exchange for transferring goods or services can change. Changes in the fair value of noncash consideration after contract inception that result from the form of the consideration are not included in the transaction price. If the fair value of the noncash consideration promised by a customer changes for reasons other than the consideration's form (for example, the exercise price of a share option changes based on the entity's performance), an entity must apply the guidance on estimating and constraining variable consideration. If the reasons underlying the change in the fair value of noncash consideration include both the consideration's form and reasons other than that, an entity must apply the guidance on variable consideration only to the variability resulting from reasons other than the form of the consideration.

A customer might contribute goods or services to an entity (for example, a customer for a construction contract might supply materials, equipment, or labor the entity will use in performing the construction services). In those circumstances, an entity must assess whether it obtains control of the contributed goods or services. If so, those contributed goods or services are accounted for as noncash consideration received from the customer, and the contractual transaction price is increased by the estimated fair value of the noncash consideration. Similarly, the value of such contributed materials is included in the cost of the good or service, effectively resulting in a gross up of the income statement. If the entity does not obtain control of the contributed goods or services, the estimated fair value of those items is not included in the transaction price.

Entities must also consider whether contracts involving the receipt of noncash consideration represent contracts with customers and are thus within the scope of ASC 606. For example, ASC 606 does not apply to:

- Barter transactions in which two entities exchange nonmonetary items in the same line of business to facilitate sales to customers (see Chapter 1).
- Transactions in which an entity accepts a noncash item (for example, shares in a customer entity) in settlement of a debt owed to the entity.

EXAMPLE 4-11 (ADAPTED FROM ASC 606-10-55-248 THROUGH 55-250): ENTITLEMENT TO NONCASH CONSIDERATION

An entity enters a contract with a customer on January 1, 20X1, to provide a weekly service for one year (that is, 52 weeks). Work begins immediately. Because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress (a time-based measure of progress)), the entity concludes that the service is a single performance obligation.

The customer promises 200 shares of its common stock for each week of service as the consideration for the services (that is, 10,400 shares for the contract). The contractual terms require that the shares must be paid upon the successful completion of each week of service.

To determine the transaction price (and hence the amount of revenue to be recognized), the entity measures the estimated fair value of 10,400 shares at contract inception on January 1, 20X1. The estimated fair value of 10,400 shares is the transaction price for the contract and is recognized in revenue as the services are transferred to the customer (see Chapter 6 for discussion on revenue recognition when or as a performance obligation is satisfied).

Any changes in the fair value of the 10,400 shares after contract inception are not reflected in the transaction price. Upon receipt of the shares, the entity applies other U.S. GAAP to determine whether and how any changes in fair value that occur after January 1, 20X1 are recognized.

BDO INSIGHTS: RECOGNIZING REVENUE FOR NONCASH CONSIDERATION

Because of the requirement to measure the fair value of noncash consideration at contract inception in determining the transaction price in Step 3, an entity may recognize a gain or loss in the income statement upon the initial recognition of noncash consideration received after contract inception. To illustrate, assume in Example 4-11 that the fair value of the shares changes after contract inception because of the form of the consideration. If the revenue recognition criteria are met when the shares are received (or become receivable) a week after contract inception, the entity will recognize the following at that date:

- Revenue measured using the fair value of the shares at contract inception (included in the transaction price).
- A financial asset for the shares at its then-current fair value under ASC 321.
- A gain or loss in the income statement for any changes in the fair value of the shares between contract inception and the date when they are received (or become receivable).

BDO INSIGHTS: GOODS OR SERVICES RECEIVED FROM A CUSTOMER

In some circumstances a customer may provide goods or services that an entity subsequently integrates with other goods or services into a combined output that it then sells to the customer. If the entity controls the goods or services received from the customer before integrating them into a combined output, they are considered noncash consideration. The value of such goods or services is included in the consideration in the contract and thus in revenue, and that value is included in cost of goods sold or cost of services. However, if the customer retains control of them, the goods or services are not considered noncash consideration. In that situation, an entity must consider whether the promise is to modify or enhance an asset controlled by the customer, resulting in over-time revenue recognition (see Section 6.3.2).

We believe the following indicators may be relevant in determining whether an entity obtains control of goods provided by the customer:

- Does the entity obtain title to the goods or does the customer retain title?
- If the contract is terminated, must the entity return any unused goods to the customer?
- Are the goods proprietary to the customer or are they fungible?
- Could the entity obtain the goods from an unrelated third party?
- Does the entity have the contractual and practical ability to redirect the goods to another customer?

While it is less common for a customer to contribute services an entity controls, in some instances, an entity might provide a significant service of integrating services provided by the customer with other goods and services provided by the entity into a single combined output (see Section 7.2.2.1).

Determining whether such goods or services are noncash consideration requires judgment based on the facts and circumstances.

EXAMPLE 4-11A: CUSTOMER PROVIDES PROPRIETARY RAW MATERIALS

An entity, a contract manufacturer, enters a contract with a customer to manufacture a chemical solvent. The customer holds a patent on the formula for the chemical solvent and the chemical precursor used in the manufacturing process. The customer provides the chemical precursor to the entity to manufacture the chemical solvent. The contract prohibits the entity from using the chemical precursor for any reason other than to manufacture the chemical solvent for sale to the customer. Any unused chemical precursor remaining at the end of the contract term must be returned to the customer.

In determining whether it controls the chemical precursor received from the customer, the entity considers that:

- The customer holds the patent on the formula for the chemical precursor.
- The entity cannot use the chemical precursor for any reason other than to manufacture the chemical solvent.
- Any unused chemical precursor at the end of the contract term must be returned to the customer.

The entity concludes that it does not control the chemical precursor. Therefore, the chemical precursor received from the customer is not considered noncash consideration.

EXAMPLE 4-11B: CUSTOMER PROVIDES GENERIC RAW MATERIALS

An entity, a contract manufacturer, enters a contract with a customer to manufacture a chemical solvent. The formula for the chemical solvent includes a chemical precursor that is not proprietary to the customer and can be obtained from various sources. However, the customer previously purchased a large volume of the chemical precursor from another supplier. The customer transfers the chemical precursor to the entity to use in manufacturing the chemical solvent. Further:

- The entity owns additional volumes of the chemical precursor that are indistinguishable from that received from the customer.
- The entity will add the chemical precursor received from the customer to its existing stock, such that any amounts used to manufacture the chemical solvent under the contract will not be identifiable.
- The contract provides a reduced cash price for the first 1,000 units of chemical solvent, which is approximately the number of units that can be manufactured with the volume of chemical precursor provided by the customer.
- Once the entity uses all the chemical precursor provided by the customer, it will be responsible for obtaining more.

The entity concludes that it controls the chemical precursor because:

- The chemical precursor is not proprietary to the customer and can be obtained from multiple sources.
- The contract does not require the entity to use the chemical precursor received from the customer in manufacturing the chemical solvent. Instead, it provides a reduced cash price for the initial 1,000 units.
- The entity plans to co-mingle the chemical precursor received from the customer with other quantities already owned and use it to fulfill multiple customer contracts.

Therefore, the entity concludes that the chemical precursor received from the customer is noncash consideration. It includes the value of the precursor in consideration in the contract and recognizes it as revenue as it transfers chemical solvent to the customer. The cost of the precursor received from the customer is recognized as inventory when received (with an offsetting contract liability), and as cost of goods sold as units of solvent are transferred to the customer.

4.6 CONSIDERATION PAYABLE TO A CUSTOMER

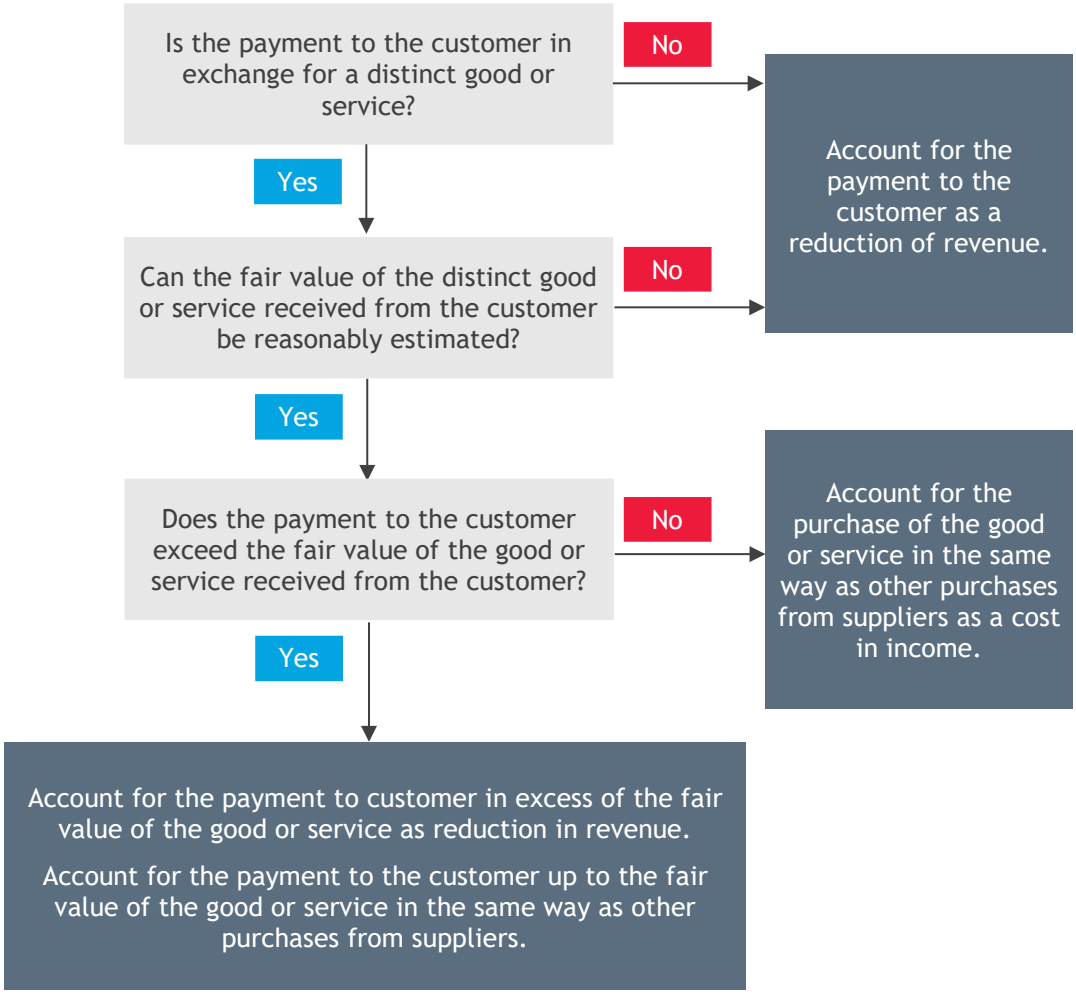
FASB REFERENCES

ASC 606-10-32-25 through 32-27 and ASC 606-10-55-251 through 55-254

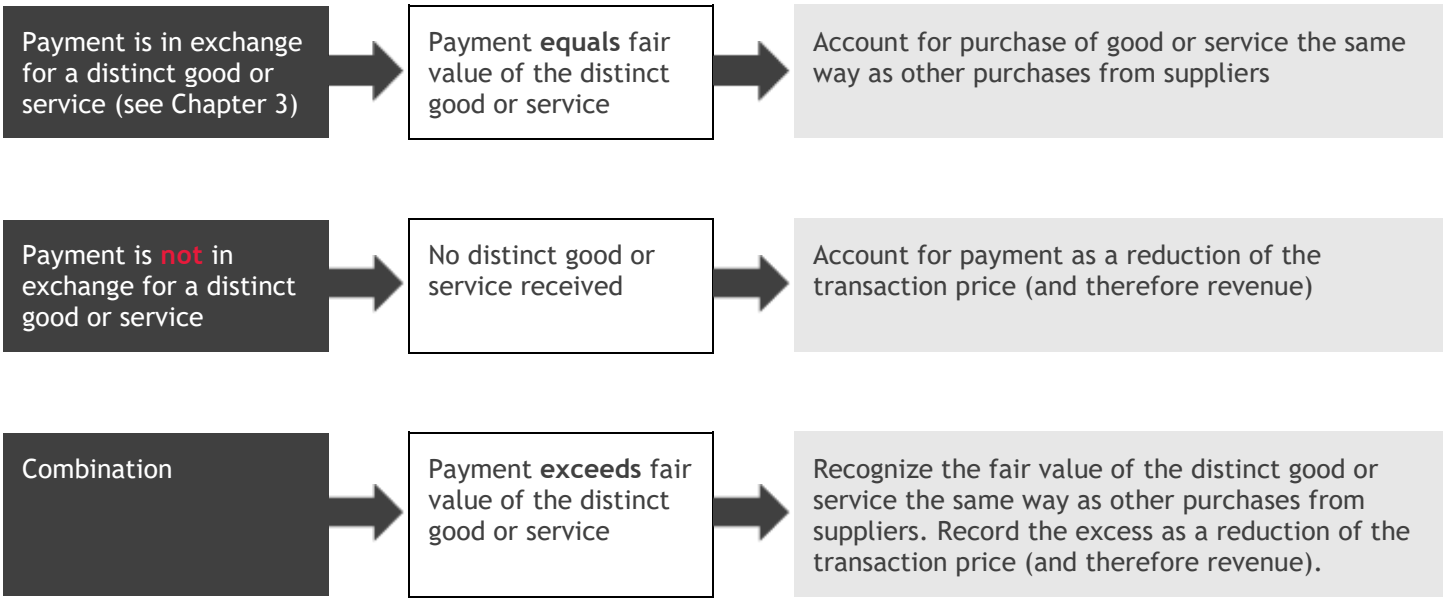
In some cases, a contract between an entity and a customer may require an entity to pay consideration to its customers or customer's customer (for example, an entity may sell a product to a distributor and subsequently issue a credit to a customer of that distributor). Consideration payable to a customer includes:

- Cash amounts an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer).
- Credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer).
- Equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares or share options) (see Section 4.6.2).

The following diagram provides an overview of an entity's recognition of consideration payable to a customer:



Consideration payable to a customer might be a payment in exchange for goods or services received from the customer, a discount or refund for goods or services transferred to the customer, or a combination of both. The amount of consideration received from a customer for goods or services and the amount of consideration paid to that customer for goods or services could be linked even if they are separate events. For example, an entity might overpay for the goods or services it purchases from its customer, and the customer might make inflated payments to the entity for purchasing goods or services from it. To faithfully depict revenue in those cases, any amount accounted for as a payment to the customer for goods or services received is limited to the fair value of those goods or services, with any amount over fair value recognized as a reduction of the transaction price (and therefore revenue).



CONSIDERATION PAYABLE TO A CUSTOMER MAY BE VARIABLE

If the consideration payable to a customer includes a variable amount, an entity must estimate the transaction price and assess whether the estimate of variable consideration must be constrained (see Section 4.3).

If consideration payable to a customer is accounted for as a reduction of the transaction price (and therefore revenue), an entity recognizes the reduction of revenue when or as the **later of either** of the following events occurs:

- The entity recognizes revenue for the transfer of the related goods or services to the customer (see Chapter 6).
- The entity pays or promises to pay (explicitly or implicitly based on it customary business practices) the consideration even if the payment is conditional on a future event. For example, a promise to pay a customer that is conditional on the customer making a specified number of purchases would be reflected in the transaction price when the entity makes the promise. That promise represents variable consideration, so the guidance on estimating variable consideration and constraining that estimate (that is, the probability of the customer making the future purchases) must also be considered.

If a payment to a customer is accounted for as a reduction of the transaction price, an entity recognizes less revenue when or as it satisfies any related performance obligations. However, an entity sometimes promises to pay consideration to a customer only after it has satisfied its performance obligations and therefore after it has recognized revenue. In those cases, a reduction in revenue is recognized immediately.

BDO INSIGHTS: CONSIDERATION PAYABLE TO A CUSTOMER THAT IS VARIABLE — IMPLIED PRICE CONCESSION — TIMING OF RECOGNITION

An entity's past practice of providing discounts or other price concessions may represent an implied consideration payable to a customer in the form of variable consideration. Variable consideration is generally estimated and recognized in revenue before the uncertainty underlying the variability is resolved. If the implied payment to the customer is variable, it may be recognized in revenue (as a reduction) before the entity makes the payment or explicitly promises to make the payment to the customer (see Section 4.3 for discussion on variable consideration).



TRG DISCUSSIONS: INTERACTION OF THE GUIDANCE ON VARIABLE CONSIDERATION AND CONSIDERATION PAYABLE TO A CUSTOMER

In January and March 2015, the TRG discussed the appropriate timing for recognizing consideration payable to a customer that is variable. It noted that the guidance on consideration payable to a customer states that such amounts are recognized as a reduction of revenue at the later of when:

- The related revenue is recognized.
- The entity pays or promises to pay such consideration.

Some TRG members highlighted that if an entity intends to provide its customer with a price concession when entering the contract (regardless of the form of the price concession; for example, cash payment, rebate, account credit, or coupon), the contract includes variable consideration, and the entity must consider that price concession when estimating variable consideration. If the contract includes variable consideration because of an expected price concession, the entity would not wait until it has communicated the price concession to the customer to recognize a reduction in revenue under the "later of" requirement. Instead, the entity re-estimates the expected price concession at each reporting date.

In reaching that conclusion, the TRG considered the following example:

- An entity that manufactures consumer goods enters a contract to sell a new product to a customer, a retail store chain, on December 15. Before delivering any of the new products to the retail store chain, the entity's marketing department assesses whether the entity should offer one-dollar-off coupons in newspapers to encourage customers to buy the new product. The entity will reimburse the retail store chain for any coupons redeemed. The entity has not historically offered similar coupons.
- The entity delivers the new consumer goods (1,000 units at $10 per unit) to the retail store chain on December 28. The customer has no right to return the products.
- On December 31, the entity decides to make the coupon offering. On January 2, the entity communicates to its customers that it will reimburse the retail store chain on March 30 for any coupons redeemed by the retail store's customers. The entity prepares its financial statements based on a calendar-year end.

TRG members generally agreed that the reversal of revenue from consideration payable to a customer must be made at the earlier of the date when there is a change in the transaction price (see Section 4.8) and when the consideration payable to a customer is promised, especially if the entity has a past practice of granting a discount. That determination requires judgment.

In the example above, at contract inception, the entity must consider its past practice and other factors (for example, its intent to offer coupons or whether the customer has a reasonable expectation that a concession will be provided in the form of consideration payable to the customer) to determine whether the transaction price is variable. If so, the coupon offering constitutes variable consideration and reduces the transaction price. If all requirements in Step 5 have been met to recognize revenue for the sale of 1,000 units of consumer goods on December 28, the entity would reduce the revenue recognized on that date to reflect the estimated amount of

coupon offering (consideration payable to customer). That estimate will be reassessed on December 31 (the reporting date) in accordance with the guidance on variable consideration (see Section 4.3.6).

If the coupon offering does not constitute variable consideration, the guidance on variable consideration does not apply and the later of requirement on recognizing consideration payable to a customer applies. In that scenario, the entity would reduce its revenue to recognize the coupon offering on January 2.



TRG DISCUSSIONS: CONSIDERATION PAYABLE TO A CUSTOMER — DISTRIBUTION CHAIN

The guidance on consideration payable to a customer refers to payments made to other parties that purchase the entity's goods or services from the customer. BC255 of ASU 2014-09 refers to payments an entity makes to *"its customers or to its customer's customer (for example, an entity may sell a product to a dealer or distributor and subsequently pay amounts to or provide a cash incentive to a customer of that dealer or distributor)."*

In March 2015, the TRG discussed whether the guidance on consideration payable to a customer applies only to payments to customers in the distribution chain of an entity or whether the term "customer's customer" should be interpreted more broadly.

The TRG considered an example in which an entity that is acting as an agent views the principal in the arrangement as its customer. The agent may make incentive payments to parties that purchase the principal's good or service. In many cases, those incentives are not part of the contract with the principal or a promise made explicitly or implicitly to the principal. The principal may, however, be aware of the agent's incentive program. The agent makes incentive payments, such as providing coupons or cash rebates to the principal's customer, to increase the volume of transactions on which it earns its agency fee. However, the principal's customers are not purchasing the agent's goods or services.

Most TRG members supported the view that an entity's customers include those parties in the distribution chain and might include a customer's customer outside that chain. An entity must identify its customer in each revenue transaction and entities within the distribution chain. Further, an entity that is acting as an agent (that is, arranging for another party to provide goods or services), might identify multiple customers depending on the facts and circumstances of the arrangement. In other words, the entity might view both the principal and the end customer as customers in the arrangement. Regardless of whether an entity concludes that the principal's end customer is also a customer of the entity, a payment to a principal's end customer that is contractually required based on an agreement between the entity and the principal represents consideration payable to a customer.

BDO INSIGHTS: CONSIDERATION PAYABLE TO A CUSTOMER — DISTRIBUTION CHAIN

An entity may make payments on behalf of a customer to a third party that might be outside the customer's distribution chain. Consistent with the TRG discussions on distribution chain, we believe the guidance on consideration payable to a customer is interpreted broadly and may include payments made to a third party on a customer's (or customer's customer's) behalf. For example, an entity may agree to pay certain transaction costs, such as broker fees, on behalf of its customer. Because the entity is not the principal in the arrangement with the broker but instead is paying the broker at its customer's direction, the payment would be recognized as a reduction in revenue.

TRG DISCUSSIONS: SCOPE OF CONSIDERATION PAYABLE TO A CUSTOMER

In January and March 2015, the TRG discussed which payments to a customer are within the scope of the guidance on consideration payable to a customer. The TRG members had differing opinions about which one of the following two views is correct:

- **View A:** An entity should assess all consideration payable to a customer.
- **View B:** An entity should assess only consideration payable to a customer included in a contract (or combination of contracts) with the customer.

The FASB staff concluded that View A is the only supportable interpretation because BC257 of ASU 2014-09 notes that the receipt of consideration from a customer and the payment of consideration to a customer can be linked even if they are separate events. While some TRG members favored View B, all TRG members generally agreed that an entity must evaluate a payment to a customer (or to a customer's customer) — particularly when no goods or services have been transferred — to determine the commercial substance of the payment and whether the payment is linked to a revenue contract with the customer.

EXAMPLE 4-12: CONSIDERATION PAYABLE TO CUSTOMER

An entity sells a product to its customer for $100. The contract requires the entity to pay the customer $25.

Scenario A

The customer is not providing any distinct goods and services to the entity. Therefore, the transaction price (and, hence, revenue) recognized by the entity for the sale of the product is reduced to $75 ($100 - $25).

Scenario B

The contract requires the customer to provide a service to the entity. That service is considered distinct, and its estimated fair value is $25. Therefore, the transaction price (and, hence, revenue) recognized by the entity for the sale of the product is $100. The entity separately recognizes the purchase of services from its customer for $25 under other U.S. GAAP.

Scenario C

Consider the same facts in Scenario B with the exception that the estimated fair value of the distinct service provided by the customer to the entity is $15. Therefore, the transaction price (and, hence, revenue) recognized by the entity for the sale of the product is reduced to $90 ($100 - $10). The excess of the consideration payable to the customer ($25) over the fair value of the distinct service the entity receives from the customer ($15) is $10. The entity separately recognizes the purchase of services from its customer for $15 under other U.S. GAAP.

4.6.1 Determining Whether a Good or Service Received From a Customer Is Distinct

FASB REFERENCES

ASC 606-10-32-25 and ASC 606-10-55-251 through 55-254

To determine whether a payment to a customer is recognized as a reduction in revenue or as a cost in the income statement, an entity must determine whether it receives a distinct good or service from the customer (see Chapter 3).

EXAMPLE 4-13 (ADAPTED FROM ASC 606-10-55-251 THROUGH 55-254): CONSIDERATION PAYABLE TO CUSTOMER

An entity that manufactures consumer products enters a contract to sell goods to a customer (a large supermarket group) for one year. The customer is contractually required to purchase at least $10 million of goods during the year.

The customer also is contractually required to change the shelving at the stores that will sell the retail goods. To compensate the customer for making those changes, the entity makes a nonrefundable payment of $1 million to the customer at contract inception.

The payment by the entity to its customer does not result in the entity obtaining a distinct good or service. Although the customer will use the shelving to sell the retail goods purchased from the entity, the entity does not obtain control of any rights to those shelves.

Therefore, the entity accounts for the $1 million payment to the customer as a reduction in the transaction price when the entity recognizes revenue for the transfer of retail goods. The $1 million payment is recorded as an asset and is amortized as a reduction of revenue as the related sales of retail goods are recognized, resulting in total revenue recognition of $9 million for the contract.

BDO INSIGHTS: DISTINCT GOOD OR SERVICE — SLOTTING FEES

A manufacturer often pays consideration to a retailer to obtain prominent positioning for its goods in the retailer's shops. Those payments are sometimes referred to as "slotting fees." Whether the retailer provides a distinct good or service to the manufacturer depends on the facts and circumstances; specifically, whether the manufacturer obtains control of a good or service provided by the retailer. However, we believe it would be rare for that type of payment to result in the manufacturer receiving control of a distinct good or service.

BDO INSIGHTS: GOOD OR SERVICE RECEIVED FROM A CUSTOMER

Accounting for payments to customers is a key aspect of ASC 606 and could have a significant effect on an entity's financial statements. ASC 606 focuses on whether a good or service received from a customer is distinct to determine whether a payment to a customer is accounted for as a reduction in revenue or as a cost in the income statement. Sometimes, general terms such as marketing fees, advertising fees, transportation fees, or warehousing fees are used to describe payments to customers. While those types of fees may be commonly presented as selling expenses or cost of sales when paid to service providers that are not customers, entities must not assume that is the appropriate presentation when they are included in a contract with a customer. Rather, entities must carefully evaluate whether the payments to customers are made in exchange for distinct goods or services. If the good or service received from the customer is not distinct, the payment to the customer is presented as a reduction of revenue, rather than as a cost of sales or selling expense.

Determining whether a good or service is distinct requires the application of professional judgment based on the facts and circumstances.

BDO INSIGHTS: DISTINCT GOOD OR SERVICE — MARKETING ACTIVITIES

Sometimes it is challenging to determine whether a payment to a customer is in exchange for a distinct good or service when an entity compensates its customer for the costs of marketing the entity's products. The FASB acknowledged that in BC256 of ASU 2014-09:

> *"The Boards decided that the only circumstance in which an entity should account for any good or service received in the same way as for other purchases from suppliers is if the good or service is distinct. Previous guidance in U.S. GAAP on the consideration that a vendor gives to a customer used the term identifiable benefit, which was described as a good or service that is "sufficiently separable from the recipient's purchase of the vendor's products such that the vendor could have entered into an exchange transaction with a party other than a purchaser of its products or services in order to receive that benefit." The Boards concluded that the principle in Topic 606 for assessing whether a good or service is distinct is similar to the previous guidance in U.S. GAAP.*

Therefore, we believe the following indicators may be relevant when determining whether the marketing activities provide a service that is distinct from the sales of the entity's products to that customer:

- Does the marketing activity reach end consumers beyond customers of the entity's customers?
- Could the specific marketing activities be obtained from an unrelated third party?
- Are the marketing activities expected to result in an increase in sales to parties other than the customer providing the marketing services?
- Which entity controls the marketing activities, including making decisions about the content of the marketing materials?

An entity may sell goods or services to a customer, such as a retailer, for further resale and receive in-store marketing services from the retailer (or digital advertising services on the retailer's website) to promote the resale of those goods or services to end customers. In that scenario, we believe it would be unusual to conclude that the marketing service is distinct from the revenue transaction because the retailer would not provide the marketing services if it were not also purchasing the goods or services from the entity.

EXAMPLE 4-13A: ADVERTISING FEE PAYABLE TO CUSTOMER — REDUCTION IN REVENUE

An entity that manufactures health supplement products enters a contract to sell its products to a customer that is a large distributor. The customer resells the products to end consumers on a large online retail platform. The customer is contractually required to purchase at least $20 million of products from the entity during the year, and the entity is required to make a payment of $7 million to the customer as a nonrefundable advertising and marketing fee.

The customer uses the advertising and marketing fee to promote the entity's product on the online retailer's platform. The advertisements placed by the customer are linked to the customer's product page (that is, the customer's online shop) on the online retail platform. An end consumer who sees the advertising and clicks to purchase the product is directed to the customer's product page on the retail platform to make the purchase.

The entity determines that the payment of the advertising fee to the customer is not in exchange for a distinct advertising service purchased by the entity from the customer. Although the customer uses the advertising fee to promote the entity's products, the promotional activities result in a direct benefit to the customer in the form of increased sales. The advertisements are linked to the customer's online retail shop and directly benefit the customer. Further, the customer would not provide the advertising and marketing services if it were not also purchasing the products from the entity.

Therefore, the entity accounts for the $7 million payment to the customer as a reduction in the transaction price when it recognizes revenue for the transfer of the products, resulting in total revenue recognition of $13 million for the contract (assuming the customer does not purchase additional products from the entity).

EXAMPLE 4-13B: ADVERTISING FEE PAYABLE TO CUSTOMER — SELLING EXPENSE

Consider the same facts as in Example 4-13A, except the customer places advertisements for the entity's products on various third-party search engines and social media platforms. The advertisements are linked to the entity's website such that an end consumer who sees the advertising and clicks to purchase the product is led to the entity's website to make the purchase.

The entity determines that the payment of the advertising fee to the customer is in exchange for a distinct advertising service purchased by the entity from the customer. The advertising is broad based and reaches potential customers outside the customer's own customers and may lead to additional sales for the entity (rather than for the customer).

Assuming the $7 million fee does not exceed the fair value of the advertising and marketing services, the entity recognizes the $7 million payment to the customer as selling expenses.



TRG DISCUSSIONS: UPFRONT PAYMENT TO A CUSTOMER OR POTENTIAL CUSTOMER

In November 2016, the TRG discussed the accounting for upfront payments to customers. An entity may make an upfront payment to a customer to, for example:

- Reimburse the customer for costs associated with entering a contract (such as costs for setting up a new vendor or costs to shut down operations that will be outsourced to the vendor).
- Obtain a contract with a customer in a competitive environment (pay-to-play or exclusivity).
- Provide additional incentives or discounts to customers.

Upfront payments to customers that are not in exchange for a distinct good or service are accounted for as a reduction of the transaction price. However, recognizing a payment to a customer as a reduction in revenue may result in a loss recognition in some scenarios. For example:

- An entity may make an upfront payment to a potential customer in anticipation of future purchases from the customer before obtaining a contract with the customer.
- An entity may make an upfront payment to a customer it has a contract with. However, the upfront payment may relate to the current contract, as well as any anticipated future contracts.

The TRG discussed two views about the timing of when the reduction in revenue for an upfront payment should be recorded:

- **View A:** Payments to customers are capitalized and amortized as a reduction of revenue as the related goods or services that are expected to be purchased by the customer are transferred to the customer. The asset is assessed for impairment in subsequent reporting periods. Under this view, the payment to a customer might be recognized in profit or loss over a period that is longer than the current legally enforceable contract. This view is appropriate only if the payment meets the definition of an asset in FASB Concepts Statement No (CON). 6, *Elements of Financial Statements*[12], and future purchases are expected.

[12] CON 6 was superseded by Chapter 4 of CON 8, *Conceptual Framework for Financial Reporting* in July 2024. As asset is now defined as "*a present right of an entity to an economic benefit.*"

- **View B:** Payments to customers are recognized as a reduction of revenue from the existing contract. If a contract with the customer does not exist, the entire payment is immediately recognized in profit or loss. The TRG noted that for this view to apply, the payment must relate to the existing contract only.

TRG members agreed that applying either view is not a policy election. Rather, an entity must understand the reasons for the payment, any rights and obligations resulting from the payment, the nature of any promises in the contract, and other relevant facts and circumstances for each arrangement when determining the appropriate accounting.

Finally, the TRG said the assessment requires significant judgment in some cases and that appropriate disclosures in the financial statements might be important.

BDO INSIGHTS: AMOUNTS RECEIVED FROM A SUPPLIER

Although ASC 606 addresses an entity's accounting for consideration payable to a customer, it does not directly address how an entity accounts for amounts received from a supplier. ASC 705-20, *Cost of Sales and Services — Accounting for Consideration Received From a Vendor*, provides guidance on accounting for consideration received from a supplier. We believe that in Example 4-13 in this Blueprint, the supermarket should reflect a reduction in the cost of inventory purchased (and, hence, ultimately a reduction in cost of sales) rather than revenue or a contribution offset against the costs of changing the shelving. Specifically, the supermarket should recognize a $1 million liability for the slotting fee it received as an offset against the cost of inventory when the future purchases occur.

In that example, the manufacturer is not the retailer's customer (that is, the changes to the shelving are not an output of the retailer's ordinary activities and do not represent a good or service that is distinct from its purchases from the manufacturer). This approach results in consistency in the accounting between the manufacturer and the retailer because if the manufacturer is not receiving a distinct good or service for the consideration paid to the retailer, the retailer is similarly not providing a distinct good or service to the manufacturer. That treatment is consistent with the guidance in ASC 705-20.

However, in other circumstances, a retailer can receive consideration from manufacturers that would constitute revenue for the retailer, as illustrated by the following three scenarios:

Scenario A: Discount granted based on purchases not related to manufacturers' products

A manufacturer and retailer agree on a promotion under which:

- The retailer's customers receive coupons based on their total purchases in the retailer's store regardless of whether the purchased products are manufactured by the manufacturer or another party ($10 coupon for each $100 of purchases).
- The retailer's customers use the coupons to acquire the manufacturers' products at a discounted price in the retailer's stores.
- The manufacturer bears the difference between the sales price and the discounted price granted to the customer.

The manufacturer's product has a selling price of $60. An end customer purchases that product from the retailer in exchange for three coupons with a total value of $30 and cash of $30. The manufacturer reimburses $30 cash to the retailer, which is the face value of the coupons used by the end customer. The retailer recognizes revenue of $60, which includes the $30 cash received from the end customer and the $30 cash reimbursement from the manufacturer for the coupon used by the end customer.

Scenario B: Promotional discount granted to the customer

A manufacturer and retailer agree on a promotional pricing for a product manufactured by the manufacturer and sold by the retailer to end customers. The retailer generally purchases the manufacturer's product for $85 for sale

to end customers at $102. During the promotional period, the retailer sells the product for $97 to its customers. The manufacturer reimburses the retailer for the incremental discount of $5 over the regular retail price of $102.

For each sale of the product, the retailer recognizes revenue of $102, which includes the price paid by its customer ($97) plus the amount reimbursed by the manufacturer ($5).

Scenario C: Discount granted to the end customer based on coupons issued by the manufacturer

A manufacturer (not the retailer) initiates a promotional campaign under which end customers receive coupons issued by the manufacturer when they purchase the manufacturer's products from a retailer. The manufacturer bears the difference between the retail price and the discounted price. A customer receives a coupon for $10 off the purchase of one of the manufacturer's products.

The manufacturer's product has a selling price of $60, and an end customer purchases the product in exchange for a coupon with a value of $10 and cash of $50. The retailer receives $10 from the manufacturer. The retailer recognizes revenue in an amount of $60, which includes the $50 cash received from the end customer and the $10 cash reimbursement from the manufacturer for the coupon used by the end customer.

All Scenarios: Payment on behalf of the customer

In all three scenarios, although the payments received by the retailer are from the manufacturer (the supplier), the payments are received on behalf of the retailer's customer, so the retailer recognizes the amounts due from the manufacturer as revenue. If the manufacturer reimburses the retailer at an amount that exactly matches the discount the end customer receives, the coupon has in effect been issued by the manufacturer (not the retailer) to the end customer and therefore is recognized as revenue by the retailer. In those scenarios, there is no payment to a customer from the perspective of the retailer, so there is no reduction in revenue or a rebate for the cost of inventory sold.

However, from the manufacturer's perspective, the reimbursement of coupons is a payment to its customer (the retailer) and therefore results in a reduction of revenue recognized by the manufacturer.

4.6.2 Equity Instruments Granted as Consideration Payable to a Customer (Before Adoption of ASU 2025-04)

FASB REFERENCES

ASC 606-10-32-23, ASC 606-10-32-25 through 32-25A, and ASC 606-10-55-88A and 55-88B

Share-based consideration granted by an entity to a customer in conjunction with selling goods or services are measured and classified under ASC 718. Share-based consideration payable to a customer is measured at the grant date in accordance with ASC 718 (for both equity- and liability-classified awards). Consistent with accounting for noncash consideration received from a customer (see Section 4.5), changes in the measurement of an award to a customer (through the application of ASC 718) after the grant date caused by the form of the consideration are not included in the transaction price. Rather, changes stemming from the form of the consideration are reflected elsewhere in the grantor's income statement.

In some contracts, the seller offers the customer a share-based payment that includes vesting conditions (for example, the customer receives additional shares as it purchases additional goods or services). Changes in the expected outcome of a service condition or a performance condition (both those that affect vesting and those that affect factors other than vesting) are not considered changes caused by the form of the consideration and hence are reflected in the transaction price (and, therefore, revenue).

If the number of equity instruments promised in a contract is variable because of a service condition or performance condition that affects the vesting of an award, an entity must estimate the number of equity instruments it will be obligated to issue to its customer and update that estimate of the number of equity instruments until the award

ultimately vests in accordance with ASC 718. Before adoption of ASU 2025-04, ASC 718 does not specify how to determine whether a customer award contains a service or a performance condition. Also, before adoption of ASU 2025-04, ASC 718 requires an entity to apply the same forfeiture policy to nonemployee and customer awards with service conditions. In other words, an entity may elect not to estimate forfeitures for both nonemployee and customer awards with service conditions before adopting the ASU. See Section 4.6.2A for applicable guidance after an entity adopts ASU 2025-04.

Further, in accordance with ASC 718, the entity must include the effect of any market conditions and service or performance conditions that affect factors other than vesting when measuring each instrument. ASC 718-10-30-15 provides examples of factors other than vesting.

Also, when an estimate of the fair value of an equity instrument is required before the grant date in accordance with the guidance on variable consideration, the estimate is based on the fair value of the award at the reporting dates that occur before the grant date. An entity must change the transaction price for the cumulative effect of measuring the fair value at each reporting period after the initial estimate until the grant date occurs. In the period in which the grant date occurs, the entity must change the transaction price for the cumulative effect of measuring the fair value at the grant date rather than the fair value previously used at any prior reporting date. See our Blueprint: **Share-Based Payments Under ASC 718**.

4.6.2A Equity Instruments Granted as Consideration Payable to a Customer (After Adoption of ASU 2025-04)

FASB REFERENCES

ASC 606-10-32-23, ASC 606-10-32-25 through 32-25A, and ASC 606-10-55-88A through 55-88C

In May 2025, the FASB issued ASU 2025-04 to clarify several narrow aspects of accounting for share-based consideration payable to a customer. ASU 2025-04 is effective for all entities for annual reporting periods beginning after December 15, 2026, and interim reporting periods within those annual reporting periods. Early adoption is allowed. See our Bulletin, **Share-based Consideration Payable to a Customer**, for additional information. ASU 2025-04 does not change the principle that share-based consideration an entity grants to a customer in conjunction with selling goods or services is measured and classified under ASC 718 (see Section 4.6.2). However, ASU 2025-04 clarifies some aspects of the guidance, as noted in this section.

Share-based consideration payable to a customer is measured at the grant date in accordance with ASC 718 (for both equity- and liability-classified awards). Consistent with accounting for noncash consideration from a customer (see Section 4.5), changes in the measurement of an award to a customer (through the application of ASC 718) after the grant date caused by the form of the consideration are not included in the transaction price. Rather, those changes are reflected elsewhere in the grantor's income statement.

In some contracts, the seller offers the customer a share-based payment that includes vesting conditions (for example, the customer receives additional shares as it purchases additional goods or services). Changes in the expected outcome of a service condition or performance condition (both those that affect vesting and those that affect factors other than vesting) are not considered changes caused by the form of the consideration and hence are reflected in the transaction price (and therefore, revenue).

If the number of equity instruments promised in a contract is variable because of a service condition or performance condition that affects the vesting of an award, an entity must estimate the number of equity instruments it will be obligated to issue to its customer and update that estimate until the award ultimately vests in accordance with ASC 718. After adopting ASU 2025-04, an entity treats vesting conditions based on purchases by customers or their customers as performance conditions. Also, ASU 2025-04 eliminates the policy election to account for forfeitures as they occur for customer awards with service conditions. After adopting the ASU, an entity must adjust the transaction price for a contract with a customer for the probability that a customer award with a performance condition will vest and for the estimate of forfeitures for a customer award with a service condition. For some customer awards, that change could result in earlier revenue recognition.

Further, in accordance with ASC 718, an entity must include the effect of any market conditions and service or performance conditions that affect factors other than vesting when measuring each award. ASC 718-10-30-15 provides examples of factors other than vesting.

Finally, when an estimate of the fair value of an equity instrument is required before the grant date in accordance with the guidance on variable consideration, the estimate is based on the fair value of the award at the reporting dates that occur before the grant date. An entity must change the transaction price for the cumulative effect of measuring the fair value at each reporting period after the initial estimate until the grant date occurs. In the period in which the grant date occurs, the entity must change the transaction price for the cumulative effect of measuring the fair value at the grant date rather than the fair value used at any prior reporting date. ASU 2025-04 clarifies that regardless of whether an award's grant date has occurred, an entity must apply the ASC 718 guidance on measuring a share-based payment rather than the ASC 606 guidance on constraining variable consideration when determining the value of customer awards. See our Blueprint: Share-Based Payments Under ASC 718.

4.7 NONREFUNDABLE UPFRONT FEES

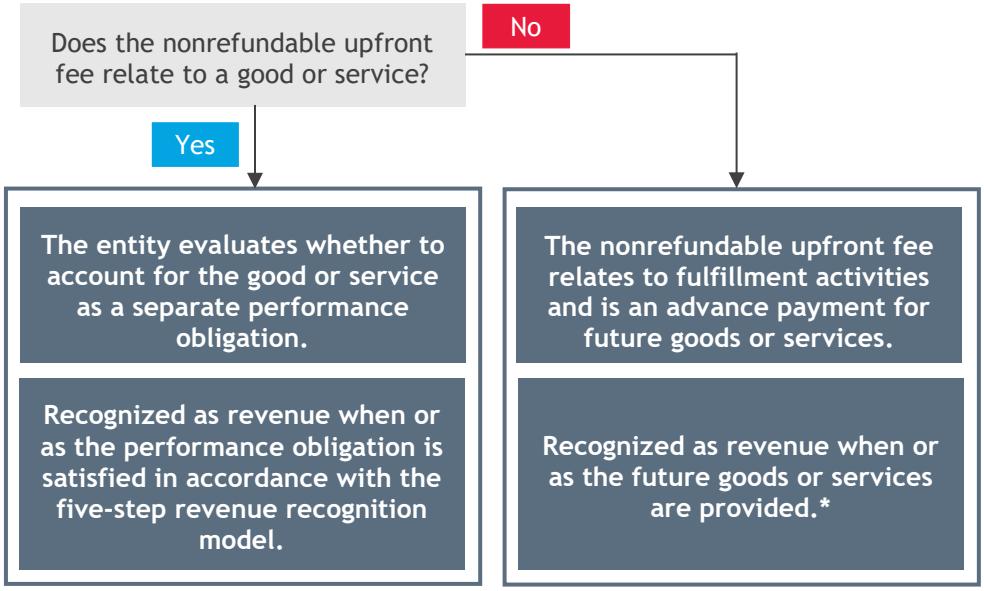
FASB REFERENCES

ASC 606-10-55-50 through 55-53

An entity may charge a customer a nonrefundable upfront fee at or near contract inception, such as for:

- Joining fees for health club membership contracts
- Activation fees for telecommunication contracts
- Setup fees in some services contracts (for example, SaaS contracts)
- Initial fees in some supply contracts.

The following diagram illustrates the key accounting considerations for nonrefundable upfront fees:



*The revenue recognition period generally extends beyond the initial contract term if the entity grants the customer a renewal option that is determined to be a material.

When a contract includes a nonrefundable upfront fee, an entity assesses whether that fee relates to the transfer of a promised good or service in Step 2 and accounts for the fee as follows:

- If the nonrefundable upfront fee relates to a good or service, the entity evaluates whether to account for the good or service as a separate performance obligation.
- If the nonrefundable upfront fee does not result in the transfer of a promised good or service to the customer but rather relates to fulfillment activities, the fee is an advance payment for future goods or services and therefore is recognized as revenue when those future goods or services are provided. The revenue recognition period generally extends beyond the initial contract term if the entity grants the customer renewal options for the contract that are determined to be material rights (see Section 7.4).

In many cases, even though a nonrefundable upfront fee may relate to an activity the entity must undertake at or near contract inception to fulfill the contract, that activity might not result in the transfer of a promised good or service to the customer but instead be a fulfillment activity.

See Chapters 3 and 6 for discussion on identifying fulfillment activities and performance obligations in a contract and recognizing revenue when or as the performance obligations are satisfied.

EXAMPLE 4-14 (ADAPTED FROM 606-10-55-358 THROUGH 55-360): NONREFUNDABLE UPFRONT FEE — MATERIAL RIGHT VERSUS ADVANCE PAYMENT FOR SERVICES TO BE PROVIDED IN FUTURE

A technology entity enters a contract with a customer to provide SaaS for one year. The contract includes standard terms and conditions that are the same for all customers. The customer is contractually required to pay a nominal nonrefundable upfront fee in return for the entity setting up the customer in the entity's systems and processes. The customer can renew the contract each year at the SSP of the services and is not required to pay any additional fee after the initial set up.

The entity observes that:

- Its initial setup activities do not transfer a good or service to the customer and therefore do not give rise to a performance obligation.
- Although the contract can be renewed without paying another upfront fee, the amount of the fee is not significant to the price of the services during the renewal period.

Therefore, the entity concludes that the renewal option is priced at the SSP of the services and thus does not provide a material right to the customer (see Section 7.4).

The entity determines that the upfront fee is, in effect, an advance payment for the services to be provided in future. Therefore, it includes the nonrefundable upfront fee in the transaction price in Step 3 and recognizes it as revenue for SaaS as the service is provided. See Chapter 6 for discussion on recognizing revenue when or as a performance obligation is satisfied.

EXAMPLE 4-14A: NONREFUNDABLE UPFRONT FEE — MATERIAL RIGHT

A software entity contracts with a customer to provide SaaS for one year. The contract includes standard terms and conditions. The contract requires the customer to pay a significant nonrefundable upfront fee in addition to the amounts payable for the initial one year of service. The customer can renew the contract for four additional years at the same price as the initial year of service but without paying another nonrefundable upfront fee.

The entity observes that:

- The amount of the upfront fee is significant to the price of the services during the renewal period.
- The renewal options are priced below the standalone selling price of the services because the customer can renew the contract without paying an additional nonrefundable upfront fee.

- The significance of the upfront fee and amounts paid for the initial one year compared to the price payable for renewals may economically compel the customer to renew the services. In other words, the upfront fee could influence the customer's purchasing decision regarding renewing the services.

Based on the above observations, the software entity concludes that the upfront fee provides a material right(s) (separate performance obligations) to the customer.

The software entity allocates a portion of the upfront fee and amounts paid for the initial one year to the material right(s) and recognizes it in revenue as the option(s) is exercised or lapses unexercised.



TRG DISCUSSIONS: PRESENTATION OF A PAYMENT TO A CUSTOMER

An entity may make a nonrefundable upfront payment to a customer that is not in exchange for distinct goods or services. In some cases, recognizing such upfront payments immediately as a reduction of revenue (as required by the guidance on consideration payable to a customer — see Section 4.6) could result in an upfront loss.

In November 2016, the TRG discussed two approaches about the timing of recognizing a reduction in revenue for an upfront payment to a customer:

- **View A:** Payments to customers are recognized as a reduction of revenue as the expected total purchases resulting from the upfront payment are transferred to the customer. The period over which the payment is recorded in the income statement may be longer than the current legally enforceable contract. The entity determines the amortization period and pattern to amortize the asset recognized. The asset is periodically assessed for impairment.
- **View B:** Payments to customers are recognized as a reduction of revenue over the term of the existing legally enforceable contract.

TRG members agreed that View A is appropriate when the payment to the customer meets the definition of an asset in Concepts Statement 6 (superseded by Concepts Statement 8) and is recoverable from future cash flows, whereas View B is appropriate when the payment relates to the existing contract only.

Consistent with the TRG discussions, we believe that determining whether to capitalize an upfront payment to a customer and the appropriate recognition period requires significant judgment and depends on the facts and circumstances. An entity must evaluate the nature of the payment to the customer, the rights and obligations in the contract, the underlying economic reasons for the payment and all relevant facts and circumstances to appropriately apply the requirements in ASC 606 and other U.S. GAAP.

BDO INSIGHTS: PRESENTATION OF "NEGATIVE REVENUE"

As discussed above, the TRG discussed how to account for upfront payments to a customer. For instance, a vendor may provide an upfront payment to secure a contract with a new customer, with the potential for significant ongoing sales in future contracts. However, an entity may make payments to its customer that are not in exchange for distinct goods or services and that exceed the amount of consideration to which the entity is entitled from that customer. A question arises as to whether such excess should be presented as "negative revenue" or as an expense in the income statement. ASC 606 does not address this situation. While the issue was submitted to the TRG for consideration at its January 2015 meeting, no consensus was reached, nor was any interpretive guidance provided.

In the absence of authoritative guidance, we believe entities may apply the superseded guidance in ASC 605-50-45-9 (formerly, EITF 01-09) which stated negative revenue could be recharacterized as an expense if at the time the consideration is recognized in the income statement it exceeds cumulative revenue and probable future revenue

from the customer. That is, the entity considers the entire customer relationship to determine what amount, if any, may be presented as an expense.

We also believe it is acceptable for entities to present such amounts as negative revenue, rather than an expense.

Determining the appropriate characterization of such payments requires the application of professional judgment, based on the facts and circumstances.

4.7.1 Costs Related to Nonrefundable Upfront Fees

An entity may charge a nonrefundable upfront fee in part as compensation for costs incurred in setting up a contract or other administrative tasks. If those setup activities do not satisfy a performance obligation, but are rather fulfillment activities (see Section 3.2), the entity must:

- Disregard those setup activities and the related costs when measuring progress to recognize revenue because the costs of setup activities do not depict the transfer of services to the customer.
- Assess whether the costs incurred in setting up a contract result in an asset that is recognized in accordance with ASC 340-40-25-5 (see Section 7.7).

4.8 CHANGES IN THE TRANSACTION PRICE



FASB REFERENCES

ASC 606-10-32-42 through 32-45

The transaction price for a contract can change after contract inception for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

An entity must allocate any subsequent changes in the transaction price to the performance obligations in the contract on the same basis as at contract inception. In other words, an entity does not reallocate the transaction price to reflect any changes in standalone selling prices after contract inception.

Also, an entity allocates a change in the transaction price entirely to one or more, but not all, performance obligations or distinct goods or services promised in a series that form part of a single performance obligation if the criteria for the variable consideration allocation exception are met (see Section 5.5).

Any amount allocated to a satisfied performance obligation is recognized as revenue or as a reduction of revenue in the period in which the transaction price changes (see Example 4-5).

A change in the transaction price that arises because of a contract modification is accounted for in accordance with the guidance on contract modifications (see Section 7.3). However, for a change in the transaction price that occurs after a contract modification, an entity must allocate the change in the transaction price in one of the following ways:

- The modification is accounted for as a termination of the existing contract and the creation of a new contract (in accordance with ASC 606-10-25-13(a)) — An entity must allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification.
- In all other cases in which the modification is not accounted for as a separate contract (in accordance with ASC 606-10-25-12) — An entity must allocate the change in the transaction price to the remaining performance obligations in the modified contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

Examples 7-9 and 7-11 illustrate accounting for changes in the transaction price that arise because of contract modifications.

ASC 606 requires an entity to update its estimate of the transaction price throughout the contract to depict conditions that exist at the end of each reporting period (and changes in conditions during the reporting period). That is because an entity may revise its expectations about the amount of consideration it expects to be entitled to after contract inception as uncertainties are resolved or as new information becomes available about remaining uncertainties. BC224 of ASU 2014-09 states that reflecting current assessments of the amount of consideration to which the entity expects to be entitled provides more useful information to users of financial statements than retaining the initial estimates, especially for long-term contracts that are subject to significant changes in conditions during the lives of the contracts.

Further, BC227 and BC228 of ASU 2014-09 state that an entity must allocate a change in the transaction price to all the performance obligations in the contract because the resulting cumulative revenue recognized depicts the revenue the entity would have recognized at the end of the subsequent reporting period if the entity had the information at contract inception. Therefore, the transaction price that is allocated to performance obligations that have already been satisfied is immediately recognized as revenue or as a reduction of revenue.

In some cases, while an entity might make an estimate of the amount of variable consideration to include in the transaction price at the end of a reporting period, information relating to the variable consideration might arise between the end of the reporting period and the date when the financial statements are issued or available to be issued. The FASB decided not to provide guidance on the accounting in those situations because they are addressed by ASC 855, *Subsequent Events*.

BDO INSIGHTS: EFFECT OF RECOGNIZED AND NONRECOGNIZED SUBSEQUENT EVENTS ON TRANSACTION PRICE

ASC 855 requires an entity to distinguish between recognized and nonrecognized subsequent events. A recognized subsequent event provides additional evidence about conditions that existed as of the date of the balance sheet. Nonrecognized subsequent events provide information about conditions that arose after the balance sheet date. We believe most information related to an entity's estimate of variable consideration provides better evidence of the conditions that existed at the balance sheet date and thus is generally considered a recognized subsequent event that must be reflected in an entity's estimate of variable consideration.

For example, in the healthcare industry, payments for services are often received from governmental agencies such as Medicare or Medicaid. Those payments are subject to regulatory review and audit. If a healthcare entity receives information from a government payer indicating that reimbursement rates will be higher or lower than expected before the financial statements are issued or available to be issued, the healthcare entity must consider that new information when assessing its estimates of variable consideration.

However, events that arise after the balance sheet date are sometimes considered nonrecognized subsequent events. For example, receipt of FDA approval after the balance sheet date is generally considered a nonrecognized subsequent event that does not result in recognition of a milestone payment based on FDA approval as of the balance sheet date.

In some cases, determining whether information obtained after the end of a reporting period provides additional information about the amount of revenue to which an entity is entitled may require the application of professional judgment based on the facts and circumstances.

Chapter 5 — Step 4: Allocate the Transaction Price to the Performance Obligations



5.1 OVERVIEW — STEP 4: ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS

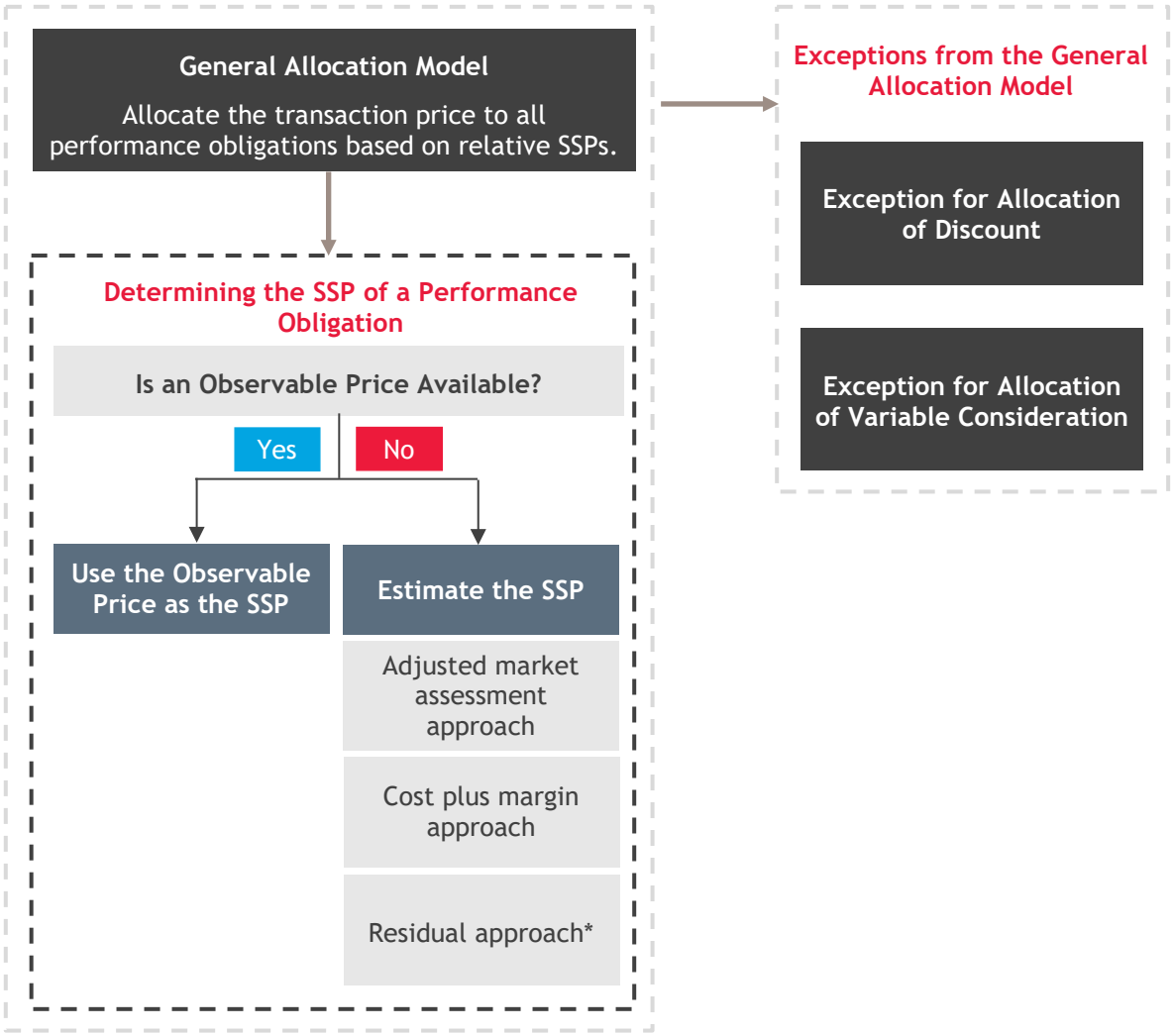
FASB REFERENCES

ASC 606-10-32-28

After determining the transaction price for the contract in Step 3, an entity must allocate the transaction price to the performance obligations identified in the contract in Step 2. ASC 606 includes an allocation objective that generally requires the allocation of transaction price to each performance obligation based on the relative standalone selling price of the goods or services underlying each performance obligation. There are exceptions to the general allocation objective for specific discounts and variable consideration.

In Step 4, determining the appropriate SSP for each performance obligation is the first step to determining the amount to allocate to each performance obligation in a contract. The amount allocated to each performance obligation is ultimately recognized in revenue when or as that obligation is satisfied.

The following diagram summarizes the key concepts in Step 4:



*Use of residual approach has restrictions (see Section 5.3).

5.2 ALLOCATION OBJECTIVE

FASB REFERENCES

ASC 606-10-32-28 through 32-29

The objective of Step 4 is to allocate an amount of transaction price to each performance obligation (or distinct good or service) that reflects the consideration to which an entity expects to be entitled in exchange for transferring the distinct goods or services (making up each identified performance obligation) to the customer. That concept is generally referred to as the "allocation objective."

5.2.1 General Allocation Model

FASB REFERENCES

ASC 606-10-20: Standalone selling price

The price at which an entity would sell a promised good or service separately to a customer.

To meet the allocation objective, an entity generally allocates the transaction price to all performance obligations identified in the contract in proportion to the SSPs of those performance obligations at contract inception (that is, on a relative SSP basis). That allocation approach is sometimes referred to as the "general allocation model." BC266 of ASU 2014-09 states that in most cases an allocation based on SSPs faithfully depicts the different margins applicable to multiple promised goods or services sold together in a contract.

There are exceptions to the general allocation model for discounts and variable considerations (see Sections 5.4 and 5.5).

BDO INSIGHTS: APPROPRIATE LEVEL FOR DETERMINING STANDALONE SELLING PRICE

The SSP is determined at the performance obligation level. When a single performance obligation comprises multiple goods or services, the SSP of that performance obligation is determined by considering the price at which an entity would sell the bundle separately to a customer. That price could be different than the sum of the prices at which an entity would separately sell the individual goods or services making up the bundle.

For example, consider an entity that sells solar panels and related design and installation services as a bundle that constitutes a single performance obligation. The entity enters a contract to sell that bundle, along with a distinct post-installation maintenance service, to a customer. To allocate the transaction price to the two performance obligations (the bundle and the maintenance service), the entity must assess the SSPs of the bundle and maintenance service. In determining the SSP of the bundle, the entity must consider the price at which it would sell the bundle separately to a customer rather than the price at which it would separately sell the promised goods or services underlying the bundle (solar panels and design and installation) to a customer.

5.2.2 Allocation if the Contract Includes One Performance Obligation

An entity does not allocate the transaction price if a contract has only one performance obligation (that is, Step 4 is not applicable). However, if a contract includes a series of distinct goods or services identified as a single performance obligation (see Section 3.4), the guidance on allocation of variable consideration may be applicable (see Section 5.5).

5.3 ALLOCATION BASED ON STANDALONE SELLING PRICE

FASB REFERENCES

ASC 606-10-32-31 through 32-35

At contract inception, an entity must determine the SSP of each performance obligation in the contract and allocate the transaction price to each performance obligation on a relative SSP basis.

5.3.1 Directly Observable Standalone Selling Price

FASB REFERENCES

ASC 606-10-32-32

The best evidence of SSP is the observable price of a good or service when the entity sells that good or service separately in similar circumstances to similar customers.

CONTRACTUALLY STATED PRICE IS NOT PRESUMED TO BE THE STANDALONE SELLING PRICE

While a contractually stated or list price for a good or service might be the SSP for that good or service, it must not be presumed to be SSP. For example, an entity might typically grant discounts from its list prices, or it might not sell the distinct good or service separately from other goods or services. In those scenarios, the list price of a distinct good or service does not provide a directly observable price of that good or service.

BDO INSIGHTS: DIRECTLY OBSERVABLE STANDALONE SELLING PRICE

Sometimes an entity only sells goods or services that are each distinct together at a bundled price. In determining the SSP of each good and service in the bundle, the entity cannot use the bundled price as the directly observable SSP of each good and service.

For example, consider an entity that always sells electronic equipment and a related service together. The entity also sells other goods and services; for example, electrical services and home improvement services. Each good and service is a separate performance obligation. The entity enters a contract with a customer to sell electronic equipment (an entertainment system) and the related installation service. To allocate the consideration in the contract to each performance obligation on a relative SSP, the entity evaluates whether the SSP of each performance obligation is directly observable. The entity determines that:

- The SSP of the entertainment system and installation service is directly observable because the entity often sells each separately to customers at its list price.
- The SSPs of the electronic equipment and related service (each a separate performance obligation making up the entertainment system) are not directly observable because the equipment and related service are always sold together and the list price reflects the price for the bundle.

The SSPs of the entertainment system comprising the electronic equipment and related service are not directly observable even if the equipment and related service are priced separately in the contract. Because those items are never sold on a standalone basis, the entity cannot assume that the contract price is the SSP.

Therefore, the entity must estimate the SSP of the electronic equipment and related service (see Section 5.3.2).

5.3.2 Estimating Standalone Selling Price

FASB REFERENCES

ASC 606-10-32-33 through 32-35

If a SSP is not directly observable, an entity estimates that price at an amount that would result in the allocation of the transaction price meeting the allocation objective.

INFORMATION CONSIDERED IN ESTIMATING STANDALONE SELLING PRICE

In estimating a SSP, an entity must consider all information reasonably available, including:

- Market conditions.
- Entity-specific factors.
- Information about the customer or class of customer.

In considering the information available to estimate an SSP, an entity must **both**:

- Maximize the use of observable inputs.
- Apply estimation methods consistently in similar circumstances.

BDO INSIGHTS: ESTIMATING STANDALONE SELLING PRICE — RANGE

A question comes up in practice regarding whether the SSP must be estimated as a precise amount or can be estimated as a range. While ASC 606 is silent on that topic, we believe the SSP of a performance obligation can be derived from a range of amounts if **all** the below conditions are met:

- The range is sufficiently narrow.
- The entity would sell the performance obligation separately to a customer at any point within the range.
- The resulting allocation outcome is consistent with the allocation objective.

Determining an appropriate range of SSPs requires the application of professional judgment based on the facts and circumstances. An entity must maximize the use of observable inputs and consider the contract circumstances (for example, class of customer) in determining the range.

The use of a range is not appropriate when the SSPs are so widely dispersed that an appropriate SSP for a performance obligation in a transaction is not determinable.

When it establishes SSP as a range, an entity allocates the transaction price as follows:

- Using the contractually stated price as the SSP if it falls within the established range.
- Using a point within the range based on the entity's accounting policy election if the contractually stated price falls outside the established range. We believe an entity may use the midpoint in a range or the outer limit closest to the contractually stated price as the SSP. The entity must consistently apply its accounting policy election. Also, the resulting allocation from the entity's accounting policy election must be consistent with the allocation objective in ASC 606 (see Section 5.2).

BDO INSIGHTS: SIGNIFICANCE OF STANDALONE SELLING PRICE IN DISAGGREGATED REVENUE DISCLOSURES

A contract with a customer can include multiple performance obligations that have the same pattern and timing for revenue recognition. That might happen when:

- Multiple performance obligations are satisfied at the same point in time; for example, in a contract to deliver 10 products (each a separate performance obligation satisfied at a point time) at the same point in time rather than at different points in time.
- Multiple performance obligations are satisfied concurrently over time over the same term and have the same measure of progress; for example, in a contract to provide SaaS and customer support that are coterminous and have a time-based measure of progress.

In those situations, because control of the performance obligations is transferred to the customer at the same time, the allocation of the consideration in the contract to the performance obligations (or distinct services) might not have a practical effect on the amount and timing of revenue recognition. However, if an entity presents the performance obligations in separate lines in the income statement, or if its disaggregated revenue disclosure results in separate disclosure of the distinct performance obligations, the entity must determine the SSPs of its performance obligations in accordance with ASC 606. The entity cannot presume the contractually stated or list price is the SSP of each. In other words, an entity would need to determine the SSPs to comply with the presentation and disclosure requirements even if, as a practical matter, it does not allocate the transaction price in Step 4 (because all the performance obligations have the same pattern and timing for revenue recognition).

See Chapters 6 and 8 for discussion on recognizing revenue and disclosure requirements, respectively.

Suitable methods for estimating the SSP of a good or service include, but are not limited to, the following three approaches:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach

While ASC 606 does not specify a hierarchy of evidence to estimate the SSP of a good or service, the FASB has said an entity must maximize the use of observable inputs when developing estimates of SSPs.[13] It has also said that the estimation approaches (adjusted market assessment approach, expected cost plus a margin approach and residual approach) are "*examples of suitable estimation methods for estimating the standalone selling price*."[14] Further, the FASB has decided not to preclude or prescribe any particular method for estimating an SSP so long as the estimate is a faithful representation of the price at which the entity would sell the distinct good or service if it were sold separately to the customer. The method used by an entity to estimate an SSP must maximize the use of observable inputs and be applied consistently to estimate the SSPs of other goods or services with similar characteristics.

Also, in BC269 of ASU 2014-09, the FASB observed that when developing processes for determining SSPs, an entity must consider all reasonably available information based on the specific facts and circumstances, including:

- Reasonably available data points, such as a SSP of the good or service, the costs incurred to manufacture or provide the good or service, related profit margins, published price listings, third-party or industry pricing, and the pricing of other goods or services in the same contract.
- Market conditions, including supply and demand for the good or service in the market, competition, restrictions, and trends.
- Entity-specific factors, such as business pricing strategy and practices.
- Information about the customer or class of customer, such as type of customer, geographical region, and distribution channel.

[13] ASU 2014-09, BC274.
[14] Id. at BC268.

5.3.2.1 Adjusted Market Assessment Approach

The adjusted market assessment approach:

- Requires an evaluation of the market in which an entity sells goods or services to estimate the price that a customer in that market would be willing to pay for those goods or services.
- May include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

5.3.2.2 Expected Cost Plus a Margin Approach

The expected cost plus a margin approach requires an entity to forecast its expected costs of satisfying a performance obligation and then add an appropriate profit margin.

BDO INSIGHTS: DETERMINING THE APPROPRIATE PROFIT MARGIN

When an entity estimates SSP using the cost-plus-margin approach, the margin must reflect the price the entity could charge in a specific market for a specific product or service. An entity may use different profit margins for different products and services (including within the same contract), classes of customers, or geographical markets.

An entity determines the appropriate margin by considering entity-specific and market factors such as:

- The nature of the good or service.
- Historical margins of similar goods or services sold the good or service on a standalone basis.
- Average industry margins.
- Current market and economic conditions that may affect the profit margin a market would be willing to pay.

The list of factors is not exhaustive, and no single factor is determinative. Determining the appropriate margin to use in a cost-plus-margin approach requires the application of professional judgment based on the facts and circumstances.

5.3.2.3 Residual Approach

The residual approach requires an estimation of the SSP by reference to the total transaction price less the sum of the observable SSPs of other goods or services promised in the contract. It may be used to estimate the standalone selling price of a good or service only if **both** of the following conditions are met:

The entity has observable standalone selling prices for one or more other goods or services promised in the contract. That is, at least one good or service promised in the contract is sold on a standalone basis in other situations.

AND

The entity sells the same good or service to different customers at or near the same time for a broad range of amounts (that is, the selling price is highly variable because a representative SSP is not discernible from past transactions or other observable evidence).

OR

The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

Further, a combination of methods may be used to estimate the SSPs of the goods or services in a contract if two or more of those goods or services have highly variable or uncertain SSPs. For example, a residual approach may be used to estimate the aggregate SSP for multiple promised goods or services with highly variable or uncertain SSPs and another method may be used to estimate the SSPs of the individual goods or services relative to that estimated aggregate SSP determined by the residual approach. However, to use the residual approach to estimate the aggregate SSP for multiple promised goods or services, the observable SSPs of other goods or services promised in the contract must be available.

When an entity uses a combination of methods to estimate the SSP of each promised good or service in the contract, it must evaluate whether allocating the transaction price at those estimated SSPs would be consistent the allocation objective, which requires an entity to estimate each SSP at an amount that reflects the amount of consideration that the entity expects to receive for transferring the promised goods or services to the customer.

Further, BC273 of ASU 2014-09 states that when the residual approach is used to determine the SSP of a distinct good or service, the outcome of that approach cannot realistically result in an SSP of zero if the good or service is in fact distinct. To be distinct, a good or service must have value on a standalone basis. Therefore, if the residual approach results in no, or very little, consideration being allocated to a performance obligation, the entity must consider whether that estimate is appropriate in those circumstances. If not, the entity must use another method to estimate SSP.

BDO INSIGHTS: RESIDUAL APPROACH — SOFTWARE LICENSE AND MAINTENANCE SERVICE

In some situations, an entity never sells a distinct good or service separately. Instead, it sells them as part of a bundle, which may be sold for a range of amounts. That is common in the software industry in which software licenses are often bundled with maintenance for an initial period. Software maintenance (postcontract support (PCS)) can typically be renewed after the initial period on a standalone basis. However, the license and the PCS will often represent separate performance obligations even though the entity might never sell one without the other (see Chapter 3 for discussion on identifying separate performance obligations).

In some circumstances, an entity may have strong pricing policies for PCS by which it charges customers a fixed amount for maintenance renewals and the price does not vary from customer to customer. That could also be the case if PCS renewals are stated as a percentage of the list price of a license (that is, the list price before any customer-specific discounts or adjustments) if the list price is not subject to significant regular and artificial adjustments.

That scenario leads to the question of whether it would be acceptable for an entity to apply the residual approach to establish the SSP for a license that is never sold separately.

We believe using a residual approach to calculate the SSP of the software license is appropriate if an entity can identify that the pricing variability that exists in the software license and PCS bundle is attributable to the software license, and that the SSP of the PCS is not highly variable. Although an entity may not sell the software license on its own for a broad range of amounts, the entity may sell a bundle that contains both software and PCS for a broad range of amounts. There may be observable evidence that a PCS renewal is always sold for either a fixed amount or a fixed percentage of the list price or of the contractual price of the software license. In this case, an entity can identify that it is the license component of the bundle that is sold to different customers for a broad range of amounts, and not the PCS (because there is an observable SSP for the PCS). If there are no other goods or services in the bundle for which observable SSP does not exist, then the use of the residual approach may be appropriate to calculate the SSP of the license.

Determining SSPs of software licenses and PCS requires application of professional judgment based on the facts and circumstances.

EXAMPLE 5-1 (ADAPTED FROM ASC 606-10-55-256 THROUGH 55-258): ALLOCATION METHODOLOGY

An entity sells Products A, B, and C to a customer for a combined price of $200. Each product will be transferred to the customer at a different point in time, and each represents a separate performance obligation, which is satisfied at a point in time.

Product A is regularly sold separately for $100, so its SSP is directly observable. Products B and C are not sold separately, so their SSPs are not directly observable. The entity estimates the SSPs of B and C as $50 and $150, respectively.

PRODUCT	SSP
A	$ 100
B	50
C	150
Total	**$ 300**

There is no evidence that suggests the discount of $100 (sum of the SSPs ($300) less the transaction price ($200)) relates entirely to one, or a group of two, of the products being sold (see Section 5.4). Therefore, the discount is allocated proportionately to the three products and the allocated transaction price is:

PRODUCT	ALLOCATED TRANSACTION PRICE	
A	$ 67	(200 * (100/300))
B	33	(200 * (50/300))
C	100	(200 * (150/300))
Total	**$ 200**	

5.3.2.4 Other Approaches

According to ASC 606-10-32-34, the adjusted market assessment, cost-plus-margin, and residual approaches are acceptable methods to estimate SSP, but other methods may also be appropriate. For example, life science entities frequently enter licensing arrangements that contain distinct performance obligations to deliver a license of intellectual property (IP) and R&D services. Those entities often do not license the IP on a standalone basis and therefore must estimate the IP's SSP.

In many cases, there are no market transactions involving the sale of identical or comparable IP, so using a market approach to estimate SSP might not be the most appropriate method. Also, because much of the R&D costs incurred to develop the IP may have been incurred historically, a cost-plus-margin approach might not be the most appropriate method. Instead, an entity may use a different valuation approach to estimate the IP's SSP. One approach is the **relief-from-royalty (RFR) method**, which is in an income valuation approach. The RFR method estimates the IP's value based on the present value of royalty payments that would be required if the entity did not own the IP but instead licensed it from a third party. Those royalty payments are based on rates observed in comparable, arm's-length licensing transactions involving similar intangible assets.

Software entities often sell co-terminus bundles that include both a term software license and PCS. Because the license and PCS are bundled both upon initial purchase and renewal, a software entity might not have directly observable SSP for either the license or PCS and therefore must estimate SSP for each performance obligation.

BDO INSIGHTS: ESTIMATING SSP BY USING A VALUE RELATIONSHIP

While ASC 606 requires an entity to estimate the standalone selling price of a distinct performance obligation, we believe that in some instances, a software entity may instead establish a **value relationship** between a software license and PCS and use that relationship to allocate the transaction price. For example, an entity may determine the percentages of the transaction price to allocate to each of the license and PCS based on the relationship between the two performance obligations.

As discussed in Section 5.3.2, an entity must maximize the use of observable inputs when estimating SSP. For term licenses, relevant observable inputs could include:

- Standalone PCS renewals related to perpetual licenses of similar types of IP
- Publicly disclosed information by similar entities

An entity may use such inputs as a starting point to determine the value relationship between the license and PCS. However, the entity must also consider the facts and circumstances specific to its distinct promises and adjust the value relationship as appropriate. Factors to consider include:

- **Product features:** If the entity's software includes features not found in a competitor's product or in similar perpetual licenses, that could indicate a greater portion of the transaction price should be allocated to the license.
- **License and PCS term length:** A term of more than one year indicates that a greater portion of the transaction price should be allocated to PCS. Specifically, when using standalone PCS renewals to estimate the value of PCS related to a term license, the entity must adjust the PCS percentage, which typically represents PCS for only one year, to reflect the full term of the license.
- **Frequency and significance of software updates:** If updates are minor or infrequent during the term, a smaller portion of the transaction price should be allocated to the PCS. Conversely, if the entity frequently releases more significant new features as part of the PCS, a greater portion of the transaction price should be allocated to the PCS.
- **Level of technical support:** If the entity provides extensive support during the term, that could indicate a greater portion of the transaction price should be allocated to PCS.

Determining the value relationship between a software license and PCS in a co-terminus bundle requires professional judgment based on the facts and circumstances.

5.4 ALLOCATION OF A DISCOUNT

FASB REFERENCES

ASC 606-10-32-36 through 32-38

While the general allocation model based on relative SSPs is the default method for allocating the transaction price, the allocation of a discount using relative SSPs might not always result in a faithful depiction of the amount of consideration to which the entity expects to be entitled from the customer. For example, in a contract that includes both high- and low-margin items, the allocation of a discount based on the relative SSPs could result in a loss on one part of the contract even though the contract may be profitable in total. Therefore, ASC 606 includes an exception to the general allocation model for allocation of a discount (the discount allocation exception).

A discount exists if the sum of the SSPs of the goods or services in a contract exceeds the consideration payable by the customer.

Unless there is observable evidence that an entire discount relates to one or more (but not all) performance obligations in a contract, the discount is allocated proportionately to all performance obligations in the contract based on relative SSPs.

5.4.1 Observable Evidence and Specific Allocation of a Discount

FASB REFERENCES

ASC 606-10-32-36 through 32-37

The entire discount is allocated to one or more (but not all) performance obligations in a contract if **all** of three criteria are met:

- **Regular standalone sales:** Each distinct good or service (or each bundle of distinct goods or services) in the contract is sold regularly by the entity on a standalone basis.
- **Regular standalone sales of a bundle at discount:** The entity regularly sells any bundles of some of those distinct goods or services on a standalone basis at a discount to the sum of the SSPs of the goods or services in each bundle.
- **Discount in the contract is substantially the same as the discount in regular standalone sales of a bundle:** The discount attributable to each bundle of goods or services in regular standalone sales of the bundle is substantially the same as the discount in the contract. Also, an analysis of the goods or services in each bundle provides observable evidence of any performance obligation(s) to which the entire discount in the contract relates.

For example, there could be observable evidence that a discount relates to only some (but not all) performance obligations if a contract includes a discount for the sale of three goods, but two of those goods are often sold together at a discount to the sum of the SSPs of those two goods.

HIERARCHY IN APPLYING THE DISCOUNT ALLOCATION EXCEPTION AND THE RESIDUAL APPROACH FOR ESTIMATING STANDALONE SELLING PRICE

If a discount is allocated entirely to one or more performance obligations in the contract, an entity must allocate the discount before using the residual approach to estimate the SSP of a good or service (see Examples 5-2 through 5-4).

5.4.2 Application of the Discount Allocation Exception

BC283 of ASU 2014-09 states that discount allocation exception would generally apply to contracts in which there are at least three performance obligations. That is because an entity could show that a discount relates to two or more performance obligations when it has observable information supporting the SSP of a bundle of those promised goods or services when they are sold together. While it may be possible for an entity to have sufficient evidence to allocate a discount to only one performance obligation, the FASB expected that to occur only rarely.

In BC282 of ASU 2014-09, the FASB considered whether the discount allocation exception is too restrictive and might result in outcomes inconsistent with the economics of some transactions. The FASB's view was that the discount allocation exception is included to maintain the rigor and discipline of a relative SSP allocation and therefore appropriately limits the situations in which a discount would not be allocated pro rata to all performance obligations in the contract. In other words, limiting the applicability of the discount allocation exception was intentional.

EXAMPLE 5-2 (ADAPTED FROM ASC 606-10-55-259 THROUGH 55-269): ALLOCATING A DISCOUNT AND RESIDUAL APPROACH

An entity regularly sells three products (A, B, and C) individually and has therefore established the following directly observable SSPs:

PRODUCT	SSP	
A	$	80
B		110
C		90
Total	**$**	**280**

The entity also regularly sells Products B and C together for $120. Each product represents a separate performance obligation that is satisfied at a point in time.

The entity enters a contract to sell Products A, B, and C to a customer for $200. Each product will be transferred to the customer at a different point in time. The contract includes a discount of $80 (sum of the SSPs, ($280) less the transaction price ($200)) for the sale of the three products together. However, the entity has evidence that Products B and C are regularly sold together at $120 rather than at $200 ($110 + $90, the sum of their SSPs). In other words, a discount of $80 is regularly applied to the sale of Products B and C together. Therefore, the entire discount of $80 in the contract is allocated to Products B and C only. The selling price attributed to Products B and C is determined first, and a residual amount is attributed to Product A.

The entity allocates $120 of the transaction price (which incorporates the entire discount of $80) to Products B and C (SSPs of $110 and $90, respectively) as follows:

PRODUCT	ALLOCATED TRANSACTION PRICE		
B	$	66	($120 * ($110/$200))
C		54	($120 * ($90/$200))
Total	**$**	**120**	

The residual transaction price of $80 ($200 - $120) is allocated to Product A.

EXAMPLE 5-3 (ADAPTED FROM ASC 606-10-55-259 THROUGH 55-269): ALLOCATING A DISCOUNT AND RESIDUAL APPROACH — RESIDUAL APPROACH IS APPROPRIATE

Assume the same facts as in Example 5-2 except the contract also includes the sale of Product D, and the consideration payable by the customer is $260. Each product will be transferred to the customer at a different point in time. The SSP of Product D is highly variable because it is sold to different customers for a broad range of amounts ($30 to $90). Therefore, the entity decides to use the residual approach to estimate the SSP of Product D.

Before applying the residual approach to estimate Product D's SSP, the entity considers whether any discount must be specifically allocated to one or more (but not all) performance obligations in the contract.

As discussed in Example 5-2, the entity has observable SSPs for the standalone sale of Product A ($80) and bundled sale of Products B and C ($120). In other words, there is observable evidence that $200 of the transaction price must be allocated to Products A, B and C, and a discount of $80 must be allocated entirely to Products B and C together. The entity estimates Product D's SSP of $60 under the residual approach as follows:

PRODUCT	SSP	
A	$	80
B and C		120
D		60
Total	**$**	**260**

The entity considers whether the resulting allocation is consistent with the allocation objective and the guidance on estimating the SSP. It concludes that the resulting allocation is appropriate because the $60 allocated to Product D is within the range of its observable selling prices (between $30 and $90).

EXAMPLE 5-4 (ADAPTED FROM ASC 606-10-55-259 THROUGH 55-269): ALLOCATING A DISCOUNT AND RESIDUAL APPROACH — RESIDUAL APPROACH IS NOT APPROPRIATE

Consider the same facts in Example 5-3 except the consideration payable by the customer is $210. Here, the residual approach would result in an estimated SSP of $10 for Product D ($210 transaction price less $200 allocated to Products A, B, and C). The entity observes that $10 does not approximate the SSP of Product D, which ranges from $30 to $90. Therefore, it concludes that $10 would not faithfully depict the amount of consideration to which it expects to be entitled in exchange for the sale of Product D.

Therefore, the entity reviews its observable data, including sales and margin reports, to estimate Product D's SSP using another suitable method. In this case, the entity allocates the transaction price of $210 to Products A, B, C and D on a relative SSP basis.

BDO INSIGHTS: ALLOCATION OF DISCOUNT

It is common for entities in the retail sector to bundle different goods together and sell them at a discount. Although the approach in ASC 606 appears straightforward, determining an appropriate basis for allocating discounts and evaluating whether the allocation objective is met requires the application of professional judgment based on the facts and circumstances. That process may be particularly complex if an entity also expects to apply a residual approach. For example, the entity may have to consider the range of prices at which each good within a bundle has historically been sold separately to appropriately apply the discount allocation exception and the residual approach.

5.5 ALLOCATION OF VARIABLE CONSIDERATION

FASB REFERENCES

ASC 606-10-32-39 through 32-41

The application of the general allocation model based on relative SSPs to a contract that includes multiple performance obligations and variable consideration results in the allocation of variable consideration to all performance obligations in the contract. However, that might not necessarily result in a faithful depiction of the amount of consideration to which the entity expects to be entitled from the customer upon satisfying a particular

performance obligation if the variable consideration does not relate to all the performance obligations in the contract. For example, an entity might contract to sell two products that are delivered at different points in time with a bonus fee payable by the customer that is contingent on the timely delivery of only the second product. It might be inappropriate to allocate the bonus (a variable consideration included in the transaction price) to both products. Therefore, an exception to the general allocation model was provided for allocating variable consideration (the variable consideration allocation exception).

Variable consideration in a contract may be attributable to the entire contract or to a specific part of the contract, such as the following:

- One or more, but not all, performance obligations in the contract. (For example, a bonus is contingent on an entity transferring a good or service within a specified period of time.)
- One or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation (see Section 3.4). (For example, the consideration promised for the second year of a two-year cleaning service contract will increase based on movements in a consumer price index).

The variable consideration allocation exception states that an entity allocates a variable amount of consideration (and subsequent changes to that amount) entirely to a single performance obligation (or a distinct good or service that forms part of a single performance obligation that meets the definition of a series) if **both** of the following criteria are met:

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- When considering all the performance obligations and payment terms in the contract, the allocation of the variable amount in its entirety to a performance obligation (or distinct good or service) is consistent with the allocation objective that the transaction price must be allocated to each performance obligation (or distinct good or service) to reflect the consideration to which the entity expects to be entitled in exchange for transferring the promised good or service.

An entity applies the general allocation model (see Section 5.2.1) and the discount allocation exception (see Section 5.4) to allocate the remaining amount of transaction price that does not meet the criteria for the variable consideration allocation exception.



TRG DISCUSSIONS: ALLOCATION OF VARIABLE CONSIDERATION TO A DISTINCT GOOD OR SERVICE IN A SERIES

In July 2015, the TRG discussed whether the allocation of variable consideration to a distinct good or service in a series must be based on SSPs. That approach could have limited the number of transactions that qualify for the variable consideration allocation exception because it might imply that each distinct service that is substantially the same would need to be allocated the same amount (absolute value) of variable consideration.

ASC 606-10-32-29 states that to meet the allocation objective, an entity must allocate the transaction price to each performance obligation on a relative SSP basis. However, that paragraph specifically excludes from its requirements ASC 606-10-32-39 through 32-41 on allocating variable consideration to a distinct service in a series. Further, ASC 606-10-32-30 states that the guidance in ASC 606-10-32-31 through 32-41 on the relative SSP allocation does not apply to the allocation of variable consideration. BC280 of ASU 2014-09 describes that while SSP is the default method for determining whether the allocation objective is met, the FASB decided that other methods could be used in some instances and therefore included the guidance on allocating variable consideration.

Thus, the TRG agreed that an allocation based on relative SSPs is not required to meet the allocation objective when allocating variable consideration to a distinct good or service in a series. However, as illustrated in Example 35 in ASC 606 (see adaptations in Examples 5-5 and 5-6), when variable consideration is allocated to different performance obligations, SSPs might sometimes (but do not have to) be used to determine the reasonableness of the allocation.

The FASB did not describe other methods that could be used to comply with the allocation objective other than stating in ASC 606-10-32-40(b) that an entity must consider all the payment terms and performance obligations. For instance, an entity might consider its effort to fulfill the obligation and whether the variable consideration is commensurate with the value provided to the customer. As such, an entity must apply reasonable judgment to determine whether the allocation results in a reasonable outcome.

In addressing those concepts, the TRG discussed three non-exhaustive examples (that is, there could be other reasons why a variable fee would or would not meet the allocation objective).

Example A

IT Seller and IT Buyer execute a 10-year IT outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term. For example, IT Seller will provide server capacity, manage the customer's software portfolio, and run an IT help desk. The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power, number of software applications used, or number of employees supported, and the price per unit differs for each type of activity.

Before the delivery of the service, IT Seller performs initial set-up activities to be able to provide the other services in the contract. IT Seller charges the IT Buyer a nonrefundable upfront fee related to the transition activities. IT Seller concludes that the set-up activities do not transfer services to the customer.

The per-unit price IT Seller charges declines over the life of the contract. The agreed pricing at the onset of the contract is considered to reflect market pricing. The pricing decreases to reflect the associated costs decreasing over the term of the contract as the level of effort to complete the tasks decreases. Initially, the tasks are performed by more expensive personnel for activities that require more effort. Later, the level of effort for the activities decreases, and the tasks are performed by less expensive personnel. The contract includes a price benchmarking clause whereby the IT Buyer engages a third-party benchmarking firm to compare the contract pricing to current market rates at specific points in the contract term. The price automatically adjusts if the benchmark is significantly below IT Seller's price.

IT Seller concludes that there is a single performance obligation that is satisfied over time because the customer simultaneously receives and consumes the benefits provided by its services as it performs.

The events that trigger the variable consideration are the same throughout the contract, but the price per unit decreases each year. Even with the declining prices, the allocation objective could be met if the pricing is based on market terms, or if the changes in price are substantive and linked to changes in the entity's cost to fulfill the obligation or value provided to the customer based on the third-party benchmarking data.

Example B

Transaction Processer (TP) enters a 10-year agreement with a customer. Over the 10-year period, TP will provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use TP's system to process all its transactions; however, the ultimate quantity of transactions is unknown. TP concludes that the customer simultaneously receives and consumes the benefits as it performs.

TP charges the customer per transaction. For each transaction, the customer is charged a contractual rate per transaction and a percentage of the total dollars processed. TP also charges the customer a fixed upfront fee at the beginning of the contract.

If the nature of the entity's promise is a single service to process as many transactions as the customer requires, the fees based on quantity processed and the fees based on a percentage of dollars processed could meet the allocation objective for each month of service. For example, the allocation objective could be met if the fees are priced consistently throughout the contract and the rates charged are consistent with the entity's standard pricing practices with similar customers.

Example C

Hotel manager (HM) enters a 20-year agreement to manage properties on behalf of the customer. HM receives monthly consideration based on 1% of monthly rental revenue, reimbursement of labor costs incurred to perform

the service, and an annual incentive payment based on 8% of gross operating profit. HM concludes that the customer simultaneously receives and consumes the benefits provided by its services as it performs.

The base monthly fees could meet the allocation objective for each month because there is a consistent measure throughout the contract period that reflects the value to the customer each month (the percentage of monthly sales). Similarly, if the labor cost reimbursements are commensurate with the entity's efforts to fulfill the promise each day, the allocation objective for those variable fees could also be met. Finally, the allocation objective could be met for the incentive fee if it reflects the value delivered to the customer for the annual period (reflected by the profits earned) and is reasonable compared to the incentive fees that could be earned in other periods.

EXAMPLE 5-5 (ADAPTED FROM ASC 606-10-55-270 THROUGH 55-279): ALLOCATION OF VARIABLE CONSIDERATION — ENTIRELY TO ONE PERFORMANCE OBLIGATION

An entity enters a contract with a customer for two licenses of IP (Licenses A and B). Each license represents a separate performance obligation, which is satisfied when it is transferred to the customer (that is, at a point in time). The SSPs of licenses A and B are $1,200 and $1,500, respectively.

The consideration payable by the customer is:

- **License A:** a fixed amount of $1,200.
- **License B:** a royalty payment of 5% of the selling price of the customer's future sales of products that use the IP to which license B relates.

The entity estimates that the amount of sales-based royalties it will be entitled to in respect of license B will be $1,500.

The entity then considers the criteria in the variable consideration allocation exception to determine the allocation of the transaction price to each of the licenses. The entity determines that:

- The variable consideration (sales-based royalty) relates specifically to an outcome from the entity's performance obligation to transfer license B (that is, the customer's subsequent sales of products that use that license).
- Allocating the expected sales-based royalty amounts of $1,500 entirely to license B is consistent with the allocation objective because the estimated amount of royalties approximates the SSP of license B ($1,500) and the fixed amount of $1,200 approximates the SSP of license A. Based on an assessment of the facts and circumstances relating to both licenses, the entity determines that allocating some of the fixed consideration ($1,200) to license B in addition to all the variable consideration would not meet the allocation objective.

Therefore, the entity allocates the transaction price in accordance with the variable consideration allocation exception as:

- **License A:** $1,200.
- **License B:** the variable royalty payment.

Although revenue of $1,200 will be recognized for license A when it is transferred to the customer, no revenue will be recognized when license B is transferred to the customer. Sales-based royalties allocated to license B are not recognized before the subsequent sales of the customer's products that use license B take place because of the exception in ASC 606-10-55-65 that precludes estimation of sales- or usage-based royalties for licenses of IP (see Section 7.5).

EXAMPLE 5-6 (ADAPTED FROM ASC 606-10-55-270 THROUGH 55-279): ALLOCATION OF VARIABLE CONSIDERATION — BASED ON STANDALONE SELLING PRICES

Assume the same facts as in Example 5-5 except that the prices included in the contract are:

- **License A:** a fixed amount of $450
- **License B:** a royalty payment of 7.5% of the selling price of the customer's future sales of products that use license B.

The entity estimates that the amount of sales-based royalties that it will be entitled to in respect of license B will be $2,250. It then considers the criteria in the variable consideration allocation exception to determine the allocation of the transaction price to each of the licenses. The entity determines that although the variable payments (the sales-based royalties) relate solely to the transfer of license B, allocating the variable consideration only to license B would be inappropriate because allocating $450 to license A and $2,250 to license B would not reflect a reasonable allocation based on the licenses' SSPs. As a result, the entity must apply the general allocation model based on relative SSPs.

Allocation of the fixed consideration

The entity allocates the fixed amount of $450 to the two licenses based on their SSPs. The allocation is calculated as:

PRODUCT	ALLOCATED TRANSACTION PRICE	
License A	$ 200	($450 * ($1,200/$2,700))
License B	250	($450 * ($1,500/$2,700))
Total	**$ 450**	

Allocation of the variable consideration

As the sales by the customer of products that use license B occur, the sales-based royalties are allocated to Licenses A and B on a relative SSP basis.

Revenue Recognition at Contract Inception

License A is transferred to the customer three months after contract inception and License B is transferred at contract inception. As a result:

- Revenue of $200 is recognized for License A three months after the contract inception when License A is transferred to the customer.
- Revenue of $250 is recognized for License B at contract inception when License B is transferred to the customer.
- Recognition of the sales-based royalty allocated to each of the two licenses is deferred to future periods because ASC 606-10-55-65 precludes the recognition of sales-based royalty before the related sales occur (see Section 7.5).

Although the royalty relates solely to the transfer of License B, the allocation of the fixed consideration ($450) to License A and the entire sales-based royalties to License B (estimated at $2,250) is disproportionate in comparison with the SSPs of the two licenses. In other words, there is pricing interdependency between the two licenses, which indicates that some of the royalty generated by License B in fact relates to the sale of License A and that some of the fixed license fee ($450) stated in the legal contract as relating solely to License A also relates to the sale of License B.

See Example 7-32 (a continuation of this example) for a discussion of the recognition of sales-based royalties in revenue.

EXAMPLE 5-7: ALLOCATION OF VARIABLE CONSIDERATION — ENTIRELY TO ONE PERFORMANCE OBLIGATION

Assume the same facts as in Example 5-5 except that the prices included in the contract are:

- **License A:** a fixed amount of $1,950.
- **License B:** a royalty payment of 2.5% of the selling price of the customer's future sales of products that use License B.

The entity estimates that the amount of sales-based royalties that it will be entitled to in respect of License B will be $750.

The entity then considers the criteria in the variable consideration allocation exception to determine the allocation of the transaction price to each of the two licenses. It determines that:

- The variable consideration (sales-based royalty) relates specifically to an outcome from it performance obligation to transfer License B (that is, the customer's subsequent sales of products that use that license).
- Allocating the expected sales-based royalty amounts of $750 entirely to License B is consistent with the allocation objective. Although the estimated amount of royalties is less than the SSP of License B ($1,500), the fixed amount of $1,950 is also greater than the SSP of License A ($1,200). Therefore, the entity allocates the fixed amount of $1,950 to each of Licenses A and B after allocating the expected sales-based royalty amounts of $750 entirely to License B.

Allocation of the fixed consideration

The entity allocates the fixed amount of $1,950 to the two licenses based on their SSPs after allocating the variable amount to License B.

The allocation is calculated as:

PRODUCT	ALLOCATED TRANSACTION PRICE	
License A	$ 1,200	($1,950 * ($1,200/$1,950))
License B	750	($1,950 * (($1,500 — $750)/$1,950))
Total	**$ 1,950**	



TRG DISCUSSIONS: ALLOCATION HIERARCHY — VARIABLE CONSIDERATION AND DISCOUNT

In March 2015, the TRG considered an arrangement that included both variable consideration and a discount and discussed whether the guidance in ASC 606 on allocating discounts to one or more (but not all) performance obligations in a contract is different from the guidance on allocating variable consideration to one or more (but not all) performance obligations.

TRG members agreed that ASC 606 establishes a hierarchy for allocating variable consideration, including variable discounts. When a contract includes variable consideration, an entity applies the guidance on allocating variable consideration before considering the guidance on allocating discounts.

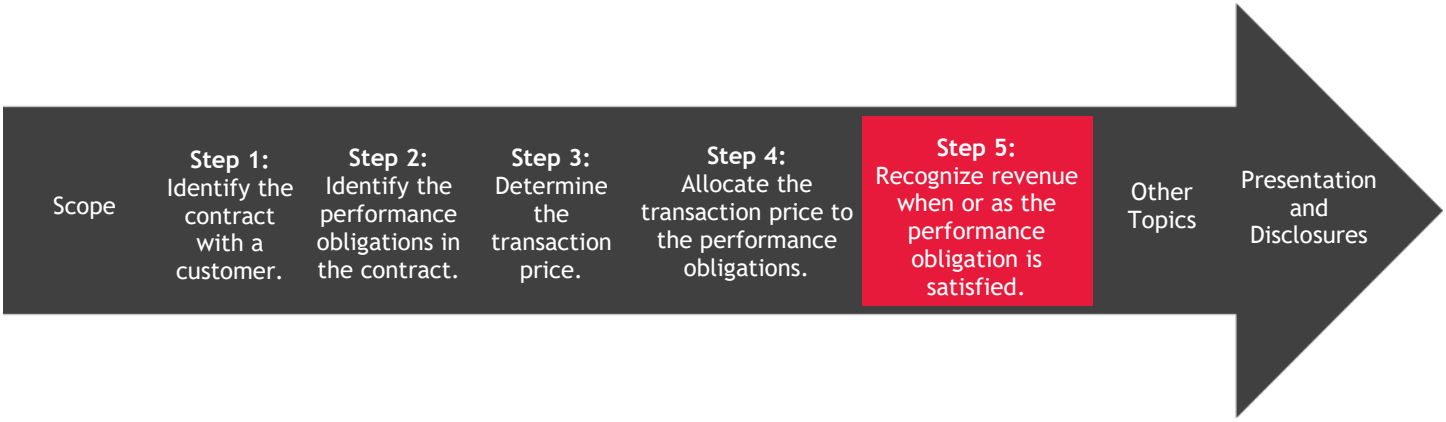
TRG members also stated that not all discounts are variable and that if a discount is fixed, it does not give rise to variable consideration. In those cases, an entity would apply the guidance for the allocation of discounts, not the guidance for the allocation of variable consideration.

BDO INSIGHTS: ALLOCATION OF VARIABLE CONSIDERATION AND DISCOUNT

Some contracts with customers include both variable consideration and a discount that is variable. In those cases, a question arises regarding the sequence of applying the guidance on allocation of variable consideration and on allocation of discount. Consistent with the TRG discussions above, we believe an entity must first apply the guidance on variable consideration allocation and then apply the guidance on general allocation or on allocating a discount to the remaining amount of the transaction price. An entity first needs to determine whether the discount is variable consideration. Determining whether a discount is a variable consideration, as well as its appropriate allocation, requires the application of professional judgment based on facts and circumstances.

In the absence of specific guidance in ASC 606, we believe multiple approaches could be acceptable for determining the amount that represents a discount (rather than variable consideration) and is therefore not within the scope of the guidance on variable consideration allocation. Any approach selected must result in an allocation that is consistent with the criteria for the variable consideration allocation exception and the allocation objective.

Chapter 6 — Step 5: Recognize Revenue When or as the Performance Obligation is Satisfied



6.1 OVERVIEW — STEP 5: RECOGNIZE REVENUE WHEN OR AS THE PERFORMANCE OBLIGATION IS SATISFIED

FASB REFERENCES

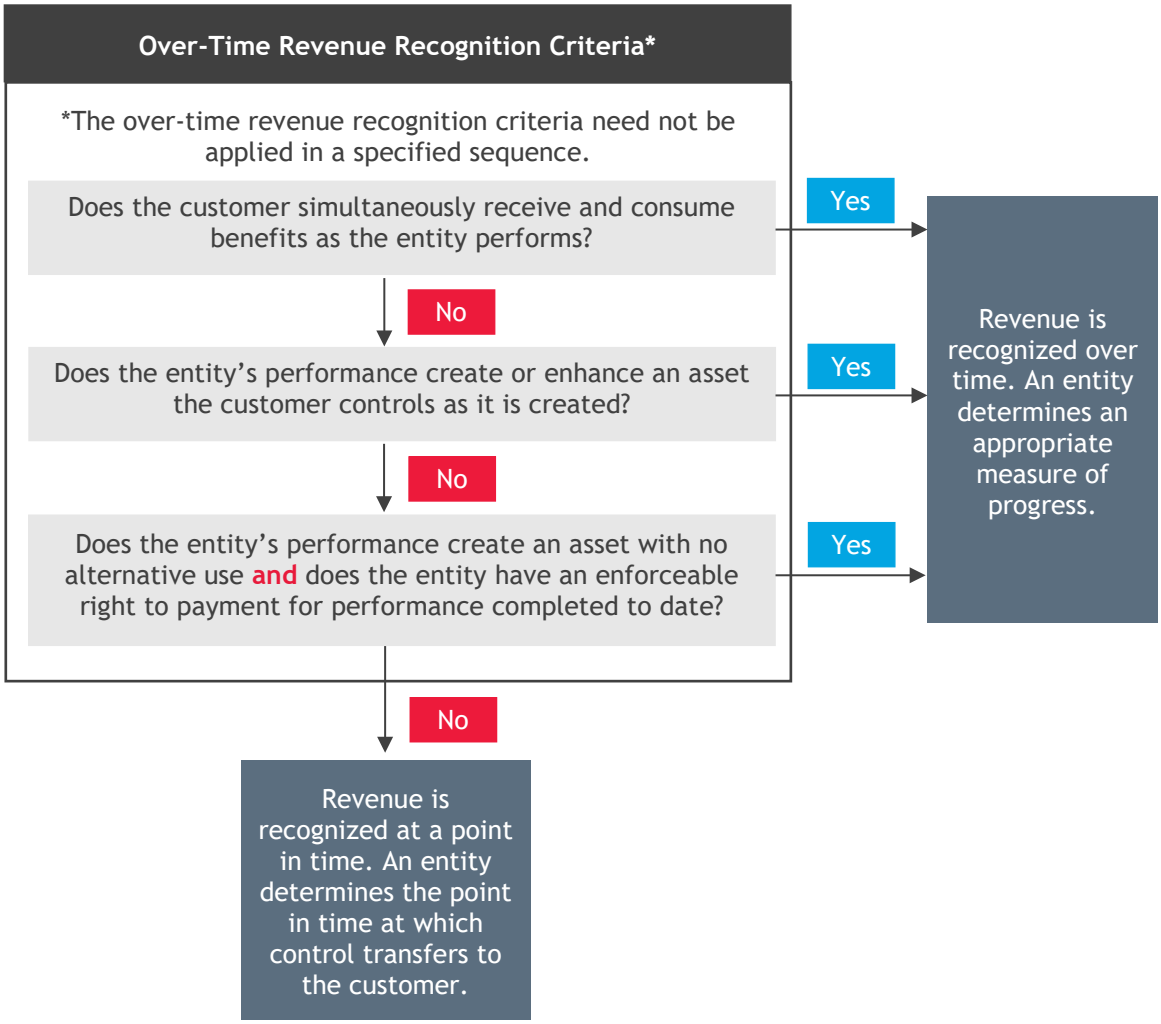
ASC 606-10-25-23

After allocating (Step 4) the transaction price (determined in Step 3) to the performance obligations identified in the contract (Step 2), an entity assesses when it satisfies each performance obligation by transferring a promised good or service to the customer and recognizes revenue allocated to each performance obligation when or as that performance obligation is satisfied. An entity satisfies its performance obligation in a contract by transferring control of the promised good or service underlying that performance obligation to the customer, which may be at a point in time or over time. Therefore, assessing when control of a good or service is transferred to a customer is a critical aspect of Step 5.

Control in the context of ASC 606 is the ability to direct the use of, and obtain substantially all the remaining benefits from, an asset. ASC 606 includes indicators to help apply the control principle.

ASC 606 includes three criteria to determine whether a performance obligation is satisfied over time. An entity must first consider those criteria to determine if a performance obligation is satisfied over time. If none of those criteria are met, the performance obligation is satisfied at a point in time. The entity then must consider the indicators of control to determine at what point in time the control transfers to the customer.

The following diagram gives an overview of those requirements:



For each performance obligation satisfied over time, an entity recognizes revenue over time by measuring the progress toward complete satisfaction of that performance obligation.

ASC 606 includes specific guidance on the following topics to assist in determining whether and when control transfers in Step 5:

- Repurchase agreements
- Consignment arrangements
- Bill-and-hold arrangements
- Customer acceptance clauses

6.2 SATISFACTION OF PERFORMANCE OBLIGATIONS

FASB REFERENCES

ASC 606-10-25-23 through 25-25

An entity recognizes revenue when or as it satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred to a customer when or as the customer obtains control of that asset. Goods and services are assets, even if only momentarily, when received and used (as in the case of many services) by customers.

At contract inception, an entity must determine whether it satisfies the performance obligation identified in Step 2 over time or at a point in time. A performance obligation is satisfied at a point in time **only** if an entity does not satisfy the performance obligation over time.

BDO INSIGHTS: SEQUENCE FOR DETERMINING WHETHER A PERFORMANCE OBLIGATION IS SATISFIED OVER TIME OR AT A POINT IN TIME

ASC 606 establishes a sequence for analyzing whether a performance obligation is satisfied at a point in time or over time. The three criteria in ASC 606-10-25-27 establish whether a performance obligation is satisfied over time (see Section 6.3). An entity must first evaluate each performance obligation against each of those criteria to conclude whether a performance obligation is satisfied over time. If none of the over-time revenue recognition criteria are met, the performance obligation is satisfied at a point in time. An entity cannot omit the analysis of the over-time revenue recognition criteria and default to a conclusion that a performance obligation is satisfied at a point in time. Rather, to conclude that a performance obligation is satisfied at a point in time, an entity must first conclude that none of the over-time revenue recognition criteria are met.

6.2.1 Notion of Control

FASB REFERENCES

ASC 606-10-25-25 and 25-26 and ASC 606-10-25-30

Control of an asset refers to the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

BC120 of ASU 2014-09 states that the description of control in ASC 606 is based on the meaning of control in the definition of an asset in the FASB's conceptual framework. The components that make up the description of control are:

- **Ability:** A customer must have the present right to direct the use of, and obtain substantially all the remaining benefits from, an asset for an entity to recognize revenue related to the transfer of that asset to the customer. For example, in a contract that requires a manufacturer to construct an asset for a customer, it might be clear that the customer will ultimately have the right to direct the use of, and obtain substantially all the remaining benefits from, the asset. However, the manufacturer must not recognize revenue until the customer has obtained that right (which based on the contract, might occur during or after production).

- **Direct the use of:** A customer's ability to direct the use of an asset refers to the customer's right to deploy that asset in its activities, allow another entity to deploy that asset in its activities, or restrict another entity from deploying that asset.
- **Obtain the benefits from:** The customer must have the ability to obtain substantially all the remaining benefits from an asset to obtain control of it. The benefits from a good or service are the potential cash flows (either an increase in cash inflows or a decrease in cash outflows) that can be obtained directly or indirectly; for example, by:
  - Using the asset to produce goods or provide services (including public services).
  - Using the asset to enhance the value of other assets.
  - Using the asset to settle liabilities or reduce expenses.
  - Selling or exchanging the asset.
  - Pledging the asset to secure a loan.
  - Holding the asset.

BC121 of ASU 2014-09 states that the assessment of when control has transferred to a customer could be applied from the perspective of either the entity selling, or the customer purchasing, the good or service. Therefore, revenue could be recognized when the entity surrenders control, or the customer obtains control, of that good or service. Although in many cases both perspectives lead to the same result, the FASB decided that control must be assessed primarily from the perspective of the customer to minimize the risk of an entity recognizing revenue from undertaking activities that do not coincide with the transfer of goods or services to the customer.

ASC 606 provides the following nonexhaustive list of indicators (see Section 6.5) that control has transferred to the customer:

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



REPURCHASE RIGHTS

In evaluating whether a customer obtains control of an asset, an entity must consider any agreement to repurchase the asset, or a component of that asset, transferred to the customer (see Section 6.6).

BDO INSIGHTS: REVENUE RECOGNITION IS BASED ON TRANSFER OF CONTROL (NOT RISKS AND REWARDS)

Revenue recognition under ASC 606 is based on the transfer of control, not on risks and rewards only. Under the control model, an analysis of risks and rewards is only one of the many factors considered in determining whether and when revenue is recognized. Revenue recognition based on the notion of control (rather than risks and rewards) may significantly affect the timing and pattern of revenue recognition in some industries.

6.3 PERFORMANCE OBLIGATIONS SATISFIED OVER TIME

FASB REFERENCES

ASC 606-10-25-27

An entity transfers control of a good or service over time and therefore satisfies a performance obligation and recognizes revenue over time if **any** the following criteria are met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.
- 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.

The three criteria provide an objective basis for assessing when control transfers over time and thus when a performance obligation is satisfied over time.

6.3.1 Customer Simultaneously Receives and Consumes Benefits as the Entity Performs

FASB REFERENCES

ASC 606-10-25-27(a) and ASC 606-10-55-5 and 55-6

If a customer simultaneously receives and consumes the benefits provided by an entity's performance as the entity performs, the entity transfers control of a good or service underlying a performance obligation to the customer over time and therefore revenue attributed to that performance obligation is recognized over time.

For some types of performance obligations, the analysis of whether a customer receives the benefits of an entity's performance as the entity performs and simultaneously consumes those benefits as they are received is straightforward. For example, for routine or recurring services, such as a cleaning service, the receipt and simultaneous consumption by the customer of the benefits of the entity's performance may be readily identified.

In many typical service contracts, an entity's performance creates an asset only momentarily because that asset is simultaneously received and consumed by the customer. In those cases, the simultaneous receipt and consumption of the asset that has been created means the customer obtains control of the entity's output as the entity performs. Thus, the entity's performance obligation is satisfied over time.

BDO INSIGHTS: ANALYZING WHETHER THE CUSTOMER SIMULTANEOUSLY RECEIVES AND CONSUMES BENEFITS

Although ASC 606 includes cleaning services as an example of a performance obligation satisfied over time, entities must carefully analyze this type of contract to appropriately identify distinct performance obligations and determine the pattern of satisfaction of the obligations identified. For example, consider a three-year cleaning contract of an office building in which the windows are cleaned every six months (which requires five days to complete), carpets are deep cleaned once a month (and takes place over a weekend), and trash disposal and vacuuming is done daily outside normal office working hours. Each cleaning activity may constitute a separate performance condition and, if so, it would be necessary to allocate the transaction price to each of the performance obligations. The transaction price allocated to window cleaning and the deep cleaning of carpets would be recognized as those activities take place (rather than ratably over the three-year contractual period).

Similarly, in some industries, such as the airline industry, an entity may provide ongoing maintenance for critical equipment such as airplane engines, as well as periodic overhaul services. While both the ongoing maintenance and overhaul services likely meet the criterion to be recognized over time (because the customer simultaneously receives and consumes the benefits provided by the entity), the entity would likely conclude that the ongoing maintenance and overhaul services are distinct performance obligations, each with different timing for revenue recognition. As such, the transaction price must be allocated to the ongoing maintenance activities and overhaul activities, and the allocated amounts are recognized in revenue as those separate activities take place.

6.3.1.1 Substantial Reperformance of the Performance Completed to Date

FASB REFERENCES

ASC 606-10-55-159 and 55-160

For some types of performance obligations in service-type contracts, an entity might not be able to readily identify whether a customer simultaneously receives and consumes the benefits from the entity's performance as the entity performs because the notion of benefit can be subjective. In those circumstances, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially reperform the work the entity has completed to date if another entity were to fulfill the remaining performance obligation to the customer.

In determining whether another entity would not need to substantially reperform the work the entity has completed to date, an entity must make **both** of the following assumptions:

Disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity.

Presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity (for example, a partially completed service or item of property, plant, and equipment) and would remain controlled by the entity if the performance obligation were to transfer to another entity.

BC126 of ASU 2014-09 states that the assessment of whether another entity would need to substantially reperform the performance completed to date can be used as an objective basis for determining whether the customer receives benefit from the entity's performance as it is provided. BC127 of ASU 2014-09 states that an entity disregards any contractual or practical limitations in assessing whether another entity would need to substantially reperform the performance completed to date. The objective of the criterion on whether the customer receives benefit from the entity's performance as it is provided is to determine whether control of the goods or services has already been transferred to the customer by using a hypothetical assessment of what another entity would need to do if it were to take over the remaining performance requirements. Therefore, actual, practical, or contractual limitations on the remaining performance have no bearing on whether the entity has transferred control of the goods or services provided to a customer to date.

EXAMPLE 6-1 (ADAPTED FROM ASC 606-10-55-159 AND 55-160): CUSTOMER SIMULTANEOUSLY RECEIVES AND CONSUMES THE BENEFITS

An entity enters a contract with a customer to provide monthly payroll processing services to a customer for one year. Assume the promised payroll processing services are accounted for as a single performance obligation in accordance with the series guidance (see Section 3.4).

The performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed. That is demonstrated by another entity not needing to reperform payroll processing services for the service the entity has provided to date.

In performing the above assessment, the entity disregards any practical limitations on transferring the remaining performance obligation; for example, any setup activities that may be undertaken by another entity.

The entity recognizes revenue over time by measuring its progress toward complete satisfaction of that performance obligation (see Section 6.4).

EXAMPLE 6-2: CUSTOMER SIMULTANEOUSLY RECEIVES AND CONSUMES THE BENEFITS

A shipping entity enters a contract with a customer to transport goods from New York to the Netherlands. When the entity enters the contract, the ship used to transport the goods is docked in Miami. At the reporting date, the goods have been collected from New York, and the ship is halfway across the Atlantic Ocean.

The entity concludes that it can recognize revenue for its performance completed to date (that is, transportation of goods from New York to a location halfway across the Atlantic Ocean) because another entity would not need to reperform the transportation services provided to date. In reaching that conclusion, the entity disregards the practical limitation from a hypothetical transfer of the goods from its ship to another shipping entity's ship in the middle of the Atlantic Ocean.

Therefore, the entity recognizes revenue over time by measuring its progress toward complete satisfaction of that performance obligation (see Section 6.4).

BDO INSIGHTS: EXAMPLE 6-2 AND SHIPPING CONTRACTS

Careful analysis of shipping contracts may be required. In some circumstances, those contracts may contain a lease of the ship used to transport goods because the customer has the right to direct the use of the ship for a period of time. In those cases, ASC 842 may also apply to the contract (rather than only ASC 606). If a shipping contract includes services (for example, providing crew for the ship) with the lease of the ship, the services would be within the scope of ASC 606 and the lease would be within the scope of ASC 842.[15] However, if the shipping contract does not include the transfer of a good or service within the scope of ASC 606, the entire contract would be accounted for as a lease under ASC 842 (that is, no part of the contract would be within the scope of ASC 606). If the arrangement is accounted for under ASC 842, lease income (assuming the lease is classified as an operating lease under ASC 842) would be recognized from the date of lease commencement (that is, right to direct the use of the ship passes to the customer), which could result in lease income being recognized as the ship sails from Miami to New York.

If the contract does not contain a lease and is instead accounted for as a promise to provide shipping services under ASC 606, revenue is not recognized to reflect the effort required to move the ship from Miami, its location at contract inception, to New York because the shipping entity does not provide any service to the customer during that part of the overall journey. Rather, the entity recognizes revenue at the reporting date to reflect the extent to which the goods have been transported from New York to the Netherlands. Also, the entity must consider whether the costs for the journey from Miami to New York represent costs to fulfill the contract that is accounted for under ASC 340-40 (see Section 7.7).



TRG DISCUSSIONS: TRANSFER OF CONTROL — COMMODITIES

In July 2015, the TRG discussed whether the control of a commodity (such as gas, electricity, or heating oil) is transferred at a point in time or over time.

The TRG members generally agreed that all known facts and circumstances must be considered when determining whether a customer simultaneously receives and consumes the benefits of a commodity. Those facts and circumstances might include:

- Contract terms
- Customer infrastructure
- Whether the commodity can be stored

Therefore, depending on the facts and circumstances surrounding the sale of a commodity, revenue may or may not be recognized over time. For example, a performance obligation to provide natural gas to a residential location on an as-needed basis would likely meet the over-time revenue recognition criterion that the customer simultaneously benefits from the entity's performance as the entity performs because the residential household likely would not have the ability to store gas and instead would pay for any gas that is delivered as it is used. Conversely, a contract to deliver a fixed amount of natural gas to a reseller of that gas would likely not meet that over-time revenue recognition criterion because the contract includes a fixed amount of gas to be delivered, and the customer/reseller would likely have the intent and ability to store the gas until it is resold to an end consumer.

[15] ASC 842-10-15-42A provides a lessor an accounting policy election to combine some nonlease components (such as services) within the scope of ASC 606 with a lease component in a contract and account for the combined component under ASC 606 or ASC 842 based on whether the lease or nonlease component is predominant. See our Blueprint, **Accounting for Leases Under ASC 842**, for guidance.

BC128 of ASU 2014-09 states that the over-time revenue recognition criterion that the customer simultaneously benefits from the entity's performance as the entity performs is not intended to apply to contracts in which the entity's performance is not immediately consumed by the customer, which would be typical when the entity's performance results in an asset such as work in process in a construction contract. If an entity applies ASC 606 to contracts in which the entity's performance results in an asset (which could be tangible or intangible) being created or enhanced, it considers the other two over time revenue recognition criteria (see Sections 6.3.2 and 6.3.3).

6.3.2 Performance Creates or Enhances an Asset the Customer Controls as It Is Created

FASB REFERENCES

ASC 606-10-25-27(b) and ASC 606-10-55-7

If an entity's performance creates or enhances an asset (for example, work in process) the customer controls as the asset is created or enhanced, the entity transfers control of a good or service underlying a performance obligation to the customer over time. Therefore, revenue attributed to that performance obligation is recognized over time. In those cases, because the customer controls any work in process, the customer is obtaining the benefits of the goods or services the entity is providing, so the performance obligation is satisfied over time.

To determine whether a customer controls an asset that is being created or enhanced by an entity's performance as it is created or enhanced, an entity must apply the guidance on control, including considering whether the indicators of control are met related to any work in process as the promises are being delivered (see Section 6.2.1).

The asset being created or enhanced by an entity could be tangible or intangible; for example, a building that is being constructed by an entity on land owned by the customer or customized software being integrated into a customer's existing IT infrastructure.

BC130 of ASU 2014-09 states that the basis for the over-time revenue recognition criterion that an entity's performance creates or enhances an asset the customer controls is consistent with the rationale underlying the percentage-of-completion revenue recognition approach in the prior revenue recognition guidance. That prior guidance acknowledged that in many construction contracts, the entity in effect agrees to sell its rights to the asset (that is, work in process) as the entity performs, which effectively results in a continuous sale (that is, the customer controls the work in process) that occurs as the work progresses.

The criterion that an entity's performance creates or enhances an asset the customer controls is most likely relevant when a customer clearly controls the asset as it is created or enhanced; for example, when an asset is being constructed by an entity on the customer's premises. For some performance obligations, it may be unclear whether the asset that is created or enhanced is controlled by the customer. In those cases, it can be more challenging to determine when control transfers. Therefore, ASC 606 includes the third over-time revenue recognition criterion (see Section 6.3.3).

BDO INSIGHTS: ANALYSIS OF OVER-TIME REVENUE RECOGNITION CRITERIA IN CONTRACTS WITH THE U.S. GOVERNMENT

Contracts with the U.S. government under the federal acquisition regulations (FAR) generally require analysis of the over-time revenue recognition criteria in ASC 606-10-25-27(b) and (c) (that is, the criterion that an entity's performance creates or enhances an asset that the customer controls and the criterion that an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date).

Contracts governed by FAR generally include termination clauses that provide the federal government with the right to obtain any work in process throughout the contract period if the contract is terminated before completion. The customer's ability to terminate the contract and obtain the interim work product is an indicator of control that

must be analyzed with other rights, such as rights to payment and transfer of legal title, but often results in meeting the criterion that an entity's performance creates or enhances an asset the customer controls.

Contracts governed by FAR may also contain substantive contractual restrictions that prevent an entity from redirecting completed products to another entity if the contract with the federal government is terminated. The entity also typically has an enforceable right to payment for performance completed to date under the standard FAR payment terms, resulting in those contracts meeting the criterion that an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date (see Section 6.3.3).

In some cases, an entity may serve as a subcontractor under a FAR contract. The subcontract may implicitly or explicitly refer to FAR provisions. Whether and how FAR applies to contracts with subcontractors is generally a legal question. Determination of the applicability of FAR to a particular contract and the related analysis of the over-time revenue recognition criteria in ASC 606-10-25-27(b) and (c) requires the application of judgment based on all facts and circumstances.

6.3.3 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

FASB REFERENCES

ASC 606-10-25-27(c)

If an 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 created to date, the entity transfers control of a good or service underlying a performance obligation to the customer over time. Therefore, revenue attributed to that performance obligation is recognized over time.

Application of the two over-time revenue recognition criteria discussed in Sections 6.3.1 and 6.3.2 could be challenging in some fact patterns. Therefore, the FASB provided the third criterion to help with the assessment of control. The FASB observed that this criterion may be necessary for services that are specific to a customer (for example, consulting services that ultimately result in a professional opinion specifically for the customer), as well as for the creation of tangible or intangible goods.

That criterion consists of two sub-criteria, **both** of which must be met:

- No alternative use.
- An enforceable right to payment.

BC142 of ASU 2014-09 explains why the assessment of control in that criterion requires both the creation of an asset with no alternative use and a right to payment. Specifically, if an asset an entity is creating does not have an alternative use to the entity, the entity is effectively constructing an asset at the customer's direction. Therefore, the entity will want to be economically protected from the risk of the customer terminating the contract and leaving the entity with no asset or an asset that has little value to the entity. That protection will be established by requiring the customer to pay for the entity's performance completed to date if the contract is terminated before completion. Therefore, the fact that the customer is obligated to pay for the entity's performance (or, in other words, is unable to avoid paying for that performance) implies the customer has obtained the benefits from the entity's performance. That is consistent with other exchange contracts when a customer is typically obligated to pay only if it has received control of goods or services in the exchange. Sections 6.3.3.1 and 6.3.3.2 discuss the notions of alternative use and right to payment.

6.3.3.1 Performance Does Not Create an Asset With an Alternative Use

FASB REFERENCES

ASC 606-10-25-28 and ASC 606-10-55-8 and 55-9

An asset created by an entity's performance does not have an alternative use to an entity if **either** of the following applies:

- The entity is restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset.
- The entity is limited practically from readily directing the asset in its completed state for another use.

At contract inception, an entity must assess whether the asset in its completed form has an alternative use to the entity. After contract inception, an entity does not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation (see Section 7.3). BC140 of ASU 2014-09 states that the requirement to assess alternative use at contract inception only is intended to avoid a continual reassessment of whether the asset has an alternative use, which could lead to a pattern of performance (and therefore revenue recognition) that is not useful.

CONTRACTUAL RESTRICTIONS AND PRACTICAL LIMITATIONS

In assessing whether an asset has an alternative use to an entity, an entity must consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use, such as selling it to a different customer. However, the probability of the contract with the customer being terminated is not relevant in assessing whether the entity would be able to readily direct the asset for another use.

6.3.3.1.1 Substantive Contractual Restriction

FASB REFERENCES

ASC 606-10-55-9

A contractual restriction on an entity's ability to direct an asset for another use must be substantive for the asset to have no alternative use to the entity.

- A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use.
- A contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets the entity could transfer to another customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract. For example, when the asset being sold is mass produced and it would be straightforward to substitute an equivalent item for a particular item subject to an existing contract, with the original item being sold to another customer, any contractual restriction is not substantive even if each of the items produced could be specified individually by each customer from a range of options. In that situation, the contractual restriction is not substantive because it is straightforward to produce another item with the same options and therefore meet the requirements of a particular contract.

EXAMPLE 6-3: SUBSTANTIVE CONTRACTUAL RESTRICTION — SALE OF REAL ESTATE

A contract for the sale of real estate with a contractual restriction on the seller's ability to direct an asset for another use is typically considered substantive if the seller is prohibited from selling the asset to another customer. For example, a seller typically cannot substitute a different condominium unit for the one contracted for by the customer, even if the two condominium units are substantially the same, as might be the case for two condominium units with identical floor plans in the same building.

EXAMPLE 6-4: CONTRACTUAL RESTRICTION IS NOT SUBSTANTIVE — SALE OF A CAR

Generally, a contract for the sale of a car with customer-specific customizations (color, wheels, interior finishes, etc.) does not include a substantive contractual restriction on the seller's ability to direct that car for another use; for example, by selling that car to another customer. Even if the contract prohibited selling the car to another customer, each car produced could be customized by each customer from a range of optional extras and the seller could produce another car with the same options without incurring significant costs to meet the requirements of a particular contract.

CONTRACTUAL RESTRICTIONS THAT PROVIDE A PROTECTIVE RIGHT TO THE CUSTOMER

Contractual restrictions that provide a protective right to the customer are not sufficient to establish that an asset has no alternative use to the entity. BC138 of ASU 2014-09 states that a protective right typically results in the entity having the practical ability to physically substitute or redirect the asset without the customer's awareness of or objections to the change. Consider an example in which a contract states that an entity cannot transfer a good because a customer has legal title to the goods in the contract. However, the customer's legal title to the goods is intended to protect the customer in the event of the entity's liquidation, and the entity can physically substitute and redirect the goods to another customer for little cost. In that example, the contractual restriction is merely a protective right and does not indicate that control of the goods has transferred to the customer.

6.3.3.1.2 Practical Limitation

FASB REFERENCES

ASC 606-10-55-10

A practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss could arise because the entity would either incur significant costs to rework the asset or only be able to sell the asset at a significant loss. For example, an entity may be practically limited from redirecting assets that either have customer-specific design specifications or are located in remote areas.

BC134 through BC138 of ASU 2014-09 explain further the concept of alternative use and how to consider whether a contractual or practical restriction exists. First, the notion of alternative use was developed to exclude the circumstances in which an entity's performance would not result in the transfer of control of goods or services to the

customer over time. Specifically, when the entity's performance creates an asset with an alternative use to the entity, for example a standard inventory-type item that could be used to fulfil different contracts with different customers, the entity could readily direct the asset to another customer. In those cases, the customer cannot control the asset as it is being created because absent any contractual restrictions, the customer does not have the ability to restrict the entity from directing that asset to another customer.

Further, when an entity creates an asset that is highly customized for a specific customer, the asset would be less likely to have an alternative use to the entity because the entity would incur significant costs to reconfigure the asset for sale to another customer or would need to sell the asset for a significantly reduced price. In that case, the customer could be regarded as receiving the benefit of that performance and as a result, controlling the goods or services (that is, the asset being created) as the performance occurs if the entity also has a right to payment (see Section 6.3.3.2).

In addition, although the level of customization might be a helpful factor to consider in assessing whether an asset has an alternative use, it is not a determinative factor because in some cases (for example, some real estate contracts), an asset may be standardized but still might have no alternative use to an entity because of substantive contractual restrictions that prevent the entity from readily directing the asset to another customer. As discussed in Section 6.3.3.1.1, if a contract precludes an entity from transferring an asset to another customer and that restriction is substantive, the entity does not have an alternative use for that asset because it is legally obligated to direct the asset to the customer. This fact indicates that the customer controls the asset as it is created because the customer has the present ability to restrict the entity from directing that asset to another customer if the entity also has a right to payment (see Section 6.3.3.2).

In determining whether the entity is limited practically from directing the asset for another use, an entity considers the characteristics of the asset that will ultimately be transferred to the customer. For some assets, the critical factor in making the assessment is whether the asset that is ultimately transferred could be redirected without a significant cost of rework. For example, in some manufacturing contracts, the basic design of the asset is the same across multiple contracts, but the customization in each contract is substantial. Therefore, redirecting the asset from one contract in its completed state to another customer requires significant rework.

Requiring an entity to consider contractual and practical restrictions is seemingly contradictory to the requirement to ignore contractual and practical limitations when applying the over-time revenue recognition criterion that the customer simultaneously receives benefits from the entity's performance as the entity performs (see Section 6.3.1). In BC139 of ASU 2014-09, the FASB stated that this difference is appropriate and added that although the objective of both criteria is to assess when control transfers over time, each criterion provides a different method for assessing when that control transfers because the criteria were designed to apply to different scenarios.

EXAMPLE 6-5: (ADAPTED FROM ASC 606-10-55-165 THROUGH 55-168) — ASSET HAS NO ALTERNATIVE USE TO THE ENTITY

An entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differs substantially based on each customer's needs and the type of technology that is incorporated into the satellite.

The entity enters a contract with a customer to build a specialized satellite. The contract does not preclude the entity from directing the completed satellite to another customer. The entity's sole performance obligation in the contract is to build the satellite.

The entity assesses at contract inception whether its performance obligation to build the satellite is satisfied over time. The entity observes that although the contract does not preclude the entity from directing the completed satellite to another customer, it would incur significant costs to rework the design and function of the satellite to direct that specific satellite to another customer. As a result, the entity determines that the satellite built for the customer has no alternative use to the entity because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.

EXAMPLE 6-6: ASSET IN ITS COMPLETED FORM HAS NO ALTERNATIVE USE TO THE ENTITY

A manufacturing entity manufactures metal pipe fittings for industrial use. The entity manufactures generic pipe fittings for off-the-shelf sales and customized pipe fittings for the specialized needs of a specific customer. The entity often uses a generic pipe fitting to customize it according to a customer's specifications. The entity is unable to sell a customized pipe fitting to other customers.

The entity enters a contract with a customer to manufacture a customized pipe fitting. The contract does not preclude the entity from directing the customized pipe fitting to another customer. The basic design of the customized pipe fitting (metal type, shape, etc.) is the same as for a generic pipe fitting.

The entity's sole performance obligation in the contract is to manufacture a customized pipe fitting.

The entity assesses at contract inception whether its performance obligation to manufacture a customized pipe fitting is satisfied over time. Because the basic design of the specialized pipe fitting is the same as for a generic pipe fitting, the entity can redirect the work in process (asset) to another customer or for another purpose until the customization begins in the manufacturing process. In other words, the asset remains generic and interchangeable up to a point in the manufacturing process. However, the completed asset (the customized pipe fitting) cannot be sold to another customer and redirecting it to another customer or for another purpose would require significant rework.

Therefore, the entity determines that the customized pipe fitting (that is, the asset in its completed form) has no alternative use to the entity regardless of the following:

- The asset is generic and can be redirected to another customer or for another purpose up to a certain point in the manufacturing process.
- The entity is not contractually precluded from directing the specialized pipe fitting to another customer.

Assuming the entity has an enforceable right to payment for performance completed to date (see Section 6.3.3.2), the performance obligation for the customized pipe fitting is satisfied over time, and the entity recognizes revenue over time during the manufacturing process. However, the entity begins to recognize revenue only when the customization begins in the manufacturing process. Before the customization begins, the entity's performance does not transfer an asset to the customer but rather creates an asset (inventory) for the entity (see Section 6.4).

6.3.3.2 The Entity Has an Enforceable Right to Payment for Performance Completed to Date



FASB REFERENCES

ASC 606-10-25-27(c) and ASC 606-10-25-29

Concluding that an asset has no alternative use is not sufficient to conclude that a customer controls an asset as it is being constructed. Rather, an entity must also have an enforceable right to payment for performance completed to date to demonstrate that a customer controls an asset that has no alternative use as it is being created.

EVALUATING ENFORCEABLE RIGHT TO PAYMENT FOR PERFORMANCE COMPLETED TO DATE

An entity must consider the terms of the contract as well as any applicable laws when evaluating whether it has an enforceable right to payment for performance completed to date.

While the right to payment for performance completed to date need not be for a fixed amount, the entity must be entitled to an amount that at least compensates the entity for performance completed to date at all times throughout the duration of the contract if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised.

6.3.3.2.1 Amount That at Least Compensates the Entity for Performance Completed to Date

FASB REFERENCES

ASC 606-10-55-11

An amount that compensates an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss or profit if the contract was terminated.

BDO INSIGHTS: CONTRACTS PRICED AT LOSS AT CONTRACT INCEPTION

Sometimes contracts with customers are priced at a loss at contract inception. ASC 606-10-55-11 uses the term "reasonable profit margin" to describe what would constitute the amount that would at least compensate an entity for performance completed to date. We believe a reasonable profit margin could be interpreted as the applicable loss margin in a contract that is priced at a loss at contract inception. If an entity is entitled to a proportionate amount of the transaction price (even if it is priced at loss) for performance completed to date at all times throughout the contract duration, the entity is entitled to an amount that would at least compensate it for performance completed to date. See Section 7.6 for a discussion of onerous contracts.

BC143 of ASU 2014-09 states the FASB's intent that the term "right to payment" refers to a payment that compensates an entity for its performance completed to date rather than, for example, a payment of a deposit or a payment to compensate the entity for inconvenience or loss of profit. The underlying objective of the third over-time revenue recognition criterion (whether an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date) is to determine whether the entity is transferring control of goods or services to the customer as an asset is being created for that customer. Therefore, assuming rational behavior by the seller and no broader perceived economic benefits that might exist outside the scope of the contract with the customer, the seller would only agree to transfer control of the goods or services to the customer if the seller is compensated for the costs from fulfilling the contract and it receives a profit margin that includes a return on those costs.

BC144 of ASU 2014-09 further states that the compensation to which the entity would be entitled upon termination by the customer might not always be the contract margin because the value transferred to a customer in a prematurely terminated contract may not be proportional to the value if the contract was completed. However, to demonstrate compensation for performance completed to date, the compensation must be **either**:

- A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party) or
- A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

Further, in analyzing the compensation to which the entity would be entitled upon termination by the customer, the focus must be on the amount to which the entity would be entitled upon termination rather than the amount for which the entity might ultimately be willing to settle in a negotiation.

6.3.3.2.2 Existence and Enforceability of Right to Payment

FASB REFERENCES

ASC 606-10-55-12 through 55-15

An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity could have an unconditional right to payment only at an agreed milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity must consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract was terminated before completion for reasons other than the entity's failure to perform as promised.

In BC145 of ASU 2014-09, the FASB clarified that an entity need not have a present unconditional right to payment. Instead, it must have an enforceable right to demand and retain payment for performance completed to date if the customer were to terminate the contract without cause before completion because the contractual payment terms might not always align with an entity's enforceable rights to payment for performance completed to date. For example, consider a contract in which a consulting entity agrees to provide a report at the end of the contract for a fixed amount that is conditional on providing that report. If the consulting entity were performing under that contract, it would have a right to payment for performance completed to date if the contractual terms or local laws require the customer to compensate the entity for work completed to date if the customer terminates the contract without cause before completion.

In some contracts, a customer may have a right to terminate the contract only at specified times during the contract term, or the customer may not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the contractually agreed consideration in exchange for those goods or services. In those situations, an entity has a right to payment for performance completed to date because it has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations, which include paying the promised consideration. That would be the case if the contract or other local laws require the entity and customer to complete their respective obligations (often referred to as "specific performance").

ASSESSMENT OF A RIGHT TO PAYMENT MAY EXTEND BEYOND THE CONTRACTUAL TERMS

In assessing the existence and enforceability of a right to payment for performance completed to date, an entity must consider the contractual terms, as well as any legislation or legal precedent that could supplement or override those contractual terms. That may include assessing whether:

- Legislation, administrative practice, or legal precedent confers upon the entity a right to payment for performance completed to date even if that right is not contractually specified.
- Relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect.
- An entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, even if an entity may choose to waive its right to payment in similar contracts, it would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.

That analysis may require a legal analysis involving the entity's legal counsel.

ASSESSMENT OF ENFORCEABLE RIGHT TO PAYMENT — PAYMENT SCHEDULE

A payment schedule and other related information specified in a contract do not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the contractually specified payment schedule and related information identify the timing and amount of consideration that is payable by a customer, the payment schedule and related information might not necessarily provide evidence of the entity's right to payment for performance completed to date. For example, a contract with a payment schedule could specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract. Also, a payment schedule might not adequately compensate an entity for work performed at all points during the contract.

ASSESSMENT OF ENFORCEABLE RIGHT TO PAYMENT — 100% NONREFUNDABLE UPFRONT PAYMENT

BC146 of ASU 2014-09 discusses whether a 100% nonrefundable upfront payment would meet the "right to payment for performance completed to date" criterion because a 100% payment would at least compensate the entity for work completed to date throughout the contract. That type of payment would meet the right to payment for performance completed to date criterion if the entity had an enforceable right to retain (and not refund) that payment if the customer terminated the contract; otherwise, it is questionable whether the entity actually has a right to payment.

Also, different countries and sub-national jurisdictions may provide entities with legal rights that are applicable but not explicitly included in the contracts. For example, a contract might refer to compliance with applicable laws but not specify precisely what those laws are. Therefore, in the absence of contractually specified terms that provide evidence of an enforceable right to payment for performance completed to date, an entity may need to review relevant legal precedence in its jurisdiction.

BDO INSIGHTS: ANALYZING RIGHT TO PAYMENT WHEN CONTRACT TERMS ARE SILENT

We generally believe if a contract's written terms do not specify the entity's right to payment upon contract termination, an enforceable right to payment is presumed not to exist. That is based on the interpretation the FASB staff expressed at the June 2018 Private Company Council meeting:

> *"The staff understands that questions have arisen about how to handle contracts in circumstances in which the entity creates a good with no alternative use and the contract with the customer does not specify by its written terms the entity's right to payment upon contract termination. Some stakeholders have asked whether it was the FASB's intent that companies analyze every law in every jurisdiction to determine whether there is recoverability. In the staff's view, a reasonable interpretation of the guidance is that when a contract's written terms do not specify the entity's right to payment upon contract termination, an enforceable right to payment is presumed not to exist."*[16]

However, there may be circumstances in which an enforceable right to payment exists even though the contract is silent as to such rights. If an entity asserts that it has such rights, we believe the entity must support its assertion with legislation, administrative practice, or legal precedence confirming that an enforceable right to payment exists in the relevant jurisdiction. The fact that the entity would have a basis for making a claim against the counterparty in a court of law would not be sufficient to support that an enforceable right to payment exists.

EXAMPLE 6-7 (ADAPTED FROM ASC 606-10-55-161 THROUGH 55-164): ASSESSING ALTERNATIVE USE AND RIGHT TO PAYMENT

An entity enters a contract with a customer to provide a consulting service to the customer. The service will result in the entity providing a professional opinion related to customer-specific facts and circumstances. If the customer terminates the contract for reasons other than the entity's failure to perform as promised, the customer is contractually required to compensate the entity for its costs incurred plus a 15% margin, which approximates the profit margin that the entity earns from similar contracts.

The entity assesses at contract inception whether its performance obligation to provide a consulting service with a professional opinion is satisfied over time by evaluating the criterion that the entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance completed to date. The entity determines that criterion is met because of the following factors:

- The development of the professional opinion creates an asset with no alternative use to the entity because the professional opinion relates to customer-specific facts and circumstances. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.
- The entity has an enforceable right to payment for its performance completed to date for its costs plus a reasonable margin, which approximates the profit margin in other contracts.

Therefore, the entity determines that its performance obligation is satisfied over time and recognizes revenue over time (see Section 6.4).

---

[16] FASB Staff Private Company Council Memo, *Definition of an Accounting Contract and Short Cycle Manufacturing (Right to Payment)*.

EXAMPLE 6-8 (ADAPTED FROM ASC 606-10-55-169 THROUGH 55-172): ENFORCEABLE RIGHT TO PAYMENT FOR PERFORMANCE COMPLETED TO DATE

An entity enters a contract with a customer to build an item of equipment based on the customer's unique specifications. The contractually stated payment schedule requires the customer to make payments as follows:

- An advance payment of 10% of the contract price at contract inception.
- Regular payments throughout the construction period amounting to 50% of the contract price.
- A final payment of 40% of the contract price after construction is complete and the equipment has passed the prescribed performance tests.

The payments are nonrefundable unless the entity fails to perform as promised. The entity is entitled to retain any progress payments received from the customer if the customer terminates the contract before completion. The entity has no further rights to compensation from the customer.

The entity assesses at contract inception whether its performance obligation to build the equipment is satisfied over time. Because the equipment is constructed to the customer's unique specifications, the entity concludes that the equipment has no alternative use.

As part of that assessment, the entity considers whether it has an enforceable right to payment for performance completed to date if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. The entity observes that it has the right to receive nonrefundable payments from the customer at various times during the contract term. However, the cumulative amount of those payments is not expected to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date at all points throughout the contract term. Instead, the cumulative amount of consideration paid by the customer at various times during the contract term might be less than the selling price of the partially completed item of equipment at that time. Therefore, the entity determines that it does not have a right to payment for performance completed to date for the duration of the contract.

Because the entity does not have a right to payment for performance completed to date, its performance obligation is not satisfied over time in accordance with the criterion on whether an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date.

The entity also concludes that it does not meet the other two over-time revenue recognition criteria (see Sections 6.3.1 and 6.3.2). Thus, the entity's performance obligation is not satisfied over time and the entity accounts for the construction of the equipment as a performance obligation satisfied at a point in time (see Section 6.5).

EXAMPLE 6-9: ENFORCEABLE RIGHT TO PAYMENT

A manufacturing entity entered a contract with a customer to produce a highly specialized good that has no alternative use to the entity because it is prohibited from selling that product to another customer. The customer commits to purchase a specific volume of the goods over the contract term because it needs a continuous supply of the product to avoid interruptions to its production process.

The contract includes the following terms:

- The customer must compensate the entity for an amount equal to all costs incurred by the entity to date plus an agreed margin if the customer terminates the contract without cause.
- Payment by the customer is due upon delivery of the product.
- Goods are shipped under free on board (FOB) destination terms* to the customer's international premises, and the entity insures the shipment against potential losses and damages that might affect the goods. Therefore, the customer will not pay for the products before delivery.

- Shipment timing averages 30 days from the entity's warehouse to the customer's international premises.

The entity determines that its performance obligation in the contract to manufacture and supply the goods does not meet the over-time recognition criteria in Sections 6.3.1 and 6.3.2 because:

- The customer does not consume the economic benefits of the goods while the entity is producing the goods.
- The customer does not control the goods while they are in production because among other factors, the entity is producing the goods on the entity's premises.

The entity considers whether it has an enforceable right to payment for performance completed to date and concludes that it has a contractual right to recover all costs incurred plus an appropriate margin at all times throughout the contract's duration. Therefore, the entity has a present right to payment for any production completed to date.

The entity also considers that the customer has no obligation to pay if goods are lost or damaged during the shipping period. It concludes that its failure to complete its contractual obligations because the goods are lost or damaged during the shipping period does not mean it does not have an enforceable right to payment for performance completed to date. The possibility that an entity might not perform its contractual obligations is not relevant to the analysis of whether a performance obligation is satisfied over time.

*Under FOB destination terms, the buyer takes delivery of goods being shipped by a supplier once the goods arrive at the buyer's receiving dock.

BDO INSIGHTS: ASSUME PERFORMANCE OCCURS WHEN ANALYZING RIGHT TO PAYMENT

In determining whether the third over-time criterion is met, ASC 606-10-25-29 requires an entity to assess whether it has the right to payment for performance completed to date if the contract is terminated for reasons other than the entity's failure to perform as promised. In other words, when assessing whether a contract provides for a right to payment upon termination, an entity assumes that it will perform under the contract. We believe that if there were a significant risk that an entity might not be able to perform its contractual obligations such that it would not be entitled to payment, it might not be able to conclude that a contract exists for accounting purposes (see Section 2.2).

EXAMPLE 6-10 (ADAPTED FROM ASC 606-10-55-173 THROUGH 55-182): ASSESSING WHETHER A PERFORMANCE OBLIGATION IS SATISFIED AT A POINT IN TIME OR OVER TIME — ENTITY DOES NOT HAVE AN ENFORCEABLE RIGHT TO PAYMENT FOR PERFORMANCE COMPLETED TO DATE

An entity is developing a multi-unit residential complex and enters a binding sales contract with a customer for a specified unit that is under construction. Each unit in the complex has a similar floor plan and is similar in size but other attributes are different (for example, the location of the unit within the complex).

The customer pays an upfront deposit upon entering the contract. The remainder of the price is payable upon contract completion when the customer obtains physical possession of the unit.

The following terms apply to the upfront deposit:

- The entity must refund the deposit to the customer only if the entity fails to complete construction of the unit in accordance with the contract, but the entity has the right to retain the deposit if the customer defaults on the contract before completion of the unit
- The deposit represents only 20% of the purchase price.

The entity assesses at contract inception whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. It observes the following:

- It has a right to the upfront deposit only until the construction of the unit is complete, at which time the remainder of the purchase price is due. If the customer terminates the contract, they forfeit the deposit but are not obligated to make any additional payments.
- The upfront deposit is not sufficient to provide a profit margin at all points during the contract.

Therefore, the entity determines that it does not have an enforceable right to payment for work completed to date. Accordingly, the entity's performance obligation is not a performance obligation satisfied over time. Because none of the other over time revenue recognition criteria are met, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time (see Section 6.5).

EXAMPLE 6-11 (ADAPTED FROM ASC 606-10-55-173 THROUGH 55-182): ASSESSING WHETHER A PERFORMANCE OBLIGATION IS SATISFIED AT A POINT IN TIME OR OVER TIME — ENTITY HAS AN ENFORCEABLE RIGHT TO PAYMENT FOR PERFORMANCE COMPLETED TO DATE

Assume the same facts in Example 6-10 except the customer pays a nonrefundable deposit upon entering the contract and must make progress payments during construction of the unit. Substantive contractual terms preclude the entity from being able to direct the unit to another customer. The customer does not have the right to terminate the contract unless the entity fails to perform as promised.

The following payment terms and local laws are applicable:

- If the customer defaults on its obligations by failing to make the promised progress payments, the entity has a right to all the consideration promised in the contract if it completes the construction of the unit.
- The local courts have previously upheld similar rights that entitle builders to require the customer to perform, subject to the builder meeting its obligations under the contract.

The entity determines at contract inception that its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time because:

- The unit (asset) created by the entity's performance has no alternative use to the entity because the contract precludes the entity from transferring that specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity can direct the asset to another customer.
- The contractual terms and practices in the legal jurisdiction indicate that the entity has a right to payment for performance completed to date. If the customer were to default on its obligations, the entity has an enforceable right to all the consideration promised under the contract if it continues to perform as promised.

Therefore, the criterion that an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date is met.

The entity recognizes revenue over time by measuring the progress toward complete satisfaction of the performance obligation (see Section 6.4).

BDO INSIGHTS: EXAMPLE 6-11 AND SOME CONSTRUCTION CONTRACTS

When constructing some buildings, such as a multi-unit residential complex, an entity may have entered contracts with multiple customers for the construction of individual units within the complex. The entity accounts for each contract with a customer separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction activities (that is, the foundation and basic structure) and the construction of common areas may need to be reflected when measuring its progress toward complete satisfaction of its performance obligations in each contract (see Section 6.4).

EXAMPLE 6-12 (ADAPTED FROM ASC 606-10-55-173 THROUGH 55-182): ASSESSING WHETHER A PERFORMANCE OBLIGATION IS SATISFIED AT A POINT IN TIME OR OVER TIME — ENTITY HAS AN ENFORCEABLE RIGHT TO PAYMENT FOR PERFORMANCE COMPLETED TO DATE

Assume the same facts in Example 6-11 except that in the event of a default by the customer, the entity can exercise either of the following rights:

- Require the customer to perform as required under the contract.
- Cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price.

Regardless of the fact that the entity could cancel the contract (in which case the customer would be obligated to transfer control of the partially completed unit to the entity and pay the specified penalty), the entity has a right to payment for performance completed to date because the entity also could choose to enforce its rights to full payment under the contract. The fact that the entity may choose to cancel the contract if the customer defaults on its obligations does not affect the assessment of whether the entity has a right to payment for performance completed to date, provided that the entity's rights to require the customer to continue to perform as required under the contract (by paying the promised consideration) are enforceable.



CONCLUSION THAT AN ASSET HAS AN ALTERNATIVE USE MAY CHANGE IN SUBSEQUENT CONTRACTS

In some scenarios, an entity's conclusion that an asset has no alternative use to the entity may be reassessed for subsequent contracts with customers and could result in a different conclusion. Entities must monitor changes in product and market, such as increases in customer base and the emergence of an expanded resale market, to determine whether a reassessment of the conclusion that the asset has no alternative use is warranted for subsequent contracts (see Example 6-13).

However, the conclusion about whether an asset has an alternative use is not reassessed after contract inception for a specific contract unless that contract is modified and the modified contract is not accounted for as a separate contract (see Section 7.3).

EXAMPLE 6-13: SUBSEQUENT CHANGE TO ASSESSMENT OF WHETHER ASSET HAS AN ALTERNATIVE USE TO THE ENTITY

A manufacturing entity creates some original parts for sale to an original equipment manufacturer (OEM) that is developing new products. Initially, the parts do not have an alternative use to the entity because they can be sold only to the OEM. The entity has a present right to payment for any production completed to date. Therefore, the performance obligation in the contract is satisfied over time.

After a period of time, an aftermarket emerges such that the parts can now also be sold to other customers because additional parts are manufactured under subsequent contracts entered into with either the OEM or other customers in the aftermarket. The existence of several customers for the parts suggests that as more parts are manufactured under a new contract with a customer, those parts could typically be sold to other customers, with subsequent production of additional units being used to satisfy the original contract. That indicates that once an aftermarket emerges, the entity may have an alternative use for parts being manufactured under any particular contract with a customer. Therefore, the conditions for recognizing revenue over time may not be met for contracts entered after the aftermarket develops.

6.4 MEASURING PROGRESS TOWARD COMPLETE SATISFACTION OF A PERFORMANCE OBLIGATION

For each performance obligation satisfied over time, an entity recognizes revenue over time by measuring the progress toward complete satisfaction of that performance obligation.

6.4.1 The Objective of Measuring Progress

FASB REFERENCES

ASC 606-10-25-31

The objective in measuring progress toward complete satisfaction of a performance obligation is to depict an entity's performance in transferring control of promised goods or services to a customer (that is, the satisfaction of an entity's performance obligation).

6.4.2 Methods for Measuring Progress

FASB REFERENCES

ASC 606-10-25-32 through 25-35

Appropriate methods of measuring progress include output methods and input methods. An entity must consider the nature of the good or service that it promised to transfer to the customer to determine the appropriate method for measuring progress for a specific performance obligation.

An entity must apply:

- A single method of measuring progress for each performance obligation satisfied over time.
- That method consistently to similar performance obligations and in similar circumstances.

BDO INSIGHTS: SELECTION OF MEASURE OF PROGRESS

Determining an appropriate measure of progress may require significant judgment based on the facts and circumstances. While ASC 606 does not require an entity to select a particular measure of progress for a particular type of performance obligation, an entity does not have a free choice; instead, the measure selected must reasonably reflect the transfer of control of the promised goods or services to the customer. Therefore, an entity must carefully consider whether the selected measure of progress meets that objective.

When applying a method for measuring progress, an entity must:

- Exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer.
- Include in the measure of progress any goods or services for which the entity transfers control to a customer when satisfying that performance obligation.

An entity must remeasure its progress toward complete satisfaction of a performance obligation satisfied over time at the end of each reporting period.

Also, an entity must update its measure of progress to reflect any changes in the outcome of the performance obligation as circumstances change over time. Such changes to an entity's measure of progress are accounted for as a change in an accounting estimate in accordance with ASC 250.

TRG DISCUSSIONS: MEASURE OF PROGRESS

In July 2015, the TRG discussed how to measure progress when multiple goods or services are included in a single performance obligation. Although a performance obligation may contain multiple goods or services, ASC 606 requires entities to apply a single method to measure progress toward the satisfaction of each performance obligation. Entities cannot apply one method to one part of a performance obligation and a different method to another part of that obligation.

TRG members stated that in some circumstances it may be difficult to identify a single measure of progress that reflects the entity's performance appropriately, which might indicate (albeit not definitively) the entity has not correctly identified the separate performance obligations. In other words, there might be more than one performance obligation.

6.4.2.1 Output Methods

FASB REFERENCES

ASC 606-10-55-17 through 55-19

The application of an output method results in revenue recognition based on direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract. Output methods include methods such as:

- Surveys of performance completed to date
- Appraisals of results achieved
- Milestones reached
- Time elapsed
- Units produced or units delivered

In evaluating whether to apply an output method to measure its progress, an entity must consider whether the output selected would faithfully depict the entity's performance toward complete satisfaction of the performance obligation. An output method does not provide a faithful depiction of the entity's performance if the output selected fails to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered (which exclude consideration for any work in process in the measurement of the output) would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in process that is controlled by the customer.

The disadvantages of output methods are that the outputs used to measure progress may not be directly observable and the information required to apply them may not be available to an entity without undue cost. Therefore, an input method may be necessary to measure progress toward complete satisfaction of a performance obligation (see Section 6.4.2.2).

EXAMPLE 6-14 (ADAPTED FROM ASC 606-10-55-184 THROUGH 55-186): MEASURING PROGRESS WHEN MAKING GOODS OR SERVICES AVAILABLE

An entity, an owner and manager of gymnasiums, contracts with a customer for one year of access to any of its gymnasiums. The customer has unlimited use of the gymnasiums and promises to pay $150 each month.

The entity determines that its promise to the customer is to provide a service of making the gymnasiums available for the customer to use as and when the customer wants. In other words, the entity's promise is a stand-ready obligation because the extent to which the customer uses the gymnasiums does not affect the amount of the remaining goods and services to which the customer is entitled.

The entity concludes that the customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the gymnasiums available. Therefore, the entity's performance obligation is satisfied over time.

In considering the appropriate measure of progress, the entity evaluates the nature of its performance obligation and determines that the customer benefits from the entity's service of making the gymnasiums available evenly throughout the year. In other words, the customer benefits from having the gymnasiums available to use, regardless of whether the customer uses it. Therefore, the entity concludes that the best measure of progress toward complete satisfaction of its performance obligation is a time-based measure. It recognizes revenue on a straight-line basis throughout the year at $150 per month.

6.4.2.1.1 As-Invoiced Practical Expedient

FASB REFERENCES

ASC 606-10-55-18

As a practical expedient, an entity may recognize revenue in the amount to which it has a right to invoice a customer if the entity has a right to consideration from the customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date. That expedient could be available; for example, for a service contract in which an entity bills a fixed amount for each hour of service provided.

TRG DISCUSSIONS: AS-INVOICED PRACTICAL EXPEDIENT — UPFRONT PAYMENTS

In July 2015, the TRG members agreed that an entity is not precluded from applying the as-invoiced practical expedient in situations in which the price per unit changes during the duration of the contract. They noted that application of the practical expedient in those situations involves an analysis of the facts and circumstances of the arrangement to determine whether the amount invoiced for goods or services reasonably represents the value to the customer of the entity's performance completed to date. That assessment may, but does not have to, include an assessment of market or SSP.

The TRG considered the following two examples and agreed that the as-invoiced practical expedient applies to both:

Example A: Sale of Electricity

An energy entity and its customer enter a contract for the purchase and sale of electricity over six years. The customer is obligated to purchase 10 megawatts of electricity per hour (MWh) for each hour during the contract

term (87,600 MWh per annual period) at the following prices that contemplate the forward market price of electricity at contract inception:

- Years 1-2: $50/MWh
- Years 3-4: $55/MWh
- Years 5-6: $60/MWh

The transaction price, which represents the amount of consideration to which the entity expects to be entitled in exchange for transferring electricity to the customer, is $28,908,000 (calculated as the annual contract prices per MWh multiplied by annual contract quantities).

The entity concludes that the promise to sell electricity represents one performance obligation that will be satisfied over time.

The entity concludes that the as-invoiced practical expedient applies because the amount that will be billed to the customer corresponds directly with the value to the customer of the entity's performance completed to date. The amount that will be billed is based on both the units of power transferred to the customer and a rate per unit of power that is priced by reference to one or more market indicators (for example, the observable forward commodity price curve).

While the rate per unit of power is not the same for the duration of the contract, the rates per unit reflect the value to the customer because the rates are based on one or more market indicators. When assessing the applicability of the expedient, a fixed price is not always required for the duration of the contract. However, a price increase or decrease must be based on the value of those later units to the customer. Determining whether the price change is consistent with the value to the customer often requires the use of judgment.

Example B: IT Outsourcing Arrangement

IT Seller and its customer enter an IT outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term of 10 years. IT Seller's activities include, for example, providing server capacity, managing the customer's software portfolio, and running an IT help desk. Each activity has a contractual minimum volume.

IT Seller concludes that each of the activities described will be satisfied over time.

The following are the payment terms:

- The price per unit differs for each type of activity.
- IT Seller invoices the customer monthly.
- The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power, number of software applications used, or number of employees supported.
- The agreed pricing at contract inception reflects market pricing.
- The pricing decreases to reflect the associated costs decreasing over the term of the contract as the level of effort to complete the tasks decreases. While initially the tasks are performed by more expensive personnel for activities that require more effort, the level of effort for the activities decreases later in the contract term, and the tasks are performed by less expensive personnel.
- The contract includes a price benchmarking clause whereby the customer engages a third-party benchmarking firm to compare the contract pricing to current market rates at certain points in the contract term. There is an automatic prospective price adjustment if the benchmark is significantly below IT Seller's price.
- Although each activity has a contractual minimum, the fixed minimum amount is not considered substantive because the customer is expected to exceed that minimum (in part, based on historical experience). Therefore, the customer pays the IT Seller the relevant price per unit and the amount billed to the customer reflects the rates and amounts (price and quantities) for the activities provided.

The TRG agreed that the as-invoiced practical expedient applies because the amount billed to the customer corresponds directly with the value to the customer of IT Seller's performance to date. Similar to Example A,

although the rates change for the respective activities over the duration of the arrangement, those rates reflect the value to the customer, which is corroborated by both of the following:

- The benchmarking (market) adjustment.
- Declining costs (and level of effort) of providing the tasks that correspond with the declining pricing of the activities.

Even though there are multiple activities in Example B, the conditions to apply the as-invoiced practical expedient are met because the amounts invoiced correspond with the value to the customer of each incremental activity the IT Seller provides to the customer (that is, the IT Seller's performance completed to date).

Additionally, the FASB staff stated that while not included in the examples above, if a contract includes a volume discount that is not substantive, the value to the customer could directly correspond to the amount billed.



TRG DISCUSSIONS: AS-INVOICED PRACTICAL EXPEDIENT — UPFRONT PAYMENT AND BACK-END REBATE

In July 2015, the TRG agreed that the mere existence of an upfront payment or a back-end rebate in an arrangement does not preclude an entity from applying the as-invoiced practical expedient. However, members said an assessment of the significance of those upfront and back-end fees relative to the variable consideration in the arrangement would likely be important in determining whether the expedient applies.



TRG DISCUSSIONS: EXISTENCE OF AN INVOICE OR PAYMENT SCHEDULE

In July 2015, the TRG agreed that the mere fact that an entity and its customer agree on an invoice or payment schedule does not automatically mean the amount an entity has the right to invoice at a given point corresponds directly with the value to the customer for the goods or services provided to date. For example, the customer might request lower payments earlier in the duration of the contract and higher payments later in the duration to increase its operating cash flow in the short term. As another example, the entity might request a significant payment early in the duration of the contract to reduce credit risk or to have the customer demonstrate that it is committed to a long-term service arrangement. The application of the as-invoiced practical expedient in those situations involves an analysis of the facts and circumstances of the arrangement to determine whether the amount invoiced for goods or services reasonably represents the value to the customer of the entity's performance completed to date.

BDO INSIGHTS: AS-INVOICED PRACTICAL EXPEDIENT

To apply the as-invoiced practical expedient, an entity must conclude that the amount that will be invoiced to the customer over the term of the contract corresponds directly with the value to the customer of the entity's performance completed to date throughout the contract term. Analyzing whether the invoiced amount corresponds directly with the value to the customer might be complex and requires the application of professional judgment based on the facts and circumstances. Because of the complexity of this analysis, we have observed limited use of the expedient in practice.

Also, we have observed in practice that when the performance obligation is a series of distinct services satisfied over time (see Section 3.4) and the variable consideration allocation exception (see Section 5.5) applies, the resulting revenue recognition may be similar to the outcomes under the as-invoiced practical expedient. In those cases, applying the five-step revenue recognition model may be more straightforward, and an entity may forego the expedient to avoid the burden of corroborating that it applies.

For example, consider a professional services entity that provides consulting services at a per-hour fee, which increases annually in a multiyear contract (that is, the fee is variable). The fee is billed monthly. The contract includes a single performance obligation, which is a series of distinct services satisfied over time. Each day of service is distinct. The criteria for the variable consideration allocation exception are met because the terms of the monthly fee relate specifically to the entity's efforts to satisfy the distinct consulting services provided in a month, and the resulting allocation is consistent with the allocation objective. Therefore, the entity recognizes the monthly invoiced amount in revenue in the month to which the invoice relates. That approach to recognizing revenue is more straightforward than determining whether the as-invoiced practical expedient applies, which would require an analysis of whether the increases in fees correspond directly with the value to the customer of the entity's performance completed to date throughout the contract term.

In many cases, the measurement of revenue recognized for performance obligations satisfied over time may not be the same as amounts invoiced to a customer. In those circumstances, an entity recognizes either a contract asset or liability for the difference between cumulative revenue recognized for a contract and cumulative amounts invoiced to the customer.

6.4.2.2 Input Methods

FASB REFERENCES

ASC 606-10-55-20 and 55-21

The application of an input method results in revenue recognition based on an entity's efforts or inputs to the satisfaction of a performance obligation relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis. Examples of input methods include:

- Resources used
- Labor hours expended
- Costs incurred
- Time elapsed
- Machine hours used

A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. Therefore, to comply with the objective of measuring progress, an entity must exclude from an input method the effects of any inputs that do not depict the entity's performance in transferring control of goods or services to the customer.

Following are examples of adjustments to the measure of progress that may be required when using a cost-based input method:

- **Significant inefficiencies:** If a cost incurred does not contribute to an entity's progress in satisfying the performance obligation, its effect must be excluded from the cost-based input method. For example, an entity would not recognize revenue based on costs incurred that are attributable to significant inefficiencies in its performance that were not reflected in the price of the contract (such as, the costs of unexpected amounts of wasted materials, labor, or other resources that were incurred to satisfy the performance obligation).
- **Uninstalled materials:** If a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation, the best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all the following conditions would be met:
  - The good is not distinct.
  - The customer is expected to obtain control of the good significantly before receiving services related to the good.
  - The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.
  - The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal (see Section 7.2)).

6.4.2.2.1 Learning Curve

When determining the appropriate costs to include in the measure of progress and whether some costs incurred are attributable to significant inefficiencies, an entity must consider the effects of any learning curves. A learning curve is the effect of efficiencies realized over time when an entity's costs of performing a task decline in relation to the number of times the entity performs that task. A learning curve can exist independently of a contract with a customer. For example, a typical contract manufacturer may become more efficient in its production process over time as it manufactures a product multiple times.

BC314 of ASU 2014-09 states that when an entity's performance obligation is satisfied over time, applying a measure of progress based on costs incurred would result in a higher recognition of revenue and expense for the early units produced compared to the later units if the entity incurs higher costs to produce the early units and relatively lower costs to produce the later units as production efficiencies are gained. In that scenario, a higher recognition of revenue and expense for the early units produced is appropriate because of the greater value of the entity's performance in the early part of the contract. If an entity were to sell only one unit, it would charge a customer a higher price for that unit than the average unit price the customer pays when the customer purchases more than one unit.

EXAMPLE 6-15 (ADAPTED FROM ASC 606-10-55-187 THROUGH 55-192): UNINSTALLED MATERIALS

An entity enters a contract with a customer in October 20X2 to refurbish a multistory building and install new elevators for total consideration of $500,000 (the transaction price). The promised refurbishment service, including the installation of elevators, is a single performance obligation. The entity determines that the performance obligation is satisfied over time because the customer owns the building and controls the output of the refurbishment as the entity performs.

Total expected costs are $400,000, including $150,000 for the elevators, as summarized below:

Expected Costs:			
Elevators	$	150,000	37.5% of total expected costs
Other costs		250,000	62.5% of total expected costs
Total Expected Costs	**$**	**400,000**	

The elevators are paid for and delivered at the site in November 20X2. The entity determines that it acts as a principal because it obtains control of the elevators before they are transferred to the customer (see Section 7.2).

In considering the appropriate measure of progress, the entity evaluates the nature of its performance obligation and determines that an input method based on costs is appropriate to measure its progress toward complete satisfaction of the performance obligation. The entity then assesses whether the costs incurred to procure the elevators are proportionate to the entity's progress in satisfying its performance obligation. The entity observes the following:

- Although the elevators will not be installed until June 20X3, the customer obtains control of the elevators when they are delivered to the site in November 20X2.
- The costs to procure the elevators ($150,000) are significant relative to the total expected costs to completely satisfy the performance obligation ($400,000).
- The entity is not involved in designing or manufacturing the elevators.
- As of December 31, 20X2, the entity has incurred other costs equaling $50,000 out of the total expected other costs (excluding elevators) of $250,000.

The entity observes that the control of the elevators has passed to the customer in November 20X2, so recognition of $150,000 (the costs for elevators) as an asset would be inappropriate and $150,000 must be expensed. However, the entity also determines that it would be inappropriate to recognize 37.5% of total contract revenue related to the costs for elevators and related profit because it has made limited progress in satisfying its performance obligation to refurbish the building.

Thus, the entity concludes that including the costs to procure the elevators ($150,000) in the measure of progress would overstate the extent of the entity's performance at December 31, 20X2. Therefore, the entity:

- Adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price.
- Recognizes revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (that is, at a zero margin).

As of December 31, 20X2, the entity observes that performance is 20% complete, calculated as $50,000 (other costs incurred) divided by $250,000 (total expected other costs). Therefore, on December 31, 20X2, the entity recognizes the following:

Revenue	$ 220,000	Calculated as (20% of $350,000) plus $150,000, the costs for elevators; $350,000 is calculated as $500,000 less $150,000, the costs for elevators.
Cost of Goods Sold	200,000	Calculated as $50,000 (other costs incurred) plus $150,000 (the costs incurred for elevators).
Profit	**$ 20,000**	

BDO INSIGHTS: COST-BASED INPUT METHODS

Cost-based input methods are commonly used as a measure of progress for revenue recognition in multiple industries. While ASC 606 allows the use of a cost-based input method to measure progress to recognize revenue, it provides very limited guidance on how to calculate the costs incurred and total expected costs (that is, the numerator and denominator), which provide the basis (or percentage) for recognizing a portion of the transaction price as revenue. Entities must carefully consider other U.S. GAAP that may be applicable to appropriately calculate the costs included in the numerator and the denominator. Significant inaccuracies in calculating costs may result in inappropriate revenue recognition. For example, not accruing costs incurred until invoices are paid may result in under-recognition of costs incurred and therefore an understatement of revenue.

BDO INSIGHTS: OVER TIME REVENUE RECOGNITION AND WORK IN PROCESS

For performance obligations that are satisfied over time, an entity generally does not recognize any work in process as inventory under ASC 330 (or as an asset under other U.S. GAAP), because the fundamental principle underlying over time revenue recognition is that control of the good or service is transferred to the customer continuously as the entity fulfills its contractual obligations. Any inventory or raw material costs that are specific to a performance obligation satisfied over time are expensed as those costs are assigned to that performance obligation and placed into production. As a result, if output methods are used to measure performance to date, entities may often find that profit margins vary over the contractual period. In some cases, losses may be experienced in some periods, particularly in the early stages of the contract, even though the contract is anticipated to be profitable overall because the measurement of cumulative (or periodic) outputs driving the amount of revenue recognized may not be commensurate with the cumulative (or periodic) costs incurred.

BDO INSIGHTS: MEASURE OF PROGRESS — CUSTOMIZED PRODUCT THAT IS GENERIC UP TO A POINT IN THE CONSTRUCTION OR MANUFACTURING PROCESS

An entity may construct or manufacture a customized product that remains generic up to the point in the construction or manufacturing process when the customization begins but has no alternative use to the entity in its completed form (see Example 6-6). If the entity has an enforceable right to payment for performance completed to date, it recognizes revenue over the construction or manufacturing process.

However, before the customization, the entity's performance does not transfer an asset to the customer but rather creates an asset (inventory) for the entity, because the entity can redirect the generic asset to another customer or for another purpose. Only when the customization begins does the entity's performance transfer the work in process (asset) to the customer as the entity performs. Therefore, the entity begins to recognize revenue over time only when the customization begins.

If an entity uses a cost-based measure of progress, the costs incurred before customization are included in the measure of progress to determine the revenue to be recognized once customization begins, and any related asset recognized for the work in process (for example, inventory) is recognized in expense at that point.

BDO INSIGHTS: ACCOUNTING FOR PARTIAL SATISFACTION OF A PERFORMANCE OBLIGATION BEFORE THE CONTRACT EXISTENCE CRITERIA ARE MET

Sometimes an entity may start providing goods or services which comprise a performance obligation satisfied over time before the contract existence criteria in Step 1 are met (see Section 2.2). Regardless of the entity's ongoing performance to satisfy the performance obligation over time, it may not recognize revenue before the contract existence criteria are met. Rather, the entity begins to recognize revenue when the contract existence criteria are met. This fact pattern may arise, for example, when an entity starts to manufacture a highly customized good or provide a service in advance of obtaining an expected contract from a customer. When the entity subsequently determines that the contract existence criteria are met, the question arises as to whether revenue is recognized prospectively from contract inception or if there is a cumulative catch-up adjustment for the work done to date.

Consistent with views expressed at the TRG meeting in March 2015, when a similar issue was discussed, we believe revenue is recognized on a cumulative catch-up basis because ASC 606 requires an entity to recognize revenue when or as an entity satisfies performance obligations by transferring promised goods or services to a customer. That occurs when or as the customer obtains control of the good or service. If at the point when the contract existence criteria are met the entity has satisfied part or all of specific performance obligations by transferring fully or

partially completed goods or services to its customer, the entity must recognize in revenue the related amount of consideration to which it expects to be entitled.

Recognizing revenue on a prospective basis only from the point in time at which the contract existence criteria are met is inconsistent with the notion of control underlying the five-step revenue recognition model because the control of some goods or services is transferred to the customer at contract inception. The costs incurred for those arrangements may have to be recognized before the revenue recognition begins (see Section 7.7).

TRG DISCUSSIONS: STAND-READY OBLIGATIONS

In January 2015, the TRG discussed the nature of an entity's promise in stand-ready obligations and how an entity should measure progress toward completion of a stand-ready obligation that is satisfied over time.

As discussed in Chapter 3, a stand-ready performance obligation is one in which the entity provides a service of standing ready to provide goods or services. The customer consumes and receives benefit from a stand-ready obligation from the assurance that a resource is available to it when and if needed or called upon.

Following are the examples of different types of stand-ready obligations considered by the TRG:

- Obligations in which the delivery of the goods, services, or IP underlying the obligation is within the control of the entity, but for which the entity must still further develop its goods, services, or IP. For example, a software entity might promise to transfer unspecified software upgrades at the entity's discretion, or a pharmaceutical entity might promise to provide when-and-if-available updates to previously licensed IP based on advances in R&D.
- Obligations in which the delivery of the underlying goods or services- is outside the control of the entity and customer. For example, an entity promises to remove snow from an airport's runways in exchange for a fixed fee each year.
- Obligations in which the delivery of the underlying goods or services is within the control of the customer. For example, an entity might agree to provide periodic maintenance on a customer's equipment after a preestablished amount of use by the customer.
- Obligations to make a good or service available to the customer continuously, such as a gym or health club membership.

TRG members agreed that an entity must exercise judgment in determining the appropriate method to measure progress toward satisfaction of a stand-ready obligation over time, and the substance of the stand-ready obligation must be considered to align the measurement of progress toward complete satisfaction of the performance obligation with the nature of the entity's promise. The TRG also observed that while a straight-line measure of progress might not always be conceptually pure, it might be the most reasonable estimate an entity can make for a stand-ready obligation.

BDO INSIGHTS: MEASURE OF PROGRESS FOR A STAND-READY PERFORMANCE OBLIGATION

Consistent with the TRG discussion, we believe an entity must not default to straight-line measure of progress for a stand-ready performance obligation. Rather, an entity must consider the nature of its obligation and the relevant facts and circumstances to determine the appropriate method for measuring its progress in satisfying its stand-ready obligation. For example, consider an entity that enters an annual contract with a customer to provide snow removal services in New York. While the nature of the entity's promise is to stand-ready to remove snow as it falls, a straight-line measure of progress is not appropriate for revenue recognition because it would not reflect the pattern

of benefit of the snow removal services to the customer or the entity's effort in providing those services. Rather, the entire consideration allocated to the entity's obligation for snow removal must be recognized during the winter months when snow is expected to fall in New York. However, that pattern could be different, for example in Alaska, which receives more snowfall than New York, or Texas, which receives less snowfall than New York.

EXAMPLE 6-15A: STAND-READY OBLIGATION TO PROVIDE MAINTENANCE SERVICE

An entity enters a contract with a municipality to provide maintenance services for the water tanks within the municipality for one year in exchange for an annual fee. The entity is required to provide the maintenance services as needed during the year. Based on the entity's past experience, the maintenance services are typically required once or twice a year.

The entity concludes that:

- The nature of its performance obligation is to stand ready to provide the maintenance service as needed.
- The maintenance service is satisfied over time because the municipality simultaneously receives and consumes the benefits as the entity performs.
- A straight-line measure of progress for its stand-ready performance obligation is not appropriate because the maintenance services do not occur evenly throughout the year. Rather, an input method measure of progress based on cost or labor hours incurred is a better reflection of the entity's actual efforts to satisfy its performance obligation.

Therefore, the entity recognizes the annual fee in revenue based on cost or labor hours incurred throughout the year.

6.4.3 Reasonable Measures of Progress

FASB REFERENCES

ASC 606-10-25-36 and 25-37

An entity recognizes revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress toward complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress.

In some circumstances (for example, in the initial stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation but may expect to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity recognizes revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

BC179 of ASU 2014-09 states that unless the entity can recognize an asset from the costs to fulfill a contract, any costs related to the promise would not represent an asset of the entity and therefore is recognized as expenses as they are incurred (see Section 7.7).

BC180 of ASU 2014-09 states that when an entity cannot reasonably measure its progress toward complete satisfaction of a performance obligation but still expects eventually to recover the costs incurred in satisfying the performance obligation, the entity must recognize at least some amount of revenue to reflect the fact that it is making progress in satisfying the performance obligation. Therefore, the FASB concluded that in those cases, an entity must recognize revenue for the satisfaction of the performance obligation only to the extent of the costs incurred. However, the FASB

also concluded that an entity must stop using that method when it can reasonably measure its progress toward complete satisfaction of the performance obligation and select an appropriate method to measure progress.

BDO INSIGHTS: INABILITY TO REASONABLY MEASURE PROGRESS IS EXPECTED TO BE RARE

We believe it would be rare that an entity could not reasonably measure its progress toward complete satisfaction of a performance obligation. The guidance in ASC 606 is consistent with the prior revenue recognition guidance in ASC 605-35, *Revenue — Construction-Type and Production-Type Contracts*, superseded by ASC 606. While the language in ASC 605-35-25-59 was not carried forward into ASC 606, we believe the concepts articulated there are still relevant. Specifically, that guidance stated that there is a presumption that entities whose business model involves the production of goods or services under contractual arrangements do have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion model and persuasive evidence to the contrary is necessary to overcome that presumption. We believe a similar presumption exists under ASC 606 that entities that promise goods or services that meet the criteria to be accounted for over time can make reliable estimates of progress and persuasive evidence is needed to overcome that presumption.

6.5 PERFORMANCE OBLIGATIONS SATISFIED AT A POINT IN TIME

FASB REFERENCES

ASC 606-10-25-30

An entity satisfies a performance obligation at a point in time if the performance obligation does not meet the criteria for being satisfied over time. For a performance obligation satisfied at a point in time, the performance obligation is satisfied at the point in time at which control of the goods or services transfers to the customer. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity must consider the guidance on control (see Section 6.2 for discussion on control).

Also, an entity must consider indicators of the transfer of control, which include, but are not limited to:

- **The entity has a present right to payment for the asset:** A customer's present obligation to pay for an asset may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset.
- **The customer has legal title to the asset:** Legal title may indicate whether the entity or a customer has the ability to direct the use of, and obtain substantially all the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. However, if an entity retains legal title solely as protection against the customer's failure to pay, those protective rights of the entity would not preclude the customer from obtaining control of an asset.
- **The entity has transferred physical possession of the asset:** The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not necessarily coincide with control of an asset. For example, in some repurchase agreements or consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Sections 6.6, 6.7, and 6.8 discuss accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.
- **The customer has the significant risks and rewards of ownership of the asset:** The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity must exclude any risks that give rise to a separate

performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may transfer control of a car to a customer without yet satisfying an additional performance obligation to provide maintenance services related to the transferred car. BC154 of ASU 2014-09 states the FASB's belief that risks and rewards can be a helpful factor to consider when determining the transfer of control and can often be a consequence of controlling an asset. However, whether the customer has the significant risks and rewards of ownership is only one indicator of control and does not change the principle of determining the transfer of goods or services based on the transfer of control.

- **The customer has accepted the asset:** The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset. An entity must evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred (see Section 6.9).



INDICATORS OF CONTROL — NOT A CHECKLIST

BC155 of ASU 2014-09 states that the indicators of control are not a list of conditions that must be met before an entity can conclude that control of a good or service has transferred to a customer. Rather, the indicators are a list of factors that are often present if a customer has control of an asset. That list is provided to assist entities in applying the principle of control. Accordingly, all indicators need not be present for an entity to conclude that it has transferred control of a good or service.

EXAMPLE 6-16: RISK AND REWARD VERSUS TRANSFER OF CONTROL

A property development entity enters contracts with customers to sell separate units of residential or commercial properties in multi-unit developments (for example, apartment blocks or office buildings).

- On January 1, 20X1, a customer enters a binding contract for the unit and pays a 10% deposit of the contractually agreed purchase price.
- The unit is incomplete on January 1, 20X1, (for example, because the unit has been sold off-plan, or some but not all construction activities have been completed); the entity must complete the construction of the unit by June 1, 20X2.
- From the point in time when construction of the unit is complete, the customer assumes some ownership risks, including risks from damage to the unit caused by an event (for example, severe weather) or by unrelated third parties.
- On June 15, 20X2, the customer must pay the balance of purchase price and take ownership, with legal title passing from the entity to its customer.
- If the customer does not fulfill its contractual obligation to pay the balance of the consideration on June 15, 20X2:
  - The entity has the right to retain the 10% deposit that was paid on January 1, 20X1.
  - The customer is contractually required to compensate the entity for certain loss of profit — the customer must pay the shortfall to the entity if the entity is unable to obtain a price of at least 90% of the contractually agreed price from sale to another customer.
  - The local courts in the entity's jurisdiction will likely enforce the compensation clauses stated above based on the substantial legal precedence.
- The customer is exposed to subsequent changes in the market value of the unit from January 1, 20X1, because the customer has entered a binding sales contract.

- The customer is not allowed to occupy or sublet the unit and may have either limited or no rights to access the unit until June 15, 20X2. The customer also does not have the right to make any changes to the unit or to pledge it as security in transactions such as a lending arrangement until June 15, 20X2.

The unit is the sole performance obligation in the contract.

The entity first considers whether the performance obligation is satisfied over time and hence revenue must be recognized over time. If none of the over-time revenue recognition criteria are met, revenue must be recognized at a point in time.

In determining whether the performance obligation is satisfied over time, the entity considers it has a right only to the upfront deposit until the unit's construction is complete. Accordingly, the entity determines that it does not have an enforceable right to payment for work completed to date at all times for the contract's duration. Therefore, the entity's performance obligation is not satisfied over time in accordance with the criterion that an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date. Because none of the other over-time revenue recognition criteria are met, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time.

In determining the point in time at which the performance obligation is satisfied, the entity considers that although the customer assumes some risks at January 1, 20X1, and June 1, 20X2, the restrictions over the customer's ability to derive benefits from the unit extend until June 15, 20X2, and indicate that control of the unit does not transfer to the customer until June 15, 20X2.

Therefore, the entity recognizes revenue from the sale of unit on June 15, 20X2.

BDO INSIGHTS: SIGNIFICANCE OF LOCAL LAWS IN DETERMINING THE PATTERN OF REVENUE RECOGNITION

In determining when to recognize revenue, it is important to understand the legal environment, as well as the contractual terms and conditions, because local laws and regulations may affect the assessment of whether control transfers to the customer over time or at a point in time, which is a specific date.

Also, application of the over-time revenue recognition criterion in Section 6.3.3 (whether an entity's performance creates an asset with no alternative use to the entity and the entity has an enforceable right to payment for performance created to date) particularly affects the pattern and timing of revenue recognition in multiple industries; for example, contract manufacturing. Entities must carefully consider their specific contracts with customers and legal environments to determine the appropriate patterns of revenue recognition under ASC 606.

6.6 REPURCHASE AGREEMENTS

FASB REFERENCES

ASC 606-10-55-66 and 55-67

A repurchase agreement is a contract in which an entity sells an asset to a customer and promises, or has the right, to repurchase the asset, either in the same contract or in another contract. The repurchased asset may be any of the following:

- The asset that was originally sold to the customer.
- An asset that is substantially the same as the asset originally sold to the customer.
- Another asset of which the asset that was originally sold is a component.

Repurchase agreements generally come in three forms:

- **A forward:** An entity's obligation to repurchase the asset.
- **A call option:** An entity's right to repurchase the asset.
- **A put option:** An entity's obligation to repurchase the asset at the customer's request.

6.6.1 A Forward or a Call Option

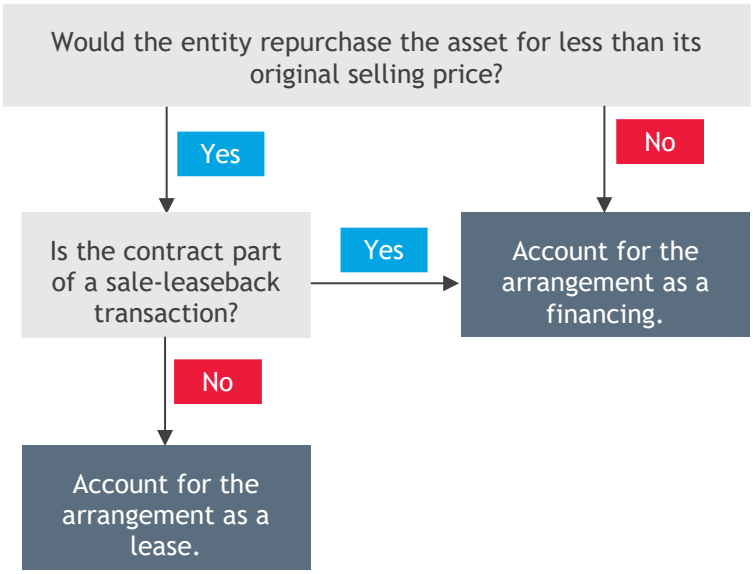
FASB REFERENCES

ASC 606-10-55-68 through 55-71

The following diagram provides an overview of the accounting considerations for repurchase rights in a forward or call option:

Forwards and Call Options

If an entity has an obligation or a right to repurchase the asset, control of the asset does not transfer to the customer. Accounting for the arrangement depends on the repurchase price.



If an entity has an obligation or a right to repurchase the asset (that is, a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all the remaining benefits from, the asset even though the customer may have physical possession of it. Therefore, an entity does not recognize revenue for that contract but instead, depending on the repurchase price of the asset as compared to its original selling price, accounts for that contract as a lease or financing.

- **A financing arrangement:** If the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset, the entity must account for the arrangement as a financing arrangement. An entity accounts for a financing arrangement as follows:
  - Continue to recognize the asset.
  - Recognize a financial liability for any consideration received from the customer.
  - Recognize as interest (and, if applicable, as processing or holding costs (for example, insurance)) any difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer.
- **A lease:** If the entity can or must repurchase the asset for an amount that is less than the asset's original selling price and the contract is not part of a sale-leaseback transaction, the entity must account for the arrangement as a lease in accordance with ASC 842.[17] If the contract is part of a sale-leaseback transaction, the entity must account for the arrangement as a financing arrangement and not as a sale-leaseback under ASC 842-40.

BC427 of ASU 2014-09 states that an entity does not consider the likelihood that a call option will be exercised because the existence of the call option effectively limits the customer's ability to control the asset. However, a nonsubstantive call option is ignored in assessing whether and when the customer obtains control of a good.

An entity considers the time value of money when comparing the repurchase price with the selling price of the asset.

An entity must derecognize the liability and recognize revenue if the call option lapses unexercised.

BDO INSIGHTS: CONTINGENTLY EXERCISABLE REPURCHASE RIGHT HELD BY AN ENTITY

ASC 606 does not include guidance on contingently exercisable repurchase right held by an entity. An entity must carefully evaluate the substance of a repurchase right and the related facts and circumstances and determine whether control of an asset underlying the contingent repurchase right has transferred to a customer. An entity may consider factors such as:

- The nature of the contingency.
- Whether the contingency is within the control of the entity or customer.
- The likelihood that the contingency will be met (but not the likelihood of exercise of the repurchase right).

The existence of a contingently exercisable repurchase right does not always preclude transfer of control to the customer. For example, if the contingency is outside its control, the entity may conclude that control has transferred to the customer and account for the transaction as a sale with a right of return.

EXAMPLE 6-17 (ADAPTED FROM ASC 606-10-55-401 THROUGH 55-407): REPURCHASE AGREEMENTS — CALL OPTION: FINANCING

An entity enters a contract with a customer for the sale of an item of equipment on January 1, 20X1, for $10 million. The contract includes a call option that provides the entity the right to repurchase the asset for $11 million on or before December 31, 20X1.

The entity determines that control of the equipment does not transfer to the customer on January 1, 20X1, because the entity has a right to repurchase the asset, which limits the customer in its ability to direct the use of, and obtain substantially all the remaining benefits from, the asset. Therefore, the entity accounts for the transaction as a financing arrangement because the exercise price of the call option ($11 million) is more than the original selling price ($10 million). The entity:

- Does not derecognize the equipment.

[17] See our Blueprint, Accounting for Leases Under ASC 842, for guidance on ASC 842.

- Recognizes the cash received as a financial liability.
- Recognizes interest expense for the difference between the exercise price ($11 million) and the cash received ($10 million), which increases the liability.

If the option lapses unexercised on January 1, 20X2, the entity would derecognize the liability and recognize revenue of $11 million.

6.6.2 A Put Option

FASB REFERENCES

ASC 606-10-55-72 through 55-78

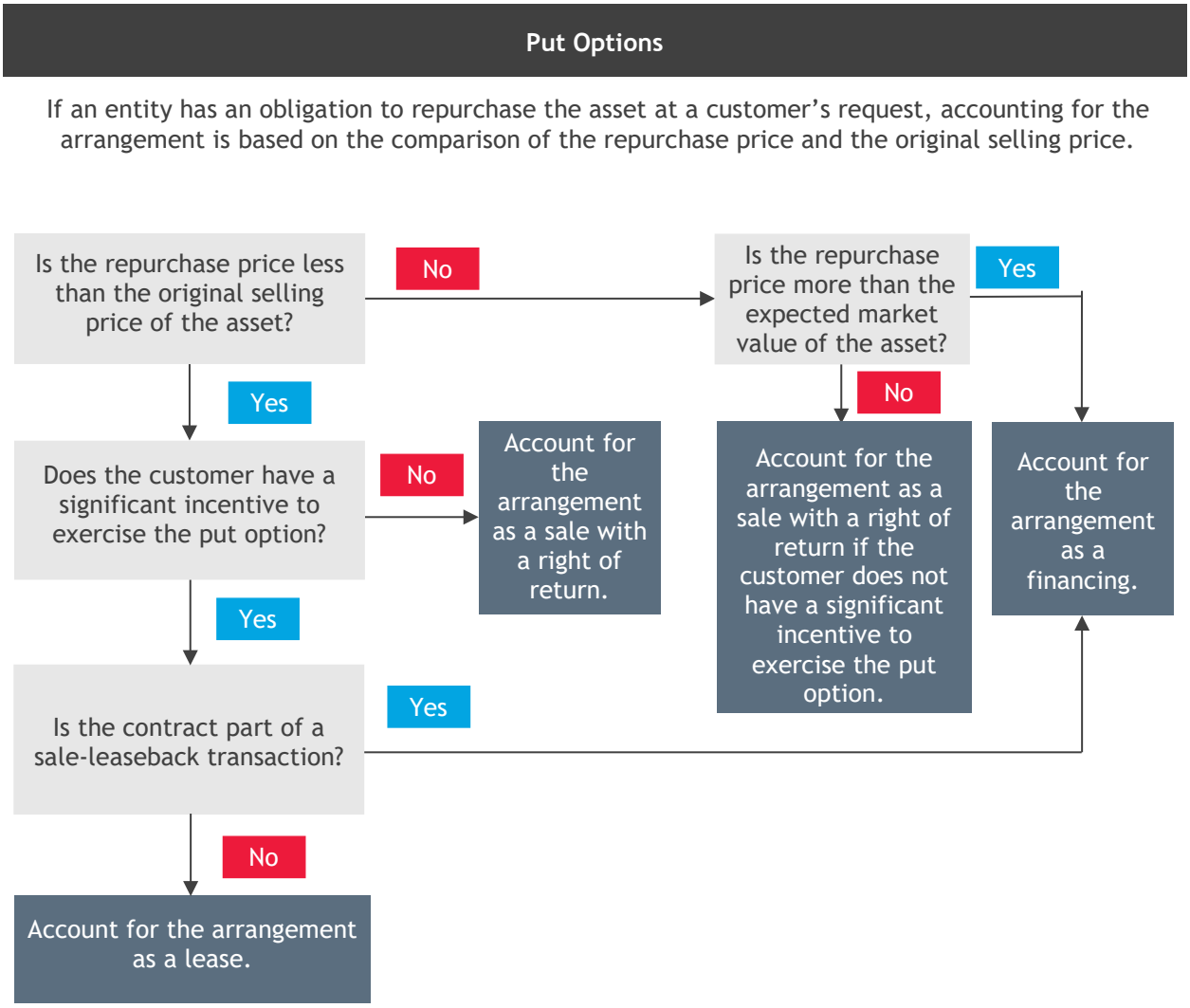
If an entity has an obligation to repurchase the asset at a customer's request, accounting for the arrangement is based on a comparison of the repurchase price and the original selling price.

BDO INSIGHTS: TRADE-IN RIGHTS

Some entities provide customers with the right to trade in the original purchased good for a newer version of the good at a later date for a specified price. We believe that if the trade-in right requires the customer to enter a subsequent contract with the entity, the right is a guarantee in the scope of ASC 460 as it does not meet the scope exception in ASC 460-10-15-7(k). For example, a trade-in right is a guarantee if the customer must enter a new equipment instalment plan to exercise its trade-in right under an existing equipment instalment plan. Trade-in rights in the scope of ASC 460 are measured at fair value and recorded as liabilities. Entities exclude the trade-in right's fair value from the contract transaction price and account for the remaining transaction price in accordance with ASC 606.

If a trade-in right does not require a customer to enter a subsequent contract, the trade-in right is in the scope of ASC 606. As entities have the obligation to repurchase the good at the customer's request, entities assess such rights under the ASC 606 repurchase agreements guidance on put options discussed in this section.

The following diagram gives an overview of the accounting considerations for an entity's repurchase obligation in a put option:



6.6.2.1 Repurchase Price Is Lower Than the Original Selling Price

FASB REFERENCES

ASC 606-10-55-72 through 55-74

If the customer can require an entity to repurchase the asset at a price that is lower than the original selling price of the asset, then the entity considers at contract inception whether the customer has a significant economic incentive to exercise that right. The exercise of that right by the customer results in the customer effectively paying the entity consideration for the right to use that asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right and the contract is not part of a sale-leaseback transaction, then the entity must

account for the agreement as a lease in accordance with ASC 842.[18] If the contract is part of a sale-leaseback transaction, then the entity must account for the arrangement as a financing arrangement and not as a sale-leaseback under ASC 842-40.

However, if the customer does not have a significant economic incentive to exercise its right at a price lower than the original selling price of the asset, then the entity accounts for the agreement as if it were the sale of a product with a right of return (see Section 4.3.8).

To determine whether a customer has a significant economic incentive to exercise its right, an entity must consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of the repurchase and the amount of time until the right expires. For example, a repurchase price that is expected to significantly exceed the market value of the asset at the date of repurchase may indicate that the customer has a significant economic incentive to exercise the put option.

6.6.2.2 Repurchase Price Is Equal to or Greater Than the Original Selling Price

FASB REFERENCES

ASC 606-10-55-75 through 55-76

If the repurchase price of the asset is equal to or greater than the original selling price, the accounting is based on a comparison of the repurchase price and the expected market value of the asset as follows:

- If the repurchase price of the asset is more than the expected market value of the asset, then the contract is in effect a financing arrangement. An entity must recognize a financial liability equal to the amount of consideration received, and the asset is not derecognized. Any difference between the consideration received from the customer and the amount paid to the customer in the future when the put right is exercised is recognized as interest expense, and as other holding costs such as insurance if applicable. If the put option lapses unexercised, the entity derecognizes the liability and recognizes revenue.
- If the repurchase price of the asset is less than or equal to the expected market value of the asset, and the customer does not have a significant economic incentive to exercise its right, the entity must account for the contract as if it were the sale of a product with a right of return (see Section 4.3.8).

An entity considers the time value of money when comparing the repurchase price with the selling price of the asset.

BDO INSIGHTS: REPURCHASE AGREEMENTS

The guidance on repurchase agreements in ASC 606 may have a significant impact in some industries. For example, an entity may sell a car to a customer while providing the customer a right to require the entity to repurchase the car for a specified price after a period of time. Careful consideration of the exercise price of a customer put option must determine the nature of the arrangement as a sale or lease. Also, an entity must carefully identify the various parties to the arrangements and their rights or obligations. For example, an entity must consider:

- Whether the entity itself or an unrelated third-party finance entity grants the put option to the customer.
- If an unrelated third-party finance entity grants the put option to the customer, whether there are any associated contractual arrangements between the entity and that third-party finance entity.

Reaching conclusions about accounting for repurchase agreements requires the application of professional judgment based on the facts and circumstances.

[18] See our Blueprint, Accounting for Leases Under ASC 842, for guidance.

EXAMPLE 6-18 (ADAPTED FROM ASC 606-10-55-401 THROUGH 55-407): REPURCHASE AGREEMENTS — PUT OPTION: LEASE

An entity enters a contract with a customer for the sale of an item of equipment on January 1, 20X1, for $10 million.

The contract includes a put option that obliges the entity to repurchase the equipment at the customer's request for $9 million on or before December 31, 20X1. The market value is expected to be $7.5 million on December 31, 20X1.

To determine the accounting for the transfer of the equipment, the entity assesses at contract inception whether the customer has a significant economic incentive to exercise the put option. The entity observes that the repurchase price ($9 million) significantly exceeds the expected market value ($7.5 million) of the asset at the date of repurchase. It therefore concludes that the customer has a significant economic incentive to exercise the put option. The entity determines there are no other relevant factors to consider in assessing whether the customer has a significant economic incentive to exercise the put option.

Therefore, the entity concludes that control of the equipment does not transfer to the customer because the customer is limited in its ability to direct the use of, and obtain substantially all the remaining benefits from, the equipment. The entity accounts for the transaction as a lease under ASC 842.[19]

EXAMPLE 6-19: REPURCHASE AGREEMENTS — CUSTOMER PUT OPTION

A manufacturer of industrial equipment enters a contract with a customer to sell an item of equipment to the customer for a sales price of $750. The cost of manufacturing the equipment is $500. The expected useful life of the equipment is five years.

The contract provides the customer with a right to return the equipment to the manufacturer after two years in exchange for a predetermined amount of $450 (the repurchase price). At contract inception, the fair value of the equipment after two years is expected to be in the range of $425 to $475 with a linear distribution of expected values (that is, the mean of the various estimates is $450). The present value of the repayment obligation, discounted at the entity's incremental borrowing rate of 6%, is $400.

The entity observes the following at contract inception:

- The repurchase price of $450 is less than the original sales price of $750.
- The customer does not have a significant economic incentive to exercise the option to return the equipment because the repurchase price is not significantly more than the expected market value of the equipment, and no other factor would compel the customer to exercise the option.

Therefore, the manufacturer accounts for the transaction as a sale with a right of return (see Section 4.3.8).

[19] See our Blueprint, Accounting for Leases Under ASC 842, for guidance.

6.7 CONSIGNMENT ARRANGEMENTS

FASB REFERENCES

ASC 606-10-55-79 and 55-80

When an entity delivers a product to another party (for example, a dealer, retailer, or distributor) for resale to end customers, the entity must evaluate whether that other party has obtained control of the product at that point in time. A product delivered to another party may be held in a consignment arrangement if that other party has not obtained control of the product.

Indicators that an arrangement is a consignment arrangement include, but are not limited to:

	The product is controlled by the entity until a specified event occurs (for example, the subsequent sale of the product to a customer of the dealer, retailer, or distributor) or until a specified period expires.
	The entity can require the return of the product or transfer the product to a third party (for example, another dealer, retailer, or distributor).
	The dealer, retailer, or distributor does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

BDO INSIGHTS: CONTRACTS WITH PRICE PROTECTION CLAUSES

Sometimes an entity may provide pricing protection to its customers that resell its products to end customers. For example, an entity might provide a retrospective reduction in the purchase price if the entity lowers its price in the future or if the entity agrees to sell similar products to another customer at a lower price. Clauses such as “most favored nation” or “most favored customer” are common for providing such pricing protection to a customer. Further, an entity may allow a customer (reseller) to return unsold items for a refund. While such provisions limit the customer’s risks associated with purchasing the goods, they do not necessarily preclude the customer from obtaining control of the items. Instead, those types of provisions typically result in the price per item being variable (see Section 4.3).

6.8 BILL-AND-HOLD ARRANGEMENTS

FASB REFERENCES

ASC 606-10-55-81 through 55-84

A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but retains physical possession of the product until it is transferred to the customer in the future. For example, a customer may request a bill-and-hold arrangement because it lacks space for the product or has had delays in its production schedules.

When considering whether an entity has satisfied its performance obligation to transfer a product under a bill-and-hold arrangement, an entity must evaluate when the customer obtains control of that product. For some contracts, control of a product is transferred to customer either when the product is delivered to the customer's site or when the product is shipped depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In those cases:

- The customer has the ability to direct the use of and obtain substantially all the remaining benefits from the product even though it has decided not to exercise its right to take physical possession of that product.
- The entity does not control the product but rather provides custodial services to the customer over the customer's asset.

In addition to applying the guidance on transfer of control (see Section 6.2), **all** the following criteria must be met for a customer to have obtained control of a product in a bill-and-hold arrangement:

CHARACTERISTIC	
	The reason for the bill-and-hold arrangement must be substantive (for example, the customer requests the arrangement).
	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 have the ability to use the product or to direct it to another customer.

BDO INSIGHTS: NO ABILITY TO USE THE PRODUCT OR DIRECT IT TO ANOTHER CUSTOMER

The fourth criterion that must be met for a customer to have obtained control of a product in a bill-and-hold arrangement is that an entity must not have the ability to use the product or direct it to another customer. That criterion is not evidenced solely by the fact that the entity has identified and segregated a product separately as belonging to a customer. Rather, it focuses on the notion of control and requires an evaluation of whether the entity continues to have the ability to direct the use of, and derive economic benefits from, a product, even if that product is identified and segregated for a particular customer.

For example, if the product is relatively homogenous such that an entity could use the segregated product to fulfill an order from a different customer and then replace it, the fourth criterion is not met, so the initial customer does not control the product. Conversely, if an entity has already transferred title to the segregated product to the customer, or if the product is serialized and the entity must deliver products with specific serial numbers to the customer, the entity does not have the ability to use that product or redirect it to another customer.

If an entity recognizes revenue for the sale of a product on a bill-and-hold basis, it must consider whether it has any remaining performance obligations (for example, for custodial services) to which its needs to allocate a portion of the transaction price. See Chapters 3 and 5 for discussion on identification of performance obligations and allocation of transaction price to the performance obligations, respectively.

EXAMPLE 6-20 (ADAPTED FROM ASC 606-10-55-409 THROUGH 55-413): BILL-AND-HOLD ARRANGEMENT

An entity enters a contract with a customer on January 1, 20X1, for the sale of an item of equipment and spare parts. The manufacturing lead time for the equipment and spare parts is two years. The promises to transfer the equipment and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time.

Upon completion of manufacturing, the entity demonstrates that the equipment and spare parts meet the contractually agreed specifications.

On December 31, 20X2, the customer pays for both the equipment and spare parts but takes physical possession of the equipment only. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its proximity to the customer's factory.

Following are additional details of the arrangement that indicate all the criteria for transfer of control in the bill-and-hold arrangement are met:

- The customer has legal title to the spare parts.
- The parts can be identified as belonging to the customer.
- The entity stores the spare parts in a separate section of its warehouse.
- The parts are ready for immediate shipment at the customer's request.
- The entity expects to hold the spare parts for two to four years and does not have the ability to use the spare parts or direct them to another customer.

The entity identifies the promise to provide custodial services as a performance obligation because it is a service provided to the customer that is distinct from the equipment and spare parts.

Therefore, the entity accounts for three performance obligations in the contract: the promises to provide the equipment, the spare parts, and the custodial services. The transaction price is allocated to the three performance obligations, and revenue is recognized when or as control transfers to the customer:

- **Equipment:** The entity determines that control of the equipment transfers to the customer on December 31, 20X2, when the customer takes physical possession.
- **Spare parts:** In determining when control of the spare parts transfers to the customer, the entity recognizes revenue for the spare parts on December 31, 20X2, when control transfers to the customer. It notes that:
  - The entity has received payment.

- The customer has legal title to the spare parts.
- The customer has inspected and accepted the spare parts.
- All criteria for transfer of control in the bill-and-hold arrangement are met, which is necessary for the entity to recognize revenue in a bill-and-hold arrangement.

- **Custodial services:** The entity determines that the performance obligation to provide custodial services is satisfied over time as those services are provided.

See Sections 6.2, 6.3, and 6.5 for discussion on transfer of control and whether a performance obligation is satisfied over time or at a point in time.

BDO INSIGHTS: BILL-AND-HOLD ARRANGEMENTS

Under ASC 606, some types of bill-and-hold arrangements may not qualify for revenue recognition until the delivery of the product to the customer's site or shipment (depending on the terms of the contract). Reaching a conclusion on when revenue from a bill-and-hold arrangement is recognized requires the application of professional judgment based on the facts and circumstances.

Further, careful consideration of the terms of bill-and-hold arrangements is required to determine whether there are additional performance obligations (for example, custodial services) to which some of the transaction price for the sale of goods must be allocated. Promises that are immaterial to the contract are not required to be accounted for as distinct performance obligations (see Chapter 3). However, we believe it would be rare for custodial services included in a bill-and-hold arrangement to be considered immaterial in the context of the contract even if the SSP of such services is quantitatively small. To apply bill-and-hold accounting, the reason for the arrangement must be substantive, which indicates that the custodial services are likely important to the customer and thus qualitatively material.

6.9 CUSTOMER ACCEPTANCE

FASB REFERENCES

ASC 606-10-25-30(e) and ASC 606-10-55-85 through 55-88

A customer's acceptance of an asset may indicate that the customer has obtained control of the asset. Customer acceptance clauses allow a customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed specifications. An entity must consider such clauses when evaluating when a customer obtains control of a good or service.

If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed specifications in the contract, customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. An entity would determine whether the criteria related to customer acceptance have been met before receiving confirmation of the customer's acceptance if, for example, the customer acceptance clause is based on meeting objectively measurable criteria such as specified size and weight characteristics of the product. An entity's experience with contracts for similar goods or services may provide evidence that a good or service provided to the customer is in accordance with the agreed specifications in the contract. If revenue is recognized before customer acceptance (for example, upon delivery), the entity still must consider if there are any remaining performance obligations (for example, installation or maintenance of the equipment) and evaluate whether to account for them separately.

If an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed specifications in the contract, the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance. In that situation, the entity cannot determine that the customer can direct the use of, and obtain substantially all the remaining benefits from, the good or service until the customer's acceptance is received.

Also, if an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses.

Chapter 7 — Other Topics



7.1 OVERVIEW — OTHER TOPICS

Other concepts in ASC 606 are critical in applying the five-step revenue recognition model including:

- Principal versus agent considerations
- Contract modification
- Customer options for additional goods or services
- Licensing
- Onerous contracts
- Contract costs

7.2 PRINCIPAL VS. AGENT CONSIDERATIONS

FASB REFERENCES

ASC 606-10-55-36 and 55-36A

ASC 606 includes guidance on performing a principal versus agent assessment when a third party is involved in providing goods or services to a customer. An entity is a principal and therefore recognizes revenue on a gross basis if it controls a good or service before transferring it to the customer. An entity is an agent and therefore recognizes revenue on a net basis if it arranges for a good or service provided by another entity. ASC 606 includes indicators and examples to assist with the analysis.

When a third party is involved in providing goods or services to a customer, an entity must determine whether the nature of its promise is to:

Provide the specified goods or services itself	→	**Principal**
Arrange for those goods or services to be provided by the third party	→	**Agent**

To determine the nature of its promise, an entity must:

- Identify the specified goods or services provided to the customer (for example, a right to a good or service provided by a third party)
- Assess whether it controls each specified good or service before it is transferred to the customer (see Section 7.2.2 for discussion on control).

BDO INSIGHTS: USING THE PRINCIPAL VERSUS AGENT GUIDANCE TO IDENTIFY THE CUSTOMER

The guidance in ASC 606 on performing a principal versus agent assessment is written from the viewpoint of the intermediary entity that obtains a good or service from a third party and subsequently sells that good or service to a customer. In that scenario, the entity may conclude **either** of the following:

- **It is a principal:** The cost of the good or service procured from the third party will be reported as an operating expense (that is, cost of goods sold or cost of services).
- **It is an agent:** The cost of the good or service will be reported net in revenue.

However, in many cases the entity performing the principal versus agent assessment might be the party that provides the good or service to a third party that then transfers the good or service to an end customer. In that scenario, the entity is considered a principal in the transaction because it controls the good or service before transferring it to the interim buyer. The assessment focuses on whether the interim buyer or the end customer is the entity's customer. To identify its customer, the entity must assess whether its immediate buyer is a principal or an agent in the sale to the end customer.

- If the entity concludes that the interim buyer is the principal in the sale to the end customer, its customer is the interim buyer, and the entity's revenue is the amount charged to the interim buyer. Any subsequent increase in price charged to the end customer by the interim buyer is not reflected in the entity's income statement.
- If the entity concludes that the interim buyer is acting as the entity's agent, and the end customer is the entity's customer, the amount charged to the end customer by the interim buyer is recognized as the entity's revenue, and any difference between that amount and the amount charged to the interim buyer is reflected as an operating expense (that is, cost of goods sold, cost of services, or selling expense). However, when an entity does not have visibility into the price charged by the interim buyer to the end customer, that unknown amount is excluded from the entity's revenue (that is, the entity does not estimate the amount charged by the interim buyer to the end customer).

BDO INSIGHTS: INTERRELATIONSHIP BETWEEN IDENTIFYING THE CUSTOMER (STEP 1) AND PERFORMANCE OBLIGATIONS (STEP 2)

The first step in applying the principal versus agent analysis is appropriately identifying the good or service an entity has promised to transfer to the customer (the specified good or service). In some arrangements, identifying the good or service an entity has promised to transfer could inform the conclusion about which party is the entity's customer. In other words, the identification of the entity's obligations could be intertwined with the identification of the entity's customer.

For example, consider a technology platform entity that has developed an app to connect car drivers to end customers to receive car rides. The end customers download the app at no cost to connect with car drivers and make payments to the technology platform entity. If the entity determines that the nature of its promise is to connect the driver to the end customer (rather than to provide ride services to the end customer), it would conclude that its customer is the driver (not the end customer). Identifying the performance obligations and customers requires the application of professional judgment based on the facts and circumstances.

7.2.1 Unit of Account

FASB REFERENCES

ASC 606-10-55-36

An entity must determine whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) provided to the customer (see Chapter 3).

CONTRACTS WITH MULTIPLE SPECIFIED GOODS OR SERVICES

If a contract with a customer includes multiple specified goods or services, an entity could be a principal for some specified goods or services and an agent for others (see Example 7-6).

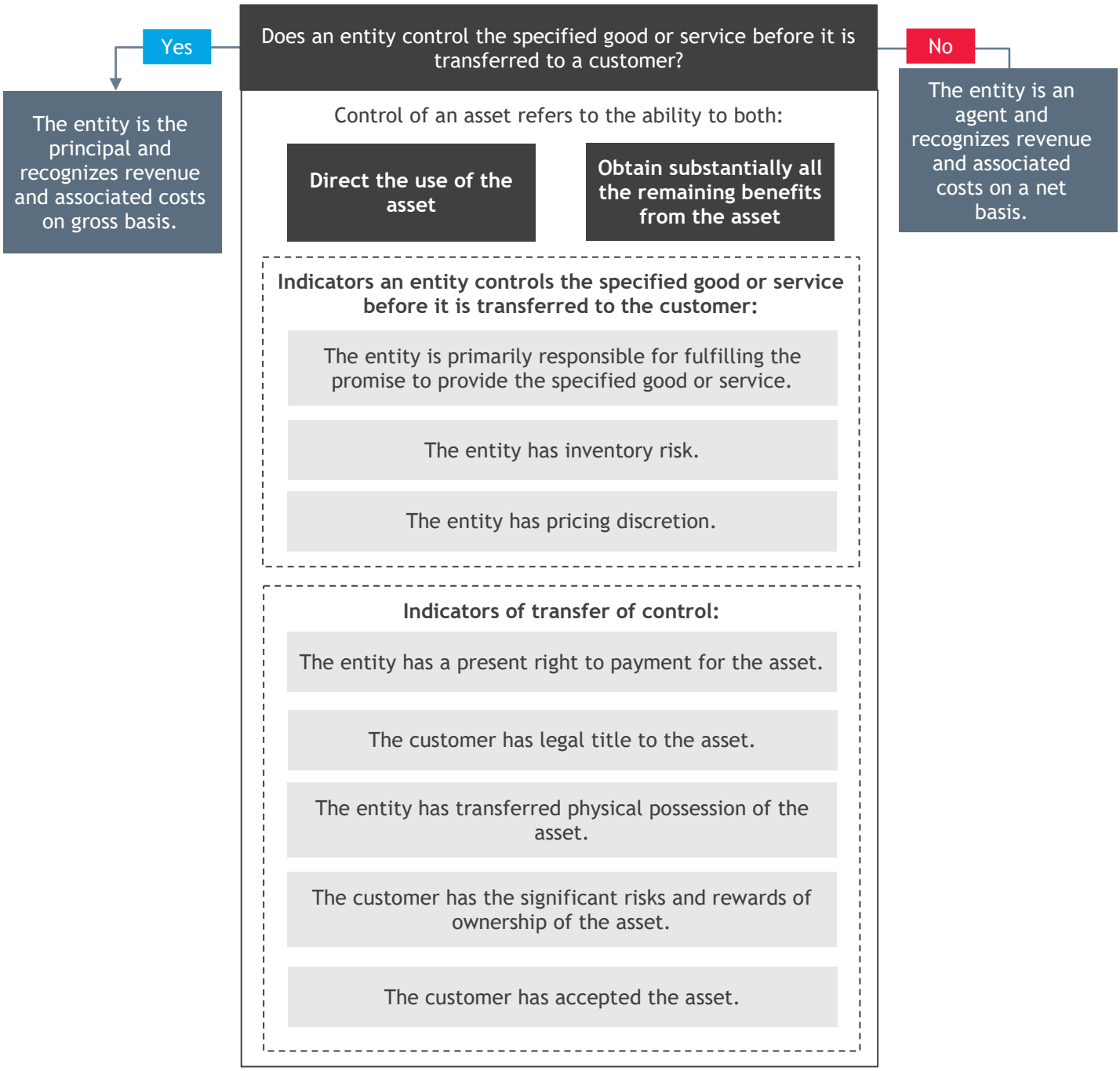
The guidance on principal versus agent considerations in ASC 606 refers to a specified good or service transferred to the customer, rather than to a performance obligation. In BC10 of ASU 2016-08, the FASB stated that the use of the term "performance obligation" would have been confusing if the entity is an agent because an agent's performance obligation is to arrange for the other party to provide goods or services to the customer; the agent does not promise to provide the goods or services itself to the end customer. Accordingly, the good or service provided to the end customer is not the agent's performance obligation.

7.2.2 Assessment of Control

FASB REFERENCES

ASC 606-10-55-37, ASC 606-10-55-37A, and ASC 606-10-55-38

The following diagram illustrates the key considerations in assessing whether an entity controls the specified good or service transferred to a customer and the related accounting outcome:


Does an entity control the specified good or service before it is transferred to a customer?
Yes
The entity is the principal and recognizes revenue and associated costs on gross basis.
No
The entity is an agent and recognizes revenue and associated costs on a net basis.
Control of an asset refers to the ability to both:
Direct the use of the asset
Obtain substantially all the remaining benefits from the asset
Indicators an entity controls the specified good or service before it is transferred to the customer:
The entity is primarily responsible for fulfilling the promise to provide the specified good or service.
The entity has inventory risk.
The entity has pricing discretion.
Indicators of transfer of control:
The entity has a present right to payment for the asset.
The customer has legal title to the asset.
The entity has transferred physical possession of the asset.
The customer has the significant risks and rewards of ownership of the asset.
The customer has accepted the asset.

An entity is:

- A principal if it controls the specified good or service before that good or service is transferred to a customer. An entity that is a principal recognizes revenue when or as it satisfies a performance obligation in the gross amount of consideration to which it expects to be entitled in exchange for the good or service transferred.
- An agent if the entity's performance obligation is to arrange for the provision of the specified good or service by a third party. An entity that is an agent does not control the specified good or service provided by a third party before that good or service is transferred to the customer. An entity that is an agent recognizes revenue when or as it satisfies a performance obligation of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services provided by the other party. That fee or commission may be the net amount of consideration the entity retains after paying the third party the consideration received in exchange for the goods or services provided by that party.

When a third party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

- A good or another asset from the third party that it then transfers to the customer (see Example 7-4)
- A right to a service performed by the third party, which gives the entity the ability to direct that third party to provide the service to the customer on its behalf (see Example 7-3)
- A good or service from the third party that it then combines with other goods or services in providing the specified good or service to the customer (see Example 7-2).

7.2.2.1 Significant Integration Service

An entity controls the specified good or service before that good or service is transferred to the customer if the entity provides a significant service of integrating goods or services (see Section 3.3.2.1) provided by a third party into the specified good or service for which the customer has contracted. In that fact pattern, the entity first obtains control of the inputs to the specified good or service (which include goods or services from third parties) and directs their use to create the combined output that is the specified good or service. For example, an entity that is a principal in providing project management service to a customer may combine specialized equipment manufactured by a third party with the entity's project management service.

BDO INSIGHTS: DETERMINING CONTROL OF AN INPUT TO A COMBINED OUTPUT

When an entity incorporates a good or service it obtains from a third party into a combined good or service it then delivers to a customer, it must control that good or service to integrate it into the combined output. The FASB further clarified this concept in BC30 of ASU 2016-08:

> *"When the entity provides a significant integration service, it controls the inputs to the combined item that is the specified good or service (including goods or services provided by another party that are inputs to the specified good or service). The entity controls the inputs by directing their use to create the combined item."*

However, determining whether an entity controls a good or service obtained from a third party and integrates that good or service into a combined output can be challenging. In a 2021 speech, the SEC staff discussed consultations in which an entity concluded it is a principal because it integrates a good or service received from a third party into its own good or service. The SEC staff indicated that the entity should consider:

- The nature of the integration service
- The significance of the integration service
- Whether it controls the third party good or service before performing the integration service

The SEC staff further noted that it may be unclear how an entity could perform a significant integration service if it does not first control a promised good or service received from a third party.

Determining whether an entity controls a good or service that it integrates into a combined output requires significant judgment based on the facts and circumstances.

7.2.2.2 Effect of Legal Title on Assessment of Control

An entity does not necessarily control a specified good if it obtains legal title to that good only momentarily before legal title is transferred to a customer, which is sometimes referred to as a "flash title."

FLASH TITLE TO A GOOD OR SERVICE

A flash title to a good or service is not a conclusive indicator of control in and of itself.

7.2.2.3 Third Party Engaged by the Principal

An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

If a third party assumes an entity's performance obligations and contractual rights in the contract so that the entity is no longer obliged to satisfy the performance obligation to transfer the specified good or service to the customer (that is, the entity is no longer acting as the principal), the entity does not recognize revenue for that performance obligation. Instead, the entity evaluates whether to recognize revenue for satisfying a performance obligation to obtain a contract for the other party (that is, whether it is acting as an agent).

7.2.3 Indicators of Control

FASB REFERENCES

ASC 606-10-55-39

In some instances, it may not be clear whether an entity controls a good or service before transferring it to a customer. To assist with assessing control, ASC 606 provides the following nonexclusive list of indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore the principal for the specified good or service):

Primary Responsibility	The entity is primarily responsible for fulfilling the promise to provide the specified good or service, which typically includes responsibility for the acceptability of the specified good or service (for example, the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, that could indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.
Inventory Risk	The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer; for example, if the customer has a right of return. If the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that could indicate that the entity has the ability to direct the use of, and obtain substantially all the remaining benefits from, the good or service before it is transferred to the customer.
Discretion in Pricing	The entity has discretion in establishing the price for the specified good or service. Establishing the price the customer pays could indicate that the entity has the ability to direct the use of, and obtain substantially all the remaining benefits from, that good or service. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices to generate more revenue from its service of arranging for goods or services provided by other parties to customers.

INDICATORS OF CONTROL DO NOT OVERRIDE THE CONTROL PRINCIPLE

The indicators of control do not override the control principle (see Section 6.2.1) but rather assist entities in evaluating the control principle. The indicators might be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. Further, different indicators might provide more persuasive evidence in different contracts.

BDO INSIGHTS: INDICATORS OF CONTROL ARE HELPFUL (NOT NECESSARILY CONCLUSIVE)

The control indicators in ASC 606 serve only to help an entity determine whether it controls the good or service being transferred if it is not obvious from the terms of the arrangement. A weighted assessment of the indicators themselves does not necessarily result in a conclusion of principal or agent. Rather, the conclusive determination of principal or agent is made based on the notion of control.

Also, the principal versus agent assessment focuses on the nature of the performance obligation and whether the entity controls the good or service before transferring it to the end customer instead of determining whether the entity is exposed to the risks and rewards of the transaction.

Reaching a conclusion about whether an entity is the principal or agent in a three-party revenue transaction requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 7-1 (ADAPTED FROM ASC 606-10-55-317 THROUGH 55-319): ARRANGING FOR THE PROVISION OF GOODS OR SERVICES — ENTITY IS AN AGENT

An entity operates a website that enables end customers to purchase goods from a range of suppliers that deliver the goods directly to the customers. The key terms of the entity's contracts with suppliers are:

- The entity is entitled to a 10% commission on the sales price of the good purchased when an end customer purchases a good via the entity's website.
- The supplier sets the prices. The entity's website facilitates payment between the supplier and the customer.
- The entity requires payment from end customers before processing orders on its website; all orders are nonrefundable.
- The entity has no further obligations to the end customer after arranging for the goods provided to the customer.

To determine whether the entity's performance obligation is to provide the specified goods itself (that is, the entity is a principal) or to arrange for those goods to be provided by the supplier (that is, the entity is an agent), the entity identifies the specified good or service provided to the customer and assesses whether it controls that good or service before it is transferred to the customer.

The website the entity operates is a marketplace in which suppliers offer their goods to end customers for purchase. Accordingly, the entity determines that the specified goods provided to end customers that use the website are the goods provided by the suppliers and that it promised no other goods or services to end customers.

The entity concludes that it does not have the ability to direct the use of the goods transferred to the end customers at any time because:

- It cannot direct the goods to parties other than the end customer or prevent the supplier from transferring those goods to the end customer.
- It does not control the suppliers' inventory of goods used to fulfill the orders placed by end customers using the website.

Therefore, the entity concludes that it does not control the goods before they are transferred to end customers that order goods using the website. The entity also considered the following indicators that provide further evidence that it does not control the specified goods before they are transferred to the end customers:

- The entity is not obliged to provide the goods if the supplier fails to transfer the goods to the end customer nor is it responsible for the acceptability of the goods. Rather, the supplier is primarily responsible for fulfilling the promise to provide the goods to the end customer.
- The entity does not commit to obtain the goods from the supplier before the goods are purchased by the end customer and does not accept responsibility for any damaged or returned goods. Therefore, the entity does not take inventory risk at any time before or after the goods are transferred to the customer.
- The supplier sets the sales price and the entity does not have discretion in establishing prices for the supplier's goods.

Therefore, the entity concludes that it is an agent and that its performance obligation is to arrange for the provision of goods by the supplier to the end customer. It satisfies its promise to arrange for the goods provided by the supplier to the end customer when the customer purchases the goods. At that point in time, the entity recognizes revenue equal to the agency commission to which it is entitled.

EXAMPLE 7-2 (ADAPTED FROM ASC 606-10-55-320 THROUGH 55-324): PROMISE TO PROVIDE GOODS OR SERVICES — ENTITY IS A PRINCIPAL

An entity enters a contract with a customer to deliver equipment with unique specifications under the following terms:

- The entity and customer develop the specifications for the equipment and negotiate the selling price.
- The entity communicates those agreed specifications for the equipment to a third-party supplier that it contracts with to manufacture the equipment. The entity and supplier agree on a price paid by the entity for that equipment. The entity's profit is based on the difference between the sales price negotiated with the customer and the price charged by the supplier.
- The entity arranges to have the supplier deliver the equipment directly to the customer.
- Upon delivery of the equipment to the customer, the entity is contractually required to pay the supplier the price agreed to by the entity and supplier for manufacturing the equipment.
- The entity invoices the customer for the agreed price with 30-day payment terms.
- The contract between the entity and customer requires the customer to seek from the supplier remedies for defects in the equipment under the supplier's warranty. However, the entity is responsible for any corrections to the equipment resulting from errors in specifications.

To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services provided by another party (that is, the entity is an agent), the entity first identifies the specified good or service provided to the customer and then assesses whether it controls that good or service before it is transferred to the customer.

The entity concludes that it has promised to provide the customer with specialized equipment it designed:

- Although the entity has subcontracted the manufacturing of the equipment to the supplier, the design and manufacturing of the equipment are not distinct because they are not separately identifiable (that is, there is a single performance obligation).
- The entity is responsible for the overall management of the contract (for example, by ensuring the manufacturing service conforms to the specifications) and therefore provides a significant service of integrating those items into the combined output — the specialized equipment — for which the customer has contracted.
- The activities pertaining to the design and overall management of the contract are highly interrelated with the equipment. If necessary, modifications to the specifications are identified as the equipment is manufactured, and the entity is responsible for developing and communicating revisions to the supplier and for ensuring any associated rework required conforms with the revised specifications.

Therefore, the entity identifies the specified good provided to the customer as the specialized equipment.

The entity concludes that it controls the specialized equipment before that equipment is transferred to the customer because:

- The entity provides the significant integration service necessary to produce the specialized equipment.
- The entity directs the use of the supplier's manufacturing service as an input in creating the combined output that is the specialized equipment.
- Even though the supplier delivers the specialized equipment to the customer, the supplier has no ability to direct its use. The terms of the contract between the entity and supplier preclude the supplier from using the specialized equipment for another purpose or directing it to another customer.
- The entity obtains the remaining benefits from the specialized equipment by being entitled to the consideration in the contract from the customer.

Therefore, the entity concludes that it is a principal in the transaction. It does not consider the indicators of control (see Section 7.2.3) because the evaluation is conclusive without them.

The entity recognizes revenue in the gross amount of consideration to which it is entitled from the customer in exchange for the specialized equipment.

EXAMPLE 7-3 (ADAPTED FROM ASC 606-10-55-324A THROUGH 55-324G): PROMISE TO PROVIDE GOODS OR SERVICES — ENTITY IS A PRINCIPAL

An entity enters a contract with a customer to provide cleaning services at the customer's offices under the following terms:

- The entity and customer agree on the scope of the services and negotiate the price.
- The entity is responsible for ensuring the services are performed in accordance with the terms and conditions in the contract.
- The entity invoices the customer monthly for the agreed price with 15-day payment terms.

The entity routinely engages third-party service providers to provide cleaning services to its customers. When the entity obtains a contract from a customer, it enters a contract with one of those third-party service providers, which directs the service provider to perform cleaning services for the customer. While the payment terms in the contracts with the service providers generally are aligned with the payment terms in the entity's contracts with customers, the entity is obliged to pay the service provider even if the customer fails to pay.

To determine whether the entity is a principal or an agent, the entity first identifies the specified good or service provided to the customer and then assesses whether it controls that good or service before it is transferred to the customer.

The specified services provided to the customer are the cleaning services for which the customer contracted, and no other goods or services are promised to the customer. While the entity obtains a right to cleaning services from the service provider after entering the contract with the customer, that right is not transferred to the customer. In other words, the entity retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right. For example, the entity can decide whether to direct the service provider to provide the cleaning services for that customer or another customer, or at its own facilities. The customer does not have a right to direct the service provider to perform services the entity has not agreed to provide. Therefore, the right to cleaning services obtained by the entity from the service provider is not the specified good or service in the contract with the customer.

The entity concludes that it controls the specified services before they are provided to the customer. It obtains control of a right to cleaning services after entering the contract with the customer but before those services are provided to the customer. The terms of the entity's contract with the service provider give the entity the ability to direct the service provider to provide the specified services on the entity's behalf. The entity also concludes that the following indicators of control (see Section 7.2.3) provide further evidence that it controls the cleaning services before they are provided to the customer:

- The entity is primarily responsible for fulfilling the promise to provide cleaning services. Although it has hired a service provider to perform the services promised to the customer, the entity itself is responsible for ensuring the services are performed and are acceptable to the customer. In other words, the entity is responsible for fulfilling the promise in the contract, regardless of whether the entity performs the services itself or engages a third-party service provider to perform the services.
- The entity has discretion in setting the price for the services to the customer.

The entity has mitigated its inventory risk with respect to the cleaning services because it does not commit itself to obtain the services from the service provider before obtaining the contract with the customer. Even so, the entity concludes that it controls the cleaning services before they are provided to the customer based on the evidence outlined above.

Therefore, the entity is a principal in the transaction and recognizes revenue equal to the consideration to which it is entitled from the customer in exchange for the cleaning services. The entity recognizes amounts paid to the third-party service provider as cost of sales.

EXAMPLE 7-4 (ADAPTED FROM ASC 606-10-55-325 THROUGH 55-329): PROMISE TO PROVIDE GOODS OR SERVICES — ENTITY IS A PRINCIPAL

An entity, an airline ticket reseller, negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public. The entity agrees to buy a specific number of tickets and must pay for those tickets regardless of whether it is able to resell them. The reduced rate the entity pays for each ticket is negotiated and agreed in advance.

The entity enters contracts with its customers to resell the tickets. The key terms of its arrangements with its customers are:

- The entity determines the prices at which the airline tickets will be sold to its customers.
- The entity sells the tickets and collects the consideration from customers when the tickets are purchased.
- The entity assists the customers in resolving complaints about the service provided by the airlines. However, each airline (not the entity) is responsible for fulfilling ticket-related obligations, including remedies for customer dissatisfaction with the service.

To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services provided by another party (that is, the entity is an agent), the entity first identifies the specified good or service provided to the customer and then assesses whether it controls that good or service before it is transferred to the customer.

The entity concludes that with each ticket it commits to purchase from the airline, it obtains control of a right to fly on a specified flight (in the form of a ticket) that it then transfers to a customer. Therefore, the entity determines that the specified good or service provided to its customer is the right to a seat on a specific flight and that it controls that right. The entity observes that it promises no other goods or services to the customer.

The entity controls the right to each flight before transferring that specified right to a customer, because:

- The entity has the ability to direct the use of that right by deciding whether to use the ticket to fulfill a contract with a customer and if so, which contract to fulfill.
- The entity has the ability to obtain the remaining benefits from that right by either reselling the ticket and obtaining all the proceeds from the sale or by using the ticket itself.

The following indicators of control (see Section 7.2.3) also provide relevant evidence that the entity controls each specified right (ticket) before it is transferred to the customer:

- The entity has inventory risk because it committed to obtain a ticket from the airline before obtaining a contract with a customer to purchase the ticket. The entity is obliged to pay the airline for that right regardless of whether it is able to obtain a customer to resell the ticket to or can obtain a favorable price for the ticket.
- The entity establishes the price the customer will pay for the specified ticket.

Therefore, the entity concludes that it is a principal in the transactions with customers. It recognizes revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred to the customers.

7.2.4 Determining Whether the Specified Good or Service Is the Right to a Good or Service or the Underlying Good or Service

In a principal versus agent evaluation, it can be challenging to determine when the specified good or service is the right to a good or service and when it is the underlying good or service itself.

For example, in Example 7-4, it could be difficult to determine whether the specified good or service is the flight itself or a right to the flight (that is, the ticket). In BC26 through BC28 of ASU 2016-08, the FASB stated that assessing whether the entity controls a right to a good or service is important to the principal versus agent evaluation and that there may be judgment involved in identifying the specified good or service in some cases. The FASB highlighted some distinctions between the fact patterns in Examples 7-3 and 7-4 (which are adapted from ASC 606):

- In Example 7-4, the ticket reseller itself does not transport the customers, and it cannot change or modify the service (for example, change the flight time or destination). The ticket reseller does not obtain a customer and then

obtain a flight service provider to fulfill its performance obligation to the customer to transport the customer from one location to another. Rather, the ticket reseller obtains tickets before a customer is identified for those tickets. The tickets represent rights to fly on specific flights operated by a third-party airline. The ticket reseller then transfers that specific right to the customer. Therefore, the customer obtains from the ticket reseller a specified asset (the ticket representing the right to fly on a particular flight) that the ticket reseller controlled. The ticket reseller controls a right to fly, which is an asset because the reseller can:

- Direct the use of the ticket by using the ticket itself, selling the ticket to any customer it wants, or letting the ticket expire unused.
- Obtain substantially all the remaining benefits of the ticket by either consuming the right or obtaining all the cash flows from selling that right.

- In contrast, Example 7-3 concludes that the specified good or service is the underlying cleaning services rather than a right to those services. The entity obtains the contract with the customer to provide the cleaning services before it engages a subcontractor (the third-party cleaning services provider) to perform those services. While the entity enters a contract to obtain cleaning services from the subcontractor after entering the contract with the customer (but before the cleaning services are provided to the customer), the right to the subcontractor's services is not transferred to the customer. The entity retains control over that right because it can use the services from the subcontractor as it sees fit (to fulfill the customer contract or another customer contract or to service its own facilities). The customer does not obtain control of the entity's right to direct the subcontractor. It has contracted with the entity for cleaning services and is indifferent as to whether the subcontractor, the entity, or any other subcontractor carries out the cleaning services as long as those services are in accordance with the contractual terms.

In Example 7-4, the customer is not indifferent as to which ticket the ticket reseller transfers to it. The customer wants the ticket reseller to transfer a specific right that it will then control (that is, a ticket for a specific flight).

EXAMPLE 7-5 (ADAPTED FROM ASC 606-10-55-330 THROUGH 55-334): ARRANGING FOR THE PROVISION OF GOODS OR SERVICES — ENTITY IS AN AGENT

An entity sells vouchers that entitle customers to future meals at specified restaurants. The selling price of the voucher provides the customer with a significant discount over the normal meal price. The key terms of the three-party arrangement are:

- The entity purchases vouchers only as customers request them. In other words, the entity does not purchase or commit itself to purchase vouchers in advance of the sale of a voucher to a customer.
- The entity sells the nonrefundable vouchers through its website.
- The entity and the restaurants jointly determine the selling price of the vouchers.
- Under the terms of its contracts with the restaurants, the entity is entitled to 20% of the selling price when it sells the voucher.
- The entity assists the customers in resolving complaints about the meals and has a buyer satisfaction program. However, the restaurant is responsible for fulfilling voucher-related obligations, including remedies for customer dissatisfaction.

To determine whether the entity is a principal or an agent, the entity first identifies the specified good or service to be provided to the customer and assesses whether it controls the specified good or service before that good or service is transferred to the customer.

A customer obtains a voucher for the restaurant it selects. The entity does not engage the restaurants to provide meals to customers on the entity's behalf. Therefore, the entity concludes that the good or service to be provided to the customer is the right to a meal (in the form of a voucher) at a specified restaurant. The customer purchases that right, rather than purchasing the meal itself, and can use that right itself or transfer it to another person. Further, the entity promises no goods or services other than the vouchers to customers.

The entity concludes that it does not control the voucher (right to a meal) at any time by principally considering the following:

- The vouchers are created only when transferred to the customers and therefore do not exist before that. Consequently, the entity does not at any time have the ability to direct the use of the vouchers or obtain substantially all the remaining benefits from them before they are transferred to customers.
- The entity neither purchases, nor commits itself to purchase, vouchers before they are sold to customers. It also has no responsibility to accept any returned vouchers. Therefore, the entity does not have inventory risk related to the vouchers.

Therefore, the entity concludes that it is an agent in the arrangement to sell the vouchers. It recognizes revenue in the net amount of consideration to which it will be entitled in exchange for arranging for the restaurants to provide vouchers to customers for the restaurants' meals, which is the 20% commission it is entitled to upon the sale of each voucher.

EXAMPLE 7-6 (ADAPTED FROM ASC 606-10-55-334A THROUGH 55-334F): ENTITY IS BOTH A PRINCIPAL AND AGENT IN THE SAME CONTRACT

An entity sells services to assist its customers in more effectively targeting potential recruits for open job positions. The entity performs several services, such as interviewing candidates and performing background checks. In addition, the entity arranges for the customer to obtain a license from a third party. The key terms of the three-party arrangement are:

- The customer agrees to obtain a license to access a third-party's database of background information on potential recruits as part of the contract between in and the entity.
- The entity arranges for the license with the third party, but the customer contracts directly with the database provider for the license.
- The database provider sets the price charged to the customer for the license and is responsible for providing technical support and credits to which the customer may be entitled for service downtime or other technical issues.
- The entity collects payment on behalf of the third-party database provider as part of its overall invoicing to the customer.

To determine whether the entity is a principal or an agent, the entity first identifies the specified goods or services provided to the customer and then assesses whether it controls those goods or services before they are transferred to the customer.

The entity concludes that its recruitment services and the database access license are distinct (see Chapter 3). Accordingly, there are two specified goods or services provided to the customer:

- Access to the third-party's database
- Recruitment services

The entity concludes that it does not control the access to the third-party database before it is provided to the customer. It does not have the ability at any time to direct the use of the license because the customer contracts for the license directly with the third-party database provider. The entity does not control access to the provider's database. For example, it cannot grant access to the database to a party other than the customer or prevent the database provider from providing access to the customer.

In reaching that conclusion, the entity also considers the following indicators of control (see Section 7.2.3) that provide further evidence that it does not control access to the database before that access is provided to the customer:

- The entity is not responsible for fulfilling the promise to provide the database access service. The customer contracts for the license directly with the third-party database provider, and the database provider is responsible for the acceptability of the database access (for example, by providing technical support or service credits).

- The entity does not have inventory risk because it does not purchase or commit to purchase the database access before the customer contracts for database access directly with the database provider.
- The entity does not have discretion in setting the price for the database access with the customer because the database provider sets that price.

Therefore, the entity concludes that it is an agent in relation to the third-party's database service. In contrast, the entity concludes that it is the principal in relation to the recruitment services because it performs those services itself and no other party is involved in providing those services to the customer.

BDO INSIGHTS: PRINCIPAL VERSUS AGENT ANALYSIS IS COMPLEX

In practice, determining whether an entity is acting as a principal or an agent can be difficult and may require significant judgment based on the facts and circumstances. We expect those judgments to continue to be challenging when applying the guidance to complex arrangements. For example, transactions involving virtual goods and services are often executed in milliseconds and involve multiple counterparties. Consequently, control over those goods and services might transfer almost instantaneously, making it challenging to assess which party controls those goods and services before they are transferred to the end customer.

Assessing whether an entity is acting as a principal or an agent can also be complex in situations in which two parties collaborate to deliver a product on demand to a customer. Consider an example in which Entity A installs water filtration systems on Entity B's retail premises. The product (filtered water) is delivered on demand by filtering water obtained from a municipal water supplier, with Entity B receiving a portion of the proceeds from the customer. Neither party would appear to control the underlying good (the water) before delivery to the customer, so assessing which entity is acting as the principal or the agent is challenging.

We believe a principal must be identified in any three-party revenue transaction: Gross revenue must be presented by at least one party in a transaction even if significant collaboration exists with other entities in delivering an underlying good or service.

BDO INSIGHTS: SIGNIFICANCE OF CONTRACTS IN PRINCIPAL VERSUS AGENT ANALYSIS

An entity might need to focus on the precise contractual terms in a three-party revenue transaction to determine the nature of the promises made and consideration earned by each party. In determining which party controls the good or service transferred to the end customer, we generally believe the existence of a contract with the end customer is a strong indicator that the counterparty controls the good or service transferred. However, determining whether an entity is the principal or agent requires the application of professional judgment based on the facts and circumstances.

BDO INSIGHTS: DROP SHIPMENT ARRANGEMENTS

Drop shipment arrangements illustrate the complexity of the principal versus agent analysis. Drop shipping is a supply chain management technique in which an entity does not keep physical stock of the goods it sells; instead, it simply arranges for the sale between a customer and its supplier, and the supplier ships the good directly to the customer. That type of arrangement is becoming more common in the online retail environment because it allows online retailers to keep less physical inventory on hand while still servicing their customers. In such instances, physical possession and legal title are likely less relevant in establishing whether the retailer that facilitates the shipment between its supplier and the end customer is a principal or an agent in the transaction. An entity must

carefully consider other factors in determining whether it is acting as a principal or an agent in a drop-ship arrangement, including:

- Does the entity have latitude in establishing price?
- Does the entity receive only a fixed fee for establishing the relationship between the supplier and the customer?
- Who is responsible for customer satisfaction and addressing customer complaints (for example, product quality issues or returns)?
- Are the goods customized or interchangeable for other goods?
- Which entity has the primary (or greater) responsibility toward the customer that receives the goods?
- Which party does the customer think it is buying from?

All those factors can inform the analysis of whether the entity controls the good (that is, whether the entity can direct the use of, and derive substantially all of the benefits from, the good) before it is transferred to the customer.



SEC STAFF GUIDANCE

Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments

Sheri L. York, Professional Accounting Fellow, Office of the Chief Accountant

December 10, 2018

> *In this consultation [that OCA received on this topic], the registrant distributed a wide variety of health-care related goods to retailers. The registrant maintained inventory for the majority of the goods sold; however, for certain specialized goods, the manufacturer shipped the goods directly to the retailer. The registrant managed the return process with the retailer; however, due to regulatory reasons, certain returned goods were returned directly to the manufacturer.*
>
> *The registrant concluded that it was acting as a principal in the arrangement because it controlled the specified good before it was transferred to the customer. That is, the registrant had the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods. As part of its assessment of control, the registrant considered the indicators of control and concluded that it was primarily responsible for fulfillment and had discretion in establishing the price at which the goods were sold to the retailer. The registrant believed that it was primarily responsible for fulfillment based on the terms of the agreement and marketing materials communicated to the customer. In this fact pattern, the registrant was the primary point of contact with the retailer, and was contractually responsible for ensuring that products were acceptable to the retailer, including responsibility for issues related to delivery, quantity, and spoilage.*
>
> *In this fact pattern, the [SEC] staff did not object to the registrant's conclusion that it was the principal in the transaction. Based on my experience, I think it is important to remember that the conclusion as to whether or not an entity is a principal or an agent requires a consideration of the definition of control, often including consideration of the indicators of control, of which inventory risk is only one of the possible indicators. In some circumstances, physical possession will not coincide with control of a specified good.*

7.3 CONTRACT MODIFICATIONS

7.3.1 Identifying Contract Modifications

FASB REFERENCES

ASC 606-10-25-10 and 25-11

A contract modification is defined as a change in the contract's scope or price as approved by the parties. In some industries and jurisdictions, a contract modification may be described as a change order, variation, or amendment. A contract modification exists when the parties to a contract approve a modification that either creates new enforceable rights and obligations for the parties or changes their existing enforceable rights and obligations. A contract modification could be approved in writing, by oral agreement, or implied by customary business practices.

Generally, an entity must continue to apply the guidance in ASC 606 to the existing contract until the contract modification is approved. However, a contract modification may exist even though the parties to the contract have a dispute about the scope or price of the modification or have approved a change in the scope but have not yet determined the corresponding change in price. An entity must consider all relevant facts and circumstances to determine whether the rights and obligations created or changed by a modification are enforceable.

BDO INSIGHTS: DETERMINING WHETHER A CONTRACT MODIFICATION HAS OCCURRED

Determining whether a contract modification has occurred requires the application of professional judgment based on the facts and circumstance. Generally, the legal form of an amendment to an existing contract does not affect the applicability of contract modification guidance. For example, contract modification guidance may apply if an amendment to a contract is legally structured by terminating the existing contract and executing a new contract (rather than executing an amendment to the original contract).

UNPRICED CHANGE ORDERS

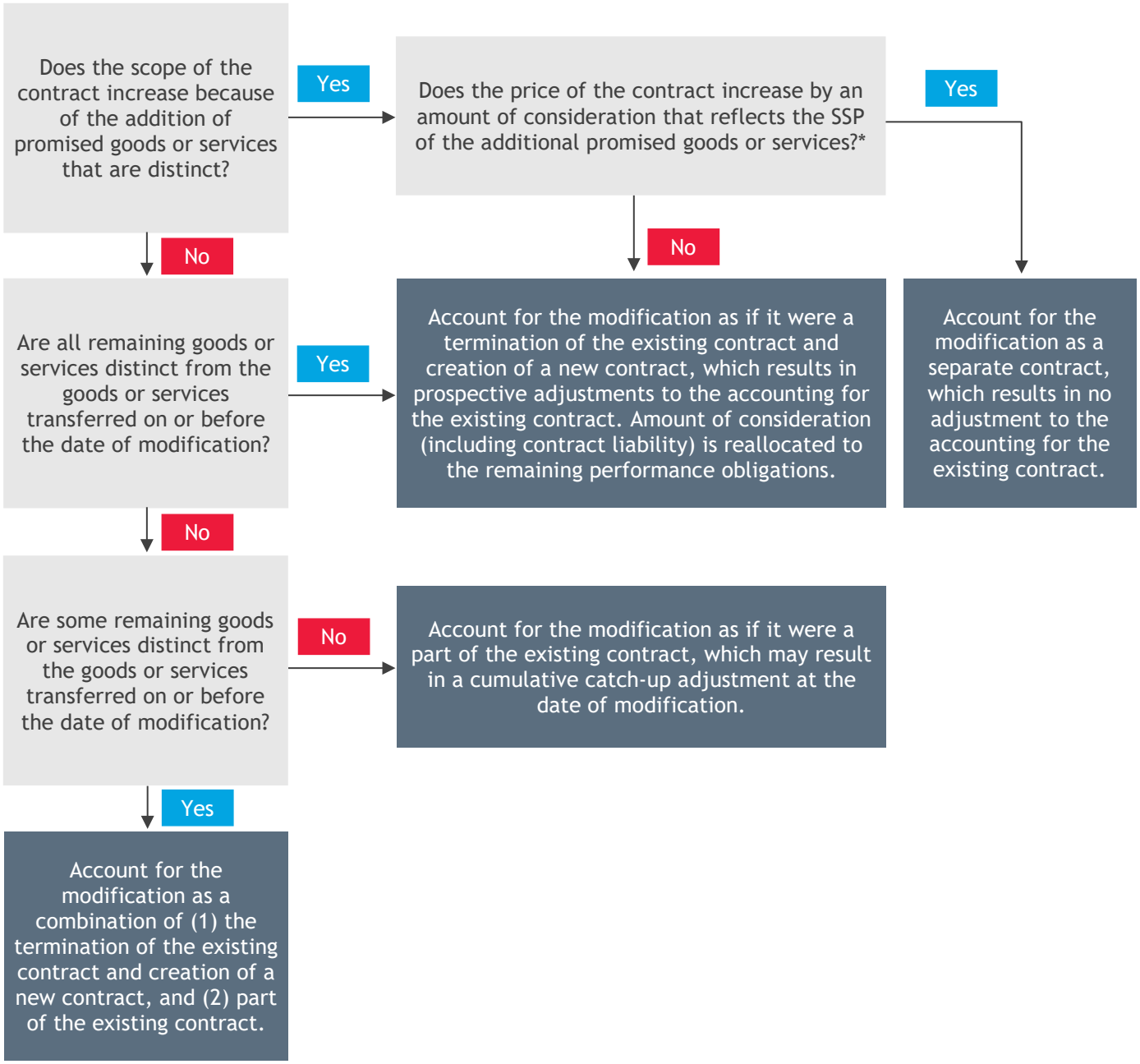
If the parties to a contract have approved a change in scope but have not yet determined the corresponding change in price, an entity must estimate the change to the transaction price arising from the modification in accordance with the guidance on estimating variable consideration and constraining estimates of variable consideration (see Section 4.3).

7.3.2 Accounting for Contract Modifications

FASB REFERENCES

ASC 606-10-25-12 and 25-13

The following diagram provides an overview of the accounting for contract modifications:



*Including any appropriate adjustments to that SSP to reflect the circumstances of the particular contract.

A contract modification is accounted for as a separate contract, and does not affect the accounting for the existing contract in any way, if **both** of the following conditions are met:

- The scope of the contract changes because of the addition of promised goods or services that are distinct
- The price of the contract increases by an amount of consideration that reflects the SSP of the additional promised goods or services, including any appropriate adjustments to that price to reflect the circumstances of the particular contract.

If either of the two conditions stated above are not met, the accounting for the modification depends on whether the promised goods or services under the existing contract that have not yet transferred at the date of the contract modification (that is, the remaining goods or services) are distinct from any additional goods or services arising from the contract modification. The following approaches are applicable based on whether the remaining goods or services are distinct:

- **Termination of the existing contract and creation of a new contract:** If the remaining goods and services are distinct (or are distinct goods or services that constitute a series), the contract modification is accounted for as a replacement of the existing contract with a new contract. Any revenue and cost remaining unrecognized under the existing contract, as well as revenues and costs from the contract modification, are combined and accounted for prospectively as if it were a new contract. In other words, there is no adjustment made to the revenue recognized to date under the existing contract.
- **Continuation of the existing contract:** If the remaining goods and services are not distinct, the contract modification is accounted for as part of the existing contract. That may result in an upward or downward adjustment to revenue recognized to date under the existing contract (that is, a cumulative catch-up adjustment as of the date of the contract modification).
- **Combination of the approaches above:** If some of the remaining goods or services are distinct and others are not, the entity must apply judgment to determine how to account for the effects of the modification on the unsatisfied performance obligations in the modified contract. However, the approach must be consistent with the objectives of the two approaches described above.

BDO INSIGHTS: ACCOUNTING FOR MODIFICATIONS WHEN ONLY SOME REMAINING PERFORMANCE OBLIGATIONS ARE DISTINCT

Accounting for a modification in which only some (not all) of the remaining goods or services are distinct requires the application of professional judgment based on the facts and circumstances. Multiple approaches may be acceptable as long as they are consistent with the objectives of the accounting approaches for a modification that is a termination of the existing contract and creation of a new contract and a modification that is a continuation of the existing contract. See Example 7-12 for an illustration of one acceptable approach.

While accounting for a modification that increases the scope (or promised goods or services) in a contract is more straightforward, significant judgment may be required in accounting for a modification that includes changes other than to increase the scope of the existing contract. Examples 7-7 and 7-8 illustrate the accounting for:

- A modification to increase the quantity of goods sold to the customer
- A modification to increase the quantity of goods sold to the customer and provide a concession related to the goods already delivered under the existing contract.

BDO INSIGHTS: MODIFICATIONS THAT REDUCE THE SCOPE OF A CONTRACT

A modification may result in a reduction in the scope of a contract. This type of modification cannot be treated as a separate contract, as that approach requires the addition of promised goods or services that are distinct. Instead, a modification that reduces the scope of a contract will be accounted for as either the termination of the existing contract and creation of a new contract or a continuation of the existing contract (or a combination of the two approaches) based on whether the remaining goods and services to be transferred are distinct from the goods and services already transferred.

EXAMPLE 7-7 (ADAPTED FROM ASC 606-10-55-111 THROUGH 55-116): MODIFICATION OF A CONTRACT FOR GOODS — ADDITIONAL GOODS FOR A PRICE THAT REFLECTS THE STANDALONE SELLING PRICE

An entity enters a contract with a customer to sell 120 goods for $12,000 (that is, $100 per good). The goods are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 goods to the customer, the contract is modified to require the delivery of an additional 30 goods (for a total of 150 identical goods) to the customer.

The contract modification provides that the price for the additional 30 goods is an additional $2,850 (that is, $95 per good).

At the date of contract modification, the entity determines that:

- The pricing for the additional goods reflects the SSP of the goods at that date.
- The additional products are distinct from the goods provided under the original contract.

Therefore, the entity accounts for the contract modification for the additional 30 goods as in effect a new and separate contract for future goods that does not affect the accounting for the existing contract. The entity recognizes revenue of $100 per good for the 120 goods in the original contract and $95 per good for the 30 goods in the new contract.

EXAMPLE 7-8 (ADAPTED FROM ASC 606-10-55-111 THROUGH 55-116): MODIFICATION OF A CONTRACT FOR GOODS — ADDITIONAL GOODS FOR A PRICE THAT DOES NOT REFLECT THE STANDALONE SELLING PRICE

Assume that in the fact pattern in Example 7-7, the parties agree on a price of $80 per good as the price for the additional 30 goods. However, after that negotiation, the customer discovers that the initial 60 goods transferred to the customer contained minor defects that were unique to those delivered goods. The entity and customer agree that:

- The entity will issue a partial credit of $15 per item to compensate the customer for the poor quality of those 60 goods (that is, $900 credit for 60 goods).
- The credit of $900 will be incorporated into the price the entity charges for the additional 30 goods.

As a result, the contract modification specifies that the price for the additional 30 goods is $1,500 ($50 per good), which consists of the agreed price for the additional 30 goods of $2,400 ($80 per good) less the credit of $900.

At the time of modification:

- The entity recognizes the $900 credit as a reduction of the transaction price and therefore as a reduction of revenue for the initial 60 goods (each a distinct performance obligation) transferred. That is because the $900 concession relates to the 60 goods previously delivered.
- In evaluating the contract modification for the sale of the additional 30 goods, the entity determines that:
  - The remaining goods delivered are distinct from those already transferred.
  - The negotiated price of $80 per good does not reflect the SSP of the additional goods.

Therefore, the entity accounts for the contract modification as a termination of the original contract and creation of a new contract.

As a result, the amount of revenue recognized for each of the remaining goods is a blended price of $93.33 ((($100 * 60 goods not yet transferred under the original contract) + ($80 * 30 goods transferred under the contract modification)) /90 remaining goods).

EXAMPLE 7-9 (ADAPTED FROM ASC 606-10-55-117 THROUGH 55-124): CHANGE IN THE TRANSACTION PRICE AFTER A CONTRACT MODIFICATION

On June 1, 20X0, an entity promises to transfer Products A and B to a customer. Product A transfers to the customer at contract inception and Product B transfers on March 1, 20X1.

The consideration in the contract includes fixed consideration of $1,000 and variable consideration estimated at $200 at contract inception. Both products have the same SSP.

The entity includes its estimate of variable consideration in the transaction price because it concludes that it is probable that a significant reversal in cumulative revenue recognized will not occur when the uncertainty related to the variable consideration is resolved. Therefore, the transaction price for the contract is $1,200.

The criteria for the variable consideration allocation exception (see Section 5.5) are not met. Based on the relative SSPs of the two products, the entity allocates the transaction price of $1,200 equally to the performance obligations for Products A and B.

The entity recognizes revenue of $600 when Product A transfers to the customer at contract inception.

On November 30, 20X0, the scope of the contract is modified to:

- Add a promise to transfer Product C (in addition to the undelivered Product B under the original contract) to the customer on June 1, 20X1.
- Increase the price of the contract by $300 (fixed consideration), which does not represent the SSP of Product C, which is the same as the SSP of Products A and B.

At the date of the contract modification, the entity determines that:

- The remaining Products B and C are distinct from Product A, which transferred to the customer before the modification.
- The promised consideration for the additional Product C does not represent that product's SSP.

The entity accounts for the contract modification as if it were the termination of the existing contract and the creation of a new contract. As a result, the consideration allocated to the remaining performance obligations (Products B and C) is $900, which consists of:

- The transaction price from the original contract that had been allocated to Product B — $600
- The consideration promised in the modification — $300.

The $900 transaction price for the modified contract is allocated equally to the performance obligations for Products B and C based on their relative SSPs (that is, $450 is allocated to each performance obligation).

After the modification but before the delivery of Products B and C, the entity revises its estimate of the amount of variable consideration to which it expects to be entitled to $240 (rather than the previous estimate of $200). The entity concludes that the change in estimate of the variable consideration can be included in the transaction price because it is probable that a significant reversal in cumulative revenue recognized will not occur when the uncertainty is resolved.

Even though the modification was accounted for as if it were the termination of the existing contract and the creation of a new contract, the increase in the transaction price of $40 is attributable to variable consideration promised before the modification. Therefore, the change in the transaction price (a $40 increase) is allocated to the performance obligations for Products A and B on the same basis as at contract inception (see Section 4.8). That $40 increase in transaction price is accounted for as follows:

- The entity recognizes revenue of $20 for Product A in the period in which the change in the transaction price occurs.
- Because Product B had not transferred to the customer before the contract modification, the change in the transaction price that is attributable to Product B ($20) is allocated to the remaining performance obligations at the time of the contract modification. That is consistent with the accounting that would have been required if

that amount of variable consideration had been estimated and included in the transaction price at the time of the contract modification.

- Therefore, the entity allocates the $20 increase in the transaction price for the modified contract equally to the performance obligations for Products B and C because the products have the same SSPs and the variable consideration allocation exception criteria are not met (see Section 5.5). Consequently, the amount of the transaction price allocated to the performance obligations for Products B and C increases by $10 to $460 each.

On March 1, 20X1, the entity transfers Product B to the customer and recognizes revenue of $460. On June 1, 20X1, the entity transfers Product C to the customer and recognizes revenue of $460.

EXAMPLE 7-10 (ADAPTED FROM ASC 606-10-55-125 THROUGH 55-128): MODIFICATION OF A SERVICES CONTRACT — INTERACTION OF THE CONTRACT MODIFICATION GUIDANCE AND THE SERIES PROVISION

An entity enters a three-year contract with a customer to clean the customer's offices weekly. The customer promises to pay $200,000 annually. The SSP of the services at contract inception is $200,000 annually. The entity recognizes revenue of $200,000 per year during the first two years of providing services.

At contract inception, the entity concludes that each week of cleaning service is distinct. It determines that the weekly cleaning services are a series of distinct services that are substantially the same and have the same pattern of transfer to the customer (that is, the services transfer to the customer over time and use the same method (time-based) to measure progress). Therefore, even though each week of cleaning service is distinct, the entity accounts for the cleaning contract as a single performance obligation (see Chapter 3).

At the end of the second year, the entity and customer modify the contract:

- The fee for the third year is reduced to $160,000.
- The customer agrees to extend the contract for three additional years for consideration of $400,000 payable in three equal annual installments of $133,333 at the beginning of years 4-6.

At the date of the modification, the entity determines:

- The additional services (for years 4-6) are distinct.
- The SSP of the additional services at the date of contract modification (that is, the beginning of the third year) is $160,000 per year. The entity's SSP at the date of contract modification, multiplied by the additional three years of services, is $480,000, which is considered an appropriate estimate of the SSP of the multiyear contract.
- The price for the additional years of service does not reflect the SSP of the additional services.

Therefore, the entity accounts for the modification as if it were a termination of the original contract and the creation of a new contract with consideration of $560,000 for four years of cleaning service. The entity recognizes revenue of $140,000 per year ($560,000 divided by four years) as the services are provided over the remaining four years.

EXAMPLE 7-11 (ADAPTED FROM ASC 606-10-55-129 THROUGH 55-133): MODIFICATION RESULTING IN A CUMULATIVE CATCH-UP ADJUSTMENT TO REVENUE

A construction entity enters a contract with a customer to construct a building on a piece of land owned by the customer. The contract provides for fixed consideration of $2 million and a performance bonus of $400,000 if the building is completed within 24 months of contract inception.

The entity determines that the contract includes a single performance obligation (to construct the building). It also determines that the customer controls the building during construction and that its performance obligation is therefore satisfied over time (see Chapters 3 and 6).

At contract inception, in determining whether to include the bonus in the transaction price, the entity observes:

- The completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals.
- The entity has limited experience with similar types of contracts.

Therefore, the entity does not include the $400,000 bonus in the transaction price because it cannot conclude that it is probable that a significant reversal of cumulative revenue recognized will not occur (see Section 4.3).

At contract inception, the entity determines that a cost-based input measure provides an appropriate measure of progress toward complete satisfaction of the performance obligation.

The entity expects the following at contract inception:

Transaction Price	$ 2,000,000
Expected Costs	1,400,000
Expected Profit (30%)	$ 600,000

By the end of the first year, the entity has satisfied 60% of its performance obligation based on costs incurred to date ($840,000) relative to total expected costs ($1.4 million). The entity reassesses the variable consideration and concludes that the bonus is still fully constrained. Therefore, the cumulative revenue and costs recognized for the first year are:

Revenue	$ 1,200,000
Expected Costs	840,000
Expected Profit (30%)	$ 360,000

In the first quarter of the second year, the entity and customer agree to modify the contract by changing the floor plan of the building. As a result:

- The fixed consideration and expected costs increase by $300,000 and $240,000, respectively. In other words, total potential consideration after the modification is $2.7 million ($2.3 million fixed consideration plus $400,000 performance bonus).
- The allowable time for achieving the $400,000 bonus is extended to 30 months from the original contract inception date.

At the date of the modification, the entity considers its experience and the remaining work to be performed (which is primarily inside the building and not subject to weather conditions) and concludes it is probable that including the bonus in the transaction price will not result in a significant reversal of cumulative revenue recognized. Therefore, the entity includes the $400,000 in the transaction price.

In assessing the appropriate accounting for the contract modification, the entity concludes that the remaining goods and services provided under the modified contract are not distinct from the goods and services transferred on or before the date of contract modification.

Therefore, the entity accounts for the contract modification as if it were part of the original contract:

- The entity updates its measure of progress at the date of contract modification and estimates that it has satisfied 51.2% of its performance obligation ($840,000 actual costs incurred divided by $1.64 million total expected costs).
- The entity recognizes additional revenue of $182,400 [(51.2% complete multiplied by the $2.7 million modified transaction price) less $1.2 million revenue recognized to date] at the date of the modification as a cumulative catch-up adjustment.

EXAMPLE 7-12: MODIFICATION OF A CONTRACT — APPLICATION OF A COMBINATION OF MODIFICATION ACCOUNTING APPROACHES WHEN ONLY SOME REMAINING GOODS OR SERVICES ARE DISTINCT

A technology entity enters a contract with a customer to provide the following goods and services:

- Three-year software license
- Significant software customizations
- One year of PCS, including maintenance and helpdesk services

At contract inception, the software customization services are expected to take four months. When customization services are 40% completed, a rival entity releases software that has additional functionality not currently available in the technology entity's software. The entity agrees to add the new functionality as part of the customization services at no extra cost to the customer. It expects the additional functionality to take an additional two months to complete.

At contract inception, the entity determines that the contract includes two performance obligations (see Chapter 3):

- Customized software
- PCS

Also at contract inception, the entity determines that:

- The customized software is transferred over time to the customer because the customer controls the customized software during customization.
- The PCS is transferred over time to the customer because the customer simultaneously receives and consumes its benefit.

(See Chapter 6.)

At the effective date of the modification, the entity observes that its remaining goods and services include:

- Remaining goods or services for the customized software with added functionality.
- PCS, which has not transferred to the customer yet and will be transferred to the customer after the software customizations are complete.

In assessing the appropriate accounting for the contract modification, the entity concludes that some of the remaining goods and services provided under the modified contract are distinct from the goods and services transferred on or before the date of contract modification, and that some are not.

- The customized software is in process at the effective date of the modification. The customization efforts completed before the contract modification are not distinct from the customization efforts remaining after the contract modification.
- The PCS is distinct from the customized software.

The entity accounts for the contract modification by applying a combination of the two modification accounting approaches (that is, the termination of the existing contract and the creation of a new contract and the continuation of the existing contract) as follows:

- Arrangement consideration is reallocated between the two performance obligations based on the SSP of the customized software, updated to reflect the additional promised functionality and the original SSP of the PCS.
- Amounts allocated to the customized software are accounted for as part of the existing contract (that is, as a continuation of the existing contract) and a cumulative catch-up adjustment is made to reflect the new measure of progress.
- Amounts allocated to the PCS are accounted for as the termination of the existing contract and creation of a new contract and are deferred until the software customizations are completed and the PCS period begins.

BDO INSIGHTS: CONTRACT MODIFICATION GUIDANCE

The application of the contract modification guidance requires the application of professional judgment based on the facts and circumstances. The accounting outcome is based on whether the modified promises for goods or services are distinct and whether the distinct promises are priced at their SSPs.

Further, application of the contract modification guidance to some contracts for which revenue is recognized over time (for example, construction contracts and software application development contracts) could result in a downward or upward cumulative catch-up adjustment to revenue at the date of contract modification.

Therefore, entities must carefully evaluate changes in the scope or pricing of existing customer contracts to appropriately account for the effects of modifications on the amount and timing of revenue recognition.

7.4 CUSTOMER OPTIONS FOR ADDITIONAL GOODS OR SERVICES

Customer options to acquire additional goods or services for free or at a discount come in many forms, including:

- Sales incentives
- Customer award credits (or points)
- Contract renewal options
- Other discounts on future goods or services.

7.4.1 Material Right

FASB REFERENCES

ASC 606-10-25-16A and 25-16B, ASC 606-10-25-18(j), ASC 606-10-32-29, and ASC 606-10-55-42 through 55-45

An entity may grant its customer an option that allows the customer to purchase additional goods or services as part of or in conjunction with a contract. The option represents a promised good or service when the option provides the customer with a material right. In other words, customer options for additional goods or services may represent a performance obligation in Step 2 (see Chapter 3).

7.4.1.1 Identification of a Material Right (a Performance Obligation in Step 2)

FASB REFERENCES

ASC 606-10-55-42 through 55-43

Customer options for future goods or services represent a material right to the customer and hence a performance obligation in the contract if the option provides a material right to the customer that it would not receive without entering that contract. Therefore, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market represents a material right. Conversely, if the option allows the customer to acquire an additional good or service at a price that would reflect the SSP for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract.

A material right is a performance obligation identified in Step 2 of the five-step revenue recognition model, so the subsequent steps related to allocation of transaction price and recognition of revenue must be applied.

IMMATERIALITY EXCEPTION IN IDENTIFYING THE PERFORMANCE OBLIGATIONS IS NOT AVAILABLE FOR A MATERIAL RIGHT

An entity cannot apply the immateriality exception in identifying the performance obligations in Step 2 (see Section 3.2.5) to a customer option that is determined to represent a material right.

BDO INSIGHTS: PURCHASES OF PRODUCTS IN THE FUTURE AT COST

Some arrangements allow a customer to purchase products from an entity in the future at a price equal to the entity's cost. For example, licensing arrangements entered by life science entities may allow a licensee to purchase a drug compound for clinical trials at cost. Such an option typically constitutes a material right because:

- A market participant would charge a reasonable margin when selling the compound.
- The customer would not have received the option had it not entered the licensing arrangement with the entity.

TRG DISCUSSIONS: ASSESSMENT OF WHETHER AN OPTION GIVES RISE TO A MATERIAL RIGHT

In October 2014, the TRG discussed two issues from the evaluation of whether customer options to acquire additional goods and services give rise to a material right:

- Whether the evaluation should be performed only in the context of the current transaction or whether it should factor in past and expected future transactions.
- Whether the evaluation should consider both qualitative and quantitative factors.

Most TRG members agreed that the evaluation should **both**:

- Factor in past, present, and future transactions.
- Consider qualitative factors, such as whether the right accumulates over time, as happens with loyalty points.

TRG DISCUSSIONS: ASSESSMENT OF WHETHER VARIABLE QUANTITY CONSTITUTES A PURCHASE OPTION OR VARIABLE CONSIDERATION

In November 2015, the TRG considered how an entity should determine whether a contractual right to acquire additional goods or services represents an option to purchase additional goods and services or variable consideration based on a variable quantity. That question might arise, for example, if a software entity grants 500 licenses to use software for a fixed fee of $500,000, with the price for additional users being $800.

TRG members agreed that all facts and circumstances should be considered when analyzing contracts with similar provisions and that this analysis requires judgment. However, they concluded that the first step in distinguishing between optional goods or services and variable consideration for promised goods or services is to identify:

- The nature of the entity's promise to the customer.
- The parties' enforceable rights and obligations.

With an option for additional goods or services, the customer has a present right to choose to purchase additional distinct goods or services (or change the goods and services delivered). Before the customer exercises that right, the entity is not obligated to provide those goods or services and the customer is not obligated to pay for them.

In contrast, in the case of variable consideration for a promised good or service, the entity and customer previously executed a contract that requires the entity to transfer the promised good or service and the customer to pay for that promised good or service. The future events that trigger payment of additional consideration to the entity occur after or as control of the goods or services have or are transferred. When a contract includes variable consideration based on a customer's actions, those actions do not oblige the entity to provide additional distinct goods or services (or change the goods or services transferred). Instead, they resolve the uncertainty from the amount of variable consideration the customer is obligated to pay.

7.4.1.2 Allocation of Transaction Price to Customer Options: Determination of Standalone Selling Price (Step 4)

FASB REFERENCES

ASC 606-10-55-44 through 55-45

When applying the general allocation model to allocate the transaction price to performance obligations on a relative SSP basis (see Section 5.2.1), an entity must estimate the SSP for a material right if the SSP of the option is not directly observable. That estimate must reflect the discount the customer would obtain when exercising the option, adjusted for **both** of the following:

- Any discount the customer could receive without exercising the option.
- The likelihood that the option will be exercised.

However, when the material right represents a renewal option, an entity may use an alternative approach to allocate the consideration (see Section 7.4.2).

7.4.1.3 Revenue Recognition for a Material Right (Step 5)

If an option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services. Therefore, the entity must recognize the related revenue when **either** of the following applies:

- Those future goods or services are transferred.
- The option expires.

If an option does not provide a material right to the customer, the entity has made a marketing offer, which is accounted for in accordance with ASC 606 only when the customer exercises the option to purchase the additional goods or services.

EXAMPLE 7-13 (ADAPTED FROM ASC 606-10-55-134 AND 55-135): OPTION THAT PROVIDES THE CUSTOMER WITH A MATERIAL RIGHT — DISCOUNT VOUCHER

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

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

To estimate the SSP of the discount voucher, the entity estimates that:

- There is an 80% likelihood that a customer will redeem the voucher.
- On average, a customer will purchase $50 of additional products.

Thus, the entity's estimated SSP of the discount voucher is $12 ($50 average purchase price of additional products times the 30% incremental discount times the 80% likelihood of exercising the option).

Based on the relative SSPs of the shirt and discount voucher, the entity allocated the $100 transaction price as follows:

PERFORMANCE OBLIGATION	SSP
Shirt	$ 100
Discount voucher	12
Total	**$ 112**

PERFORMANCE OBLIGATION	ALLOCATED TRANSACTION PRICE
Shirt	$ 89 ($100 * ($100/$112))
Discount voucher	11 ($100 * ($12/$112))
Total	$ 100

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

EXAMPLE 7-14 (ADAPTED FROM ASC 606-10-55-134 AND 55-135): OPTION THAT DOES NOT PROVIDE THE CUSTOMER WITH A MATERIAL RIGHT — ADDITIONAL GOODS OR SERVICES

A telecommunications entity enters a contract with a customer to provide a handset and monthly network service for three years. The network service includes up to 1,500 call minutes and 2,000 text messages each month for a fixed monthly fee. The customer may choose to purchase additional call minutes or texts in any month at contractually specified prices that are equal to their SSPs.

The entity determines that the promises to provide the handset and network service are separate performance obligations (see Chapter 3) because:

- The customer can benefit from the handset and network service on their own or with other resources that are readily available.
- The handset and network service are separately identifiable.

In analyzing the customer's option to purchase additional minutes or texts, the entity observes that the prices of additional minutes and texts reflect their SSPs. Therefore, the entity concludes that the option to purchase additional minutes and texts does not provide a material right that the customer would not receive without entering the contract. Rather, the entity has made a marketing offer that is accounted for in accordance with ASC 606 only when the customer exercises the option.

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

EXAMPLE 7-15 (ADAPTED FROM ASC 606-10-55-353 THROUGH 55-356): CUSTOMER LOYALTY PROGRAM

A retail entity has a customer loyalty program that rewards a customer with one loyalty point for every $10 of purchases. Each point is redeemable for a $1 discount on any future purchases of the entity's products. During a reporting period, customers purchase products for $100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed, and the SSP of the purchased products is $100,000.

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

Based on the historical data and other relevant evidence, the entity estimates that 9,500 points are expected to be redeemed. Based on the likelihood of redemption, the entity estimates an SSP of $0.95 per loyalty point, for a total value of points earned during the period of $9,500.

The entity allocates the transaction price of $100,000 to the product and the loyalty points on a relative SSP basis as follows:

Product	$ 91,324 ($100,000 * ($100,000/$109,500))
Points	$ 8,676 ($100,000 * ($9,500/$109,500))

At the end of the first reporting period, 4,500 points have been redeemed, and the entity continues to expect 9,500 points to be redeemed in total. The entity recognizes the following related to the loyalty points at the end of the first reporting period:

- Revenue of $4,110 [(4,500 points/9,500 points) * $8,676]
- A contract liability of $4,566 ($8,676 – $4,110) for the unredeemed points

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

BDO INSIGHTS: CUSTOMER LOYALTY ARRANGEMENTS AND PRINCIPAL VERSUS AGENT CONSIDERATIONS

The accounting illustrated in Example 7-15 might not apply to all customer loyalty arrangements because the terms and conditions might differ. Especially when there are more than two parties to the arrangement, an entity must consider all facts and circumstances to determine the customer in the transaction that gives rise to the award credits. For example, a bank may issue loyalty points to a credit card customer that can be redeemed by the customer at a third-party entity such as an airline, hotel, or restaurant. An entity must consider principal versus agent considerations to appropriately account for three-party revenue transactions (see Section 7.2). Accounting for customer loyalty programs requires the application of professional judgment based on facts and circumstances.

7.4.2 Renewal Options

FASB REFERENCES

ASC 606-10-55-45

A renewal option is different from customer loyalty programs, discount vouchers, and many other discounts on future goods or service. With loyalty programs and vouchers, the underlying goods or services often differ from the goods or services in the original contract. A renewal option, in contrast, gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. Because of that difference, an entity may elect a practical alternative to estimate the SSP of a renewal option that constitutes a material right.

BDO INSIGHTS: EFFECT OF TERMINATION PROVISIONS ON ENFORCEABLE RIGHTS AND OBLIGATIONS

As discussed in Section 2.3.2, the revenue recognition model is applied to the period in which enforceable rights and obligations exist between an entity and its customer. If the customer has the unilateral right to terminate the contract without incurring a substantial penalty, for accounting purposes, the contract term is limited to the period before the date the termination right can be exercised. Because the customer has the right to elect not to exercise the termination option, periods after that date are economically the same as renewal options and are assessed when determining whether the contract includes a material right.

Instead of estimating the SSP of the renewal option directly, an entity can elect a practical alternative to allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration if **both** of the following conditions are met:

- The additional goods or services are similar to the original goods or services in the contract (that is, an entity continues to provide additional goods or services that are similar to what it was already providing). As a result, it may be more intuitive to view the goods or services underlying such options as part of the initial contract.
- The additional goods or services are provided in accordance with the terms of the original contract. As a result, their pricing cannot be changed beyond the parameters specified in the original contract.

In essence, that alternative approach allows an entity to treat the material right as if the optional goods or services were additional promises in the contract and the consideration to be received when the option is exercised as additional consideration. (See Section 7.5.3.3 for a discussion of rights to renew licenses of IP.)

BC393 of ASU 2014-09 states that the practical alternative requires an entity to include the optional goods or services that it expects to provide and the corresponding consideration that it expects to receive in the initial measurement of the transaction price. The FASB reasoned that it would be simpler for an entity to view a contract with renewal options as a contract for its expected term (that is, including the expected renewal periods) rather than as a contract with a series of renewal options.

EXAMPLE 7-16 (ADAPTED FROM ASC 606-10-55-343 THROUGH 55-352): OPTION THAT PROVIDES THE CUSTOMER WITH A MATERIAL RIGHT — RENEWAL OPTION

An entity enters 100 separate contracts with customers to provide one year of maintenance services for $10,000 per contract. The key terms are:

- At the end of the year, each customer has the contractual right (or option) to renew the maintenance contract for a second year by paying an additional $10,000.
- Customers that renew for a second year are granted the option to renew for a third year for $10,000.
- If customers do not sign up for the maintenance services initially (when the products are new) or if they allow the services to lapse, the entity charges significantly higher prices for annual maintenance services:
  - $30,000 in Year 2
  - $50,000 in Year 3

The entity evaluates the customer's renewal option for maintenance services in Step 2 and determines that:

- The renewal option provides a material right to the customer that it would not receive without entering the contract because the price for maintenance services is significantly higher if the customer elects to purchase the services only in Year 2 or 3.
- Part of each customer's payment of $10,000 in Year 1 is, in effect, a nonrefundable prepayment of the services provided in a subsequent year.

Thus, the entity concludes that the promise to provide the renewal option is a performance obligation.

The entity then observes that the renewal option is for a continuation of maintenance services provided in accordance with the terms of the existing contract.

In accordance with the practical alternative for estimating the SSP of a renewal option, the entity allocates the transaction price by determining the consideration it expects to receive in exchange for all the services it expects to provide under the renewal options (instead of determining the SSPs for the renewal options directly).

At contract inception, the entity estimates that:

- 90 customers are expected to renew at the end of Year 1 (90% of contracts sold).
- 81 customers are expected to renew at the end of Year 2 (90% of the 90 customers that renewed at the end of Year 1 will also renew at the end of Year 2).

Therefore, the entity determines that at contract inception, the expected consideration for each contract is $27,100 [$10,000 + (90% * $10,000) + (81% * $10,000)].

The entity also determines that recognizing revenue based on costs incurred relative to the total expected costs depicts the transfer of services to the customer.

Estimated costs for a three-year contract are:

Year 1	$ 6,000
Year 2	7,500
Year 3	10,000

Accordingly, the pattern of revenue recognition expected at contract inception for each contract is:

	EXPECTED COSTS ADJUSTED FOR LIKELIHOOD OF CONTRACT RENEWAL	ALLOCATION OF CONSIDERATION EXPECTED
Year 1	$ 6,000 ($6,000 * 100%)	$ 7,799 [($6,000/$20,850) * $27,100]
Year 2	6,750 ($7,500 * 90%)	8,773 [($6,750/$20,850) * $27,100]
Year 3	8,100 ($10,000 * 81%)	10,528 [($8,100/$20,850) * $27,100]
Total	**$ 20,850**	**$ 27,100**

Therefore, at contract inception, the entity allocates $220,100 of the consideration received to date (cash of $1 million less revenue of $779,900 ($7,799 * 100) to be recognized in Year 1) to the option to renew at the end of Year 1.

Assuming there is no change in the entity's expectations and the 90 customers renew as expected, at the end of Year 1, the entity has collected cash of $1.9 million [(100 * $10,000) + (90 * $10,000)], recognized revenue of $779,900 ($7,799 * 100), and recognized a contract liability of $1,120,100.

Consequently, upon renewal at the end of Year 1, the entity allocates $242,800 to the option to renew at the end of Year 2 (cumulative cash of $1.9 million less cumulative revenue of $1.657 million ($780,000 + $8,773 * 100) recognized in Year 1 and to be recognized in Year 2).

If the actual number of contract renewals differs from what it expected, the entity would update the transaction price and the revenue recognized accordingly.

EXAMPLE 7-17: GYMNASIUM MEMBERSHIP — RENEWAL OPTION

An entity operates gymnasiums for its members. To become a member, a customer must pay a one-time upfront joining fee of $1,000 and an annual membership fee. At the end of each year, the customer has a right to renew the membership by paying the annual membership fee.

At contract inception, the entity concludes that the upfront joining fee does not relate to the transfer of a promised good or service and instead represents an advance payment for future gym services.

To determine whether to recognize the upfront fee over the contract period (for example, one year) or based on expected renewal behavior (for example, potentially longer than one year), the entity must assess whether the renewal option provides a material right to the customer.

The entity observes that:

- The upfront joining fee in effect entitles the customer to renew the contract by paying the annual membership fee and avoiding the upfront joining fee in subsequent years.
- Because a member is not required to pay the upfront fee in renewal periods, the upfront fee essentially results in a discounted fee for subsequent membership periods when compared with the fee payable upon signing a new membership.

The entity concludes that the renewal option (that is, the customer's option to continue to purchase gymnasium services beyond Year 1) provides a material right to the customer and therefore is a separate performance obligation.

The entity estimates the number of renewal options customers are expected to exercise and allocates the upfront fee plus the total annual fees for the current term and each expected renewal period to the current term and the expected renewal periods. Practically, that may result in:

- Straight-line recognition of the upfront fee over the expected membership term.
- Recognition of each annual membership fee over the annual period to which it relates.

TRG DISCUSSIONS: ACCOUNTING FOR A CUSTOMER'S EXERCISE OF A MATERIAL RIGHT — CONTINUATION OF A CONTRACT OR CONTRACT MODIFICATION

ASC 606 does not provide explicit guidance on the accounting model to apply when a customer exercises an option that is a material right. The question that arises is whether it should be considered:

- A continuation of the original contract whereby the additional consideration would be allocated to the material right.
- A contract modification, which could require consideration to be reallocated between performance obligations.
- Variable consideration.

In March 2015, TRG members agreed that the exercise of a material right should be viewed as a continuation of the contract but also acknowledged the FASB staff's view that it would be reasonable for an entity to account for it as either a continuation of the contract or a contract modification. The TRG rejected the possibility of treating the amount allocated to the material right as variable consideration.

Further, TRG members observed that in most, but not all, cases, the outcome of applying either acceptable approach would be similar. Only when the optional goods or services are determined not to be distinct from the original promised goods or services would the results appear to differ because the application of the contract modification guidance may result in a cumulative catch-up adjustment to the revenue recognized (see Section 7.3). However, the FASB staff observed that an entity typically would conclude that an optional good or service is distinct.

BDO INSIGHTS: POLICY ELECTION TO ACCOUNT FOR A CUSTOMER'S EXERCISE OF A MATERIAL RIGHT

Based on the TRG discussions on accounting for a customer's exercise of a material right as either a continuation of a contract or a contract modification, an entity needs to make an accounting policy election regarding the approach it uses to account for the exercise of a material right. Determining the appropriate method to account for a customer's exercise of a material right requires the application of judgment. An entity must consistently apply the method elected to similar types of material rights with similar facts and circumstances.

EXAMPLE 7-18: RENEWAL OPTION — SPORTS SEASON TICKETS

An entity, a professional football club, regularly offers season tickets for the following season (Season 1) for $5,000. However, as part of a promotion drive, it offers customers the opportunity to buy a season ticket for the following season (Season 1) for $8,000, which will also grant those customers the right to a 25% discount off the standard season ticket price for the next four seasons (Seasons 2-5).

At contract inception, the entity makes the following estimates:

- The price of annual season tickets in future years is expected to remain at $5,000.
- All customers that purchase a Season 1 ticket for $8,000 are expected to exercise the option to purchase season tickets at a discount in Seasons 2-5 (that is, a 100% renewal rate is expected).

The entity determines that the practical alternative for estimating the SSP of a renewal option applies because the services provided in Seasons 2-5:

- Are similar to the services provided in Season 1.

- Will be provided in accordance with the terms of the existing contract. The entity does not have a contractual right to change or withdraw the 25% discount offer.

Under the practical alternative election, the total transaction price is allocated to all season tickets expected to sell over the five-year period (that is, Seasons 1-5). In effect, the contract is viewed as a single contract for its expected term of five years (not a one-year contract with a series of renewal options) because all renewal options are expected to be exercised.

As a result, the total consideration receivable ($8,000 in Season 1 plus $3,750 for each of Seasons 2-5) is recognized evenly over the five-year period, resulting in revenue of $4,600 (($8,000 + ($5,000 * 4 * 0.75))/5) being recognized in each year.

For simplicity, no adjustment has been made for any potential financing component.

For each Season 1 ticket sold for $8,000, it would not be appropriate for the entity to recognize $5,000 during Season 1 and allocate $3,000 to customer renewal options for Seasons 2-5 (rather than allocating $8,000 to all five seasons based on relative SSPs). That approach would result in separate contracts being accounted for in the initial and subsequent periods instead of a single overall contract for a five-year period. The allocation of $3,000 to Seasons 2-5 would also be similar to the use of a residual approach for the allocation of the transaction price to the renewal options, which would be inappropriate.



TRG DISCUSSIONS: ANALYZING CUSTOMER LIFE TO DETERMINE WHETHER A NONREFUNDABLE UPFRONT FEE PROVIDES A MATERIAL RIGHT TO THE CUSTOMER

In March 2015, the TRG discussed whether a one-time nonrefundable upfront fee (for example, an initial fee for a health club membership or an activation fee related to telecommunication services) provides the customer with a material right. Members said an entity's average customer life might indicate whether an upfront fee provides the customer with a material right. For example, a customer life that extends beyond a one-month contractual period may indicate the upfront fee encourages the customer to continue purchasing a health club membership or telecommunication services because the customer will not be charged an additional initial or activation fee in subsequent months, as opposed to incurring a similar upfront fee with a new entity.

BDO INSIGHTS: ANALYZING CUSTOMER LIFE TO DETERMINE THE EXISTENCE OF A MATERIAL RIGHT

While we agree that an entity's average customer life might indicate whether an upfront fee provides the customer with a material right consistent with the TRG discussions on analyzing customer life to determine whether a nonrefundable upfront fee provides a material right to the customer, we do not believe that the average customer life is necessarily indicative of the **number** of renewal options a customer is expected to exercise. For example, consider a health club that sells health club membership on monthly basis in exchange for a monthly fee. A new customer is required to pay a significant nonrefundable upfront payment in the first month. Assume that the health club has determined that the average customer life is 5 years. In determining the number of renewal options a new customer is expected to exercise, the health club considers that while the customer can renew its membership indefinitely without being required to pay the upfront fee again, the incentive (that is, a discount on future purchases) inherent in the upfront fee for the customer to continue purchasing the health club membership might not remain significant to the customer after a period shorter than the average customer life.

Additionally, customer life depends on both parties wanting to continue the relationship. For instance, gym memberships and telecommunication services are often provided month to month. In practice, there is no requirement for entities to guarantee the availability of monthly services, such that customers are the only parties

with renewal rights. In those scenarios, the entities typically reserve the right to discontinue services in their terms and conditions. However, we believe a material right might still exist based on the reasonable expectation of additional purchases, as opposed to only those situations in which the customer obtains an enforceable right to additional purchases after the initial term. We believe that approach is consistent with the discussion in BC87 of ASU 2014-09, which states that promises in a contract do not need to be enforceable by law but rather are identified based on a customer's expectations. If the customer has a valid expectation that the entity will transfer a good or service, the customer would view those promises as part of the negotiated exchange.

Analyzing the accounting for upfront fees and determining the average customer life require the application of professional judgment based on the facts and circumstances.

7.4.3 Early Renewal Rights

Entities often offer noncancelable contracts that provide customers with the option to renew the contract before contract expiry. That practice is common in the telecommunications industry and other industries in which a product is sold at the inception of the contract with ongoing services provided over the contract period (see Section 7.5.3.3 for a discussion of rights to renew licenses of IP).

EXAMPLE 7-19: EARLY RENEWAL RIGHT — TELECOMMUNICATION DEVICE AND SERVICES

An entity in the telecommunications industry contracts with customers to sell a device and a package of services. The key terms are:

- The contract has a 24-month noncancelable term.
- Customers must pay in 24 equal monthly installments. The entity allocates each installment between the device and the services on the same basis.
- The contract states that the customer has the option to renew at any time after 21 months without penalty. No recovery is made for installments that would have been made during the period from renewal up to the end of the original 24-month contract period.
- The early renewal results in the customer's obtaining a new device and the same services for a subsequent 24 months from the renewal date.
- The renewed contract is priced at the SSP for that contract when the customer exercises the early renewal right.

The entity needs to determine the appropriate accounting for the customer's option to renew early (that is, before the end of the full 24-month contract term).

The entity observes that the early renewal right was embedded in the enforceable rights and obligations agreed by the parties at contract inception. Therefore, the early renewal option is not a contract modification because it is not an amendment to the parties' original rights and obligations. ASC 606 states that a *"contract modification exists when the parties to the contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract."*

The entity observes that the option to renew early affects the amount of consideration it expects to be entitled to for the device provided to the customer at contract inception. The amount of consideration could vary depending on when customers exercise the option to renew. Further, because customers renew at the SSP, there is no material right. Consequently, the amount of consideration allocated to the device is considered variable.

The entity must therefore estimate the amount of variable consideration to which it will be entitled, subject to the constraint on variable consideration. As a result, variable consideration (that is, the monthly installments between months 21 and 24) will be recognized as revenue only to the extent that it is probable that there will not be a significant reversal of cumulative revenue recognized when the uncertainty over the variable consideration is resolved (see Section 4.3).

In this case, the uncertainty will be resolved when it is known whether the customers will exercise their early renewal rights, which will affect the allocation of monthly installments between:

- The handset, for which revenue will be recognized upon transfer of control to the customer (generally at contract inception), with a related receivable being settled through the partial allocation of future monthly installments (see Chapter 8).
- The services, for which revenue will be recognized over the period of the contract.

The amount of variable consideration expected to be received will depend on the facts and circumstances in each case. However, to consider a period of more than 21 months for part or all of the customer base, clear evidence would be required of the expected pattern of exercise of the early renewal option.

7.4.4 Customers' Unexercised Rights: Breakage

FASB REFERENCES

ASC 606-10-45-2 and ASC 606-10-55-46 through 55-49

A customer's nonrefundable prepayment to an entity gives the customer a right to receive a good or service in the future and obliges the entity to stand ready to transfer a good or service. Upon receipt of a prepayment from a customer, an entity must recognize a contract liability in the amount of the prepayment for its performance obligation to transfer, or to stand ready to transfer, goods or services in the future (see Chapter 8).

An entity must derecognize that contract liability and recognize revenue when it transfers those goods or services and therefore satisfies its performance obligation. However, customers might not always exercise all their contractual rights. Those unexercised rights are often referred to as "breakage." Common examples include:

- Forfeited balances on gift cards.
- Unredeemed loyalty points or air miles.
- Nonrefundable theatre and travel tickets, with the customer forgoing amounts paid in advance if they do not attend the event.
- Declining to exercise a renewal option that is accounted for as a material right.

Depending on whether an entity expects to be entitled to a breakage amount, it accounts for any resulting breakage as:

- If an entity expects to be entitled to a breakage amount in a contract liability, it recognizes the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer.
- If an entity does not expect to be entitled to a breakage amount, it recognizes the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote.

CONSIDER VARIABLE CONSIDERATION CONSTRAINT TO DETERMINE BREAKAGE

To determine whether it expects to be entitled to a breakage amount, an entity must consider the guidance in Section 4.3 on constraining estimates of variable consideration. Specifically, an entity must recognize breakage revenue only to the extent that it is probable that there will not be a significant reversal of cumulative revenue recognized when the uncertainty related to the breakage is subsequently resolved.

BDO INSIGHTS: REVENUE RECOGNITION FOR A CONTRACT WITH MINIMUM VOLUME GUARANTEE

A contract with a minimum volume guarantee, often called a "take-or-pay arrangement" requires a customer to pay for a specified volume of goods or services even if it does not ultimately purchase the specified minimum volume of goods or services. Typically, such contracts will include a penalty equal to the difference between the contractual minimum and the amount actually purchased. Contractual minimums generally create enforceable rights and obligations for an entity to transfer the minimum volume of the product to a customer and the customer to purchase the minimum volume of the product and pay for it (see Section 2.3).

In many cases, an entity expects at contract inception that the customer will fulfill its obligation and purchase at least the contractual minimum. However, the entity may subsequently conclude that it is probable that the customer will not purchase the minimum volume and thus the penalty will apply. ASC 606 does not explicitly address that scenario. Therefore, we believe the following alternative approaches may be acceptable based on the facts and circumstances of the arrangement:

- An entity applies the guidance on breakage to:
  - Estimate the breakage revenue for the performance obligation it does not expect to have to satisfy. For example, an entity does not expect the customer to purchase a minimum number of goods required by the contract.
  - Determine the timing/pattern for recognizing breakage revenue.
- The entity applies the contract modification guidance if the customer does not purchase the minimum specified volume of goods or services (see Section 7.3).

See Example 7-20A for illustration of this concept.

An entity must not recognize breakage revenue for any consideration received that must be remitted to another party, for example, to a government entity in accordance with applicable unclaimed property laws. Instead, the entity reports a liability due to the relevant third party, rather than a contract liability or deferred revenue.

BDO INSIGHTS: ACCOUNTING FOR BREAKAGE LIABILITIES MAY REQUIRE LEGAL ANALYSIS

Determining whether breakage liabilities are subject to unclaimed property laws is a legal question and may require judgment. Because the laws often vary by state, an entity could have multiple breakage liabilities that are accounted for differently. As such, entities may need to discuss their fact patterns with unclaimed property specialists. Accounting for breakage liabilities requires the application of professional judgment based on the facts and circumstances.

Separately, this guidance does not address the accounting for dormancy or other fees charged to holders of unused stored-value products.

EXAMPLE 7-20: OPTION THAT PROVIDES THE CUSTOMER WITH A MATERIAL RIGHT — BREAKAGE

An entity sells 10,000 season tickets for $8,000 each that grant customers the right to a 25% discount in each of the subsequent Seasons 2-5. At the start of Season 1, the entity has received $80 million, of which $46 million is recognized as revenue in Season 1 and $34 million relates to customers' renewal options.

The two extremes of potential outcomes are:

- If no customer exercises its renewal option, $80 million would be received for Season 1.
- If every customer exercises its renewal options for all of Seasons 2-5, $8.5 million will be recognized as revenue in each of Seasons 2-5 (that is, $34 million, or $850 per season ticket holder per season).

The contractual terms of the renewal option stipulate that if a customer fails to renew a season ticket in any year, it loses its right to the 25% discount in all subsequent seasons. For example, if a season ticket holder renews at a 25% discount in Season 2 but does not renew its season ticket in Season 3, it would lose its right to a 25% discount in Seasons 4 and 5.

At the start of Season 2:

- The price of a standard season ticket increases to $5,500.
- 800 customers do not exercise their renewal option and forfeit their rights to a 25% discount in Seasons 3-5.
- 9,200 customers renew season tickets at $4,125, which is the standard price of $5,500 less the 25% discount.

The entity has no prior experience offering such discounts to customers and therefore cannot rely on historical experience to estimate whether it will be entitled to any breakage. However, it considers that the customers paid a premium for the current season tickets to obtain the future discount, indicating that most expect to exercise their renewal rights. Consequently, the entity concludes that it cannot recognize any of the $34 million as breakage revenue before knowing whether customers have forfeited their option (that is, by not renewing their season ticket). To do otherwise could result in a significant reversal of revenue in future periods of the amount of breakage recognized. Therefore, the entity does not recognize any revenue in Season 1 for breakage.

At the start of Season 2, the entity recognizes $2.72 million as breakage ($850 * 800 * 4). That recognition reflects that 800 customers have forfeited their renewal rights (valued at $850 per season for each of Seasons 2-5) and is therefore accounted for as additional revenue earned for services provided in Season 1. The entity also recognizes:

- $7.82 million during Season 2 ($850 * 9,200) reflecting that 9,200 customers exercised their renewal right for Season 2.
- $37.95 million during Season 2 ($4,125 *9,200) reflecting the amounts paid by those 9,200 customers for the price paid for the Season 2 ticket.

EXAMPLE 7-20A: A CONTRACT WITH A MINIMUM VOLUME COMMITMENT

An entity enters a master services agreement (MSA) with a customer to supply a product according to the MSA's terms and conditions. The MSA provides that the customer will place purchase orders for the quantity of products needed throughout the two-year MSA term and that each purchase order will be subject to the MSA's terms and conditions. The MSA includes a minimum volume commitment under which the entity guarantees the supply of the product, and the customer agrees to purchase a minimum volume of 5,000 units of the product at $10 per unit during the contract term. If the customer fails to purchase the minimum volume required, the entity has the right to charge a penalty equal to the value of the shortfall.

Assume that:

- The MSA creates enforceable rights and obligations for the entity to transfer the minimum volume of the product to the customer and the customer to purchase the minimum volume of the product and pay for it according to the MSA's pricing information and payment terms.
- Each unit of the product is distinct.
- The performance obligation for each product is satisfied at a point in time.

The entity determines that the transaction price is $50,000 (5,000 units of product x $10 per unit of product).

At the end of Year 1, the entity concludes it is now probable that because of changes in its business, the customer will purchase only 4,000 units before the end of the contract term. Therefore, the entity expects to invoice the customer for the shortfall of $10,000 ((5,000 units of product guaranteed – 4,000 units purchased) x $10 per unit of product) at the end of Year 2. The entity could apply **either** of the following approaches to recognize revenue:

Approach A: Breakage Model

At contract inception, the entity concluded it was probable that the customer would purchase at least 5,000 units of product and that it therefore would not be entitled to breakage revenue.

The entity continuously updates its estimate of breakage throughout the contract term in accordance with the guidance on breakage and variable consideration. At the end of Year 1, the entity determines that it expects to be entitled to breakage revenue in the amount of $10,000. It therefore recognizes the estimated breakage as revenue in proportion to the pattern of rights exercised by the customer (that is, in proportion to revenue recognized for the products purchased by the customer).

Approach B: Contract Modification Model

The entity recognizes revenue for the products as they are transferred to the customer. If the customer purchases fewer than 5,000 units, the entity applies the contract modification guidance. As discussed in Section 7.3.2, the modification would be accounted for as the termination of the existing contract and the creation of a new contract. That is because the change results in a reduction in the scope of the contract, and the products transferred before the change are distinct from the products remaining to be transferred. Under that approach, the entity does not estimate breakage.

BDO INSIGHTS: PERPETUAL CUSTOMER OPTIONS

In some cases, customer options are perpetual and do not have expiration dates (for example, air miles often have no expiry date). Some have questioned whether an entity applies the guidance on unexercised rights (or breakage) in those cases. We believe the guidance on constraining estimates of variable consideration applies to all customer options, such as breakage liabilities, including those that are perpetual.

The guidance on a customer option that is a material right requires an entity to estimate the SSP of the option at contract inception. In determining the option's SSP, an entity must consider the likelihood that the option will be exercised. It also must recognize any change in the likelihood that the option will be exercised when estimating the measure of progress of the performance obligation related to the option.

In other words, the option's SSP is not updated after contract inception. Rather, the entity updates its estimate of the portion of the option that will be redeemed, which results in the entity recognizing revenue in proportion to the pattern of recognition of other performance obligations in the contract.

Once the options expected to be exercised have actually been exercised, the entity no longer recognizes a contract liability for the options.

When a single option exists and the portfolio approach is not or cannot be applied, the SSP of the option would still include the likelihood that the option will be exercised. The revenue related to the option would be recognized when the option is exercised or when it is determined that the likelihood of the option being exercised becomes remote.

BDO INSIGHTS: TRACKING DATA TO ACCOUNT FOR BREAKAGE REVENUE COULD BE CHALLENGING

The model for recognizing breakage revenue can be challenging to apply in practice. For example, to recognize breakage in proportion to the pattern of rights expected to be exercised for gift cards that are expected to expire unused, an entity must track gift card redemptions based on when the cards were sold. Entities should proactively work with any third-party program managers to ensure the managers will be able to provide adequate tracking and related reporting to support the entities' recognition of breakage.

7.5 LICENSING

FASB REFERENCES

ASC 606-10-55-54 through 55-65B, ASC 985-20-15-5, and ASC 985-20-20: Hosting Arrangement

The promised good or service in a contract may include granting a license that establishes a customer's rights over the IP of an entity. Licenses of IP might include licenses of:

- Technology, such as drug compounds or technical designs
- Media and entertainment (for example, motion pictures, music, podcasts)
- Franchises
- Patents, trademarks, and copyrights

A software license is also a license of IP because it establishes a customer's rights over the IP of a software entity. However, software subject to a hosting arrangement may not be a license for purposes of applying the implementation guidance in ASC 606 related to licenses. ASC 985-20, *Software — Costs of Software to be Sold, Leased or Marketed,* defines a hosting arrangement as "*In connection with accessing and using software products, an arrangement in which the customer of the software does not currently have possession of the software; rather, the customer accesses and uses the software on an as-needed basis.*" Software provided in a hosting arrangement is often referred to as software-as-a-service, or SaaS.

To determine whether a contract with a customer includes a software license for accounting purposes, a software entity needs to determine whether **both** of the following criteria are met for a hosting arrangement:

- The customer has the contractual right to take possession of the software at any time without significant penalty.
- It is feasible for the customer to run the software on its own hardware or contract with an unrelated party to host the software.

The contract includes a software license for accounting purposes if both criteria are met. Conversely, if either one of the criteria is not met then the contract does not include a software license for accounting purposes (regardless of the contractual terms) and the software entity is providing SaaS to the customer.

BDO INSIGHTS: DETERMINING WHETHER A SOFTWARE ENTITY HAS GRANTED A LICENSE REQUIRES JUDGMENT

Determining whether a software entity has granted a software license to its customer requires judgment. To reach an appropriate accounting conclusion, it is critical to thoroughly understand the solution being provided and what access rights the customer has. In practice, an arrangement that meets the definition of a license is often referred to as an "on premise" or "on prem" solution which reflects the fact that the software is or could be delivered to the customer and the customer could install and run it on its own hardware.

Given the unique nature of a license, ASC 606 includes implementation guidance to assist with the application of the five-step revenue recognition model to licenses.

7.5.1 Identification of Performance Obligations in a Contract That Includes a License (Step 2)

FASB REFERENCES

ASC 606-10-55-54 through 55-57

An entity may explicitly or implicitly promise to transfer other goods or services to the customer in addition to a promise to grant a license. When a contract with a customer includes a promise to grant a license (or licenses) in addition to other promised goods or services, an entity applies the guidance to identify each distinct promised good or service (that is, a performance obligation) in the contract, consistent with the requirement in Step 2 for any other contracts with customers that include multiple promises. See Chapter 3 for discussion of determining whether a promised good or service is distinct.

If the promise to grant a license is not distinct from other promised goods or services in the contract, an entity must account for the promise to grant a license and those other promised goods or services together as a single performance obligation.

Licenses that are not distinct from other goods or services promised in the contract include:

- A license that forms a component of a tangible good and is integral to the functionality of the good.
- A license the customer can benefit from only in conjunction with a related service; for example, an online service provided by the entity that, by granting a license, enables the customer to access content.

When a single performance obligation includes a license (or licenses) of IP and one or more other goods or services, an entity considers the nature of the combined good or service for which the customer has contracted when:

- Determining whether that combined good or service is satisfied over time or at a point in time (see Section 7.5.2 and Chapter 6).
- Selecting an appropriate method for measuring progress if the combined good or service is satisfied over time (see Section 6.4).

In considering the nature of the combined good or service for which the customer has contracted, an entity must also consider whether the license that is part of the single performance obligation provides the customer with a right to use or a right to access IP.

BDO INSIGHTS: INITIAL ADMINISTRATIVE OR SET UP ACTIVITIES

An entity may perform certain initial administrative or set up activities when selling a software license or SaaS to a customer. To determine whether those activities are separate promises (and potential performance obligations) or fulfillment activities, the entity must determine whether those activities provide an incremental benefit to the customer (that is, a benefit beyond granting the software license or access to SaaS).

For example, initial account set up activities may be necessary for the customer to access the hosted software to derive the benefits of a SaaS subscription. In that case, the initial account set up activities do not directly transfer additional services to the customer and hence are not separate promises.

Conversely, an entity may perform certain services upfront that provide incremental benefits to the customer (that is, benefits beyond granting the software license or access to SaaS). For example, an entity may provide data migration services to migrate historical data from a customer's existing systems to its SaaS platform. Additional examples of initial activities in a software arrangement that might be separate promises rather than fulfillment activities include certain customer-specific customization or training to use the software effectively.

We generally observe that initial activities that can be provided by a third party are promised services, not fulfillment activities. However, the converse is not true. An initial activity that cannot be provided by a third party may nonetheless represent either a promised service or a fulfillment activity. For example, consider an entity that

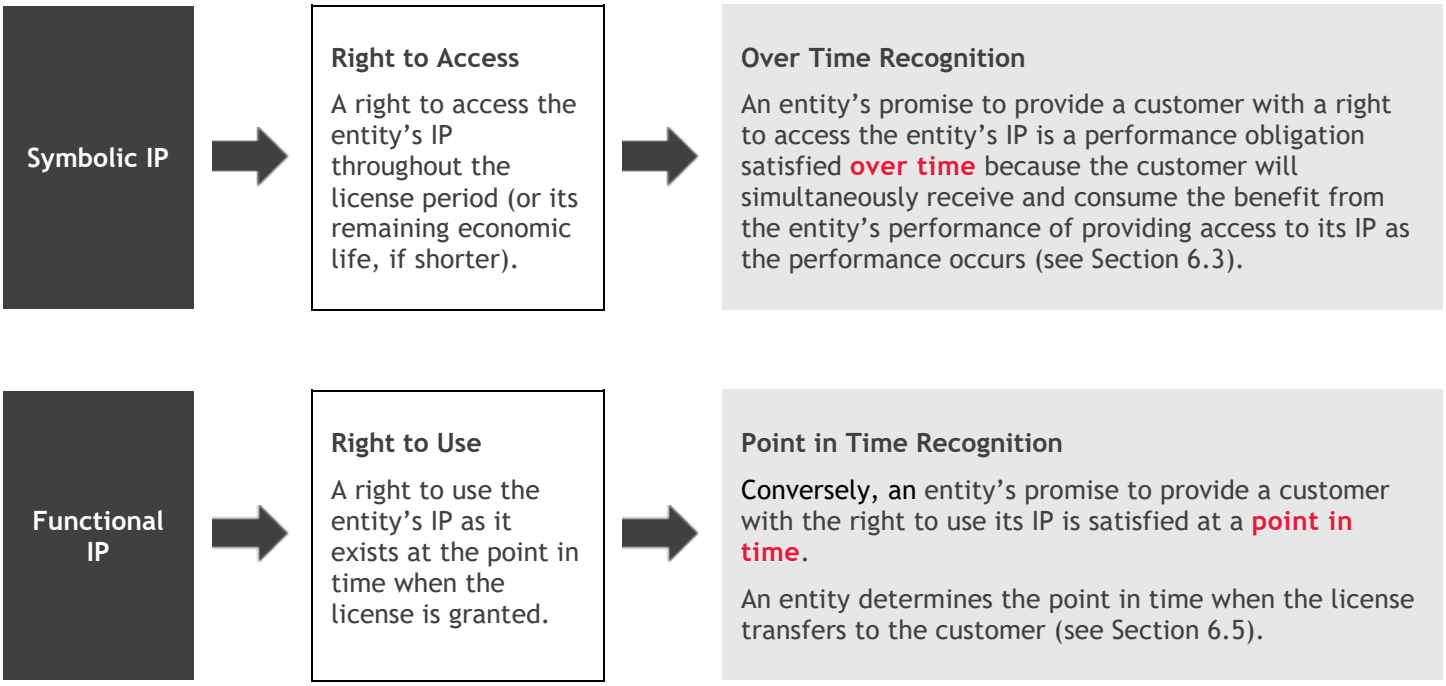
contracts with a customer for a SaaS subscription along with training services. The training allows the customer to use the software more efficiently and effectively in the customer's business environment. A third party cannot provide the training service. Regardless, the training is a separate promise because it provides the customer benefits that are incremental to accessing the SaaS.

7.5.2 Nature of License: Right to Access vs. Right to Use

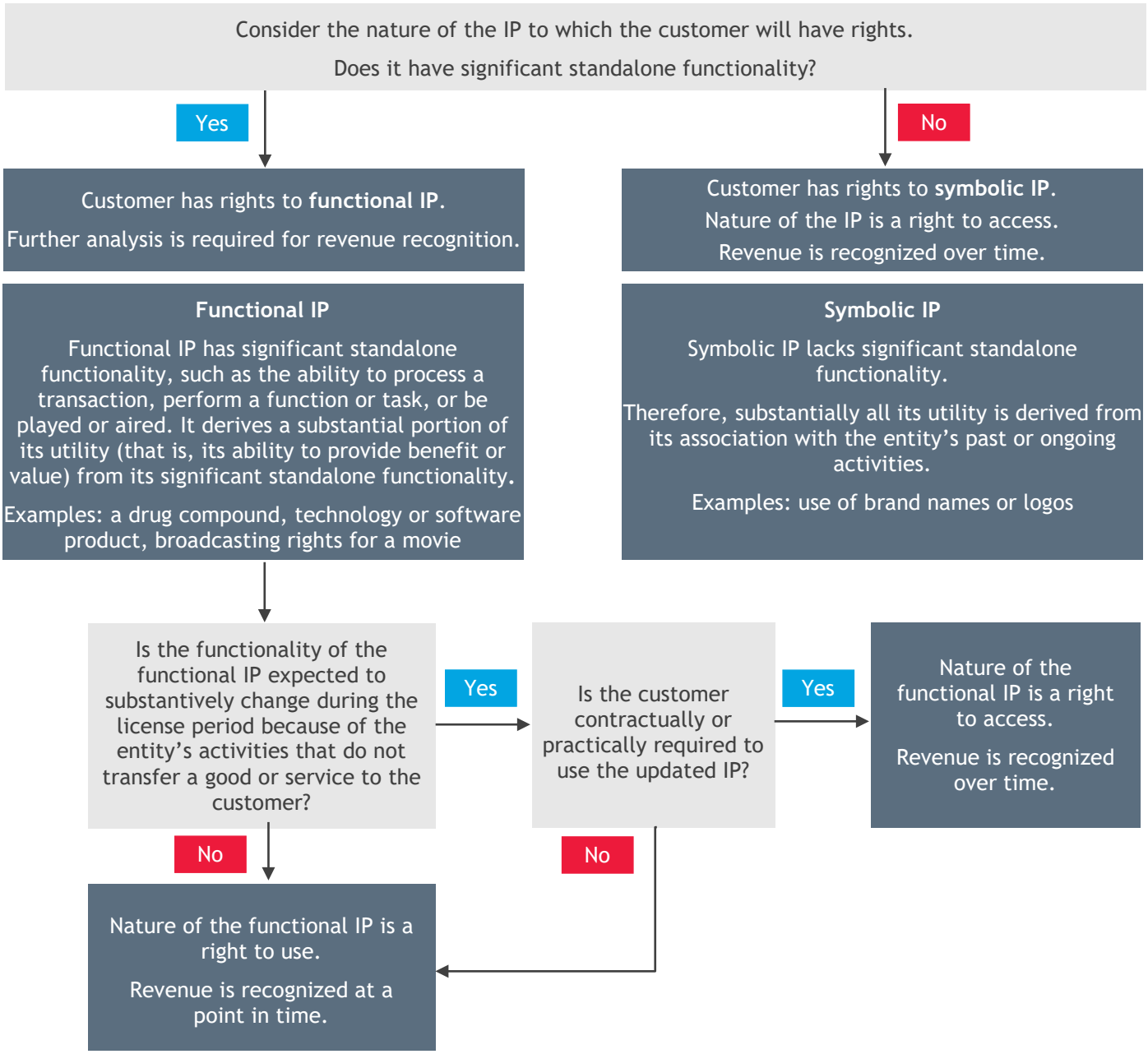
FASB REFERENCES

ASC 606-10-55-58 and 55-59 through 55-63A

To evaluate whether a license of IP transfers to a customer at a point in time or over time and hence whether revenue for the license is recognized at a point in time or over time, an entity must consider whether the nature of its promise in granting the license to the customer is to provide the customer with a right to access or to use the underlying IP. ASC 606 identifies two types of licenses: symbolic and functional. The following diagram summarizes the guidance related to determining whether the nature of the IP right granted to a customer is a right to access or a right of use and its effect on the timing and pattern of revenue recognition for the IP license:



The diagram below depicts the decision process in evaluating whether a license of IP is a license of functional IP or symbolic IP and whether the nature of an entity's promise in granting that license is to provide the customer with a right to access or a right to use the entity's IP.


Consider the nature of the IP to which the customer will have rights.
Does it have significant standalone functionality?
Yes
No
Customer has rights to functional IP.
Further analysis is required for revenue recognition.
Customer has rights to symbolic IP.
Nature of the IP is a right to access.
Revenue is recognized over time.
Functional IP
Functional IP has significant standalone functionality, such as the ability to process a transaction, perform a function or task, or be played or aired. It derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality.
Examples: a drug compound, technology or software product, broadcasting rights for a movie
Symbolic IP
Symbolic IP lacks significant standalone functionality.
Therefore, substantially all its utility is derived from its association with the entity's past or ongoing activities.
Examples: use of brand names or logos
Is the functionality of the functional IP expected to substantively change during the license period because of the entity's activities that do not transfer a good or service to the customer?
Yes
Is the customer contractually or practically required to use the updated IP?
Yes
Nature of the functional IP is a right to access.
Revenue is recognized over time.
No
No
Nature of the functional IP is a right to use.
Revenue is recognized at a point in time.

Regardless of the nature of the license, revenue from a license of IP cannot be recognized before **both**:

- An entity provides (or makes available) to the customer a copy of the IP.
- The beginning of the period during which the customer can use and benefit from its right to access or its right to use the IP. In other words, an entity would not recognize revenue before the beginning of the license period even if the entity provides (or makes available) a copy of the IP before the start of the license period or the customer has a copy of the IP from another transaction.

For example, an entity recognizes revenue from a license renewal no earlier than the beginning of the renewal period.

7.5.2.1 Symbolic IP

FASB REFERENCES

ASC 606-10-55-60

A customer's ability to derive benefit from a license to symbolic IP depends on the entity's continuing to support or maintain the IP. Therefore, a license to symbolic IP grants the customer a right to access the entity's IP, which is satisfied over time as the entity fulfills its promise to both:

- Grant the customer rights to use and benefit from the entity's IP.
- Support or maintain the IP. An entity generally supports or maintains symbolic IP by continuing to undertake those activities from which the utility of the IP is derived and/or refraining from activities or other actions that would significantly degrade the utility of the IP. For example, the activities an entity continues to undertake to support the utility of a franchise might include marketing and advertising to support the brand.

7.5.2.2 Functional IP

FASB REFERENCES

ASC 606-10-55-62 through 55-63

Generally, a license to functional IP grants a right to use the entity's IP as it exists when the license is granted. However, in some instances, future changes to the underlying IP may result in the licenses being treated differently. Specifically, a license grants a right to access the entity's IP that is recognized over time if **both** of the following criteria are met:

- The functionality of the IP to which the customer has rights is expected to substantively change during the license period because of activities of the entity that do not transfer a promised good or service to the customer. Additional promised goods or services (for example, IP upgrade rights or rights to use or access additional IP) are not considered in assessing this criterion.
- The customer is contractually or practically required to use the updated IP resulting from the activities in the above criterion.

BDO INSIGHTS: FUNCTIONAL IP THAT PROVIDES THE CUSTOMER A RIGHT TO ACCESS THE ENTITY'S IP

ASC 606 and a 2019 SEC staff speech include two fact patterns in which the two criteria discussed in Section 7.5.2.2 are met, resulting in overtime revenue recognition for a functional IP:

- Example 3-9, adapted from ASC 606, illustrates a functional IP license to an anti-virus software that is combined with the updates to be provided when and if available as a single performance obligation. The updates ensure that the customer's ability to benefit from the software does not decline significantly during the license term.
- The SEC staff speech (see Section 3.3.2.4) described an arrangement in which a functional IP license for software was combined with the updates to be provided when and if available as a single performance obligation. The software allows the customers (application developers) to build and monetize their own applications on various third-party platforms. Because the third-party platforms undergo frequent updates, the entity makes corresponding updates to its own software to ensure customers can continue to build applications that are compatible with all supported third-party platforms. Without the software updates, the customer's ability to benefit from the software would be significantly limited over the contract term because the customer would not be able to build applications compatible with the updated third-party platforms.

We believe there may be additional, albeit limited, scenarios in which functional IP may be combined with a service provided over time and hence revenue from the functional IP would be recognized over time rather than at a point in time. Significant judgment is required to analyze the nature of functional IP sold with a service that would substantively change the functionality of the IP and hence the benefit derived by the customer during the license term.

Because functional IP has significant standalone functionality, an entity's activities that do not substantively change that functionality do not significantly affect the utility of the IP to which the customer has rights. Therefore, an entity's promise to the customer in granting a license to functional IP does not include supporting or maintaining the IP. Any promise to support or maintain the functional IP would be a separate performance obligation. As a result, if a license to functional IP is a separate performance obligation and does not meet both the criteria in Section 7.5.2.2, it is satisfied at a point in time.

Also, guarantees provided by an entity that it has a valid patent to IP and will defend that patent from unauthorized use do not affect whether a license provides a right to access or a right to use the entity's IP. Similarly, a promise to defend a patent right is not a promised good or service because it provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract.

EXAMPLE 7-21 (ADAPTED FROM ASC 606-10-55-362 THROUGH 55-363B): RIGHT TO USE — SOFTWARE LICENSE

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

The entity identifies four performance obligations in the contract:

- The software license
- Installation services
- Software updates
- Technical support

The entity assesses the nature of its promise to transfer the software license and concludes that the license is functional IP because the software has significant standalone functionality from which the customer can derive substantial benefit regardless of the entity's ongoing business activities.

Further, the entity considers whether the functional license represents a right to access IP and concludes:

- While the functionality of the underlying software is expected to change during the license period because of the entity's continued development efforts, the functionality of the software to which the customer has rights (that is, the customer's instance of the software) will change only because of the entity's promise to provide when-and-if available software updates. Because the entity's promise to provide software updates represents an additional promised service in the contract, the entity's activities to fulfill that promised service are not considered in evaluating the two criteria in Section 7.5.2.2.
- The customer has the right to install, or not install, software updates when they are provided. Therefore, the criterion in Section 7.5.2.2 that the customer is contractually or practically required to use the updated IP would not be met even if the entity's activities to develop and provide software updates met the other criterion in Section 7.5.2.2 that the functionality of the IP to which the customer has rights is expected to substantively change during the license period because of activities of the entity that do not transfer a promised good or service to the customer.

Thus, the entity concludes that it has provided the customer with a right to use its software as it exists when the license is granted. Accordingly, it accounts for the software license performance obligation as a performance obligation satisfied at a point in time.

The entity recognizes revenue for the software license at the point in time at which the control of the license transfers to the customer (see Sections 6.2 and 6.5), which cannot occur before the customer can use and benefit from the license.

EXAMPLE 7-22 (ADAPTED FROM ASC 606-10-55-383 THROUGH 55-388): RIGHT TO ACCESS — LICENSES TO USE IMAGES AND NAMES

An entity, a creator of comic strips, licenses the use of the images and names of its characters in three of its comic strips to a customer, an operator of cruise ships, for five years. The customer can use the entity's characters in various ways, for example, in shows or parades, within reasonable guidelines. While there are main characters involved in each of the comic strips, new characters appear and disappear regularly, and the characters' images evolve over time.

The customer must pay a fixed payment of $1 million in each year of the five-year term.

In assessing the goods and services promised to the customer, the entity concludes that:

- It has made no other promises to the customer other than the promise to grant a license.
- The additional activities from the license do not directly transfer a good or service to the customer.

Thus, the entity concludes that its only performance obligation is to transfer the license.

The entity assesses the nature of its promise to transfer the license and determines that:

- The licensed IP (the character names and images) does not have standalone functionality. In other words, the names and images cannot process a transaction, perform a function or task, or be played or aired separately from significant additional production that would, for example, use the images to create a movie or show.
- The utility of those names and images is derived from the entity's past and ongoing activities, such as producing the weekly comic strip that includes the characters.

Therefore, the entity concludes that the nature of its promise is to grant the customer the right to access the entity's symbolic IP. Accordingly, it accounts for the promised license as a performance obligation satisfied over time.

The contract includes a single performance obligation (the license), so the entire consideration is allocated to the license.

The entity considers a measure of progress that best depicts its performance in the license (see Section 6.4). It determines that a time-based method would be the most appropriate measure of progress toward complete

satisfaction of the performance obligation because the contract provides the customer unlimited use (within the defined parameters) of the licensed characters for a fixed term.

EXAMPLE 7-23 (ADAPTED FROM ASC 606-10-55-367 THROUGH 55-374): IDENTIFYING A DISTINCT LICENSE

A pharmaceutical entity enters a contact with a customer to:

- License to the customer its patent rights to an approved drug compound for 10 years.
- Manufacture the drug for the customer for five years while the customer develops its own manufacturing capability.

The drug is a mature product, so there is no expectation that the entity will undertake activities to change it (for example, alter its chemical formula). There are no other promised goods or services in the contract.

The manufacturing process used to produce the drug is highly specialized so, no other entity can manufacture the drug while the customer learns the manufacturing process and builds its own manufacturing capability. Therefore, the license cannot be purchased separately from the manufacturing service.

Based on the above analysis, the entity determines that the customer cannot benefit from the license without the manufacturing service. Therefore, the promises are not capable of being distinct and the license and manufacturing service are not distinct (see Sections 3.2 and 3.3). The entity accounts for the license and manufacturing service as a single performance obligation.

During the first five years, the customer benefits from the license only because of having access to a supply of the drug. Therefore, the nature of the combined good or service for which the customer contracted is a sole sourced supply of the drug for the first five years.

After the first five years, the customer retains solely the right to use the entity's functional IP (see Example 7-24), and no further performance (such as manufacturing the drugs) is required of the entity during Years 6–10. The entity's performance under the contract will be complete at the end of Year 5.

EXAMPLE 7-24 (ADAPTED FROM ASC 606-10-55-367 THROUGH 55-374): IDENTIFYING A DISTINCT LICENSE

Assume in Example 7-23 that the manufacturing process used to produce the drug is not unique or specialized and that several other entities can manufacture the drug for the customer.

The entity assesses whether the promised goods and services (the license and the manufacturing service) are distinct (see Chapter 3) as follows:

- Because there are other entities that can provide the manufacturing service, the customer can benefit from the license together with readily available resources other than the entity's manufacturing service and from the manufacturing service together with the license transferred to it at the start of the contract. Therefore, the promises are capable of being distinct.
- The entity concludes that its promises to grant the license and provide the manufacturing service are separately identifiable. In concluding that the license and the manufacturing service are not inputs to a combined item in the contract, the entity considers that:
  - The customer could separately purchase the license without significantly affecting its ability to benefit from the license.
  - Neither the license nor the manufacturing service significantly modifies or customizes the other.
  - The entity is not providing a significant service of integrating the license and the manufacturing service into a combined output.

- The license and the manufacturing service are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the license independently of fulfilling its promise to subsequently manufacture the drug for the customer. Similarly, the entity would be able to manufacture the drug for the customer even if the customer had previously obtained the license and initially used a different manufacturer.

Therefore, although the manufacturing service necessarily depends on the license in this contract (that is, the entity would not contract for the manufacturing service without the customer having obtained the license), the license and the manufacturing service do not significantly affect each other.

Thus, the entity concludes that its promises to grant the license and to provide the manufacturing service are distinct and that there are two performance obligations:

- License
- Manufacturing service

The entity then assesses the nature of its promise to grant the license, observing that:

- The license to the patented drug formula has significant standalone functionality in the form of its ability to treat a disease or condition and therefore is functional IP.
- There is no expectation that the entity will undertake activities to change the functionality of the drug formula during the license period.
- Because the IP has significant standalone functionality, any other activities the entity might undertake (for example, advertising to promote its drug formula or activities to develop other drug products) would not significantly affect the utility of the licensed IP.

Therefore, the entity concludes that the nature of its promise in transferring the license is to provide a right to use its functional IP. The entity accounts for the license as a performance obligation satisfied at a point in time and recognizes revenue for it in when control of the license transfers to the customer (see Section 6.5), which cannot happen before the customer can use and benefit from the license.

In assessing the nature of the license, the entity does not consider the manufacturing service because it is an additional promised service in the contract. The entity determines whether the manufacturing service is a performance obligation satisfied at a point in time or over time (see Chapter 6).

EXAMPLE 7-25 (ADAPTED FROM ASC 606-10-55-395 THROUGH 55-399): ACCESS TO IP — NAME AND LOGO OF A SPORTS TEAM

An entity, a well-known sports team, licenses the use of its name and logo to a customer, an apparel designer, for two years. The customer has the right to use the sports team's name and logo on items, including t-shirts, caps, mugs, and other merchandise for those two years. The customer must pay fixed consideration of $4 million, as well as a royalty of 5% of the sales price of any items using the team name or logo. The customer expects that the entity will continue to play games and provide a competitive team.

In assessing the goods and services promised to the customer, the entity concludes that:

- The only good or service promised to the customer is the license.
- The additional activities associated with the license (that is, continuing to play games and provide a competitive team) do not directly transfer a good or service to the customer.

Thus, the entity concludes that the license is the only performance obligation in the contract.

The entity assesses the nature of the IP license (right to access or right to use the entity's IP) and concludes that it is symbolic IP because:

- The utility of the team name and logo to the customer is derived from the entity's past and ongoing activities of playing games and providing a competitive team. That is, those activities effectively give value to the IP.
- Absent those activities, the team name and logo would have little or no utility to the customer because they have no standalone functionality. That is, the team name and logo do not have an ability to perform or fulfill a task separate from their role as symbols of the entity's past and ongoing activities.

Based on the above analysis, the entity's promise in granting the license provides the customer with the right to access the entity's IP throughout the license period, and the entity accounts for the promised license as a performance obligation satisfied over time.

EXAMPLE 7-26 (ADAPTED FROM ASC 606-10-55-399A THROUGH 55-399J): RIGHT TO USE IP — BROADCAST RIGHTS

An entity, a television production entity, licenses all the existing episodes of a popular television show (which consists of the first five seasons) to a customer. The show is presently in its sixth season, and the television production entity is producing episodes for that sixth season, as well as promoting the show to attract further viewership, when the contract is entered. The Season 6 episodes in production are still subject to change before airing.

The customer obtains the right to broadcast the existing episodes, in sequential order, for three years. The customer must make fixed monthly payments of an equal amount throughout the three-year license period.

The show has been successful through the first five seasons, the customer is aware that Season 6 is in production, and the entity continues to promote the show.

The entity assesses the goods and services promised to the customer and determines that:

- The license to broadcast the existing episodes is the only promise in the contract because the entity's activities to produce Season 6 and its continued promotion of the show do not transfer a promised good or service to the customer.
- The contractual requirement to broadcast the episodes in sequential order is an attribute of the license (that is, a restriction on how the customer may use the license).

Therefore, the entity determines that the single license to the completed Seasons 1–5 is the only performance obligation in the contract.

The entity assesses the nature of the IP license (right to access or right to use the entity's IP) and concludes that the license provides the customer with a right to use its functional IP because:

- The existing episodes have substantial standalone functionality when they are transferred to the customer because they can be aired in the form transferred without any further participation by the entity. Therefore, the customer can derive substantial benefit from the completed episodes, which have significant utility to the customer without any further activities of the entity.
- The existing episodes are complete and not subject to change. Thus, there is no expectation that the functionality of the IP to which the customer has rights will change (that is, the criteria in Section 7.5.2.2 are not met).

Therefore, the license is a performance obligation satisfied at a point in time. The entity recognizes revenue for the license when the customer is first allowed to air the licensed content, which is the date when the content is made available to the customer. The date the customer is first allowed to air the licensed content is the beginning of the period during which the customer can use the IP and benefit from that right.

EXAMPLE 7-27 (ADAPTED FROM ASC 606-10-55-399A THROUGH 55-399J): RIGHT TO USE IP — BROADCAST RIGHTS

Assume the same facts as in Example 7-26 except that the contract also grants the customer the right to broadcast the episodes being produced for Season 6 once all those episodes are completed.

The entity assesses the goods and services promised to the customer and concludes that there are two promised goods or services in the contract:

- The license to the existing episodes.
- The license to the episodes in Season 6 when all those episodes are completed.

The entity then evaluates whether the license to the existing episodes is distinct from the license to the Season 6 episodes when they are completed. It concludes that the two licenses are distinct from each other and therefore are separate performance obligations because:

- Each license is capable of being distinct because the customer can benefit from its right to air the existing completed episodes on their own and from the right to air the episodes in Season 6 when they are all completed on their own and together with the right to air the existing completed content.
- Each of the promises to transfer a license in the contract is separately identifiable (that is, they do not together constitute a single overall promise to the customer). That conclusion is based on the following:
  - The existing episodes do not modify or customize the Season 6 episodes in production, and the existing episodes do not, together with the pending Season 6 episodes, result in a combined functionality or changed content.
  - The right to air the existing content and the right to air the Season 6 content when available are not highly interdependent or highly interrelated because the entity's ability to fulfill its promise to transfer either license is unaffected by its promise to transfer the other.
  - Whether the customer or another licensee had rights to air the future episodes would not be expected to significantly affect the customer's license to air the existing, completed episodes (for example, viewers' desire to watch existing episodes from Seasons 1–5 on the customer's network generally would not be significantly affected by whether the customer or another network had the right to broadcast the episodes that will make up Season 6).

The entity assesses the nature of the two IP licenses (that is, the license to the existing, completed episodes of the series and the license to episodes that will make up Season 6 when completed) and concludes that both provide the customer with a right to use its functional IP as it exists at the point in time the licenses are granted because:

- The licensed IP (that is, the completed episodes in Seasons 1–5 and the episodes in Season 6 when completed) has significant standalone functionality separate from the entity's ongoing business activities, such as in producing additional IP (for example, future seasons) or in promoting the show, and completed episodes can be aired without the entity's further involvement.
- There is no expectation that the entity will substantively change any of the content once it is made available to the customer for broadcast (that is, the criteria in Section 7.5.2.2 are not met).
- The activities expected to be undertaken by the entity to produce Season 6 and transfer the right to air those episodes constitute an additional promised good (license) in the contract and therefore do not affect the nature of the entity's promise in granting the license to Seasons 1–5.

The entity recognizes the portion of the transaction price allocated to each license when the customer is first allowed to air the content included in each performance obligation, which is the beginning of the period during which the customer can use the IP and can benefit from that use.

EXAMPLE 7-28 (ADAPTED FROM ASC 606-10-55-389 THROUGH 55-392D): RIGHT TO USE IP

An entity, a music record label, licenses a recording of a classical symphony by Beethoven to a customer. The customer, a consumer products entity, has the right to use the recorded symphony in all commercials, including television, radio, and online advertisements for three years in Canada starting January 1, 20X1. The customer must pay fixed consideration of $20,000 per month. The contract does not include any other goods or services to be provided by the entity, and it is noncancelable.

In assessing the goods and services promised to the customer, the entity concludes that:

- Its only performance obligation is to grant the license
- The following are attributes of the promised license (not separate promises or performance obligations):
  - The term of the license (three years).
  - The geographical scope of the license (that is, the customer's right to use the symphony only in Canada).
  - The defined uses for the recording (that is, in commercials).

In determining whether the promised license provides the customer with a right to use its IP as it exists at the point in time at which the license is granted, the entity considers:

- The Beethoven symphony recording has significant standalone functionality because it can be played in its present, completed form without the entity's further involvement. The customer can derive substantial benefit from that functionality regardless of the entity's further activities or actions. Therefore, the nature of the licensed IP is functional.
- The contract does not require, and the customer does not reasonably expect, the entity to undertake activities to change the licensed recording (that is, the criteria in Section 7.5.2.2 are not met).

Therefore, the entity determines that the promised license, which provides the customer with a right to use the entity's IP, is a performance obligation satisfied at a point in time. The entity recognizes revenue when control of the license transfers to the customer (see Section 6.5), which cannot happen before the customer can use and benefit from the license.

7.5.3 Options for Additional Licenses

7.5.3.1 Attributes of a License vs. an Additional License

FASB REFERENCES

ASC 606-10-55-64, ASC 606-10-55-367 through 55-374, ASC 606-10-55-389 through 55-392D, ASC 606-10-55-395 through 55-399, ASC 606-10-55-399A through 55-399J, and ASC 606-10-55-399K through 55-399O

Contractual provisions that explicitly or implicitly require an entity to transfer control of additional goods or services to a customer (for example, by requiring the entity to transfer control of additional rights to use or rights to access IP the customer does not already control) must be distinguished from contractual provisions that explicitly or implicitly define the attributes of a single promised license (for example, restrictions of time, geographical region, or use). Attributes of a promised license define the scope of a customer's right to use or right to access the entity's IP. Therefore, they do not define whether the entity satisfies its performance obligation at a point in time or over time and do not create an obligation for the entity to transfer any additional rights to use or access its IP.

EXAMPLE 7-28A: ATTRIBUTES OF A LICENSE

A software entity's contract with a customer includes the following key terms:

- The software entity grants to the customer a four-year term license to a payroll processing software for 25 authorized users at contract inception.
- The customer can use the license within the U.S.

The software entity determines that the restrictions of time (four-year term) and geographical region (the U.S. only) define the attribute of a single license transferred at contract inception. There are no additional promises or licenses to be delivered by the software entity in the future.

EXAMPLE 7-28B: ATTRIBUTES OF A LICENSE VERSUS ADDITIONAL LICENSE

Consider the same facts in Example 7-27A except that the number of authorized users increases to 35 at the beginning of Year 2 of the license term.

The software entity determines that the customer does not control the additional rights for 10 more users at contract inception. Rather, the software entity must grant additional rights to the customer to use its software at the beginning of Year 2.

Therefore, at contract inception, the contract includes two promises:

- At contract inception, a 4-year license to 25 users.
- At the beginning of Year 2, a 3-year license to 10 users.

EXAMPLE 7-29 (ADAPTED FROM ASC 606-10-55-399K THROUGH 55-399O): DISTINGUISHING MULTIPLE LICENSES FROM ATTRIBUTES OF A SINGLE LICENSE

On December 15, 20X0, an entity enters a contract with a customer that allows the customer to embed the entity's functional IP in two classes of the customer's consumer products (Classes 1 and 2) for four years beginning January 1, 20X1. The key terms are:

- During the first year of the license period, the customer can embed the entity's IP only in Class 1.
- Beginning in Year 2 (that is, on January 1, 20X2), the customer is allowed to embed the entity's IP in Class 2.
- The entity provides or otherwise makes available (for example, makes available for download) a copy of the IP to the customer on December 20, 20X0.

There is no expectation that the entity will undertake activities to change the functionality of the IP during the license period. There are no other promised goods or services in the contract.

In identifying the goods and services promised to the customer in the contract (see Chapter 2), the entity considers whether the contract grants the customer:

- A single promise with an attribute that during Year 1 the customer cannot embed the IP in the Class 2 consumer products.
- Two promises: A license for a right to embed the entity's IP in Class 1 for a four-year period beginning January 1, 20X1, and a right to embed the entity's IP in Class 2 for a three-year period beginning January 1, 20X2.

The entity determines that the provision in the contract stipulating that the customer's right to embed the entity's IP in Class 2 only commences one year after the right for the customer to embed the entity's IP in Class 1 begins. That means that after the customer can begin to use and benefit from its right to embed the entity's IP in Class 1 on January 1, 20X1, the entity must still fulfill a second promise to transfer an additional right to use the licensed IP. In other words, the entity must still fulfill its promise to grant the customer the right to embed the entity's IP in

Class 2. The entity does not transfer control of the right to embed its IP in Class 2 before the customer can begin to use and benefit from that right on January 1, 20X2.

The entity concludes that the contract includes two promises:

- The four-year license to embed its IP in Class 1.
- The three-year license to embed its IP in Class 2.

The entity then concludes that the first promise and the second promise are distinct from each other because:

- The customer can benefit from each license on its own and independently of the other. Therefore, each license is capable of being distinct.
- The promise to transfer each license is separately identifiable (that is, distinct in the context of the contract) because:
  - The entity is not providing any integration service with respect to the two licenses (that is, the two rights are not inputs to a combined output with functionality different from the functionality provided by the licenses independently).
  - Neither license significantly modifies nor customizes the other.
  - The entity can fulfill its promise to transfer each right to the customer independently of the other. In other words, the entity could transfer either right to the customer without transferring the other.
  - Neither the Class 1 license nor the Class 2 license is integral to the customer's ability to use or benefit from the other.

Because each right is distinct, they constitute separate performance obligations.

Based on the nature of the licensed IP and the fact that there is no expectation that the entity will undertake activities to change the functionality of the IP during the license period, each promise to transfer one of the two licenses provides the customer with a right to use the entity's IP. Thus, the entity's promise to transfer each license is satisfied at a point in time.

The entity determines when the revenue allocable to each performance obligation must be recognized. Because the customer does not control a license until it can begin to use and benefit from the rights conveyed, the entity recognizes revenue allocated to the Class 1 license no earlier than January 1, 20X1, and the revenue on the Class 2 license no earlier than January 1, 20X2.

7.5.3.2 Customer Option for Cloud Conversion

A software entity's contract with a customer to grant a software license may provide the customer the right to convert the software license to a SaaS subscription for the same software. That is, at contract inception the contract explicitly or implicitly includes a customer option for cloud conversion. The accounting for the conversion option depends on the specific facts and circumstances.

Cloud Conversion Results in Rights to SaaS and Continued Right to Software License

If the customer continues to have a right to the software license after exercising its conversion option, the contract provides the customer an option to purchase an additional service (SaaS) and the software entity must determine whether the customer option is a material right (see Section 7.4). If the customer is not required to pay for the SaaS or the payment is not commensurate with the standalone selling price of the SaaS, the conversion option is a material right. If, however, the payment for SaaS is commensurate with its standalone selling price, the conversion option is a marketing offer (not a separate performance obligation).

Cloud Conversion Results in Rights to SaaS and Forfeiture of Right to Software License

Diversity exists in practice in accounting for a cloud conversion option when the customer forfeits its software license upon conversion to SaaS. While some apply the above discussed material right approach to determine whether the customer option is a material right, which results in allocating a portion of the consideration to the conversion right, others view the forfeiture of the software license as a return of that license and apply the right to return guidance to account for the conversion option. Under the right of return approach, a software entity estimates an amount of payment for the software license that must be attributed to SaaS because the entity expects the customer to return the license. The software entity defers the estimated amount ("refund") and recognizes it in revenue as SaaS revenue after converting the license to SaaS. The Emerging Issues Task Force (EITF)[20] considered this issue and discussed alternative views but did not reach a conclusion.

Note that if the payment for SaaS is commensurate with the standalone selling price of SaaS, then the conversion option is effectively a marketing offer and not a separate performance obligation under either view because:

- Under the material right approach, the option is not a material right because the customer does not receive a discount on SaaS.
- Under the right of return approach, there is no theoretical refund of the customer's payment for the software license upon conversion to SaaS because the customer pays the standalone selling price for SaaS.

BDO INSIGHTS: CLOUD CONVERSION

Accounting for cloud conversion rights requires significant judgment, based on the facts and circumstances.

A software entity that grants a cloud conversion option that results in forfeiture of the customers' software licenses must make an accounting policy election to account for the conversion option as a material right or a right to return the software license. We believe this election must be consistently applied to similar contracts, and appropriately disclosed.

A customer option for cloud conversion may be explicit or implied by the entity's customary business practices at contract inception. For example, consider a software entity that is actively encouraging customers to convert software licenses to its SaaS offering at discounted prices. A customer that contracts for a software license may have the expectation at contract inception that it has an option to convert its software license to SaaS even though the contract may not explicitly provide that right.

If a cloud conversion option is not explicitly or implicitly provided at contract inception, and a software entity and its customer subsequently agree to covert a license to SaaS, then the original license contract is modified, and the software entity must apply the contract modification guidance.

Remix Rights

A software entity may grant multiple licenses of software to a customer (for example a license to Product A with 10 users and a license to Product B with 20 users) and allow the customer to change the mix in which it uses each license (referred to as a "remix right"). A remix right does not provide the customer with a right to purchase additional good or service in the future. Rather, it allows the customer to change the composition of the rights that it has already received (and the rights that a software entity has already granted) under the existing contract. Therefore, remix rights are not customer options or material rights.

[20] EITF 19-B, Issue 2

7.5.3.3 Renewal Rights

FASB REFERENCES

ASC 606-10-55-58C and ASC 606-10-55-389 through 55-392D

A license agreement may provide the customer with the option to renew the license at the end of the license term. In addition to assessing whether the renewal right meets the definition of a material right (see Section 7.4), an entity must consider when to recognize a customer's exercise of a renewal right. Under ASC 606, an entity cannot recognize revenue from a license of IP before **both**:

- The entity provides (or otherwise makes available) a copy of the IP to the customer.
- The customer can use and benefit from its right to access or use the IP, typically the beginning of the license term.

This guidance applies to both the initial transfer of a license of IP and a customer's exercise of a right to renew that license.

EXAMPLE 7-30 (ADAPTED FROM ASC 606-10-55-389 THROUGH 55-392D): RIGHT TO USE IP — LICENSE RENEWAL

Assume the same facts as in Example 7-28 except that at the end of the first year of the license period, on December 31, 20X1, the entity and customer agree to renew the license to the Beethoven symphony for three additional years, subject to the same terms and conditions as the original license. The entity and customer agree on a significantly discounted price of $15,000 per month for the three-year renewal period.

The entity considers the contract combination guidance (see Section 2.6) and determines that the renewal was not entered at or near the same time as the original license and therefore is not combined with the initial contract.

The entity evaluates whether the license renewal must be treated as a new license or the modification of an existing license in accordance with the guidance on contract modification (see Section 7.3). The renewal is distinct. The entity notes that:

- If the price for the renewal reflects its SSP, the renewal would be accounted for as a separate contract with the customer.
- If the price for the renewal does not reflect the SSP of the renewal, the renewal would be accounted for as a modification of the original license contract.

The entity determines that the price for the renewal does not reflect the SSP of the renewal, so the renewal is accounted for as modification of the original license contract that requires a reallocation of remaining consideration between the existing license and the renewal.

The entity then analyzes when to recognize revenue attributable to the license renewal. It determines that the customer cannot use and benefit from the license renewal before the beginning of the three-year renewal period on January 1, 20X4. The entity concludes that regardless of the amount of consideration allocated to the renewal, revenue for the renewal cannot be recognized before January 1, 20X4.

Early Renewal Rights

Software entities often offer noncancellable contracts that provide the customer with the option to renew the contract prior to contract expiry. For example, a software entity may sell a software license with a one-year term and provide the customer with a right to renew the contract for another year at any time within the last 90 days of the original license term. Revenue from license renewal cannot be recognized before the renewal period has begun and the customer can use and benefit from the renewed license.

Additionally, when a customer exercises an early renewal option, a software entity must consider whether the scope or price stipulated in the original contract has been amended resulting in a contract modification. For example, when a customer exercises an early renewal option for a software license in the original contract, it may also negotiate with the software entity to reduce the term of another software license included in the original contract or purchase additional goods or services. In that case, a software entity applies the contract modification guidance to determine the appropriate accounting. See the following related discussion on blend-and-extend modifications.

Blend-and-Extend Modifications

A software entity may amend a contract with a customer to extend the period of the contract in exchange for a new blended price for the remaining term (commonly referred to as a blend-and-extend modification). For example, a two-year software license priced at $10,000 per year may be modified at the end of one year to extend the term for two additional years at $7,500 per remaining year.

To account for a blend-and extend modification, a software entity applies the contract modification guidance, which requires an analysis of:

- Whether a performance obligation in the original contract has been satisfied before the modification date.
- Whether the modification adds distinct goods or services, that is, separate performance obligations.
- Whether the prices of the distinct goods or services are at their standalone selling prices.

If the remaining undelivered goods or services are distinct, a software entity accounts for the modified contract prospectively, whereas if the remaining goods or services are not distinct from those already provided, a software entity makes a cumulative effect adjustment for the effects of the modification.

7.5.4 Sales- or Usage-Based Royalties

FASB REFERENCES

ASC 606-10-55-64 through 55-65B, ASC 606-10-55-375 through 55-382 and ASC 606-10-55-393 through 55-399

ASC 606 includes an exception from the requirements in Step 3 to estimate and constrain variable consideration (see Section 4.3) that is a sales- or usage-based royalty promised in exchange for a license of IP (a royalty exception).

The royalty exception applies if **either** of the following requirements are met:

- The royalty relates only to a license of IP.
- A license of IP is the predominant item to which the royalty relates. For example, the license of IP may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates.

If the royalty does not relate solely or predominantly to a license of IP, the general guidance on estimating the variable consideration and constraining that estimate applies. See Section 4.3 for discussion on variable consideration.

An entity recognizes revenue for such sales- or usage-based royalty only when or as the **later** of the following occurs:

- The subsequent sale or usage.
- The (whole or partial) satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.



SEC STAFF GUIDANCE

Remarks before the 35th Annual SEC and Financial Reporting Institute Conference

Wesley R. Bricker, Deputy Chief Accountant, Office of the Chief Accountant

June 9, 2016

Recognition of Sales- and Usage-Based Royalty Exception

The standard setters did not provide a lagged reporting exception with the new standard [when an entity is unable to obtain licensee usage information before issuing the financial statements]. Accordingly, I believe companies should apply the sales- and usage-based royalty guidance as specified in the new standard. The reporting, which may require estimation of royalty usage, should be supported by appropriate internal accounting controls.

BDO INSIGHTS: ROYALTY EXCEPTION AND ESTIMATING UNREPORTED ROYALTY USE

In the context of the SEC staff guidance on recognition of sales- and usage-based royalty, an entity that must estimate any unreported royalty usage must develop an accounting policy regarding whether to apply the variable consideration constraint (see Section 4.3). We believe either approach is acceptable as long as it is consistently applied.

BDO INSIGHTS: ROYALTY EXCEPTION AND ALLOCATION CONSIDERATIONS IN STEP 4

The interaction of the royalty exception and the requirement to consider SSPs when allocating consideration to multiple performance obligations in a contract can lead to patterns of revenue recognition that differ from the amounts stated in the contract. That arises, for example, when two or more licenses of IP that are to be transferred to a customer at different times are included in a single contract and the prices specified in the contract do not reflect the licenses' SSPs. The "later of" approach prevents the amount and timing of revenue recognition from being affected by what might be considered artificial price allocations in contracts (see Section 7.5.4).

In some contracts, an IP license is offered with other goods or services in exchange for consideration in the form of a sales- or usage-based royalty (for example, software licenses with post-contract customer support, franchise licenses with training services, biotechnology and pharmaceutical licenses sold with R&D services or a promise to manufacture a drug for the customer). If a contract includes a license and other goods or services:

- Regardless of whether the other goods or services are distinct from the license, the royalty exception applies if the license is the predominant item in the arrangement.
- If a single license is not the predominant item in the contract to which the royalty relates but the royalty predominantly relates to two or more licenses, the royalty exception applies.
- If the license is not the predominant item in the contract, the royalty income represents variable consideration, which must be estimated and constrained (see Section 4.3) and allocated to each performance condition, including the license based on relative SSPs unless the allocation exception for variable consideration or a discount is met (see Chapter 5). The revenue allocated to each performance obligation is recognized at a point in time or over time based on when control of the good or service is transferred to the customer (see Chapter 6 and Section 7.5.2).



APPLICABILITY OF THE ROYALTY EXCEPTION — SAAS

The applicability of royalty exception is explicitly limited to licenses of IP and cannot be applied to sales- or usage-based royalties in exchange for providing other goods or services, including SaaS.

EXAMPLE 7-31 (ADAPTED FROM ASC 606-10-55-395 THROUGH 55-399): ACCESS TO IP — NAME AND LOGO OF A SPORTS TEAM — ROYALTY EXCEPTION

An entity, a well-known sports team, licenses the use of its name and logo to a customer for two years. The customer, an apparel designer, has the right to use the sports team's name and logo on items, including t-shirts, caps, mugs, and other merchandise, for those two years. The customer must pay fixed consideration of $4 million and a royalty of 5% of the sales price of any items using the team name or logo. The customer expects the entity to continue to play games and provide a competitive team.

In assessing the goods and services promised to the customer, the entity concludes that:

- The only performance obligation in the contract is the license.
- The license is a symbolic IP and the entity's promise in granting the license provides the customer with the right to access the entity's IP throughout the license period.
- The performance obligation is satisfied over the two-year license term (that is, over time).

The entity recognizes the consideration from the customer as follows:

- Fixed consideration allocable to the license is recognized over the two-year license term but not before the customer can use and benefit from the license. The entity identifies the measure of progress that best depicts the entity's performance in satisfying the license (see Section 6.4).
- Variable consideration in the form of a sales-based royalty is recognized in accordance with the royalty exception because the royalty relates solely to the license, which is the only performance obligation in the contract. The entity recognizes revenue from the sales-based royalty when the customer's subsequent sales of items using the team's name or logo occur.

In other words, the entity concludes that ratable recognition of the fixed consideration of $4 million plus recognition of the royalty fees as the customer's subsequent sales occur reasonably depicts the entity's progress toward complete satisfaction of the license performance obligation (see Section 6.4 for discussion on measure of progress).

EXAMPLE 7-32 (ADAPTED FROM ASC 606-10-55-270 THROUGH 55-279): ALLOCATION OF SALES-BASED ROYALTY AND APPLICATION OF ROYALTY EXCEPTION

An entity enters a contract with a customer for two licenses of IP (Licenses A and B). Each license represents a separate performance obligation, which is satisfied when it is transferred to the customer (that is, at a point in time). The SSPs of Licenses A and B are $1,200 and $1,500, respectively. The consideration for the contract includes:

- **License A:** a fixed amount of $450
- **License B:** a royalty payment of 7.5% of the selling price of the customer's future sales of products that use License B.

The entity estimates that the amount of sales-based royalties that it will be entitled to in respect of License B will be $2,250.

The entity then considers the criteria in the variable consideration allocation exception (see Section 5.5) to determine the allocation of the transaction price to each of the licenses. It determines that although the sales-based royalties relate solely to the transfer of License B, allocating that variable consideration only to that license would be inappropriate because allocating $450 to License A and $2,250 to License B would not reflect a reasonable allocation based on the SSPs of those licenses. As a result, the entity must apply the general allocation model based on relative SSPs.

Allocation of the Fixed Consideration

The entity allocates the fixed amount of $450 to the two licenses based on their SSPs. The allocation is calculated as:

PRODUCT	ALLOCATED TRANSACTION PRICE
License A	($450 * ($1,200/$2,700)) = $200
License B	($450 * ($1,500/$2,700)) = $250
Total	**$450**

Allocation of the Variable Consideration

As customer sales of products that use License B occur, the sales-based royalty will also be allocated to Licenses A and B on a relative SSP basis.

Revenue Recognition at Contract Inception

License A is transferred to the customer three months after contract inception and License B is transferred at contract inception. Revenue of $200 will be recognized for License A when it is transferred to the customer (three months after contract inception). Revenue of $250 is recognized for License B when it is transferred to the customer (at contract inception).

Recognition of the sales-based royalty allocated to each of the licenses is deferred to future periods because the recognition before the related sales occur is precluded.

Although the royalty is calculated solely based on sales related to License B, the allocation of the fixed consideration ($450) to License A and the entire sales-based royalties to License B (estimated at $2,250) is disproportionate in comparison with the licenses' SSPs. In other words, there is pricing interdependency between the two licenses, which indicates that some of the royalty generated by License B relates to the sale of License A and some of the fixed license fee ($450) stated in the contract as relating solely to License A also relates to the sale of License B.

Subsequent Revenue Recognition for Sales-Based Royalties

A royalty of $300 is due from the customer in the first month based on its first-month sales of products that use License B. Therefore, the entity recognizes:

- $133 ($300 × $1,200 ÷ $2,700) allocated to License A as contract liability. Although the subsequent sale by the entity's customer has occurred, the performance obligation to which the sales-based royalty has been allocated has not been satisfied.
- $167 ($300 × $1,500 ÷ $2,700) allocated to License B as revenue because that license has been transferred to the customer and is therefore a satisfied performance obligation.

EXAMPLE 7-33 (ADAPTED FROM ASC 606-10-55-393 AND 55-394): SALES-BASED ROYALTY PROMISED IN EXCHANGE FOR A LICENSE OF IP AND OTHER GOODS AND SERVICES

A movie distribution entity enters a contract with a customer, an operator of movie theatres. The entity agrees to:

- Grant a license that provides the customer/operator the right to show the movie in its theatres for four weeks.
- Provide memorabilia from the filming for display at the operator's theatres before the beginning of the four-week airing period.
- Sponsor radio advertisements for the movie on popular radio stations in the customer's geographical area throughout the four-week airing period.

In exchange for the license and the additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for the movie (that is, variable consideration in the form of a sales-based royalty), which is the only consideration it is entitled to under the contract.

The entity concludes that the license to show the movie is the predominant item to which the sales-based royalty relates because the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the related promotional goods or services. Therefore, the royalty exception applies. The entity will recognize all sales-based royalties in revenue as and when the subsequent sale or use occurs.

EXAMPLE 7-34 (ADAPTED FROM ASC 606-10-55-375 THROUGH 55-382): FRANCHISE RIGHTS AND SALES-BASED ROYALTY

An entity enters a contract with a customer for the following:

- Grant of a franchise license that provides the customer with the right to use the entity's trade name and sell the entity's goods for five years.
- Sale of the equipment necessary to operate a franchise store.

The customer must pay the following:

- In exchange for granting the license, a fixed upfront fee of $1 million and a sales-based royalty of 5% of the customer's sales for the term of the license.
- In exchange for the equipment, fixed consideration of $150,000, which is payable when the equipment is delivered.

Identifying Performance Obligations

The entity considers the guidance in Chapter 3 of this Blueprint to determine which promised goods and services are distinct. As a franchisor, the entity has developed a customary business practice to undertake specific activities; for example, analyzing consumers' changing preferences and implementing product improvements, pricing strategies, marketing campaigns, and operational efficiencies, to support the franchise name. However, those activities do not directly transfer goods or services to the customer.

The entity determines that:

- The promised goods and services to the customer are the franchise license and the equipment.
- The two promises are capable of being distinct. The customer can benefit from the license together with the equipment that is delivered before the opening of the franchise, and the equipment can be used in the franchise or sold for an amount other than scrap value.
- The two promises are separately identifiable. The license and the equipment are not inputs to a combined item (that is, they are not fulfilling what is, in effect, a single promise to the customer). In reaching that conclusion, the entity considers that:

- It is not providing a significant service of integrating the license and the equipment into a combined item (that is, the licensed IP is not a component of, and does not significantly modify, the equipment).
- The license and the equipment are not highly interdependent or highly interrelated because the entity would be able to fulfill each promise (to license the franchise and to transfer the equipment) independently of the other.

Thus, the entity has two performance obligations:

- The franchise license
- The equipment

Allocating the Transaction Price

The transaction price includes fixed consideration of $1.15 million and variable consideration (5% of the customer's sales from the franchise store). The equipment's SSP is $150,000, and the entity regularly licenses franchises in exchange for 5% of customer sales and a similar upfront fee.

The entity determines that the sales-based royalty must be allocated entirely to the franchise license under the variable consideration allocation exception (see Section 5.5) because:

- The variable consideration relates entirely to the entity's promise to grant the franchise license.
- Allocating $150,000 to the equipment and allocating the sales-based royalty (and the additional $1 million in fixed consideration) to the franchise license would be consistent with an allocation based on the entity's relative SSPs in similar contracts.

Licensing

The entity concludes that the nature of the entity's promise to grant the franchise license is to provide the customer a right to access the entity's symbolic IP. In reaching that conclusion, the entity observes that:

- The trade name and logo have limited standalone functionality.
- The utility of the goods developed by the entity is derived largely from the goods' association with the franchise brand.
- Substantially all the utility inherent in the trade name, logo, and rights to goods granted under the license stems from the entity's past and ongoing activities of establishing, building, and maintaining the franchise brand.
- The utility of the license is its association with the franchise brand and the related demand for its products.

As the entity grants a license to symbolic IP, it provides the customer a right to access the entity's IP, so the entity's performance obligation to transfer the license is satisfied over time. The entity recognizes the fixed consideration allocable to the license performance obligation over time when the customer can begin to use and benefit from the license. The entity identifies the measure of progress that best depicts the entity's performance in satisfying the license (see Section 6.4).

Because the sales-based royalty relates specifically to the franchise license, the entity applies the royalty exception and recognizes revenue from the sales-based royalty as and when the sales occur.

The entity concludes that ratable recognition of the fixed $1 million franchise fee plus recognition of the periodic royalty fees as the customer's subsequent sales occur reasonably depicts the entity's performance toward complete satisfaction of the franchise license to which the sales-based royalty has been allocated.

BDO INSIGHTS: WHAT IS CONSIDERED A ROYALTY?

ASC 606 does not define the term "royalty." As a result, it is not always clear whether a payment structure is eligible for the royalty exception. Some payment terms may in substance be sales- or usage-based royalties, even if the contract does not label the payments as royalties. There also are situations in which the amount of consideration is similar to a bonus and depends on the customer's subsequent sales or usage, even though the amount is not calculated based on each sale or usage. For example:

- An entity licenses IP in exchange for a payment of $10 million if cumulative sales of the licensee's products making use of the IP exceeds $100 million over a specified five-year period.
- An entity licenses IP in exchange for payments calculated based on the sales of the licensee's products that make use of the IP subject to specific thresholds: No royalty is payable if the licensee's sales are less than $10 million, a royalty of 1% is payable if the sales are between $10 million and $25 million, and a royalty of 2% is payable if the sales are more than $25 million.

In our view, the royalty exception applies to those fact patterns because the consideration is based on the sales to the customer's customer regardless of whether it is described as a royalty. That is based on BC70 of ASU 2016-10, which says that *"for a license of IP for which the consideration is based on the customer's subsequent sales or usage, an entity should not recognize any revenue for the variable amounts until the uncertainty is resolved (that is, when a customer's subsequent sales or usage occurs)."* We believe the FASB's intention is for entities to apply the exception to variable consideration that relates to licenses of IP and is based on the customer's subsequent sales or usage regardless of whether it is labeled as a royalty or whether it is structured so that consideration accumulates evenly over all sales or usage.

However, that view must not be applied to contract clauses that have no economic substance (that is, the payment is in effect fixed and does not vary based on sales or usage). For example, a contract that includes royalty payments calculated as a defined percentage of sales but subject to a guaranteed minimum contains a fixed payment equal to the guaranteed minimum.

BDO INSIGHTS: ROYALTY SUBJECT TO A GUARANTEED MINIMUM AMOUNT

Some licenses of IP include a guaranteed minimum amount plus incremental royalties above a specified threshold. In that scenario, the amount and timing of revenue recognition depends on whether the license meets the criteria for recognition at a point in time (functional IP) or over time (symbolic IP).

When the license meets the criteria for point-in-time revenue recognition, the fixed guaranteed minimum must be recognized when the performance obligation is satisfied (that is, when the license is transferred to the customer). That treatment would be consistent with treatment for a license provided for a fixed fee.

When the license meets the criteria for over-time revenue recognition, an entity must consider the facts and circumstances and apply judgment to determine an appropriate approach that depicts progress toward the satisfaction of the performance obligation. In determining the pattern of revenue recognition, factors to consider include:

- What is the appropriate measure of progress — time or the underlying sales or usage?
- Is the guaranteed minimum substantive?
- Are the royalties expected to exceed the guaranteed minimum?

We believe multiple approaches may be acceptable depending on the facts and circumstances (see Example 7-35).

EXAMPLE 7-35: SALES-BASED ROYALTY PROMISED IN EXCHANGE FOR A LICENSE OF IP WITH MINIMUM GUARANTEE

An entity enters a five-year noncancelable contract to license its IP to a customer. The license requires the customer to pay a sales-based royalty of 5% of the customer's gross sales associated with the IP. However, the total royalties paid over the five-year license term must meet or exceed a minimum guaranteed amount of $5,000. The expected royalties over the term of the license are:

Year 1	$	750
Year 2		1,500
Year 3		2,000
Year 4		1,000
Year 5		3,000
Total	**$**	**8,250**

In the cases discussed below:

- Actual royalties received in each year equal the above expected royalties.
- The customer can use and benefit from the license at the beginning of Year 1.

Case A: Functional IP License — Point-in-Time Revenue Recognition

If the license represents a right to use functional IP (that is, it meets the criteria for recognition at a point in time), the entity recognizes revenue as follows:

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Royalties Received	$ 750	$ 1,500	$ 2,000	$ 1,000	$ 3,000
Cumulative Royalties	**750**	**2,250**	**4,250**	**5,250**	**8,250**
Revenue Recognized	5,000	—	—	250	3,000
Cumulative Revenue	**5,000**	**5,000**	**5,000**	**5,250**	**8,250**

Case B: Over Time

If the license represents the right to access symbolic IP (that is, it meets the criteria for recognition over time), the entity applies judgment in light of the specific facts and circumstances. We believe several potential approaches may be acceptable.

- **Approach 1:** This approach is appropriate **only** when the royalties are expected to exceed the minimum guarantee. The entity recognizes the royalty as revenue as the customer's gross sales associated with the IP occur. This approach is based on the underlying sales or usage being the appropriate measure on which to recognize revenue and results in annual revenue being equal to the amount of royalties received each year.

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Royalties Received	$ 750	$ 1,500	$ 2,000	$ 1,000	$ 3,000
Cumulative Royalties	**750**	**2,250**	**4,250**	**5,250**	**8,250**
Revenue Recognized	750	1,500	2,000	1,000	3,000
Cumulative Revenue	**750**	**2,250**	**4,250**	**5,250**	**8,250**

- **Approach 2:** This approach also is appropriate **only** when the royalties are expected to exceed the minimum guarantee. The entity recognizes revenue equal to the greater of the pro rata portion of the minimum guarantee earned to date and the royalties earned during the period subject to a cap of the cumulative royalties earned to date. Application of the cap results in revenues of only $1,250 being recognized in Year 2.

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Royalties Received	$ 750	$ 1,500	$ 2,000	$ 1,000	$ 3,000
Cumulative Royalties	**750**	**2,250**	**4,250**	**5,250**	**8,250**
Revenue Recognized	1,000	1,250	2,000	1,000	3,000
Cumulative Revenue	**1,000**	**2,250**	**4,250**	**5,250**	**8,250**

- **Approach 3:** The entity recognizes the minimum guarantee (fixed consideration) using a reasonable measure of progress and recognizes royalties only when cumulative royalties exceed the minimum guarantee. Assuming time is the measure of progress, $1,000 (that is, $5,000 over five years) is recognized in revenue each year. Royalties in excess of $5,000 are recognized in the year received, which results in the additional $250 and $3,000 recognized in Years 4 and 5, respectively.

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Royalties Received	$ 750	$ 1,500	$ 2,000	$ 1,000	$ 3,000
Cumulative Royalties	**750**	**2,250**	**4,250**	**5,250**	**8,250**
Revenue Recognized	1,000	1,000	1,000	1,250	4,000
Cumulative Revenue	**1,000**	**2,000**	**3,000**	**4,250**	**8,250**

BDO INSIGHTS: RECOGNITION OF REVENUE FROM ROYALTIES

Royalty revenue from licenses of IP can be recognized only once the subsequent sale or usage and related performance have both occurred. That exception applies to licenses of IP regardless of whether the license is a functional IP satisfied at a point in time or a symbolic IP satisfied over time. Also, the five-step revenue recognition model in ASC 606 provides that revenue from performance obligations satisfied over time is recognized by measuring the progress toward satisfaction of that performance obligation (see Section 6.4). The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation).

The royalty rate for a symbolic IP license that provides a customer with a right to access an entity's IP over time might not be constant over the license term. That scenario leads to the question of which guidance takes precedence:

- The requirement to recognize royalties at the rate specified in a contract (that is, royalty exception)
- The requirement to measure revenue by reference to the entity's progress toward satisfying a performance condition.

In our view, while the royalty exception overrides the requirement to estimate and constrain variable consideration, it does not take precedence over the general revenue recognition requirement to measure revenue by reference to the entity's progress toward satisfying a performance condition.

As discussed in BC71 of ASU 2016-10, the requirement that a sales- or usage-based royalty cannot be recognized in revenue before the performance obligation to which some or all of the royalty has been allocated has been fully or partially satisfied (see Section 7.5.4) is intended to ensure that the royalty exception does not subvert one of the key principles of ASC 606, which is to recognize revenue only when or as an entity satisfies a performance obligation. An entity must recognize revenue from a sales- or usage-based royalty when or as the customer's

subsequent sales or usage occur *"unless recognition in that manner would accelerate the recognition of revenue for the performance obligation to which the royalty solely or partially relates ahead of the entity's performance toward complete satisfaction of the performance obligation based on an appropriate measure of progress."* Example 7-36 illustrates revenue recognition considerations for the grant of a symbolic IP license in exchange for sales-based royalties that decline over the license term.

EXAMPLE 7-36: DECLINING SALES-BASED ROYALTY PROMISED IN EXCHANGE FOR A LICENSE OF SYMBOLIC IP

An entity enters a five-year noncancelable license agreement with a customer in exchange for a sales-based royalty. The licensee agrees to the following sales-based royalty rates: Year 1: 10%, Year 2: 8%, Year 3: 6%, Year 4: 4%, Year 5: 2%.

The entity determines that the license gives its customer the right to access the entity's IP as it may exist from time to time throughout the license period and not at the point in time when the license was granted. In other words, the license is a symbolic IP satisfied over time.

At contract inception, the entity estimates that:

- The customer's sales on which the royalty is based will be approximately equal for each of the five years of the license term.
- Any activities undertaken by the entity affecting its IP will be performed on an even and continuous basis throughout the license period.

Considering the nature of its obligations, the entity determines that following the legal form of the declining royalty payments (that is, recognizing royalty rates of 10% in Year 1, 8% in Year 2, and so forth) would not appropriately depict its progress in satisfying its performance obligation for the symbolic IP license.

The entity considers that sales-based royalties must be recognized on the later of (a) when the sale or usage occurs and (b) the satisfaction of the performance obligation to which the royalty relates. ASC 606 does not provide that all of the royalty received or receivable must necessarily be recognized in the period of receipt or in which the royalty becomes receivable. Rather, that guidance precludes the recognition of royalty revenue until the performance obligation to which the royalty has been allocated has been satisfied (or partially satisfied). In other words, the entity must consider whether some of the royalty received or receivable must be deferred to ensure compliance with the requirement to measure revenue based on performance to date.

Based on historical data and estimates, the entity determines that it must initially apply an average expected royalty rate of 6%. It reassesses that estimate at each reporting date throughout the license period to determine whether the rate applied remains appropriate.

7.5.4.1 In-Substance Sale of IP

The application of the royalty exception is limited to licenses of IP and is not available for other revenue transactions, including sales of IP. In some industries (for example, pharmaceuticals) an entity may grant a customer an exclusive perpetual license to its IP but retain the legal title to the IP. That may be viewed as an in-substance sale of the IP to the customer. In considering whether the royalty exception applies to an in-substance sale of IP, the FASB clarified in BC78 of ASU 2016-10 that an entity must not discern whether a license to IP is an in-substance sale of that IP in deciding whether the royalty exception applies. Rather, an entity considers the arrangement's legal structure to determine whether the royalty exception applies. That exception applies if the arrangement is legally structured as a license of IP but not if the arrangement is legally structured as a sale of IP. In reaching that conclusion, the FASB stated that attempting to distinguish between licenses that are or are not in-substance sales would add significant complexity to the guidance. It noted that from an accounting perspective, there can be legal differences between a contract for a license and a sale of IP that it might not be appropriate or feasible to ignore or to attempt to override.

7.6 ONEROUS CONTRACTS (LOSS CONTRACTS)

ASC 606 does not include specific guidance for onerous contracts (loss contracts) with customers. Even though ASC 606 superseded the prior revenue recognition guidance in ASC 605, the existing guidance in ASC 605-20, *Revenue Recognition — Services*, and ASC 605-35, *Construction-Type and Production-Type Contracts*, related to loss contracts was retained. If an entity has an onerous contract with a customer, it must consider the applicability of the guidance in ASC 605-20 and ASC 605-35.

BDO INSIGHTS: DIVERSITY MAY EXIST IN ACCOUNTING FOR ONEROUS CONTRACTS

Because of a lack of guidance in ASC 606 and the limited scope of the guidance in ASC 605, accounting for onerous contracts requires the application of professional judgment based on the facts and circumstances. We believe the guidance in ASC 605-20 and ASC 605-35 only applies if the associated scoping criteria is met and should not be applied by analogy. However, facts and circumstances must be considered which may create diversity in practice.

7.6.1 Recognition of Losses for Extended Warranty and Product Maintenance Contracts Under ASC 605-20

ASC 605-20 has a narrow scope and includes limited but specific guidance on accounting for the provision for losses related to extended warranty and product maintenance contracts. An entity must carefully determine whether a loss-making warranty or maintenance contract is within the scope of ASC 605-20 and therefore whether the guidance in ASC 605-20 applies.

7.6.1.1 Scope of ASC 605-20

FASB REFERENCES

ASC 605-20-05-1, ASC 605-20-15-1 through 15-3, ASC 605-20-20, and ASC 605-20-25-1

ASC 605-20, which includes guidance on accounting for the provision for losses on separately priced extended warranty and product maintenance contracts, applies to all entities. It. It does not apply to:

- Product warranties other than extended warranty or product maintenance contracts.
- Guarantees accounted for as derivatives in accordance with ASC 815 or as insurance contracts under ASC 944.

FASB REFERENCES

ASC 605-20-20: Extended warranty

> *"An agreement to provide warranty protection in addition to the scope of coverage of the manufacturer's original warranty, if any, or to extend the period of coverage provided by the manufacturer's original warranty."*

ASC 605-20-20: Product maintenance contracts

> *"An agreement to perform certain agreed services to maintain a product for a specified period of time. The terms of the contract may take different forms, such as an agreement to periodically perform a particular service a specified number of times over a specified period of time or an agreement to perform a particular service as the need arises over the term of the contract."*

Separately priced extended warranty or product maintenance contracts include **both** of the following characteristics:

- The contract provides warranty protection or product services.
- The contract price is not included in the original price of the product covered by the contract.

BDO INSIGHTS: ASC 606 AND ASC 605-20 BOTH APPLY TO CONTRACTS WITHIN THE SCOPE OF ASC 605-20

Entities that enter extended warranty and product maintenance contracts with customers apply ASC 606 to account for those contracts. Those entities must consider the scope and requirements in ASC 605-20 to make sure that a loss contract within the scope of ASC 605-20 is identified and appropriately accounted for. In other words, the requirements under both ASC 606 and ASC 605-20 apply to contracts within the scope of ASC 605-20.

7.6.1.2 Identification and Recognition of a Loss Under ASC 605-20

FASB REFERENCES

ASC 605-20-25-6

> *"A loss shall be recognized on extended warranty or product maintenance contracts if the sum of the expected costs of providing services under the contracts and any asset recognized for the incremental cost of obtaining a contract exceeds the related unearned revenue (contract liability). Extended warranty or product maintenance contracts shall be grouped in a consistent manner to determine if a loss exists."*

An entity recognizes a loss first by expensing any asset recognized for the incremental costs of obtaining a contract, determined in accordance with ASC 340-40 for contracts within the scope of ASC 606 (see Section 7.7). If the loss is greater than the recognized asset for the incremental costs of obtaining a contract, an entity must recognize a liability for the excess.

EXAMPLE 7-37: ONEROUS CONSTRUCTION CONTRACT — ASC 605-20

An entity entered a contract with a customer to sell a generator powered by liquified natural gas with a separately priced maintenance service under which the entity will maintain the generator for five years. The contract includes two performance obligations in accordance with ASC 606:

- Maintenance services that are satisfied over time.
- A generator that is satisfied at a point in time.

The maintenance services are within the scope of the guidance in ASC 605-20, but the generator is not within the scope of ASC 605-20 or ASC 605-35 (see Section 7.6.2).

In determining whether the guidance on onerous contracts applies, the entity considers that ASC 605-20 clearly applies to separately priced extended warranty contracts. The entity concluded that it must apply the onerous contract guidance in ASC 605-20 only to the maintenance performance obligation, not to the entire contract. However, under the guidance in ASC 606 on allocating consideration to performance obligations (see Chapter 5), a loss may be anticipated at contract inception for the maintenance services only if the overall contract is priced at a loss. The entity considers the allocation requirements in ASC 606 and determines that the contract is priced at a loss. The entity recognizes an initial loss on the maintenance services only when that performance obligation becomes effective (that is, after the generator was delivered and installed).

EXAMPLE 7-38: ONEROUS CONSTRUCTION CONTRACT — ASC 605-20

Assume the same facts in Example 7-37 except that the contract was not priced at a loss, so no loss related to the maintenance services was recognized at contract inception. However, at the end of the second year of the maintenance term, the entity reassesses the expected costs to be incurred during the remaining three years and concludes that the sum of those costs exceeds the remaining unrecognized revenue. Therefore, the entity recognizes a loss on the maintenance performance obligation at that time.

7.6.2 Guidance in ASC 605-35 on Construction- and Production-Type Contracts

ASC 605-35 has a narrow scope and includes limited but specific guidance on accounting for the provision for losses related to construction- and production-type contracts. An entity must carefully determine whether a loss-making construction- or production-type contract is within the scope of ASC 605-35.

7.6.2.1 Scope of ASC 605-35

FASB REFERENCES

ASC 605-35-05-1 and ASC 605-35-15-1 through 15-6

ASC 605-35 includes guidance on the accounting for a provision for losses on a contract for which specifications are provided by the customer for the construction of facilities or the production of goods or for the provision of related services. The definitions of the terms "contract" and "customer" are the same as under ASC 606 (see Sections 2.2 and 1.3, respectively, for those definitions).

BDO INSIGHTS: ASC 606 AND ASC 605-35 BOTH APPLY TO CONTRACTS WITHIN THE SCOPE OF ASC 605-35

Entities that enter construction- and production-type contracts with customers apply ASC 606 to account for those contracts. Those entities must consider the scope and requirements in ASC 605-35 to make sure that a loss contract within the scope of ASC 605-35 is identified and appropriately accounted for. In other words, the requirements under both ASC 606 and ASC 605-35 apply to contracts within the scope of ASC 605-35.

The guidance in ASC 605-35 applies only to contractors, not all entities.

FASB REFERENCES

ASC 605-35-20: Contractor

> *"A person or entity that enters into a contract to construct facilities, produce goods or render services to the specifications of a buyer either as a general or prime contractor, as a subcontractor to a general contractor or as a construction manager."*

Contracts within the scope of ASC 605-35 are binding agreements between buyers and sellers under which the seller agrees to perform a service to the buyer's specifications in exchange for compensation. Specifications imposed on the buyer by a third party (for example, a government or regulatory agency or a bank) or by conditions in the marketplace are deemed buyer specifications. Examples of contracts covered by ASC 605-35 include:

- Contracts in the construction industry, such as those of general building, heavy earth moving, dredging, demolition, design-build contractors, and specialty contractors (for example, mechanical, electrical, or paving). Generally, the type of contract under consideration here is for construction of a specific project that is generally carried on at the job site. However, ASC 605-35 also applies in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant.
- Contracts to design and build ships and transport vessels.
- Contracts to design, develop, manufacture, or modify complex aerospace or electronic equipment to a buyer's specification or to provide services related to the performance of such contracts.
- Contracts for construction consulting services, such as under agency contracts or construction management agreements.
- Contracts for services performed by architects, engineers, or architectural or engineering design firms.
- Arrangements to deliver software or a software system, either alone or with other products or services, requiring significant production, software modification, or customization.

Examples of contracts not covered by ASC 605-35 include:

- Sales by a manufacturer of goods produced in a standard manufacturing operation (even when produced to buyers' specifications) and sold in the ordinary course of business through the manufacturer's regular marketing channels if such sales are normally recognized as the sale of goods and if their costs are accounted for in accordance with GAAP of inventory costing.
- Sales or supply contracts to provide goods from inventory or from homogeneous continuing production over a period.
- Contracts included in a program and accounted for under the program method of accounting. For accounting purposes, a program consists of a specified number of units of a basic product expected to be produced over a long period in a continuing production effort under a series of existing and anticipated contracts.
- Service contracts of health clubs, correspondence schools, and similar consumer-oriented entities that provide their services to their clients over an extended period.
- Magazine subscriptions.
- Contracts of NFPs to provide benefits to their members over a period in return for membership dues.
- Contracts for which other U.S. GAAP provides special methods of accounting, such as leases.
- Cost-plus-fixed-fee government contracts, which are discussed in ASC 912, Contractors — Federal Government; other types of cost-plus-fee contracts; or contracts such as those for products or services customarily billed as shipped or rendered.
- Federal government contracts within the scope of ASC 912.
- Service transactions between a seller and a purchaser in which, for a mutually agreed price, the seller performs, agrees to perform later, or agrees to maintain readiness to perform an act or acts, including allowing others to use entity resources that do not alone produce a tangible commodity or product as the principal intended result. For example, in a transaction between an architect and a customer, the architectural services (not plans) are usually the principal intended result for the customer.

7.6.2.2 Recognizing a Loss Under ASC 605-35

If a contract is within the scope of ASC 605-35, an entity considers the guidance to determine:

- The unit of account for recognizing a loss.
- The amount and timing of recognizing the loss.

7.6.2.2.1 Unit of Account for Recognizing a Loss Under ASC 605-35

FASB REFERENCES

ASC 605-35-25-7, ASC 605-35-25-10, and ASC 605-35-25-47

An entity determines the need for a provision for losses at the contract level. However, an entity combines contracts to determine whether a provision for losses is needed when the contract combination criteria in ASC 606 are met (see Section 2.6.) If contracts are combined, they are treated as a single unit of account in determining whether a provision for losses is needed.

As an accounting policy election, an entity may elect to determine the need for provisions for losses at the performance obligation level, using the guidance in ASC 606 to identify the performance obligations in a contract or in combined contracts (see Chapter 3.), instead of at the contract level (including contracts that are combined). An entity must apply that accounting policy election in the same manner for similar types of contracts.

7.6.2.2.2 Recognition of a Loss Under ASC 605-35

FASB REFERENCES

ASC 605-35-25-45 through 25-46A and ASC 606-35-25-48 through 25-49

For a contract (or combined contracts) on which a loss is anticipated, an entity makes a provision for the entire loss on the contract when (a) the current estimates of the amount of consideration the entity expects to receive in exchange for transferring promised goods or services to the customer, which is determined in accordance with ASC 606 (see Chapter 3), and (b) the contract cost indicate a loss. An entity must make provisions for losses in the period in which the losses become evident.

To determine the amount that an entity expects to receive, an entity:

- Uses the principles in ASC 606 to:
  - Determine the transaction price except for the guidance on constraining estimates of variable consideration.
  - Allocate the transaction price (see Chapters 4 and 5 for discussion of determining and allocating transaction price).
- Adjusts that amount to reflect the effects of the customer's credit risk.

The costs used to determine the estimated loss on a contract includes all costs to fulfill the contract (see Section 7.7). Other factors considered in arriving at the projected loss on a contract include:

- Variable consideration (for example, performance penalties and rewards and potential price redeterminations).
- Nonreimbursable costs on cost-plus contracts.
- Change orders that are accounted for as contract modifications in accordance with ASC 606 (see Section 7.3).

Losses on a cost-type contract could arise if, for example, the contract provides for guaranteed maximum reimbursable costs or performance penalties. In recognizing losses for accounting purposes, a contractor:

- Uses its normal cost accounting methods to determine the total cost overrun on the contract.
- Includes provisions for performance penalties in losses.

EXAMPLE 7-39: ONEROUS CONSTRUCTION CONTRACT — ASC 605-35

An entity entered a commercial contract to construct a green-energy battery system. It considers the following factors in determining whether the contract is in the scope of ASC 605-35:

- The system is being constructed on land owned by the customer.
- The system is based on engineering designs developed by the entity to meet the customer's specifications.

Thus, the entity concludes that the commercial contract is within the scope of the guidance in ASC 605-35.

The contract includes a fixed purchase price of $35 million, which is expected to provide a profit to the entity at contract inception. However, after six months, because of unforeseen problems with the design, the costs to complete the project are expected to exceed the fixed purchase price. The entity therefore recognizes a loss at that time in an amount equal to the difference between the remaining expected costs and the unrecognized revenue.

7.7 CONTRACT COSTS

ASC 340-40 was issued concurrently with ASC 606 and provides specific guidance on the accounting for both the incremental costs of obtaining and the costs incurred in fulfilling a contract with a customer within the scope of ASC 606. Contract costs are initially recognized as an asset and expensed on a systematic basis that is consistent with the pattern of transfer to the customer of the good or service to which those costs relate.

7.7.1 Incremental Costs of Obtaining a Contract



FASB REFERENCES

ASC 340-40-25-1 through 25-4

The incremental costs of obtaining a contract are those costs an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained. A sales commission that is paid only if the contract with a customer is executed is an example of a cost to obtain a contract.

BDO INSIGHTS: TREATMENT OF PAYMENTS THAT ARE BOTH COMMISSIONS AND FOR GOODS OR SERVICES

In some arrangements, a sales agent may provide both sales and marketing services for which it earns a commission capitalized under ASC 340-40 and other goods or services accounted for in accordance with other GAAP. Although ASC 340-40 does not provide specific allocation guidance, we believe in those circumstances the entity could look to the transaction price allocation guidance in ASC 606 as a reasonable method to determine the portion of the payment that relates to the commission versus the other goods or services received.

7.7.1.1 Recognition of Incremental Costs of Obtaining a Contract

An entity must recognize the incremental costs of obtaining a contract with a customer as an asset if it expects to recover those costs.

Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained are recognized as an expense when incurred unless they are explicitly chargeable to the customer regardless of whether the contract is obtained. All costs of running the business, including costs incurred with the intention of obtaining a contract with a customer, that are not incremental are expensed unless capitalization is required or allowed under other area of U.S. GAAP (for example, ASC 360, *Property, Plant, and Equipment*).

As a practical expedient, the incremental costs of obtaining a contract can be recognized as an immediate expense rather than capitalized if the period over which they would otherwise be expensed (or amortized) is one year or less.

TRG DISCUSSIONS: IDENTIFYING INCREMENTAL COSTS TO OBTAIN A CONTRACT WITH A CUSTOMER

In many cases, identifying incremental costs to obtain a contract may be relatively straightforward. However, in other instances, commission structures may be more complex, resulting in questions about which payments qualify for deferral. The TRG concluded that one way to identify the costs to be deferred is to consider whether the entity would incur the cost if the customer (or entity) decided at the last minute not to execute the agreement. If the answer is yes, the cost is not an incremental cost to obtain the contract.

The TRG considered a scenario in which an entity pays an employee a fixed salary that is determined annually based on the employee's prior-year signed sales contracts and projected sales contracts for the current year. Although the salary is affected by prior-year sales and current-year projected sales, it will be paid regardless of whether any level of sales is achieved. Therefore, the salary paid does not represent an incremental cost to acquire a contract and should not be deferred.

The TRG also considered a situation in which an entity pays a commission that is tiered based on the number of contracts or dollar amount of contracts obtained during an annual period. For example, the employee might earn no commission for the first nine contracts executed but earn 2% of the value of contracts 10-19 and 5% of the value of the 20th contract and beyond. The TRG concluded that the commissions paid in this scenario are incremental costs of obtaining a contract and thus should be deferred under ASC 340-40-25-1. It stated that the fact that the commissions are paid on a pool of contracts rather than on each contract individually does not change the fact that the commissions would not have been incurred had the contracts not been obtained.

The TRG also clarified that the timing of paying the commission is not relevant in determining whether it should be recognized as an asset; only whether the commission is incremental or not is. An entity would apply other U.S. GAAP to determine whether a liability for the commission payment should be recognized.

EXAMPLE 7-40 (ADAPTED FROM ASC 340-40-55-2 THROUGH 55-4): INCREMENTAL COSTS OF OBTAINING A CONTRACT

An entity, a consulting services provider, wins a bid to provide consulting services to a new customer. It incurred the following costs to obtain the contract:

External legal fees for due diligence	$ 30,000
Travel costs to deliver proposal	50,000
Sales commissions	20,000
Total costs incurred	**$ 100,000**

The entity recognizes an asset for the $20,000 incremental costs of obtaining the contract arising from the sales commissions because it expects to recover those costs through future fees for the consulting services.

The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability, and individual performance evaluations. It does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. Rather, the amounts are discretionary and based on other factors, including the entity's profitability and the individuals' performances. In other words, the bonuses are not directly attributable to identifiable contracts.

Also, the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained, so those costs are expensed when incurred unless they are within the scope of other U.S. GAAP (in which case, that guidance applies).

EXAMPLE 7-41: INCREMENTAL COSTS OF OBTAINING A CONTRACT

An engineering entity enters a contract with a customer to design a water treatment plant. The design project is expected to take two years to complete. The entity will transfer the services to the customer over time.

To win the project, the entity incurred the following costs as part of developing the bid:

- External marketing consultant fee of $100,000.
- Other internal labor costs totaling $350,000.

After being selected as the winning bid, the entity incurred the following costs:

- Commission of $120,000 to a public relations agent after the contract was signed relating specifically to this contract.
- After the contract is signed, the agent is paid an additional $50,000 bonus for exceeding a threshold on total value of contracts executed year-to-date.

The $100,000 fee paid to the agent and the $350,000 of internal labor costs were incurred as part of the bid process to win the contract and would have been incurred by the entity even if it had not been selected. Therefore, those costs would not be considered incremental costs of obtaining the contract. The entity must therefore expense the $100,000 marketing fee and the labor costs as incurred.

The agent's commission and bonus are considered incremental costs of obtaining the contract because those amounts would not have been paid unless the contract had been signed. Although the bonus is paid based on the total value of contracts obtained rather than only the current contract, it is still considered an incremental cost to obtain a contract, consistent with the TRG discussions on identifying incremental costs to obtain a contract with a customer (see Section 7.7.1). The entity must capitalize the agent's commission and bonus and amortize the resulting asset over the project period (that is, to reflect the pattern of transfer of the design service to the customer).

EXAMPLE 7-42: INCREMENTAL COSTS OF OBTAINING A CONTRACT — CHANGES TO SALES COMMISSIONS BECAUSE OF A CONTRACT MODIFICATION

An entity, a sales agent, receives an initial sales commission based on the contract price when a contract with the customer is obtained. The commission is appropriately capitalized under ASC 340-40.

Subsequently, the customer modifies the contract to purchase additional goods. The modification does not result in the entity accounting for the modification as a separate contract (see ASC 606-10-25-12 and 25-13). The entity is paid an additional commission based on the increase in the contract price arising from the modification.

Even though the contract modification is not accounted for as a separate contract, the increase in the contract price results in additional commission that is incremental to obtaining the modified contract. Therefore, the additional commission paid is an incremental cost of obtaining a contract and is capitalized and amortized (with any unamortized amount relating to the initial commission) on a systematic basis that is consistent with the transfer to the customer of the remaining goods or services provided over the remaining contractual period.

7.7.2 Costs to Fulfill a Contract

FASB REFERENCES

ASC 340-40-25-5 through 25-8

The guidance in ASC 340-40 applies to costs incurred to fulfill a contract with a customer only if the costs are not within the scope of other U.S. GAAP, including:

- ASC 330, *Inventory*
- ASC 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements (see Section 7.7.1)
- ASC 350-40, *Intangibles — Goodwill and Other — Internal Use Software*
- ASC 360, *Property, Plant and Equipment*
- ASC 985-20, *Software — Costs of Software to be Sold, Leased, or Marketed*

An entity must account for the costs incurred in fulfilling a contract in accordance with other applicable GAAP, if those costs are within the scope of other U.S. GAAP.

7.7.2.1 Recognition of Costs to Fulfill a Contract

An entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet **all** the following criteria:

- The costs relate directly to a contract or anticipated contract the entity can specifically identify. For example, costs relating to services provided under renewal of an existing contract or costs of designing an asset transferred under a specific contract that has not yet been approved but is expected to be approved would be considered costs to fulfill a contract.
- The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.
- The costs are expected to be recovered.

Costs that relate directly to a contract or a specific anticipated contract include:

- Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer).
- Direct materials (for example, supplies used in providing the promised services to a customer).
- Allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract).
- Costs that are explicitly chargeable to the customer under the contract.
- Other costs that are incurred only because an entity entered into the contract such as payments to subcontractors.

An entity must expense the following costs when incurred:

- General and administrative costs unless those costs are explicitly chargeable to the customer under the contract, in which case an entity must evaluate whether those costs relate directly to a contract or a specific anticipated contract.
- Costs of wasted materials, labor, or other resources not reflected in the contract price.
- Costs that relate to partially or fully satisfied performance obligations in the contract (that is, costs that relate to past performance).
- Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

BDO INSIGHTS: FULFILLMENT COSTS THAT RELATE TO PARTIALLY SATISFIED PERFORMANCE OBLIGATIONS

Because fulfillment costs that relate to partially satisfied performance obligations cannot be capitalized, we generally do not expect any costs to fulfill an over-time contract to be capitalized under ASC 340-40 once control of the goods or services start transferring to the customer (that is, revenue recognition begins).

BC45 of ASU 2016-20 provides the FASB's expectations that:

- Costs historically accounted for within the scope of ASC 605-35 for long-term construction- and production-type contracts will be accounted for in accordance with ASC 340-40.
- Adoption of ASC 606 and ASC 340-40 will not require more entities to apply the guidance in ASC 340-10 as compared with the historical practice.

BDO INSIGHTS: PREPRODUCTION COSTS ASSOCIATED WITH LONG-TERM SUPPLY CONTRACTS

Historically, there has been diversity in practice in accounting for preproduction costs associated with long-term supply contracts. ASC 340-10 provides guidance on accounting for the costs of designing and developing "molds, dies, and other tools that will be used in producing" products under a long-term supply agreement, and ASC 606 did not amend or supersede that guidance. Entities that conclude that their preproduction costs are within the scope of ASC 340-10 should continue to follow that guidance. Entities that conclude that the guidance in ASC 340-10 is not directly applicable should apply the guidance in ASC 340-40 instead.

EXAMPLE 7-43: CONTRACT COSTS — MANUFACTURING ENTITY

An entity, a manufacturer of solar panels, enters a contract to sell 10,000 units at $500 per unit to a new customer. Once the contract was signed, the entity purchased tooling for $25,000 and incurred engineering costs of $100,000 to facilitate production of the solar panels. The tooling and engineering activities do not represent a good or service transferred to the customer (the entity retains title and control of the tooling and owns and controls all IP arising from the activities).

The entity first determines if any of the costs are within the scope of other U.S. GAAP:

- The tooling is equipment accounted for in accordance with ASC 360.
- The entity determines that the engineering activities are within the scope of ASC 730, *Research and Development*, and that the costs must be expensed as incurred because they meet the definition of development activities and are not specific to the customer contract. In other words, the entity can use the IP resulting from the engineering efforts to fulfill other future customer orders.

Because all costs incurred to begin delivering under the contract are subject to other U.S. GAAP, the guidance in ASC 340-40 does not apply.

7.7.3 Amortization and Impairment of Capitalized Costs

FASB REFERENCES

ASC 340-40-35-1 through 35-5

An entity considers the guidance discussed below to subsequently measure an asset resulting from the deferred costs to obtain or fulfill a contract with a customer.

7.7.3.1 Amortization of Capitalized Costs

An asset is amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate solely to the current contract or may also relate to future anticipated contracts. An entity must update the amortization to reflect a significant change in its expected timing of transfer to the customer of the goods or services to which the asset relates. Such a change is accounted for as a change in accounting estimate in accordance with ASC 250.



TRG DISCUSSIONS: IMPAIRMENT TESTING OF CAPITALIZED CONTRACT ACQUISITION COSTS

In July 2014, the TRG considered whether entities should factor in cash flows that are expected to arise in any period covered by customer options to extend or renew the contracts when testing capitalized contract assets for impairment. It concluded that extension and renewal periods are considered if:

- It is expected that the customer will extend or renew the contract.
- The contract costs capitalized relate to goods or services that would be transferred to the customer during such extension or renewal periods.

7.7.3.2 Impairment of Capitalized Costs

An entity recognizes an impairment charge in profit or loss if the carrying amount of a recognized asset exceeds:

The amount the entity expects to receive in the future related to transferring the goods or services	**Plus**	Amounts received but not yet recognized as revenue	**Less**	The unrecognized costs that directly relate to providing the goods or services (see Sections 7.7.1 and 7.7.2).

In determining the consideration, an entity must:

- Consider expected contract renewals and extensions (with the same customer).
- Use the principles for determining the transaction price except for the guidance on constraining estimates of variable consideration (see Chapter 4) and adjust that amount to reflect the effects of the customer's credit risk.

Subsequent reversal of a previously recognized impairment loss is not allowed.

Before an entity recognizes an impairment loss for an asset recognized under ASC 340-40, it must recognize any impairment loss for assets related to the contract that are recognized in accordance with other U.S. GAAP, including ASC 330 and ASC 985-20. After applying the impairment test in ASC 340-40-35-3, an entity must include the resulting carrying amount of the asset recognized under ASC 340-40 in the carrying amount of the asset group or reporting unit to which it belongs in applying the guidance in ASC 350, *Intangibles — Goodwill and Other*, and ASC 360.

TRG DISCUSSIONS: COMMISSIONS PAID TO OBTAIN A RENEWABLE CONTRACT WITH A CUSTOMER

In some instances, commissions paid at inception of a customer contract exceed those paid upon contract renewal, if any. Careful consideration should be given to the amortization period, including whether the entity may apply the practical expedient of immediately recording the incremental payments as a period expense. Specifically, the amortization period for the initial commissions would relate only to the current contract if the commissions paid at contract renewal are commensurate with the commissions paid at contract signing.

For example, an entity enters a one-year, $100,000 renewable maintenance contract with a customer. It pays a 5% commission on contract signing to its sales agent and will pay that same individual a 1% commission upon contract renewal. The difference in the renewal rates stems from the entity's belief that the level of effort necessary to obtain a renewal is far less than initially entering into a new contract.

The TRG indicated that the level of effort to obtain or renew a contract should not factor into determining whether the commission paid on renewal is commensurate with the initial commission. Instead, a renewal commission is commensurate with an initial commission if the two commissions are reasonably proportionate to the respective contract values (for example, both are 2% of the amounts invoiced to customers). Therefore, if a contract does not contain commensurate commissions, the initial commission may relate to an expected future contract beyond the initial term.

Returning to the example, the initial and renewal commissions are not commensurate. Accordingly, the entity would not qualify for the practical expedient and instead would defer and amortize the initial commissions over a period that considers both the initial contract term and any expected renewals. Determining how the initial and subsequent commissions should be amortized may require judgment, and multiple approaches may be acceptable, as illustrated in Example 7-44.

EXAMPLE 7-44: INCREMENTAL COSTS OF OBTAINING A CONTRACT — SALES COMMISSIONS PAID FOR A NEW CONTRACT AND SUBSEQUENT RENEWALS

An entity, a sales agent, is paid a commission for each contract obtained with a customer as follows:

- $100 is paid for a new customer contract.
- $60 is paid each time that same customer renews the contract.

The entity concludes that the $60 renewal commission is not considered commensurate with the $100 commission paid on the initial contract.

The $100 paid for the new customer contract is capitalized at contract inception.

The $60 for each renewal is capitalized upon renewal because it is also an incremental cost that would not have been incurred if the renewal was not obtained.

For the $100 capitalized when the new customer contract is obtained, alternative amortization approaches include:

- **Approach 1:** Amortizing the initial $100 over the contract period that includes the specific anticipated renewals (in this case assumed to equal the expected customer relationship life) and amortizing each capitalized renewal amount over the respective renewal period.
- **Approach 2:** Separating the initial $100 commission into two components: $60 that is amortized over the original contract term and $40 that is amortized over the period of the initial contract and the specific anticipated renewals. Upon renewal, the $60 renewal commission is capitalized and amortized over the renewal period.

EXAMPLE 7-45: (ADAPTED FROM ASC 340-40-55-5 THROUGH 55-9) — COSTS THAT GIVE RISE TO AN ASSET

An entity enters a contract with a customer to manage the customer's information technology data center for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity incurs the following costs:

- Paid an employee a $10,000 sales commission upon the customer signing the contract.
- Before providing the services, designed and built a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer but will be used to deliver services to the customer.

Incremental Costs of Obtaining a Contract

The entity recognizes an asset for the $10,000 incremental costs of obtaining the contract for the sales commission because it expects to recover those costs through future fees when providing the services. The entity amortizes the asset over seven years because the asset relates to the services transferred to the customer during the initial contract term of five years and the two anticipated one-year renewal periods thereafter.

Costs to Fulfill a Contract

The entity incurred the following initial costs to set up the technology platform:

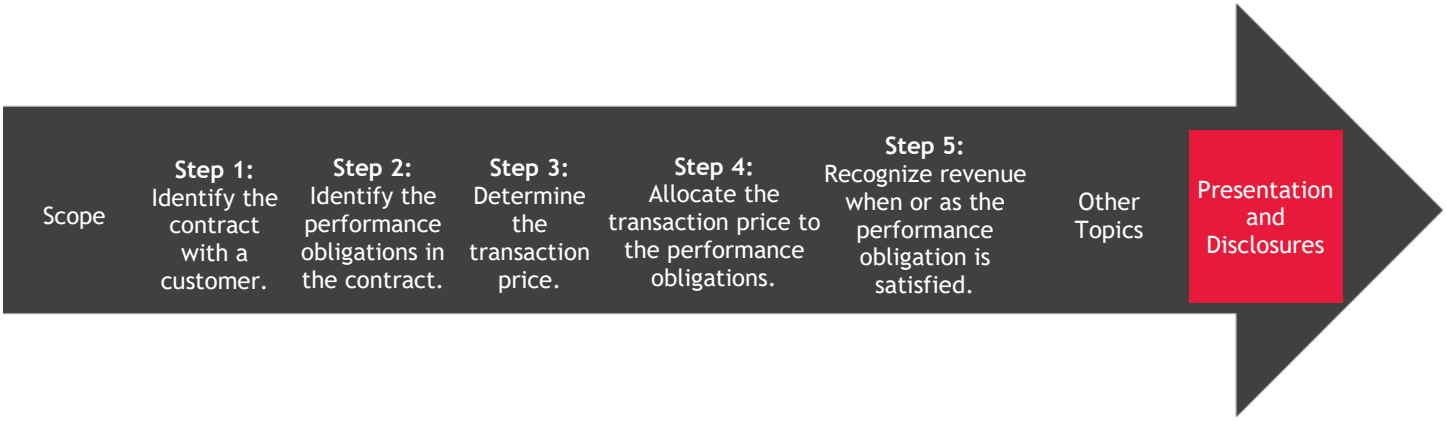
Design services	$ 20,000
Hardware	60,000
Software	45,000
Data migration and testing	50,000
Total costs incurred	**$ 175,000**

The initial set-up costs relate primarily to activities to fulfill the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

- Hardware costs: accounted for in accordance with ASC 360.
- Software costs: accounted for in accordance with ASC 350-40.
- Design services, data migration, and testing: assessed to determine whether an asset can be recognized for the costs to fulfill the contract. Any resulting asset would be amortized on a systematic basis over the seven-year period (that is, the five-year contract term and two anticipated one-year renewal periods) the entity expects to provide services related to the data center.

In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for the two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance its resources. Therefore, the costs do not meet the criteria to be recognized as an asset under ASC 340-40 and the entity recognizes the payroll expense for the two employees when incurred.

Chapter 8 — Presentation and Disclosures



8.1 OVERVIEW — PRESENTATION AND DISCLOSURES

The presentation and disclosure requirements in ASC 606 are significant and detailed. For each contract with a customer, an entity must present any contract asset, contract liability, and receivable (as applicable) on its balance sheet. It also must provide comprehensive qualitative and quantitative disclosures to meet the disclosure objective in ASC 606. That objective is to provide users of financial statements with sufficient information to understand the nature, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Relief from certain disclosure requirements is available for nonpublic entities.

8.2 PRESENTATION

8.2.1 Balance Sheet

FASB REFERENCES

ASC 606-10-45-1 through 45-5

When either party to a contract has performed, an entity presents the contract with a customer in the balance sheet as either a contract asset or a contract liability on a net basis, depending on the relationship between the entity's performance and the customer's payment. An entity presents any unconditional rights to consideration separately as a receivable.

The net presentation of remaining rights and performance obligations in a contract with a customer is based on the notion that an entity's obligation to perform and the entity's right to receive consideration from a customer is interdependent — the right to receive consideration from a customer depends on the entity's performance, and the entity performs only as long as the customer continues to pay. An entity's net position in a contract is generally recognized as a contract asset, contract liability, or receivable.

While the guidance uses the terms "contract asset" and "contract liability," an entity is not prohibited from using alternative descriptions in the balance sheet for those items. If an entity uses an alternative description for a contract asset, it must provide sufficient information to enable a user of the financial statements to distinguish between contract assets (rights to consideration that are conditional) and receivables (rights to consideration that are unconditional).

BDO INSIGHTS: PRESENTATION OF CONTRACT ASSETS AND CONTRACT LIABILITIES

For a contract that has multiple performance obligations, the contract assets and contract liabilities must be netted together at the contract level. In other words, an entity presents either a contract asset or a contract liability for each contract (or group of contracts that must be combined (see Section 2.6) rather than multiple contract assets or contract liabilities for the same contract based on individual performance obligations in the contract.



RETAINAGE PRESENTATION FOR CONSTRUCTION COMPANIES

Contracts between construction companies and their customers often include retainage provisions that allow customers to withhold a portion of the billed amount until final contract settlement. This portion is referred to as retainage. Because the entity typically does not have an unconditional right to payment (see Section 8.2.1.4), entities usually record retainage as a contract asset. For each contract, the entity adds retainage amounts to unbilled receivables (contract assets) or nets it against the related contract liability.

It is common in the construction industry to bill in advance, resulting in both a contract liability and retainage, but ASC 606 precludes presenting both a contract asset and a contract liability for the **same** contract. However, entities may elect to voluntarily disclose retainage amounts to provide users of the financial statements with more decision-useful information. Acceptable presentation and disclosure options under U.S. GAAP for private construction companies include:

- Parenthetical disclosure of retainage amounts included in contract assets or liabilities on the face of the balance sheet (see Example 8-1).
- Separate line-item presentation of retainage on the face of the balance sheet with corresponding contract assets or contract liabilities subtotal (see Example 8-2).
- Disaggregation of contract balances in the notes to the financial statements.

EXAMPLE 8-1 (ADAPTED FROM EXHIBIT A, FASB STAFF EDUCATIONAL PAPER "TOPIC 606: PRESENTATION AND DISCLOSURE OF RETAINAGE FOR CONSTRUCTION CONTRACTORS") - PARENTHETICAL DISCLOSURE OF RETAINAGE

Entity A elects to voluntarily disclose retainage amounts parenthetically on the face of the balance sheet as illustrated below:

	20X1	20X0
Assets		
Current Assets		
Contract assets, including conditional retainage of $200 and $300 at December 31, 20X1 and 20X0, respectively	$ 500	$ 700
Total Current Assets	$ 500	$ 700
Liabilities and Stockholders' Equity		
Current Liabilities		
Contract liabilities, net of conditional retainage of $100 and $200 at December 31, 20X1 and 20X0, respectively	$ 300	$ 400
Total Current Liabilities	$ 300	$ 400

EXAMPLE 8-2 (ADAPTED FROM EXHIBIT B, FASB STAFF EDUCATIONAL PAPER "TOPIC 606: PRESENTATION AND DISCLOSURE OF RETAINAGE FOR CONSTRUCTION CONTRACTORS") – CONTRACT ASSETS AND LIABILITIES SUBTOTALS PRESENTATION

Entity A elects to voluntarily disclose retainage amounts on the face of the balance sheet and present corresponding contract assets and contract liabilities subtotals as illustrated below:

	20X1	20X0
Assets		
Current Assets		
Revenue in excess of billings	$ 300	$ 400
Conditional retainage	200	300
Total contract assets	$ 500	$ 700
Total Current Assets	$ 10,000	$ 15,000
Liabilities and Stockholders' Equity		
Current Liabilities		
Billings in excess of revenue	$ 400	$ 600
Less: conditional retainage	(100)	(200)
Total contract liabilities	$ 300	$ 400
Total Current Liabilities	$ 2,000	$ 3,000

8.2.1.1 Contract Liability

A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer. If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (that is, a receivable (see Section 8.2.1.3)), before the entity transfers a good or service to the customer, the entity must present the contract as a contract liability when the payment is made or the payment is due, whichever is earlier.

BDO INSIGHTS: CASH RECEIVED BEFORE THERE IS A CONTRACT

As discussed in Chapter 2, the first step in assessing revenue from a contract with a customer is determining whether a contract exists in accordance with ASC 606-10-25-1. In some arrangements, the customer may provide cash to the entity before the criteria for contract existence are met. For example, a customer may provide a down payment while the entity and customer are still negotiating the services to be provided. If a contract does not exist under ASC 606, the cash payment from the customer must be reported as a liability. Therefore, we believe the amount received is not reported as deferred revenue because a contract does not yet exist. Instead, the entity may classify that amount as a deposit liability or another appropriate balance sheet line item until one of the criteria in ASC 606-10-25-7 is met (see Section 2.4.2).

8.2.1.2 Contract Asset

A contract asset is an entity's right to consideration in exchange for goods or services the entity has transferred to a customer. If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity must present the contract as a contract asset, excluding any amounts presented as a receivable (see Section 8.2.1.3).

Some upfront payments to a customer (or potential customer) also may be accounted for as an asset. See Section 4.6 for a summary of TRG discussions on upfront payments to a customer or potential customer. That asset generally does

not meet the definition of a contract asset because when an entity makes an upfront payment to a customer, it has not yet transferred goods or services to its customer and therefore does not have a right to consideration. An upfront payment to a customer (or potential customer) that is recognized as an asset is presented separately from contract assets. An entity may present that asset in other assets or another appropriate balance sheet line item.

A contract asset is assessed for impairment, and any impairment is measured, presented, and disclosed in accordance with ASC 326.

SEC STAFF GUIDANCE

Remarks before the 2016 AICPA Conference on Current SEC and PCAOB Developments

Ruth Uejio, Professional Accounting Fellow, Office of the Chief Accountant

December 5, 2016

Assets and Payments to Customers

… There are many different types of business activities that can result in a company making payments to its customers. For example, a company may make an upfront payment to a new customer in order to secure an exclusive relationship with that customer, or may make a payment as part of a marketing incentive program…

From my perspective, a company must first determine what the payment was made for. The following are some of the questions that OCA staff may focus on to understand the nature and substance of the payment:

1. *What are the underlying economic reasons for the transaction? Why is the payment being made?*
2. *How did the entity communicate and describe the nature of the payment to its investors?*
3. *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?*
4. *What is the accounting basis for recognizing an asset, or recognizing an upfront payment immediately through earnings?*

Once a company has determined the substance of the payment, I believe 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. Additionally, companies should establish accounting policies that are consistently applied. I'd highlight that there should be a neutral starting point in the accounting evaluation for these types of arrangements. I believe that registrants must carefully evaluate all of the facts and circumstances in arriving at sound judgments, and should perform the analysis impartially. Additionally, in my view "matching" is not a determinative factor to support asset recognition.

8.2.1.3 Receivable

A receivable is an entity's unconditional right to consideration. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognize a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity must account for a receivable in accordance with ASC 310, with impairments assessed, measured, presented, and disclosed in accordance with ASC 326.

BDO INSIGHTS: PRESENTATION OF CONTRACT ASSETS, CONTRACT LIABILITIES, AND RECEIVABLES

- Current and noncurrent portions of contract assets, contract liabilities, and receivables must be separately presented in a classified balance sheet.
- Contract assets and liabilities must be disclosed separately from other balances related to revenues outside the scope of ASC 606. For example, receivables from contract revenues must be disclosed separately from receivables that arise from leasing contracts.
- Contract assets, contract liabilities, and receivables must be presented separately on the balance sheet or in the footnotes. Entities must consider other U.S. GAAP (for example, ASC 210-20, *Balance Sheet — Offsetting*) to assess whether it is appropriate to net contract assets and contract liabilities that arise from different contracts (for example, multiple contracts with the same customer) that do not have to be combined in accordance with ASC 606.

8.2.1.4 Distinguishing Between a Contract Asset and a Receivable

A receivable is distinguished from a contract asset if the receipt of the consideration is unconditional (that is, payment is solely based on the passage of time). ASC 606 requires that receivables be presented separately from contract assets because, as stated in BC323 of ASU 2014-09, they are subject to different levels of risk. Although receivables and contract assets are subject to credit risk, contract assets are also subject to other risks, including performance risk. Once an entity's right to consideration becomes unconditional, the contract asset must be reclassified as a receivable, even if the entity has not generated an invoice (that is, an unbilled receivable).

BDO INSIGHTS: DETERMINATION OF AN UNCONDITIONAL RIGHT

In some situations, an entity has an unconditional right to consideration in advance of performance. In such situations, it would be appropriate to record both a receivable and a contract liability. However, an entity must exercise care in determining whether there is an unconditional right to payment when it has not transferred a good or service because that might be difficult to assert. Entities must carefully consider whether the contract terms and specific facts and circumstances support the existence of unconditional rights to payment.

Examples 8-1 through 8-3 illustrate the journal entries that are recorded when an entity has an unconditional right to consideration in advance of performance.

EXAMPLE 8-3 (ADAPTED FROM ASC 606-10-55-284): CONTRACT LIABILITY AND RECEIVABLE — CANCELABLE CONTRACT

On March 1, 20X2, a manufacturing entity enters a cancelable contract with a retail customer to sell products that the retail customer will resell to end consumers. The contract with the customer has the following terms:

- The retail customer must pay to the entity $10,000 at the start of the contract before the receipt of any products.
- The retail customer pays $10,000 to the entity on April 1, 20X2.
- Each product is determined to have a sales price of $500, and revenue is to be recognized when the retail customer has control of the goods.
- The manufacturing entity transfers control of the 100 products to retail customer on April 30, 20X2. The entity has no further contractual obligations to perform in the contract once transfer of control for the products has occurred.

On April 1, 20X2, the entity recorded the following journal entry to recognize a contract liability for the cash received in advance of performance:

Debit	Cash	$ 10,000	
Credit	Contract Liability		$ 10,000

On April 30, 20X2, the manufacturing entity satisfied its performance obligations to transfer control to its customer of 100 products with a purchase price of $500 each (100 * $500 = $50,000). The manufacturing entity had previously recognized the advance of $10,000 on its balance sheet as a contract liability. The entity now derecognizes that contract liability and recognizes $10,000 in revenue because it has satisfied the related performance obligation. It also recognizes a receivable for the difference of $40,000 ($50,000 revenue less the $10,000 contract liability (cash collected)).

On April 30, 20X2, the entity recorded the following journal entry to recognize revenue for the 100 products transferred to the customer:

Debit	Contract Liability	$ 10,000	
Debit	Receivable	$ 40,000	
Credit	Revenue		$ 50,000

EXAMPLE 8-4 (ADAPTED FROM ASC 606-10-55-285 AND 55-286): CONTRACT LIABILITY AND RECEIVABLE - NONCANCELABLE CONTRACT

On March 1, 20X2, an entity enters a contract with a customer to sell products on April 30, 20X2, for consideration of $10,000 paid in advance (that is, before the receipt of any products) on March 30, 20X2. The customer pays $10,000 to the entity on April 1, 20X2. The entity transfers the product on April 30, 20X2.

The contract becomes noncancelable on March 30, 20X2. Because the contract is now noncancelable, the entity has an unconditional right to payment for the $10,000. Thus, a receivable is recognized.

On March 30, 20X2, the entity recorded the following journal entry to recognize a receivable and a contract liability for the noncancelable contract:

Debit	Receivable	$ 10,000	
Credit	Contract Liability		$ 10,000

On April 1, 20X2, the entity recorded the following journal entry to recognize the receipt of cash from the customer and the reversal of the receivable:

Debit	Cash	$ 10,000	
Credit	Receivable		$ 10,000

On April 30, 20X2, the entity recorded the following journal entry to recognize revenue for the product transferred to the customer:

Debit	Contract Liability	$ 10,000	
Credit	Revenue		$ 10,000

EXAMPLE 8-5 (ADAPTED FROM ASC 606-10-55-287 THROUGH 55-290): CONTRACT ASSET RECOGNIZED FOR THE ENTITY'S PERFORMANCE

On January 1, 20X2, a retail entity enters a contract to transfer Products X and Y to a customer in exchange for $10,000. The contract with the customer specifies that:

- Product X must be provided first if the entity cannot provide both products at the same time.
- Payment for Product X will not be due until both products have been transferred to the customer.

The retail entity has determined the following:

- Product X has a SSP of $3,000 and Product Y has a SSP of $7,000.

- Revenue must be recognized when control of each product transfers to the customer.

The retail entity transfers control of Product X on March 14, 20X2. After resolving supply chain issues, the retail entity is finally able to transfer control of Product Y on July 1, 20X2.

On March 14, 20X2, the retail entity transfers control of Product X, but under the contract's terms and conditions, the entity does not have an unconditional right to consideration until both products are delivered. Therefore, on March 14, 20X2, the retail entity recorded the following journal entry to recognize revenue for Product X:

Debit	Contract Asset	$ 3,000	
Credit	Revenue		$ 3,000

On July 1, 20X2, the retail entity satisfied its performance obligations to transfer control of Product Y to its customer. Per the terms of the contract, the retail entity now has an unconditional right to consideration for both products, and it records the following journal entry to recognize revenue for Product Y and a receivable for both products:

Debit	Receivable	$ 10,000	
Credit	Contract Asset		$ 3,000
Credit	Revenue		7,000

8.2.1.5 Distinguishing Between a Contract Liability and a Refund Liability

When a customer pays consideration (or consideration is unconditionally due) and the entity has an obligation to transfer goods or services to the customer, the entity records a contract liability. However, when an entity expects to refund some or all of the amounts received to the customer, it records a refund liability. As such, a refund liability does not constitute an obligation to transfer goods or services to the customer in the future.

BDO INSIGHTS: SEPARATE PRESENTATION OF REFUND LIABILITY

A contract liability represents an entity's requirement to perform under a contract by delivering goods or services. In contrast, a refund liability represents an obligation to transfer cash or credit to a customer. Because a refund liability represents a financial liability, we believe that if that liability is material, it must be presented separately from the contract liability.

A customer's right to exchange one product for another of the same type, quality, condition, and price is not considered a right to return and hence does not result in a potential refund liability for an entity. See Section 4.3.8 for a discussion of sales with a right of return.

EXAMPLE 8-6 (ADAPTED FROM ASC 606-10-55-291 THROUGH 55-294): RECEIVABLE AND REFUND LIABILITY RECOGNIZED FOR ENTITY'S PERFORMANCE

An entity enters a contract with a new customer on January 1, 20X2, to sell widgets at $15 each. If the customer buys over 1 million widgets in a calendar year, the price per widget decreases retrospectively to $13 each. Below are some key facts:

- There are no other performance obligations in the contract.
- Payment is due when the customer receives control of the widget.
- When initially assessing the transaction price, the entity determined that the customer would meet the 1 million purchase threshold and therefore estimated that the transaction price for each widget would be $13.
- On February 1, 20X2, the entity transferred control of 100,000 widgets to the customer.

The journal entry to record the revenue recognized for the first shipment is:

Debit	Receivable	$ 1,500,000[a]	
Credit	Revenue		$ 1,300,000 [b]
Credit	Refund Liability		200,000

a) Contractual price of $15 each multiplied by 100,000 products

b) Transaction price of $13 multiplied by 100,000 products

The refund liability represents $2 per widget, which the entity expects to provide the customer for the volume-based rebate. A receivable is recognized for the contractual amount owed by the customer because control of the widgets has passed to the customer and the entity has an unconditional right to payment for them.

8.2.1.6 Presentation of Other Assets

ASC 340-40 provides guidance for the capitalization of incremental costs of obtaining a contract and costs to fulfill a contract. Such capitalized costs are presented separately from contract assets and contract liabilities.

8.2.2 Income Statement

ASC 606 requires entities to present or disclose revenue recognized from contracts with customers separately from other sources of revenue (that is, revenues outside the scope of ASC 606) either on the face of the income statement or in the footnotes. For example, if not already presented separately on the income statement, an entity that earns income from contracts from customers and leases could disclose in its footnotes:

Revenues from contracts with customers	$ 10,000,000
Lease income	1,300,000
Total revenue	$ 11,300,000

Entities must also present the effects of financing (interest income or expense) separately from revenue from contracts with customers in the income statement. BC247 of ASU 2014-09 states that entities can present interest income as revenue only when interest income represents income from their ordinary activities.

BDO INSIGHTS: PRESENTATION OF AMORTIZATION OF CONTRACT COSTS

While neither ASC 606 nor ASC 340-40 specify the presentation of amortization of contract costs in the income statement, we believe it is appropriate for an entity to present:

- Amortization of costs to obtain a contract with a customer in the same caption as other selling and marketing costs.
- Amortization of costs incurred to fulfil a contract in the same caption as cost of sales.

We generally do not believe that amortization of capitalized contract costs should be presented as depreciation and amortization.

8.3 DISCLOSURES

8.3.1 Disclosure Objective

FASB REFERENCES

ASC 606-10-45-1, ASC 606-10-50-1 through 50-23, and ASC 340-40-50-1 through 50-6

The objective of the disclosure requirements in ASC 606 is *"for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."* Also, an entity must consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each requirement. An entity aggregates or disaggregates disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.

To help entities achieve that objective, ASC 606 requires quantitative and qualitative disclosures about:

- Contracts with customers.
- Significant judgments, and changes in judgments, made in applying the guidance to those contracts.
- Assets recognized from the costs to obtain or fulfill a contract with a customer.

Judgment is required to determine the appropriate level of aggregation or disaggregation of information needed to satisfy the overall disclosure objective.

The disclosure requirements in ASC 606 apply to each reporting period for which an income statement is presented and as of each reporting period for which a balance sheet is presented. An entity does not need to disclose information in accordance with ASC 606 if it has provided the information in accordance with other U.S. GAAP.

BDO INSIGHTS: DISCLOSURES

In BC331 of ASU 2014-09, the FASB acknowledged that the disclosures described in ASC 606 must not be viewed as a checklist of minimum disclosures. Accordingly, entities do not need to include disclosures that are immaterial or irrelevant; however, they must include disclosures needed to meet the overall disclosure objective. Entities must make appropriate disclosures for each reporting period for which income statements are presented and as of each balance sheet date. Entities are not required to repeat disclosures if the information is already presented in the financial statements as required by other accounting standards.

The following table summarizes the annual and interim disclosure requirements for public and nonpublic entities under ASC 606:

	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED
Presentation	▶ Present or disclose contract assets separately from contract liabilities ▶ Present or disclose unconditional rights to consideration separately as a receivable	▶ Same requirements	▶ Same requirements
Overall	▶ Present or disclose revenue from contracts with customers separately from other sources of revenue (that is, revenues outside the scope of ASC 606) ▶ Present or disclose impairment or credit losses on any receivables or contract assets arising from contracts with customers separately from impairment or credit losses from other contracts	▶ Same requirements	▶ Same requirements
Disaggregated Revenue	▶ Disaggregate revenue into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors ▶ Disclose sufficient information to enable users to understand the relationship of disaggregated revenue presented in accordance with ASC 606 and revenue information disclosed for each reportable segment	A nonpublic entity may elect to omit the quantitative disaggregation disclosure guidance; however, if it makes that election, it must disclose at a minimum: ▶ Revenue disaggregated according to the timing of transfer of goods or services (for example, at a point in time or over time) ▶ Qualitative information about how economic factors (for example, type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows	▶ Public entities — Yes ▶ Nonpublic entities — Optional

	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED
Contract Balances	▶ Disclose opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers ▶ Disclose revenue recognized in the period that was included in the contract liability balance at the beginning of the period ▶ Explain how timing of satisfaction of performance obligations relates to the typical timing of payment and the effect those factors have on the contract asset and contract liability balances ▶ Provide an explanation of the significant changes in the contract asset and contract liability balances during the reporting period, including qualitative and quantitative information such as: • Changes caused by business combinations • Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or liability • Impairment of a contract asset • A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable) • A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability)	Nonpublic entities can elect to disclose only the opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers; the other disclosures related to contract balances are optional	▶ Public entities — Disclose opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers and revenue recognized in the period that was included in contract liability balance at the beginning of the period ▶ Nonpublic entities — Optional

	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED
Performance Obligations	Provide descriptive information about performance obligations, including: ▶ When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service), including when performance obligations are satisfied in a bill-and-hold arrangement ▶ Significant payment terms (for example, when payment is typically due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained) ▶ The nature of the goods and services the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (if the entity is acting as an agent) ▶ Obligations for returns, refunds, and other similar obligations ▶ Types of warranties and related obligations Disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price)	▶ Nonpublic entities can elect to disclose only the descriptive information about performance obligations; the other disclosures related to performance obligations are optional	▶ Public — Disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example changes in transaction price) and disclose information about remaining performance obligations ▶ Nonpublic — Optional

	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED
	Disclose information about remaining performance obligations: ▶ Aggregate amount of transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) at the end of the reporting period ▶ An explanation of when the entity expects to recognize revenue from remaining performance obligations either on a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations or by using qualitative information ▶ Optional exemptions (see Section 8.3.4.2.1)		

	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED
Significant Judgments	Disclose the judgments and changes in judgments that significantly affect the determination of amount and timing of revenue in regard to: ▶ Timing of satisfaction of performance obligations • For performance obligations satisfied over time, disclose the methods used to recognize revenue and why the method is appropriate • For performance obligations satisfied at a point in time, disclose significant judgments made in evaluating when a customer obtains control of promised goods or services ▶ Transaction price and amounts allocated to performance obligations — Disclose information about methods, inputs, and assumptions used for: • Determining the transaction price, which includes estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration • Assessing whether an estimate of variable consideration is constrained • Allocating the transaction price, including estimating SSPs of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable) • Measuring obligations for returns, refunds, and other similar obligations	▶ Nonpublic entities can elect to disclose only the information about significant judgments that affect the determination of the amount and timing of revenue recognized and the method used to recognize revenue for a performance obligation satisfied over time; the other disclosures related to significant judgments are optional	▶ Not required

	PUBLIC ENTITIES — ANNUAL DISCLOSURES	NONPUBLIC ENTITIES — ANNUAL DISCLOSURES	INTERIM — DISCLOSURES REQUIRED
Costs to Obtain or Fulfill a Contract	▶ Describe judgments made in determining the amount of costs incurred to obtain or fulfill a contract with a customer ▶ Describe method of amortization ▶ Disclose closing balances of assets recognized from costs incurred to obtain or fulfill a contract with a customer by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs) ▶ Disclose amount of amortization and any impairment losses recognized in the reporting period	▶ Not required	▶ Not required
Practical Expedients	▶ Disclose if an entity elects to use the practical expedient in either ASC 606-10-32-18 (about the existence of a significant financing component) or ASC 340-40-25-4 (about expensing the incremental costs of obtaining a contract)	▶ Not required	▶ Not required

8.3.2 Disaggregated Revenue

FASB REFERENCES

ASC 606-10-55-91

Although ASC 606 requires entities to provide disaggregated revenue information, it does not prescribe specific categories to disclose. The extent to which revenues are disaggregated depends on the facts and circumstances that pertain to an entity's contracts with customers. While some entities might need to use more than one type of revenue category, others that use only one type still meet the requirements of ASC 606.

When selecting the type of category (or categories) to comply with the requirement to disclose disaggregated revenue information, an entity must consider how its revenue information has been presented for other purposes, including **all** of the following:

- Disclosures presented outside the financial statements (for example, earnings releases, annual reports, or investor presentations).
- Information regularly reviewed by the chief operating decision-maker for evaluating the financial performance of operating segments.
- Other information that is similar to the types of information identified above and is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or to make resource allocation decisions.

Examples of categories that might be appropriate include:

- Type of good or service (for example, major product lines)
- Geographical region (for example, countries and localities)
- Market or type of customer (for example, government and nongovernment customers)
- Type of contract (for example, fixed-price and time-and-materials contracts)
- Contract duration (for example, short- and long-term contracts)
- Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)
- Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries)

DISAGGREGATED REVENUE DISCLOSURES FOR NONPUBLIC ENTITIES

While nonpublic entities are not required to provide full quantitative disaggregated revenue disclosures, at a minimum, they must disclose disaggregated revenue according to the timing of transfer of goods or services (for example, revenue recognized over time and revenue recognized at a point of time).

Nonpublic entities also must disclose qualitative information about how economic factors, such as the type of customer, geographical location of customers, and type of contract, affect the nature, amount, timing, and uncertainty of revenue and cash flows.

8.3.2.1 Relationship to Segment Disclosures

FASB REFERENCES

ASC 606-10-55-296 and 55-297

Disclosures that satisfy the objectives of ASC 606 will often present revenues disaggregated at a different level or on a different basis than segment disclosures. Accordingly, ASC 606 requires entities to disclose sufficient information to enable financial statement users to understand the relationship between disaggregated revenue disclosures and revenue information presented for each reportable segment. ASC 606 does not prescribe a format for those disclosures, but it does provide an example of them, as discussed in Example 8-5.

EXAMPLE 8-7 (ADAPTED FROM ASC 606-10-55-296 AND 55-297): DISAGGREGATION OF REVENUE

An entity reports several segments in accordance with ASC 280, *Segment Reporting*: consumer products, transportation, and energy. It disaggregates revenue into primary geographical markets, major product lines, and timing of revenue recognition for investor presentations.

The entity analyzes the requirements in ASC 606-10-50-5 and concludes that the categories in the investor presentations can be used to meet the objective of the disaggregation disclosure requirements.

The table illustrates the disaggregation disclosure by primary geographical market, major product line, and timing of revenue recognition, including a reconciliation of how the disaggregated revenue ties in with the consumer products, transportation, and energy segments in accordance with ASC 606-10-50-6.

SEGMENTS	CONSUMER PRODUCTS	TRANSPORTATION	ENERGY	TOTAL
Primary Geographical Markets				
North America	$ 900	$ 2,000	$ 5,000	$ 7,900
Europe	250	700	1,100	2,050
Asia	750	300	—	1,050
	$ 1,900	$ 3,000	$ 6,100	$ 11,000
Major Goods/Service Lines				
Office Supplies	$ 550	$ —	$ —	$ 550
Appliances	900	—	—	900
Clothing	450	—	—	450
Motorcycles	—	500	—	500
Automobiles	—	2,500	—	2,500
Solar panels	—	—	1,000	1,000
Power plant	—	—	5,100	5,100
	$ 1,900	$ 3,000	$ 6,100	$ 11,000
Timing of Revenue Recognition				
Goods transferred at a point of time	$ 1,900	$ 3,000	$ 1,000	$ 5,900
Services transferred over time	—	—	5,100	5,100
	$ 1,900	$ 3,000	$ 6,100	$ 11,000

BDO INSIGHTS: DISAGGREGATED REVENUES

ASC 606 requires entities to disaggregate revenues into categories that reflect how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows. Entities must review other publicly available information, including other portions of filings such as management's discussion and analysis, investor presentations and earnings calls. It must consider the revenue information in those other public communications when determining how to disaggregate revenue in the financial statement disclosures.

8.3.3 Contract Balances

FASB REFERENCES

ASC 606-10-50-8 through 50-11

ASC 606 requires specific disclosures regarding contract balances. The purpose of those disclosures is to provide information about the amount of revenue that is recognized in the current period that is not the result of current-period performance. ASC 606 does not prescribe a specific format for those disclosures; they could be presented in a tabular or narrative format. Example 8-6 illustrates potential disclosures using a combination of tabular and narrative formats.

EXAMPLE 8-8: CONTRACT ASSET AND LIABILITY DISCLOSURES

Entity A discloses receivables from contracts with customers separately in the balance sheet. To satisfy the other disclosure requirements for contract assets and liabilities, A includes the following information in the notes to the financial statements:

	20X9	20X8	20X7
Contract asset	$ 500	$ 700	$ 400
Contract liability (deferred revenue)	$ (200)	$ (300)	$ (100)
Revenue recognized in the period from amounts included in the contract liability at the beginning of the period	$ 250	$ 100	$ 200

The timing of revenue recognition, billings, and cash collections results in receivables, contract assets, and contract liabilities. Generally, billing occurs subsequent to revenue recognition, resulting in contract assets. However, Entity A sometimes receives advances or deposits from customers before revenue is recognized, resulting in contract liabilities. Accounts receivable are recorded when the right to consideration becomes unconditional and are presented separately in the balance sheet. Contract assets and contract liabilities are included in other assets and deferred revenue, respectively, in the balance sheet.

In 20X9, contract assets and liabilities increased by $20 and $10, respectively, as a result of cumulative catch-up adjustments caused by changes in transaction price. In 20X8, contract assets and liabilities increased by $10 and $30, respectively, as a result of cumulative catch-up adjustments caused by changes in transaction price. In 20X8, contract assets and liabilities also increased by $300 and $70, respectively, as a result of business combinations.

Although not required, an entity could elect to meet the disclosure requirements related to contract assets and liabilities by providing a full rollforward of those balances and the applicable activity for each period presented.

8.3.4 Performance Obligations

8.3.4.1 Qualitative Disclosures

FASB REFERENCES

ASC 606-10-50-12 through 50-12A

ASC 606 requires disclosures that provide descriptive information about an entity's performance obligations to help financial statement users understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Those disclosures must be entity specific and complement the entity's accounting policy disclosures. Entities must avoid boilerplate language and must tailor their disclosures to their specific facts and circumstances.

ASC 606 also requires entities to disclose the amount of revenue recognized in the current period that relates to performance obligations satisfied (or partially satisfied) in previous periods. For example, if an entity changes its estimate of transaction price, the resulting amounts recognized as revenue that relate to performance obligations satisfied in previous periods must be disclosed.

8.3.4.2 Remaining Performance Obligations

FASB REFERENCES

ASC 606-10-50-13 through 50-16

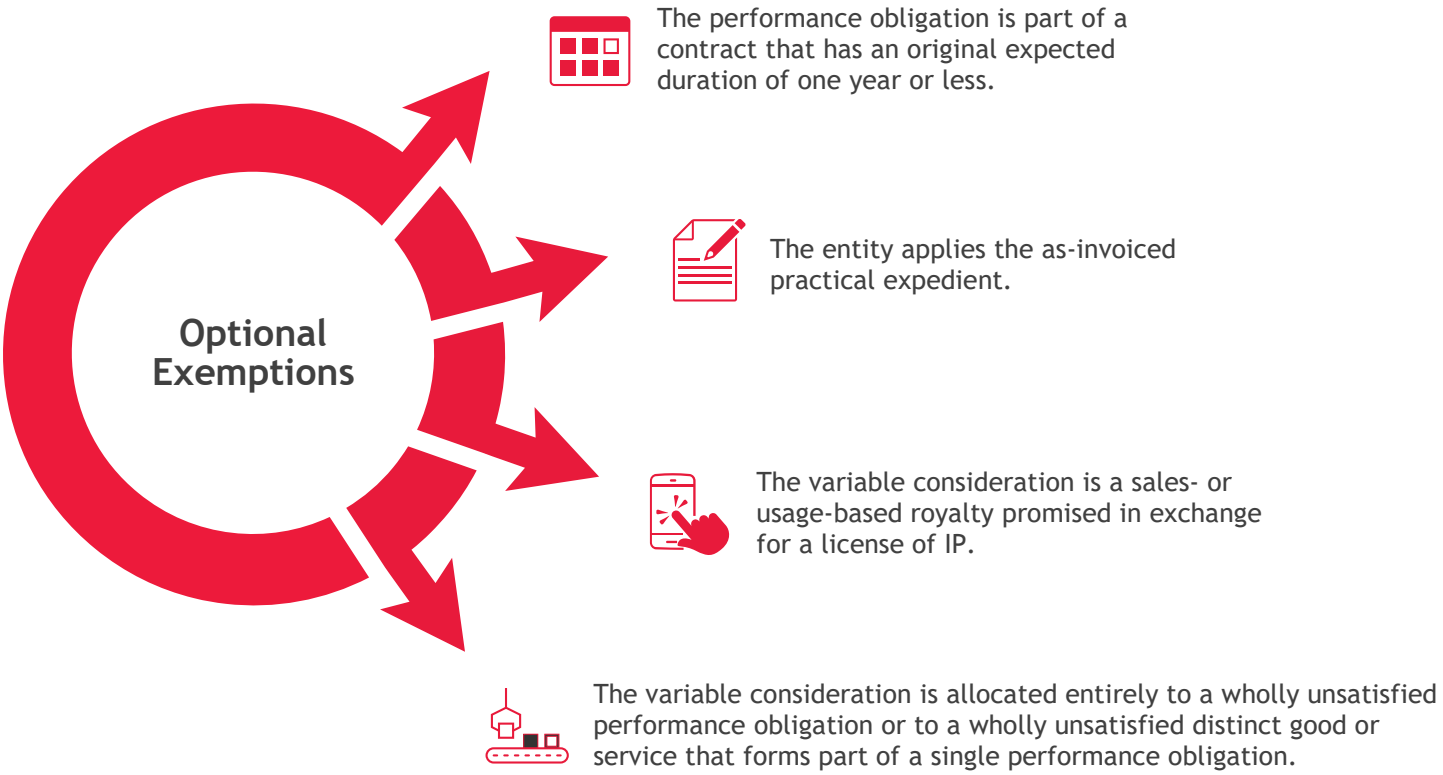
ASC 606 requires entities to disclose information about the transaction price allocated to remaining performance obligations, as well as when revenue related to those obligations will be recognized. Those types of disclosures are sometimes referred to as "backlog disclosures" because they require the disclosure of future revenue to be recorded on partially completed contracts; however, they may differ from backlog disclosures that are sometimes included in filings with the SEC.

The quantitative disclosure of remaining performance obligations must include only amounts related to performance obligations in current contracts. In other words, it must exclude renewals that have not been executed and do not represent material rights accounted for as performance obligations under current contracts. The disclosure also does not include amounts of consideration that have been excluded from the transaction price. Entities must, however, explain whether any amounts, such as variable consideration that has been constrained, have been excluded from the transaction prices (and therefore excluded from the disclosures).

Explanations of when entities expect to recognize amounts as revenue can be provided either qualitatively or quantitatively using time bands that are most appropriate for the duration of the remaining performance obligations. Judgment is required to determine which type of disclosure will be most meaningful to financial statement users.

8.3.4.2.1 Optional Exemptions

ASC 606 includes four optional exemptions related to the disclosure of transaction price allocated to the remaining performance obligations, which may be applied if **any** of the following conditions are met:



ASC 606 includes those optional exemptions to avoid instances in which an entity would be required to estimate variable consideration for disclosure purposes despite not being required to estimate it for recognition in the financial statements.

If an entity uses the optional exemptions, it must disclose the nature and remaining duration of the performance obligations and a description of the variable consideration that has been excluded from its disclosures, as well as whether any consideration is not included in the transaction price.

Examples 8-7 and 8-8 illustrate disclosures of remaining performance obligations and the application of the optional exemptions.

EXAMPLE 8-9 (ADAPTED FROM ASC 606-10-55-298 THROUGH 55-305): DISCLOSURE OF THE TRANSACTION PRICE ALLOCATED TO THE REMAINING PERFORMANCE OBLIGATIONS

On March 31, 20X1, an entity enters three contracts with separate customers to provide specific services. Each contract has a two-year noncancelable term. The description of each contract and the entity's disclosures of its remaining performance obligations for those contracts at December 31, 20X1, is included in the following:

Contract 1: Cleaning Services — Fixed Fee — As-Invoiced Practical Expedient and Related Exemption From Disclosing Remaining Performance Obligations

The entity must provide cleaning services to the customer over the two-year contract term. The services are typically provided at least once per month. The customer must pay an hourly rate of $15.

The entity bills the customer a fixed fee for each hour of service provided, and the fee corresponds directly with the value of the entity's performance completed to date. The entity elects to apply the as-invoiced practical expedient for revenue recognition. As a result, the entity elects to use the optional disclosure exemption and does not provide disclosures about its remaining performance obligations. It discloses the following:

- Election of the optional disclosure exemption.
- The nature of its performance obligation.

- The remaining contract duration.
- Description of the variable consideration that has been excluded from the disclosure of remaining performance obligations.

Contract 2: Cleaning and Common Area Maintenance Services — Fixed Fee

The entity must provide cleaning and common area maintenance services to the customer as and when needed over the two-year contract term. However, the entity will provide a maximum of four visits per month. The customer must pay a fixed monthly fee of $200 for both services.

The services represent an over-time performance obligation. The entity measures its progress toward satisfaction of the performance obligation using a time-based measure (see Chapters 3 and 6)).

Unlike in Contract 1, the entity determines that the fixed fee does not correspond directly with the value of the entity's performance completed to date. Therefore, the entity concludes that the as-invoiced practical expedient for revenue recognition cannot be elected and that the related optional disclosure relief cannot be used.

The entity provides the following quantitative information in a tabular format with time bands to disclose the amount of the transaction price that has not yet been recognized as revenue and to illustrate when it expects to recognize that amount as revenue:

	20X2	20X3	Total
Revenue expected to be recognized as of December 31, 20X1	$ 2,400[(a)]	$ 600[(b)]	$ 3,000

(a) $2,400 = $200 * 12 months

(b) $600 = $200 * 3 months

Contract 3: Cleaning Services — Fixed Fee and Variable Performance Bonus

The entity must provide cleaning services to the customer as and when needed over the two-year contract term. The customer must pay a fixed monthly fee of $100 and a one-time performance bonus related to a one-time regulatory review and certification of the customer's facility that could range between $0 and $1,000.

Assume the following:

- The entity applies the guidance on estimating and constraining variable consideration (see Chapter 4) and estimates that it will be entitled to $600 of the variable consideration.
- The service represents an over-time stand-ready performance obligation; each day represents a distinct service that forms part of a single performance obligation (see Chapter 3).
- The entity measures its progress toward satisfaction of the performance obligation using a time-based measure (see Chapter 6).

The entity considers the optional exemption from disclosing the information on remaining performance obligations for variable consideration and determines that the performance bonus does not qualify for that exemption because:

- The bonus does not represent a royalty in exchange for a license of IP.
- The bonus is not allocated to a wholly unsatisfied promise to transfer a distinct service that forms part of a single performance obligation. Rather, the bonus relates to both satisfied and unsatisfied distinct services that form part of a single performance obligation.

Therefore, the entity concludes that the optional exemption from disclosing remaining performance obligations does not apply. It provides the following disclosures:

- Quantitative information in a tabular format with time bands to disclose the amount of the transaction price that has not yet been recognized as revenue and to illustrate when the entity expects to recognize that amount as revenue:

	20X2	20X3	Total
Revenue expected to be recognized as of December 31, 20X1	$1,500[(a)]	$375[(b)]	$1,875

(a) Transaction price = $3,000 ($100 x 24 months + $600 variable consideration) recognized ratably over 24 months at $125 per month. Revenue for 12 months in 20X2 is $1,500 derived as $125 * 12 months.

(b) $375 = $125 (ratable monthly revenue) * 3 months

- Qualitative discussion about the part of the performance bonus that has been excluded from the tabular disclosure because it was not included in the transaction price in accordance with the guidance on constraining estimates of variable consideration.

EXAMPLE 8-10 (ADAPTED FROM ASC 606-10-55-306 AND 55-307): REMAINING PERFORMANCE OBLIGATIONS — QUALITATIVE DISCLOSURE

On June 1, 20X1, a construction entity enters a contract with a customer to construct a building for a fixed fee of $5 million. The construction of the building is a single performance obligation that the entity satisfies over time. As of December 31, 20X1, the entity has recognized $2 million of revenue. While the entity estimates that construction will be completed in 20X2, it is possible that the project will be completed in the first half of 20X3.

On December 31, 20X1, the entity must disclose the amount of the transaction price that has not yet been recognized as revenue and when it expects to recognize that amount as revenue. The entity observes that the disclosure can be provided either in a quantitative manner using time bands that are most appropriate for the duration of the remaining performance obligation or by a qualitative explanation. Because it is uncertain about the timing of revenue recognition, the entity makes the following qualitative disclosure:

> *As of December 31, 20X1, the aggregate amount of the transaction price allocated to the remaining performance obligation is $3 million, and the entity will recognize this revenue as the building is completed, which is expected to occur over the next 12-18 months.*

8.3.5 Significant Judgments

FASB REFERENCES

ASC 606-10-50-17 through 50-21

Financial statement users need information regarding the entity's critical judgments to understand the nature, amount, timing, and uncertainty of the entity's revenues. Accordingly, ASC 606 requires that entities disclose their judgments (and changes in judgments) that affect the amount and timing of revenue recognition.

8.3.5.1 Judgments Related to Timing

FASB REFERENCES

ASC 606-10-50-18 through 50-19

For performance obligations satisfied over time, entities must disclose the methods used to recognize revenue and why those methods provide a faithful depiction of the transfer of goods or services. For performance obligations satisfied at a point in time, entities must disclose significant judgments made in evaluating when customers obtain control of the goods or services.

8.3.5.2 Judgments Related to Transaction Price

FASB REFERENCES

ASC 606-10-50-20 through 50-21

Entities must disclose the methods, inputs, and assumptions used when determining the transaction price, which includes (but is not limited to):

- Estimating variable consideration
- Adjusting the consideration for the effects of time value of money
- Measuring noncash consideration

An entity must also disclose the methods, inputs, and assumptions used when assessing whether an estimate of variable consideration is constrained.

8.3.5.3 Judgments Related to Amounts Allocated to Performance Obligations

FASB REFERENCES

ASC 606-10-50-20 through 50-21

Entities must disclose the methods, inputs, and assumptions used for allocating the transaction price, including estimating SSPs of goods or services and any judgments made in allocating discounts and variable consideration to a specific part of the contract.

Similarly, entities must disclose judgments made in measuring obligations for returns, refunds, and other similar obligations.

8.3.6 Contract Costs

FASB REFERENCES

ASC 340-40-50-2

Consistent with the overall disclosure objective, entities must disclose the judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer, as well as the method of amortization.

Entities also must disclose the closing balances of contract costs by main category of asset (for example, contract initiation, precontract, and setup costs) and the amount of amortization and any impairment losses recognized in the period.

8.3.7 Practical Expedients and Accounting Policy Elections

FASB REFERENCES

ASC 606-10-50-22 through 50-23

ASC 606 provides several practical expedients to simplify the application of its recognition and measurement principles. A public entity must disclose if it elects **either** of the following practical expedients:

- **Significant financing components:** An entity need not adjust the promised amount of consideration for the effects of a significant financing component if, at contract inception, the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service is expected to be one year or less.
- **Contract costs:** An entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that otherwise would have been recognized is one year or less.

ASC 606 also provides two accounting policy elections, which must be disclosed if elected:

- **Shipping and handling**: Whether shipping and handling activities represent a promised service in a contract with a customer depends on when they are performed. ASC 606 clarifies that if such activities are performed before the customer obtains control of the good, they are fulfillment activities, not a promised service. If shipping and handling activities instead occur after the customer obtains control of the good, such activities would typically be a separate service provided to the customer for which consideration would need to be allocated. However, ASC 606 provides that an entity may elect to account for shipping and handling services provided after the customer obtains control of the good as fulfillment activities rather than as a separate service to the customer. Entities that make this election must accrue the costs of the shipping and handling if revenue is recognized for the related good before the fulfillment activities occur.
- **Sales (and similar) taxes:** An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes that are both imposed on and concurrent with a specific revenue transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). This accounting policy election does not apply to taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process.

8.3.7.1 Nonpublic Franchisor



FASB REFERENCES

ASC 952-606-50-1 through 50-2

A nonpublic franchisor that elects the practical expedient in ASC 952-606-25-2 regarding identification of performance obligations in Step 2 is required to disclose that. An additional disclosure is required if that entity makes the accounting policy election to recognize preopening services as a single performance obligation. See Section 3.6 for discussion on the practical expedient and policy election available to nonpublic franchisors.



Appendix A — Gains and Losses from the Derecognition of Nonfinancial Assets

A.1 OVERVIEW OF ASC 610-20



FASB REFERENCES

ASC 610-20-05-1 through 05-2

ASC 610-20 provides guidance on recognizing and presenting gains and losses on transfers of nonfinancial assets and in substance nonfinancial assets to counterparties that are not customers (noncustomers). Nonfinancial assets include intangible assets, land, buildings, and materials and supplies. An in substance nonfinancial asset is a financial asset promised to a counterparty in a contract if substantially all the fair value of the assets promised in that contract is concentrated in nonfinancial assets (for instance, a contract to sell a commercial real estate property and the related accounts receivable).

ASC 610-20 applies to all entities and includes guidance on transactions that fall within its scope. Transfers of nonfinancial assets and in substance nonfinancial assets to noncustomers that are specifically within the scope of other U.S. GAAP are excluded from the scope of ASC 610-20 (see Section A.2).

The determination of whether and when nonfinancial assets and in substance nonfinancial assets are derecognized is based on the principles of control in ASC 810 and ASC 606. ASC 810 includes guidance on determining whether an entity has a controlling financial interest in another entity. ASC 606 includes the guidance on recognizing revenue from contracts with customers.

Even though ASC 610-20 applies to contracts with noncustomers, the revenue recognition principles in ASC 606, which apply to contracts with customers, are heavily leveraged for multiple key accounting concepts. Specifically, in accounting for a transaction within the scope of ASC 610-20, an entity considers the guidance in ASC 606 to determine whether a contract exists, identify the distinct nonfinancial assets, measure the transaction price, allocate the transaction price to the distinct assets and determine the point in time control of those assets transfers (see Section 9.3).

ASC 610-20 includes presentation and disclosure requirements for transactions within its scope (see Section A.4).

A.2 SCOPE AND SCOPE EXCEPTIONS IN ASC 610-20

FASB REFERENCES

ASC 610-20-15-1 through 15- 4, ASC 610-20-15-10, ASC 845-10-15-4(k), and ASC 845-10-55-2

The guidance in ASC 610-20 applies to all entities that transfer nonfinancial assets and in substance nonfinancial assets to noncustomers, unless a scope exclusion applies (see Section A.2.1). Nonfinancial assets include intangible assets, land, buildings, and materials and supplies and may have a zero carrying value. In substance nonfinancial assets are described in Section A.2.2.

The term "transfer" is used broadly in ASC 610-20 and includes:

- Sales
- Transfer of ownership interests (or variable interests) in a consolidated subsidiary by the parent entity
- Changes in facts and circumstances resulting in the derecognition of nonfinancial assets or in substance nonfinancial assets that do not constitute a business. For example, an entity may lose control of nonfinancial assets or in substance nonfinancial assets because:
  - The expiration or termination of a contractual arrangement, a dilution event, a government action, or upon default of a subsidiary's nonrecourse debt
  - The contribution of those assets to an equity method investee, joint venture, or another noncontrolled investee

An entity applies ASC 610-20 to a transfer of an ownership interest or other variable interest in a consolidated subsidiary that is not a business or nonprofit activity, only if **all** the assets in the subsidiary are nonfinancial assets and in substance nonfinancial assets. For a transfer of a subsidiary or group of assets that constitutes a business or nonprofit activity, see Section A.2.1.

A.2.1 Scope Exceptions from ASC 610-20

The following transactions are excluded from the scope of ASC 610-20:

EXCEPTIONS	APPLICABLE GUIDANCE AND OBSERVATIONS
A transfer of a nonfinancial asset or an in substance nonfinancial asset in a contract with a customer	Apply ASC 606.
A transfer of a subsidiary or group of assets that constitutes a business or nonprofit activity	Apply ASC 810. Refer to Business Combinations Under ASC 805 for the definition of a business.
Sale and leaseback transactions	Apply ASC 842. Refer to Accounting for Leases Under ASC 842.
A conveyance of oil and gas mineral rights	Apply ASC 932-360, *Extractive Activities—Oil and Gas*.
A transaction that is accounted for entirely under ASC 860 such as specific transfers of investments	Apply ASC 860, *Transfers and Servicing*.

EXCEPTIONS	APPLICABLE GUIDANCE AND OBSERVATIONS
A transfer of nonfinancial assets as consideration in a business combination	Apply ASC 805. Refer to **Business Combinations Under ASC 805**.
A nonmonetary transaction	Apply ASC 845, *Nonmonetary Transactions*.
A lease contract	Apply ASC 842. Refer to **Accounting for Leases Under ASC 842**.
An exchange of takeoff and landing slots	Apply ASC 908-350, *Airlines—Intangibles—Takeoff and Landing Slots*.
A contribution of cash and other assets, including a promise to give	Apply ASC 720-25, *Other Expenses—Contributions Made*. Apply ASC 958-605, *Not-for-Profit Entities—Revenue Recognition*.
A transfer of an investment in a venture that is accounted for by proportionately consolidating the venture's assets, liabilities, revenues, and expenses	Apply ASC 810, specifically ASC 810-10-45-14.
A transfer of nonfinancial assets or in substance nonfinancial assets solely between entities or persons under common control	Apply ASC 805 or other U.S. GAAP. Refer to Appendix B of **Business Combinations Under ASC 805**.

BDO INSIGHTS: SCOPE OF 606 VS. 610-20

ASC 606 applies to the transfer of a nonfinancial asset in a contract with a customer, while ASC 610-20 applies to the derecognition of a nonfinancial asset in a contract with a counterparty that is not a customer. Therefore, determining whether the counterparty to a transfer of a nonfinancial asset meets the definition of a customer is crucial. The Master Glossary 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."* Therefore, whether the counterparty is considered a customer depends on whether the asset being transferred is an output of the entity's ordinary activities.

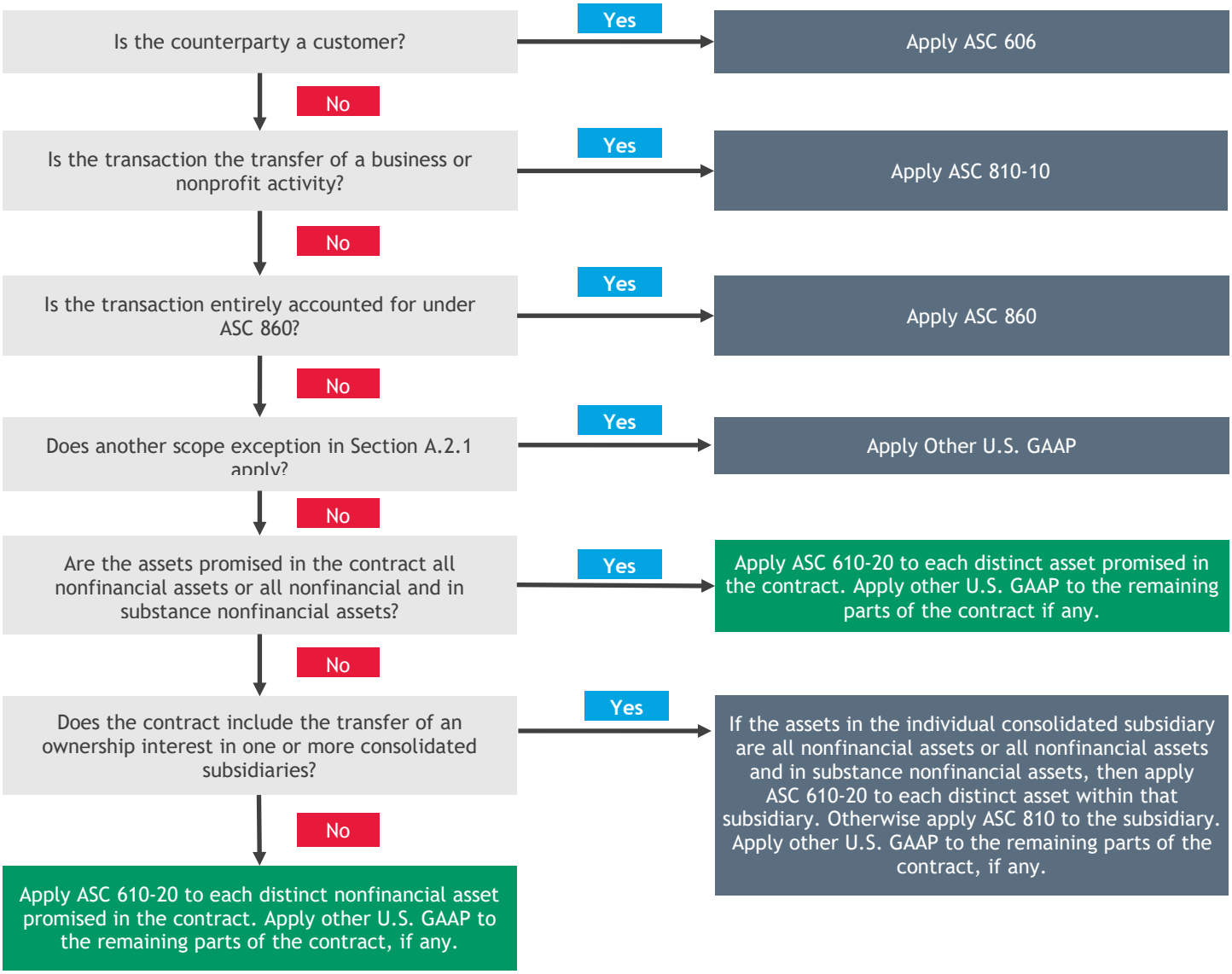
For example, consider an entity that manufactures industrial equipment. The entity decides to sell a building it obtained in an acquisition and does not plan to use. If the entity sells the building to a third party that also often buys industrial equipment from it, the sale of the building is in the scope of ASC 610-20, rather than ASC 606, because sales of real estate are not outputs of the entity's ordinary activities. Determining whether a transfer of a nonfinancial asset is an output of an entity's ordinary activities requires judgment based on the facts and circumstances.

BDO INSIGHTS: SCOPE OF ASC 610-20 VERSUS ASC 845: TRANSFER OF A NONFINANCIAL ASSET IN EXCHANGE FOR NONCASH CONSIDERATION

ASC 610-20 explicitly excludes transactions within the scope of ASC 845, but ASC 845 applies only when ASC 610-20 does not apply to a transaction – an apparent circularity in the scoping guidance of the two standards. However, the Basis for Conclusions to ASU 2017-05 (ASC 610-20) shows that the FASB intended that a transfer of a nonfinancial asset for noncash consideration is within the scope of ASC 610-20, not ASC 845.

Therefore, we believe that ASC 845 rarely will apply to transfers of nonfinancial assets in exchange for noncash consideration. For example, a transfer of real estate in exchange for receiving (or retaining) an equity method investment or another noncontrolling investment in an entity that holds real estate is within the scope of ASC 610-20, not ASC 845 (see Section A.2.2.1). However, the scope of ASC 845 does include exchanges of inventory and nonreciprocal transactions with owners.

The following decision tree, which is adapted from ASC 610-20-15-10, depicts the process of evaluating if an asset promised to a counterparty in a contract (or parts of a contract) is subject to ASC 610-20.



A.2.2 In Substance Nonfinancial Assets

FASB REFERENCES

ASC 610-20-15-5 through 15-8 and ASC 610-20-55-2 through 55-5

ASC 610-20-15-5

> *"An in substance nonfinancial asset is a financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets…"*

If substantially all the fair value of the assets promised to the counterparty in a contract **is** concentrated in nonfinancial assets, any financial assets transferred also are in substance nonfinancial assets. If substantially all the fair value of the assets promised to the counterparty in a contract is **not** concentrated in nonfinancial assets, further analysis is needed to determine which standard applies.

In determining whether substantially all the fair value of the assets promised to the counterparty in a contract is concentrated in nonfinancial assets, the following are excluded:

- Cash or cash equivalents
- Any liabilities assumed or relieved by the counterparty

BDO INSIGHTS: SUBSTANTIALLY ALL THRESHOLD

ASC 610-20 does not quantify the term "substantially all" with a percentage, but the threshold generally is understood as approximately 90% in other U.S. GAAP (for example, ASC 842). We believe that because ASC 610-20 is not specific, interpreting the term "substantially all" requires the application of professional judgment based on the facts and circumstances.

Examples A-1 and A-2 illustrate how to determine whether financial assets meet the definition of in substance nonfinancial assets.

EXAMPLE A-1 (ADAPTED FROM ASC 610-20-55-2 THROUGH 55-5): NONFINANCIAL ASSETS, IN SUBSTANCE NONFINANCIAL ASSETS, AND A GUARANTEE

An entity enters a contract with a buyer to transfer a residential building, the related operating leases, and accounts receivable. The entity provides a guarantee to the buyer that the cash flows from the building will be sufficient to meet all the building's operating needs for three years after the sale. Otherwise, the entity must pay the shortfall to the buyer.

In determining whether the transaction is within the scope of ASC 610-20, the entity concludes:

- The assets promised in the contract are not a business (as defined in ASC 805), so the transaction is not within the scope of ASC 810.
- The assets are not an output of the entity's ordinary activities, so the transaction is not within the scope of ASC 606.
- Substantially all the fair value of the assets promised in the contract is concentrated in nonfinancial assets, that is, the building and in-place lease intangibles. Therefore, the financial assets promised in the contract, that is, the accounts receivable, represent in substance nonfinancial assets.

The entity concludes that the transfer of all the assets in the contract (including the accounts receivable) is within the scope of ASC 610-20.

The issuance of the guarantee is within the scope of ASC 460. See discussion in Section A.2.3 on contracts partially within the scope of ASC 610-20 and partially within the scope of other U.S. GAAP. The entity applies the measurement and allocation guidance discussed in Section A.3 to separate and measure the guarantee.

EXAMPLE A-2 (ADAPTED FROM ASC 610-20-55-6 THROUGH 55-8): NONFINANCIAL ASSETS AND FINANCIAL ASSETS

An entity enters a contract with a buyer to transfer equipment and financial assets, both of which have significant fair value (as a proportion of the total fair value of the transferred assets). In determining whether the transaction is within the scope of ASC 610-20, the entity concludes:

- The assets promised in the contract are not a business (as defined in ASC 805), so the transaction is not within the scope of ASC 810.
- The assets are not an output of the entity's ordinary activities, so the transaction is not within the scope of ASC 606.
- Substantially all the fair value of the assets promised in the contract is not concentrated in nonfinancial assets. Therefore, the financial assets promised in the contract are not in substance nonfinancial assets.

The entity concludes that the transfer of equipment is within the scope of ASC 610-20. The transfer of financial assets is accounted for under other applicable U.S. GAAP (for example, ASC 860). See discussion in Section A.2.3 on contracts partially within the scope of ASC 610-20 and partially within the scope of other U.S. GAAP. The entity applies the measurement and allocation guidance discussed in Section A.3 to separate and measure the financial assets.

A.2.2.1 Transfer of Ownership Interests in Consolidated Subsidiaries

FASB REFERENCES

ASC 610-20-15-5 through 15-8, ASC 610-20-55-2 through 55-10, ASC 810-10-40-3A(c), and ASC 810-10-45-21A(b)(2)

When a contract transfers ownership interests in one or more consolidated subsidiaries that are **not** businesses (as defined in ASC 805), an entity applies the following guidance:

- If substantially all the fair value of the assets promised in the contract is **not** concentrated in nonfinancial assets, the entity determines whether substantially all the fair value of the assets in an **individual subsidiary within the contract** is concentrated in nonfinancial assets.
- If substantially all the fair value of the assets in such individual subsidiary **is** concentrated in nonfinancial assets, the financial assets in that subsidiary **are** in substance nonfinancial assets and the transfer of ownership interests in that subsidiary is in the scope of ASC 610-20 (see Examples A-3 and A-5).
- If substantially all the fair value of the assets in such individual consolidated subsidiary **is not** concentrated in nonfinancial assets, the financial assets in that subsidiary are **not** in substance nonfinancial assets and the transfer of ownership interests in that subsidiary is in the scope of ASC 810 if no other U.S. GAAP applies (see ASC 810-10-40-3A(c) and ASC 810-10-45-21A(b)(2)) (see also Examples A-4 and A-5).

However, that guidance does not apply to the transfer of an investment in an asset that was proportionately consolidated, because such transactions are outside the scope of ASC 610-20.[21]

[21] ASU 2017-05, BC64.

BDO INSIGHTS: TRANSFER OF NON-CONTROLLING OWNERSHIP INTEREST

As previously discussed, transfers of ownership interests in a consolidated subsidiary that is not a business may be in the scope of ASC 610-20 if substantially all the fair value of the assets promised in the contract is concentrated in nonfinancial assets and in substance nonfinancial assets. However, if an entity transfers ownership interests in an investee that it does not control and thus does not consolidate, that transfer is in the scope of ASC 860, unless a scope exception applies. Said differently, if an entity transfers an ownership interest in an investee that it accounts for under ASC 321 or as an equity method investment in accordance with ASC 323 that transfer represents a transfer of a financial asset that likely is in the scope of ASC 860, even if nonfinancial assets and in substance nonfinancial assets make up substantially all the fair value of the investee.

EXAMPLE A-3 (ADAPTED FROM ASC 610-20-55-2 THROUGH 55-5): TRANSFER OF NONFINANCIAL ASSETS, IN SUBSTANCE NONFINANCIAL ASSETS, AND A GUARANTEE THROUGH TRANSFERRING OWNERSHIP INTERESTS IN A SUBSIDIARY

Assume the same facts in Example A-1, except the entity transfers the building, operating leases, and accounts receivable by transferring ownership interests in a consolidated subsidiary to the buyer. As in Example A-1, the entity concludes that all of the assets in the subsidiary are nonfinancial assets and in substance nonfinancial assets. Therefore, the transfer of ownership interests in that subsidiary is within the scope of ASC 610-20 and the guarantee is within the scope of ASC 460.

EXAMPLE A-4 (ADAPTED FROM ASC 610-20-55-6 THROUGH 55-8): TRANSFER OF NONFINANCIAL ASSETS AND FINANCIAL ASSETS THAT ARE NOT IN SUBSTANCE NONFINANCIAL ASSETS THROUGH TRANSFERRING OWNERSHIP INTERESTS IN A SUBSIDIARY

Assume the same facts in Example A-2, except the entity transfers equipment and financial assets by transferring ownership interests in a consolidated subsidiary. Because substantially all the fair value of the assets promised to the counterparty in an individual consolidated subsidiary within the contract are not nonfinancial assets and in substance nonfinancial assets, ASC 610-20 does not apply. The entity applies ASC 810 to account for the transaction, assuming no other U.S. GAAP applies.

EXAMPLE A-5 (ADAPTED FROM ASC 610-20-55-9 THROUGH 55-10): TRANSFER OF ONE SUBSIDIARY THAT HOLDS NONFINANCIAL ASSETS AND ONE SUBSIDIARY THAT HOLDS FINANCIAL ASSETS

An entity enters a contract to transfer ownership interests in two consolidated subsidiaries, Subsidiaries A and B, to a buyer.

- Subsidiary A consists entirely of nonfinancial assets and Subsidiary B consists entirely of financial assets.
- The assets in Subsidiaries A and B have equal fair value.

In determining whether the transaction is within the scope of ASC 610-20, the entity concludes:

- The transaction is not the transfer of a business (as defined in ASC 810), and therefore is not within the scope of ASC 810.
- The underlying assets in the subsidiaries are not an output of the entity's ordinary activities, so the transaction is not within the scope of ASC 606.

The entity then concludes that substantially all the fair value of the assets promised to the buyer is not concentrated in nonfinancial assets as follows:

- Because the contract includes the transfer of ownership interests in consolidated subsidiaries, the entity analyzes the underlying assets in those subsidiaries.
- Substantially all the fair value of the assets promised to the buyer is not concentrated in nonfinancial assets because the financial assets and nonfinancial assets have equal fair value.

Next, the entity considers whether substantially all the fair value of the assets within Subsidiary A or B is concentrated in nonfinancial assets. It concludes:

- The assets in Subsidiary A are entirely nonfinancial assets; therefore, the transfer of ownership interests in Subsidiary A (and those assets) is within the scope of ASC 610-20.
- The assets in Subsidiary B are entirely financial assets; therefore, the transfer of ownership interests in Subsidiary B (and those assets) are not within the scope of ASC 610-20. The entity applies other GAAP to derecognize Subsidiary B (and those assets).

The entity applies the measurement and allocation guidance discussed in Section A.3 to separate and measure the financial assets in Subsidiary B from the nonfinancial assets in Subsidiary A that are derecognized within the scope of ASC 610-20. See discussion in Section A.2.3 on contracts partially within the scope of ASC 610-20 and partially within the scope of other U.S. GAAP.

A.2.3 Contracts Partially Within the Scope of Other U.S. GAAP



FASB REFERENCES

ASC 610-20-15-9 and ASC 606-10-15-4

A contract is partially within the scope of ASC 610-20 and partially within the scope of other U.S. GAAP if the promises to the counterparty in the contract are not all nonfinancial assets and in substance nonfinancial assets (unless the assets meet the definition of a business or are within a single consolidated subsidiary, in which case, ASC 810 applies, as discussed in Section A.2.2.1). For example, in addition to transferring nonfinancial assets, such as a building, an entity may issue a guarantee to the counterparty that is within the scope of ASC 460.

For a contract that is partially within the scope of ASC 610-20 and partially within the scope of other U.S. GAAP, an entity applies the guidance in ASC 606 to determine how to separate and measure any parts of a contract that are within the scope of other U.S. GAAP. See Section 1.4 for a discussion on separation and measurement of contracts partially within the scope of ASC 606 and partially within the scope of other U.S. GAAP.

A.3 RECOGNITION AND MEASUREMENT OF GAIN OR LOSS

FASB REFERENCES

ASC 610-20-25-1 through 25-7

A.3.1 Recognition Requirements in ASC 610-20

ASC 610-20 requires an entity to apply the principles in ASC 810 and ASC 606 when accounting for the derecognition of nonfinancial assets or in substance nonfinancial assets and the recognition of a related gain or loss. To determine whether and when to derecognize the nonfinancial assets or in substance nonfinancial assets and recognize a resulting gain or loss, an entity applies the following two-step model:

Step 1

Apply ASC 810 to determine whether the entity has or continues to have a controlling financial interest in the legal entity that holds those assets (see Section A.3.1.1).

Step 2

Apply revenue recognition guidance in ASC 606 to determine whether the entity derecognizes each distinct asset when it transfers control of that asset (see Section A.3.1.2).

A.3.1.1 Determining Whether an Entity Has a Controlling Financial Interest

FASB REFERENCES

ASC 610-20-25-2 through 25-4

An entity first determines if it has or continues to directly or indirectly have a controlling financial interest in the legal entity that holds the nonfinancial assets and in substance nonfinancial assets by applying the guidance in ASC 810. For example, if a parent transfers ownership interests in a consolidated subsidiary to a counterparty in a contract, the parent evaluates whether it continues to have a controlling financial interest in that subsidiary. Similarly, when an entity transfers assets to a counterparty, the entity evaluates whether it has a controlling financial interest in the counterparty. That analysis is also required, for example, in a partial sale in which a subsidiary issues new interests to another investor. See our Blueprint, Control and Consolidation Under ASC 810, for more guidance on determining whether an entity has a controlling financial interest in another entity.

If an entity determines it has a controlling financial interest in the legal entity that holds the nonfinancial assets or in substance nonfinancial assets, it does not derecognize those assets. Instead, the entity applies the guidance in ASC 810 and other U.S. GAAP to determine the appropriate accounting, for example, the initial consolidation of the legal entity, or the initial recognition of or an increase in noncontrolling interest in the legal entity.

If an entity determines that any nonfinancial assets or in substance nonfinancial assets transferred are held in a legal entity in which the entity does not have or ceases to have a controlling financial interest, the entity further evaluates the transfer as discussed in Section A.3.1.2 (see also Example A-6).

A.3.1.2 Applying the Revenue Recognition Guidance

FASB REFERENCES

ASC 610-20-25-5 through 25-7

If the entity determines it does not have a controlling financial interest in the legal entity that holds the nonfinancial asset or in substance nonfinancial asset transferred, it applies the recognition principles in ASC 606 to evaluate whether control of the nonfinancial asset is transferred and when the asset is derecognized.

The entity follows the following steps to apply the guidance of ASC 606:

- Determine whether a contract exists.
- Identify the distinct nonfinancial asset or in substance nonfinancial asset promised to the counterparty.
- Derecognize the distinct asset at the point in time the control of that asset transfers to the counterparty.

A.3.1.2.1 Determine Whether a Contract Exists

The first step is applying the revenue recognition guidance to determine whether a contract exists for accounting purposes, that is, whether the five contract existence criteria are met (see Section 2.2.2).

If a contract does not meet all the contract existence criteria, an entity:

- Continues to recognize the nonfinancial assets or in substance nonfinancial assets transferred and accounts for those assets in accordance with the subsequent measurement guidance in other applicable U.S. GAAP, such as ASC 350 or ASC 360.
- Continuously reassesses whether the contract existence criteria in ASC 606 are subsequently met.

If a contract meets the contract existence criteria, an entity applies the next step.

A.3.1.2.2 Identify the Distinct Assets

Once an entity determines that a contract exists, the next step is to identify the distinct nonfinancial assets or distinct in substance nonfinancial assets promised to the counterparty in the contract. For an asset to be considered "distinct," **both** of the following criteria must be met:

- The asset must be capable of being distinct.
- The promise to transfer the asset is distinct within the context of the contract.

See Section 3.3 for more guidance on determining whether the assets promised in the contract are distinct.

A.3.1.2.3 Derecognize the Asset When Control Transfers

An entity derecognizes each distinct asset when it transfers control of that asset. To determine the point in time when an entity transfers control of a distinct asset, the entity considers the notion of control and the five indicators of control in ASC 606 (see Sections 6.2 and 6.5).

If a contract includes the transfer of multiple distinct nonfinancial assets or in substance nonfinancial assets, an entity applies the principles in ASC 606 to allocate the consideration to each distinct asset. As a practical matter, an allocation of consideration might not be necessary if control of all the assets transfers at the same time.

For example, when a parent transfers ownership interests in a consolidated subsidiary that holds multiple nonfinancial assets and ceases to have a controlling financial interest in the subsidiary, control of all the assets often transfers at the same time. However, control of all assets might not transfer at the same time if the parent has control of some of those assets through an option, repurchase agreements, or other agreements (assuming that such agreement does not cause the parent to retain a controlling financial interest in the subsidiary). See Section 6.6 for discussion on a repurchase agreement and how it affects the analysis of whether control over an asset has transferred in ASC 606.

BDO INSIGHTS: TIMING OF GAIN RECOGNITION IN ASC 606 AND ASC 610-20

ASC 610-20-25-7 states that an entity must derecognize an asset at the "point in time" it transfers control of the asset in accordance with ASC 606-10-25-30, which provides guidance to help an entity determine the point in time at which control of a promised good transfers to a customer. Therefore, we believe that transactions that are within the scope of ASC 610-20 would generally be recognized at a point in time. Accordingly, we do not expect transactions that result in the creation of an asset that transfers over time to fall within the scope of ASC 610-20. However, reaching a conclusion about whether ASC 610-20 or other guidance, such as ASC 606, applies requires the application of professional judgment based on the facts and circumstances.

A.3.1.2.3.1 Analyzing Control When an Entity Retains or Receives a Noncontrolling Interest in the Legal Entity That Holds the Assets



FASB REFERENCES

ASC 610-20-25-7 and ASC 610-20-55-11 through 55-16

> *"For purposes of evaluating the indicators of the transfer of control in paragraph 606-10-25-30, if an entity has (or continues to have) a **noncontrolling interest** in the **legal entity** that holds the nonfinancial assets or in substance nonfinancial assets as a result of the transaction, the entity shall evaluate the point in time at which the legal entity holding the assets obtains (or has) control (for example, by evaluating whether the legal entity can direct the use of, and obtain substantially all of the benefits from, each distinct nonfinancial asset or in substance nonfinancial asset within it). (See Case A of Example 2 in paragraphs 610-20-55-11 through 55-14.) If the entity does not have a noncontrolling interest in the legal entity that holds the nonfinancial assets or in substance nonfinancial assets as a result of the transaction, it shall evaluate the point in time at which a counterparty (or counterparties, collectively) obtains control of the assets in the legal entity (for example, by evaluating whether a counterparty [or counterparties, collectively] can direct the use of, and obtain substantially all of the benefits from, each distinct nonfinancial asset or in substance nonfinancial asset within the legal entity)."*

As discussed in Section A.3.1.1, when a nonfinancial asset or in substance nonfinancial asset is transferred through a legal entity (or to another legal entity, which might be newly created for the transaction), and the transferor receives or retains an equity interest in that legal entity or in the counterparty, the first step is for the transferor to evaluate whether it has a controlling financial interest in the legal entity directly, or whether it controls the counterparty, in accordance with ASC 810. If the transferor does not receive or retain a controlling financial interest, it assesses at what point control of the nonfinancial asset or in substance nonfinancial asset transfers.

When analyzing the five indicators of control in ASC 606, a transferor determines **both**:

- The point in time the legal entity holding the assets obtains control of the assets.
- The point in time the counterparty obtains (or counterparties collectively obtain) control of the assets in the legal entity, which may be through obtaining (collective) control of the legal entity.

The asset is derecognized (and the gain or loss is recognized) at the later of the two points in time.

In other words, the transferor is evaluating whether any facts and circumstances (including its governing documents and the contractual arrangements between the parties) indicate that solely the legal entity (and not the transferor) controls the assets. There is no requirement for another party (for example, the buyer) to obtain a controlling financial interest in the legal entity for the transferor (former parent) to lose control of the assets, as long as it does not retain a controlling financial interest in the legal entity.

EXAMPLE A-6 (ADAPTED FROM ASC 610-20-55-11 THROUGH 55-14): TRANSFER OF CONTROL UNDER ASC 810 AND ASC 606

An entity owns 100% of Subsidiary A, a consolidated subsidiary. Subsidiary A holds title to a piece of land with a carrying amount of $10 million. The entity enters a contract to transfer 70% of Subsidiary A's equity to a buyer for $14 million in cash payable at contract inception. At contract inception, the fair value of the 30% equity interest retained by the entity is $6 million, and the buyer obtained a controlling financial interest in Subsidiary A.

In determining whether the transaction is within the scope of ASC 610-20, the entity concludes:

- Subsidiary A is not a business as defined in ASC 805, so the transaction is not within the scope of ASC 810.
- Land is not an output of the entity's ordinary activities, so the transaction is not within the scope of ASC 606.
- The transfer of 70% of Subsidiary A's equity is within the scope of ASC 610-20 because substantially all the fair value of the assets (that is, the land) promised to the buyer in the contract is in nonfinancial assets.

The entity applies the requirements in ASC 610-20 in the following manner:

- The entity first considers the guidance in ASC 810. It concludes that it no longer has a controlling financial interest in Subsidiary A and does not have a controlling financial interest in the buyer. In reaching that conclusion, the entity considered the governing documents and all contractual agreements, which give the equity holders the ability to make decisions about Subsidiary A's assets, including the land.
- The entity then determines that under ASC 606, the contract existence criteria are met and control of the land transfers to the buyer.
- Because the entity continues to have a noncontrolling interest in Subsidiary A, it evaluates the point in time when Subsidiary A, its former consolidated subsidiary, has control of the distinct nonfinancial asset. The entity concludes that it has transferred control of a distinct nonfinancial asset (the land), because Subsidiary A continues to control that asset and the buyer obtained a controlling financial interest in Subsidiary A, giving Subsidiary A the right to direct the use of, and ability to obtain substantially all the benefits from, the land. Further, the entity no longer has such rights or ability because it does not have a controlling financial interest in Subsidiary A. When evaluating the indicators of control in ASC 606, the entity determines that:
  - The entity has the present right to payment.
  - Subsidiary A has legal title to the land.
  - The entity does not have physical possession of the land because it cannot restrict or prevent other entities from accessing the land.
  - Subsidiary A has the significant risks and rewards of owning the land.
  - There is no acceptance clause in the contract.
- The difference between the amount of consideration and the carrying amount of the land results in a gain of $10 million.
  - The amount of the consideration is $20 million, calculated as the sum of the $14 million payable in cash and the $6 million for the fair value of the retained noncontrolling interest in Subsidiary A (see Section 4.5 for more guidance on measuring noncash consideration in accordance with ASC 606).
  - The carrying amount of the land is $10 million.
- The entity records the following journal entry to derecognize the land and recognize its noncontrolling interest in Subsidiary A and a gain of $10 million in the income statement:

Debit	Noncontrolling interest in Subsidiary A	$ 6 million	
Debit	Cash	14 million	
Credit	Land		$ 10 million
Credit	Gain from sale of land		10 million

- The entity subsequently accounts for its noncontrolling interest in Subsidiary A in accordance with other U.S. GAAP.

Note: The analysis would be the same even if Subsidiary A was not controlled by a single party after the transaction (which might be the case if, for example, there were two counterparties in the transaction).

EXAMPLE A-7 (ADAPTED FROM ASC 610-20-55-15 THROUGH 55-16): TRANSFER OF CONTROL UNDER ASC 810 BUT NOT ASC 606

Assume the same facts as in Example A-6, except that the entity has the right but not the obligation (that is, a call option) to repurchase the 70% ownership interest in Subsidiary A that it transferred to the buyer. The entity can repurchase 70% ownership interest in Subsidiary A in three years for $17 million.

The entity applies the requirements in ASC 610-20 in the following manner:

- The entity first considers the guidance in ASC 810. It concludes that although the call option represents a variable interest in Subsidiary A, it does not have a controlling financial interest in Subsidiary A in accordance with the guidance in ASC 810, because the option is not currently exercisable and is not deeply in the money (see Section 4.2.5 in our Blueprint, Control and Consolidation Under ASC 810, for more guidance).
- The entity then determines whether control of the land transfers under ASC 606. It concludes that despite other indicators that control has passed, as discussed in Example A-6, it did not transfer control of the land because of the repurchase option.
  - Because the exercise price on the call option is greater than the original selling price, the transaction is considered a financing agreement under ASC 606 (see Section 6.6).
- The entity does not derecognize the land, and it records a financial liability of $14 million.
- The entity does not recognize an investment for its retained 30% ownership interest until it derecognizes the land.

A.3.2 Measurement Requirements in ASC 610-20

FASB REFERENCES

ASC 610-20-32-2 through 32-6

When the criteria to derecognize a distinct nonfinancial asset or a distinct in substance nonfinancial asset is met (see Section A.3.1), an entity recognizes a gain or loss for the difference between:

- The amount of consideration measured and allocated to that distinct asset.
- The carrying amount of that distinct asset.

The amount of consideration promised in a contract includes **both**:

- The transaction price.
- The carrying amount of liabilities assumed or relieved by a counterparty.

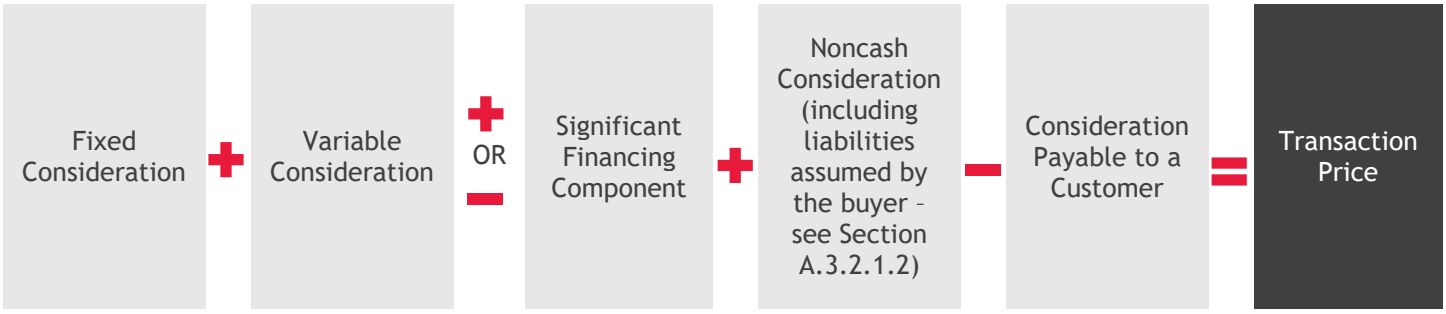
A.3.2.1 Determining Transaction Price

FASB REFERENCES

ASC 610-20-32-2 through 32-6 and ASC 610-20-55-17 through 55-19

An entity applies the guidance in ASC 606 to determine the transaction price for the transfer of nonfinancial assets or in substance nonfinancial assets and allocate the transaction price to the distinct assets transferred.

The following diagram illustrates the key concepts in determining the transaction price. See Chapter 4 for detailed discussion on transaction price.



BDO INSIGHTS: TIMING OF MEASUREMENT OF NONCASH CONSIDERATION

ASC 606-10-32-21 requires an entity to measure noncash consideration at contract inception. That approach is different than that in ASC 810, which generally requires the gain or loss upon deconsolidation of a subsidiary to be measured on the date the entity loses control of the subsidiary. Thus, the gain or loss to be recognized upon transfer of nonfinancial assets could be different under ASC 610-20 than it would be under ASC 810 if the value of the noncash consideration changes between contract inception and when the transferring entity loses control.

ASU 2025-07 — SCOPE CLARIFICATION FOR A SHARE-BASED PAYMENT FROM A CUSTOMER

In some contracts, the consideration may include equity instruments such as warrants with vesting terms (for example, the right to receive additional shares as the customer purchases additional goods or services). Questions have arisen about whether the recipient should recognize those instruments at contract inception based on the guidance in ASC 321, in ASC 815, or only as the recipient satisfies its performance obligations under ASC 606.

In September 2025, the FASB issued ASU 2025-07 to clarify that an entity applies the guidance in ASC 610-20, including the guidance on noncash consideration, to a share-based payment from a customer. The ASU also clarifies that the guidance in ASC 321 and ASC 815 does not apply unless and until the entity's right to receive or retain the share-based noncash consideration is unconditional under ASC 610-20.

The amendments in ASU 2025-07 are effective for all entities for annual reporting periods beginning after December 15, 2026, and interim reporting periods within those annual reporting periods. Early adoption is permitted.

EXAMPLE A-8 (ADAPTED FROM ASC 610-20-55-17 THROUGH 55-19): SALE OF A NONFINANCIAL ASSET FOR VARIABLE CONSIDERATION

A pharmaceutical entity sells the rights to in-process R&D that it recently acquired and measured at its fair value of $100 million in accordance with ASC 805. The buyer agrees to pay a nonrefundable amount of $10 million at contract inception plus 4% of any product sales derived from the in-process R&D over the next 20 years.

In determining whether the transaction is within the scope of ASC 610-20, the entity concludes:

- The in-process R&D does not meet the definition of a business in ASC 805 and therefore is not within the scope of ASC 810.
- The in-process R&D is not an output of the entity's ordinary activities and therefore is not within the scope of ASC 606.

The pharmaceutical entity applies the guidance in ASC 610-20 and recognizes a net loss of $90 million at contract inception as follows:

- It first concludes that it does not have a controlling financial interest in the buyer under ASC 810.
- It then applies the guidance in ASC 606 and concludes:
  - The contract existence criteria are met.
  - It has transferred control of the in-process R&D asset to the buyer at contract inception because the buyer can use the in-process R&D's records, patents and documentation to develop potential products and has relinquished all substantive rights to the in-process R&D asset.
  - It cannot apply the sales- or usage-based royalty exception to estimating variable consideration in determining the transaction price because it has sold the IP rather than out-licensing it (see Section 7.5.4).
  - The transaction price is limited to the nonrefundable upfront payment of $10 million. The estimate of the variable consideration (that is, the sales-based royalties) is fully constrained even though the entity estimates that it will receive $200 million over the 20-year royalty period. However, the entity cannot assert that it is probable that recognizing all the estimated variable consideration in other income would not result in a significant reversal of that consideration. That is because the royalty is highly susceptible to the actions and judgments of third parties, because it is based on the buyer completing development of the in-process R&D asset, obtaining regulatory approval, and commercializing and selling the in-process R&D. Therefore, the entity concludes that it cannot include any royalties in the transaction price (that is, the variable consideration is fully constrained).
- At contract inception, the entity derecognizes the in-process R&D asset and recognizes a net loss of $90 million ($10 million of consideration, less the carrying amount of the in-process R&D asset of $100 million).
- The entity reassesses the transaction price at each reporting period to determine whether it is probable that a significant reversal would not occur from recognizing the estimate as other income and, if so, recognizes that amount as other income.

A.3.2.1.1 Determining Transaction Price When the Entity Receives or Retains an Ownership Interest

If an entity transfers control of a distinct nonfinancial asset (and a distinct in substance nonfinancial asset) in exchange for a noncontrolling interest, the noncontrolling interest received from the counterparty is considered noncash consideration that is measured at fair value, as discussed in Section 4.5.

Similarly, if a parent transfers control of a distinct nonfinancial asset (and an in substance nonfinancial asset) by transferring ownership interests in a consolidated subsidiary while retaining a noncontrolling interest in its former subsidiary, the entity considers the retained noncontrolling interest as noncash consideration and measures it at fair value, as discussed in Section 4.5.

EXAMPLE A-9: CONTRIBUTION OF AN ASSET TO A JOINT VENTURE IN EXCHANGE FOR OWNERSHIP INTEREST

An entity enters a contract with a third party to form a joint venture (JV). At the time of JV formation:

- The entity transfers to the JV a specialized machinery with a carrying value of $100,000 and a fair value of $250,000.
- The JV controls the specialized machinery because it can direct the use and obtain substantially all the benefits of the IP.
- The entity receives a 35% ownership interest in the JV in exchange for contributing the specialized machinery.
- The fair value of the 35% noncontrolling interest in the JV is $250,000.

The entity concludes that it does not have a controlling financial interest in the JV and will account for its investment in the JV under the equity method (see our Blueprint, **Equity Method Investments Under ASC 323**).

At the time of JV formation and transferring control of the machinery to the JV, the entity concludes that:

- The transaction is not the transfer of a business (as defined in ASC 810), and therefore is not within the scope of ASC 810.
- The specialized machinery is not an output of the entity's ordinary activities, and therefore is not within the scope of ASC 606.
- Substantially all the fair value of the assets promised to the buyer is concentrated in nonfinancial assets (the specialized machinery).
- Under ASC 606, the contract existence criteria are met and control of the machinery transfers to the buyer.
- The 35% ownership interest (noncontrolling interest that will be accounted for using the equity method) received from the JV is noncash consideration, which is measured at fair value.
- The entity records the following journal entry to derecognize the specialized machinery and recognize its noncontrolling interest in the JV and a gain of $150,000 in the income statement:

Debit	Equity method investment in the JV	$ 250,000	
Credit	Machinery		$ 100,000
Credit	Gain from transfer of machinery		150,000

A.3.2.1.2 Determining Transaction Price When a Counterparty Assumes or Relieves a Liability

If a counterparty promises to assume or relieve an entity’s liability in exchange for a transfer of nonfinancial assets or in substance nonfinancial assets within the scope of ASC 610-20, the entity includes the carrying amount of the liability in the consideration used to calculate the gain or loss.

However, although a liability assumed or relieved by a counterparty is included in the consideration used to calculate a gain or loss, an entity does not derecognize the liability until it has been extinguished in accordance with ASC 405, *Liabilities*. If an entity transfers control of the nonfinancial assets or in substance nonfinancial assets before a liability is extinguished, it applies the guidance on constraining estimates of variable consideration (see Section 4.3.3) to determine the carrying amount of the liability when calculating the gain or loss.

EXAMPLE A-10: FORECLOSURE ON A BUILDING WITH LIABILITY EXTINGUISHED SIMULTANEOUSLY

A manufacturing entity owns an office building financed by a mortgage from a bank. The entity's ordinary activities include manufacturing goods but do not include investing in nonfinancial assets, such as residential or commercial real estate properties.

The entity defaulted on its loan payments and the bank foreclosed on the office building. As a result of the foreclosure, the bank obtained legal title to the building along with all other rights of ownership, which resulted in a loan extinguishment in accordance with ASC 405.

At the time of the transfer of the office building to the bank:

- The carrying value of the building was $10 million.
- The carrying value of the mortgage was $8 million.
- The fair value of the building was $7 million.

The entity concludes that the transfer of the foreclosed office building to the bank is in the scope of ASC 610-20 (not ASC 606) because the building is not an output of its ordinary activities and substantially all the fair value of the asset (that is, the building) transferred to the bank in the foreclosure is in a nonfinancial asset. The building does not meet the definition of a business, so the transaction is not within the scope of ASC 810. The entity applies the guidance in ASC 610-20 as follows:

- The entity first considers the guidance in ASC 810 and concludes that it does not have a controlling financial interest in the bank.
- It then determines that under ASC 606, the contract existence criteria are met and control of the building transfers to the bank.
- It accounts for the derecognition of the office building and the loan forgiveness together (because the liability was extinguished at the same time) and recognizes a single gain or loss inclusive of the loan forgiveness. In other words, in determining the gain or loss from the transfer of the building, the entity includes the outstanding loan amount forgiven by the bank. Accordingly, the loss from the transfer of the building is $2 million* (determined as the difference between the $10 million carrying value of the office building and the $8 million carrying value of the mortgage).

* This example ignores the application of the impairment guidance in ASC 360-10-35. If the entity had identified a triggering event, it would have tested the office building for impairment and recognized an impairment loss if the building (or related asset group) was not recoverable.

BDO INSIGHTS: TIMING OF ASSET TRANSFER AND LOAN EXTINGUISHMENT IN A FORECLOSURE

In a foreclosure, a mortgage generally is extinguished immediately upon the transfer of the mortgaged real estate. However, at times there might be a difference between when the mortgage loan is extinguished and when the mortgaged asset is transferred to a counterparty. For example, a mortgaged building may be placed into receivership (instead of being foreclosed on), which results in the borrower losing control over the asset. In that scenario, the borrower derecognizes the building but continues to recognize the liability for the mortgage until the criteria for liability extinguishment in ASC 405-20 are met. The borrower would recognize a contract asset or contract liability when recognizing a gain or loss for the transfer of the building (see Section A.4).

A.3.2.2 Allocating the Transaction Price

An entity allocates the transaction price calculated in Section A.3.2.1 to each distinct nonfinancial asset or in substance nonfinancial asset in accordance with the allocation guidance discussed in Chapter 5.

A.4 PRESENTATION AND DISCLOSURES REQUIRED BY ASC 610-20

A.4.1 Presentation Requirements in ASC 610-20

FASB REFERENCES

ASC 610-20-45-1 through 45-3, ASC 360-10-45-5, ASC 606-10-45-1 through 45-5, and ASC 405-20-40-1

A gain or loss recognized on the sale of a long-lived asset in a transaction in the scope of ASC 610-20 that is not a discontinued operation is included in income from continuing operations before income taxes in an entity's income statement of an entity.

When either party to a contract has performed, an entity must apply the guidance in ASC 606 to present a contract asset or a contract liability or a receivable in the balance sheet based on the relationship between the entity's performance and the counterparty's payment (see Section 8.2 for more guidance on presentation requirements).

If an entity meets the criteria for extinguishment of a liability under ASC 405 to derecognize a liability assumed or relieved by a counterparty before transferring control of a distinct nonfinancial asset, the liability is derecognized but a gain or loss must not be recognized. Rather, the entity records a contract liability, which represents consideration received before transferring control of the asset. If an entity transfers control of a distinct nonfinancial asset before meeting the criteria to derecognize a liability assumed or relieved by a counterparty, it recognizes a contract asset to the extent the carrying amount of the liability is included in the calculation of the gain or loss.

EXAMPLE A-11: FORECLOSURE ON A BUILDING IN WHICH LIABILITY IS EXTINGUISHED SUBSEQUENTLY

Assume the same facts in Example A-10, except the criteria in ASC 405-20 for derecognizing the mortgage are not met at the point in time the manufacturing entity transfers control of the building to the bank. When control of the building transfers to the bank, the entity:

- Derecognizes the office building.
- Recognizes a contract asset for an amount equal to the outstanding mortgage (that is, $8 million).
- Recognizes a loss of $2 million from the transfer of the building.

The entity derecognizes the mortgage and the contract asset when the criteria in ASC 405-20 for extinguishing the liability for the mortgage are met.

A.4.2 Disclosure Requirements in ASC 610-20

FASB REFERENCES

ASC 610-20-50-1

ASC 360-10-50-3

> *For any period in which a long-lived asset (disposal group) either has been disposed of or is classified as held for sale (see paragraph 360-10-45-9), an entity shall disclose all of the following in the notes to financial statements:*
>
> > *a. A description of the facts and circumstances leading to the disposal or the expected disposal.*
> >
> > *b. The expected manner and timing of that disposal.*
> >
> > *c. The gain or loss recognized in accordance with paragraphs 360-10-35-37 through 35-45 and 360-10-40-5.*
> >
> > *d. If not separately presented on the face of the statement where net income is reported (or in the statement of activities for a not-for-profit entity), the caption in the statement where net income is reported (or in the statement of activities for a not-for-profit entity) that includes that gain or loss.*
> >
> > *e. If not separately presented on the face of the statement of financial position, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group classified as held for sale. Any loss recognized on the disposal group classified as held for sale in accordance with paragraphs 360-10-35-37 through 35-45 and 360-10-40-5 shall not be allocated to the major classes of assets and liabilities of the disposal group.*
> >
> > *f. If applicable, the segment in which the long-lived asset (disposal group) is reported under Topic 280 on segment reporting.*

ASC 360-10-50-3A

> *In addition to the disclosures in paragraph 360-10-50-3, if a long-lived asset (disposal group) includes an individually significant component of an entity that either has been disposed of or is classified as held for sale (see paragraph 360-10-45-9) and does not qualify for presentation and disclosure as a discontinued operation (see Subtopic 205-20 on discontinued operations), a public business entity and a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market shall disclose the information in (a). All other entities shall disclose the information in (b).*
>
> > *a. For a public business entity and a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, both of the following:*
> >
> > > *1. The pretax profit or loss (or change in net assets for a not-for-profit entity) of the individually significant component of an entity for the period in which it is disposed of or is classified as held for sale and for all prior periods that are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity) calculated in accordance with paragraphs 205-20-45-6 through 45-9*

2. If the individually significant component of an entity includes a NCI, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent for the period in which it is disposed of or is classified as held for sale and for all prior periods that are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

b. For all other entities, both of the following:

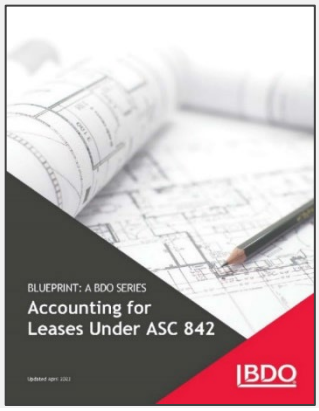
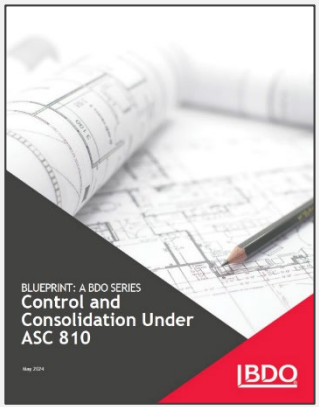
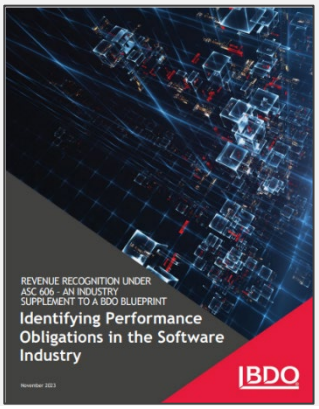
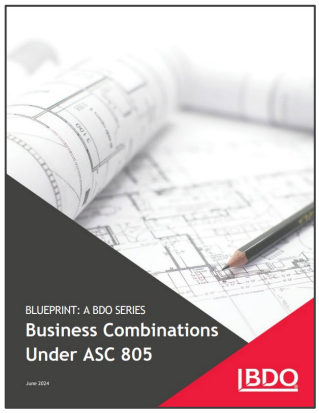
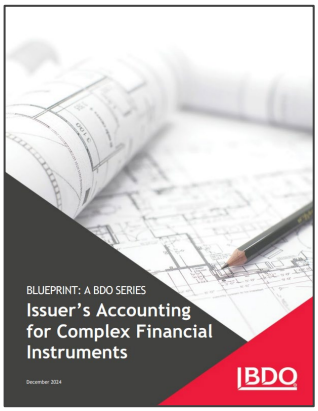
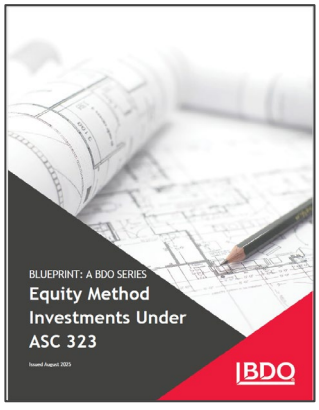
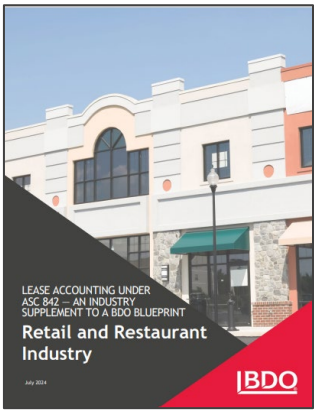
1. The pretax profit or loss (or change in net assets for a not-for-profit entity) of the individually significant component of an entity for the period in which it is disposed of or is classified as held for sale calculated in accordance with paragraphs 205-20-45-6 through 45-9

2. If the individually significant component of an entity includes a NCI, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent for the period in which it is disposed of or is classified as held for sale.

ASC 610-20 refers to ASC 360 for guidance on disclosure of a gain or loss recognized upon the derecognition of a long-lived asset (disposal group), which is provided above.

Appendix B — Other BDO Blueprints

Other publications in BDO's Blueprint series are available on the [BDO Center for Accounting Standards and Reporting Matters](#).

BDO BLUEPRINTS			INDUSTRY SUPPLEMENTS
			
[Accounting for Leases Under ASC 842](#)	[Share-Based Payments Under ASC 718](#)	[Control and Consolidation Under ASC 810](#)	[Identifying Performance Obligations in the Software Industry](#)
			
[Business Combinations Under ASC 805](#)	[Issuer's Accounting for Complex Financial Instruments](#)	[Equity Method Investments Under ASC 323](#)	[Lease Accounting for the Retail and Restaurant Industries](#)

Appendix C — Summary of Significant Changes

Several editorial changes were made in this October 2025 edition of the Blueprint as compared to the December 2024 edition. The following table lists the substantive changes made in this edition:

SECTION	DESCRIPTION OF CHANGE
1.2	Added BDO Insights on the applicability of the guidance in ASC 606 to streaming arrangements in the mining industry
2.3.2	Updated BDO Insights to discuss termination due to breach of contract clauses
2.4	Added BDO Insights to discuss the accounting when an asset is transferred before the definition of a contract is met
3.3.2.3	Updated BDO Insights and added references to SEC remarks to discuss how to market promises when determining whether promises are distinct in the context of the contract
4.2.1	Added BDO Insights to explain that tariffs are not taxes subject to the practical expedient
4.3.1	Added BDO Insights to explain that service level agreements may represent variable consideration
4.3.3	Added BDO Insights to discuss whether to constrain variable consideration that is tied to regulatory approvals
4.4.2	Updated discussion and added BDO Insights to clarify how to determine the appropriate discount rate when a contract includes a significant financing component
4.5	Added BDO Insights to clarify the accounting for cryptocurrencies received as noncash consideration
4.5	Updated BDO Insights to add indicators to consider when determining whether goods or services provided by a customer are noncash consideration
4.6.1	Expanded discussion in BDO Insights to clarify how to determine whether amounts payable to a customer for advertising services are distinct
4.6.2A	Added Section 4.6.2A to explain the accounting for vesting conditions in share-based consideration payable to a customer after adoption of ASU 2025-04
5.3.2	Updated BDO Insights to clarify how to allocate consideration when SSP is determined as a range
5.3.2.2	Added BDO Insights to clarify how to determine an appropriate profit margin

SECTION	DESCRIPTION OF CHANGE
5.3.2.4	Added Section 5.3.2.4 to discuss other approaches that may be acceptable in estimating SSP, including BDO Insights to explain the use of a value relationship
6.3.2	Updated BDO Insights to clarify how to determine whether a subcontract is subject to FAR provisions
6.8	Added BDO Insights to clarify how to determine whether an entity can use a product or direct it to another customer
7.3.2	Added BDO Insights to clarify the accounting for modifications that reduce the scope of a contract
7.4.1	Added BDO Insights to explain that a right to purchase products in the future at cost is typically a material right
7.4.2	Added BDO Insights to explain that nonsubstantive termination options are economically equivalent to renewal options
7.4.4	Added BDO Insights and Example 7-20A to clarify how to account for contracts with minimum guarantees, such as take-or-pay contracts
7.7.1	Added BDO Insights to clarify the accounting when a payment to a customer is both a commission and in exchange for distinct goods or services
8.2.1	Added a discussion and two exhibits explaining alternative approaches to presenting retainage in the financial statements based on the interpretive guidance provided in FASB staff educational paper “Topic 606: Presentation and Disclosure of Retainage for Construction Contractors”
8.2.1.1	Added BDO Insights to clarify how to report cash received before the definition of a contract is met
8.2.1.2	Added discussion and excerpt from SEC speech to explain how to present payments made to a customer before the definition of a contract is met

Contacts

ANGELA J. NEWELL
Professional Practice Principal – Accounting
214-689-5669 / ajnewell@bdo.com

ADAM BROWN
National Managing Principal – Accounting
214-665-0673 / abrown@bdo.com

JENNIFER KIMMEL
Professional Practice Principal – Accounting
203-905-6284 / jkimmel@bdo.com

Material discussed in this publication is meant to provide general information and should not be acted on without professional advice tailored to your needs.

FASB publications excerpted in this publication were reprinted with permission. Copyright 2024 by Financial Accounting Foundation, Norwalk, Connecticut.

Our purpose is helping people thrive, every day. Together, we are focused on delivering exceptional and sustainable outcomes and value for our people, our clients and our communities. BDO is proud to be an ESOP company, reflecting a culture that puts people first. BDO professionals provide assurance, tax and advisory services for a diverse range of clients across the U.S. and in over 160 countries through our global organization.

BDO is the brand name for the BDO network and for each of the BDO Member Firms. BDO USA, P.C., a Virginia professional corporation, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. For more information, please visit: www.bdo.com.

© 2024 BDO USA, P.C. All rights reserved.