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Revenue from contracts with customers

Global edition

2014

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Preface

PwC is pleased to offer the first edition of our global accounting and financial reporting guide for *Revenue from contracts with customers*. In May 2014, the FASB and IASB issued their converged standard on revenue recognition which replaces much of the prescriptive, and often industry-specific or transaction-specific, guidance included in today's accounting literature. Most entities will see some level of change as a result of the new standard. This guide begins with a summary of the new five-step revenue recognition model. The ensuing chapters further discuss each step of the model, highlighting key aspects of the standard and providing examples to illustrate application. Relevant references to and excerpts from both the FASB and IASB standards are interspersed throughout the guide. The guide also discusses the new disclosure requirements and the effective date and transition provisions.

Locating guidance on particular topics

Guidance on particular topics can be located as follows:

- Table of contents—The table of contents provides a detailed listing of the various sections in each chapter. The titles of each section are intentionally descriptive to enable users to easily find a particular topic.
- Table of examples—The table of examples includes a listing of examples in numerical order, by chapter.

The guide also includes a detailed index of key topics.

References to U.S. GAAP and International Financial Reporting Standards

Definitions, full paragraphs, and excerpts from the Financial Accounting Standards Board's Accounting Standards Codification and standards issued by the International Accounting Standards Board are clearly designated, either within quotes in the regular text or enclosed within a shaded box. The remaining text is PwC's original content.

References to other chapters and sections in this guide

Where relevant, the discussion includes general and specific references to other chapters of the guide that provide additional information. References to another chapter or particular section within a chapter are indicated by the abbreviation "RR" followed by the specific section number (e.g., RR 2.2.1 refers to section 2.2.1 in chapter 2 of this guide).

Guidance date

The content in this guide will be updated as our understanding of the new guidance evolves and implementation insights arise as entities begin to transition to the new standard. This guide considers existing guidance as of July 31, 2014. Future editions will be released to keep pace with significant developments.

Certain events such as the issuance of a new pronouncement by the FASB, a consensus (and ensuing endorsement by the FASB) of the Emerging Issues Task Force, or new SEC rules or guidance may necessitate an update or supplement to the guide. Updates, or supplements that may be in the form of other PwC communications, can be found on CFOdirect (www.cfodirect.com) or Comperio (www.pwccomperio.com).

Other information

The appendices to this guide include guidance on professional literature, a listing of technical references and abbreviations, and definitions of key terms.

* * * * *

This guide has been prepared to support you as you identify the implications of the new revenue recognition standard, evaluate its impact (on business strategies, processes, systems, controls, financial statement recognition and required disclosures) and prepare for implementation. It should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice. We hope you find the information and insights in this guide useful. We will continue to share with you additional perspectives and interpretations as they develop.

Paul Kepple
U.S. Chief Accountant

2014

Table of contents

Chapter 1: An introduction to revenue from contracts with customers

1.1	Background.....	1-2
1.2	What is revenue?	1-4
1.3	High-level overview	1-5
1.3.1	Scope.....	1-5
1.3.2	The five-step model	1-6
1.3.3	Portfolio approach	1-7
1.4	Implementation guidance	1-7
1.5	Disclosures.....	1-8
1.6	Transition and effective date	1-8

Chapter 2: Scope and identifying the contract

2.1	Chapter overview	2-2
2.2	Scope.....	2-2
2.2.1	Evaluation of nonmonetary exchanges.....	2-3
2.2.2	Contracts with components in and out of the scope of the revenue standard	2-3
2.3	Sale or transfer of nonfinancial assets.....	2-4
2.4	Identifying the customer	2-4
2.5	Arrangements with multiple parties.....	2-5
2.6	Identifying the contract	2-6
2.6.1	Contracts with customers – required criteria.....	2-7
2.6.1.1	The contract has been approved and parties are committed	2-7
2.6.1.2	The entity can identify each party's rights	2-9
2.6.1.3	The entity can identify the payment terms	2-9
2.6.1.4	The contract has commercial substance	2-9
2.6.1.5	Collection of the consideration is probable.....	2-10
2.6.2	Arrangements where criteria are not met	2-10
2.6.3	Reassessment of criteria	2-11
2.7	Combining contracts	2-11
2.8	Contract modifications	2-12
2.8.1	Assessing whether a contract modification is approved.....	2-14
2.8.2	Modification accounted for as a separate contract.....	2-15
2.8.3	Modification not accounted for as a separate contract.....	2-15

2.8.3.1	Modification accounted for prospectively	2-16
2.8.3.2	Modification accounted for through a cumulative catch-up adjustment	2-17
2.8.4	Changes in the transaction price	2-17

Chapter 3: Identifying performance obligations

3.1	Chapter overview	3-2
3.2	Promises in a contract.....	3-2
3.2.1	Promise to transfer a distinct good or service	3-3
3.2.2	Promise to transfer a series of distinct goods or services	3-3
3.3	Assessing whether a good or service is “distinct”	3-4
3.3.1	Customer can benefit from the good or service.....	3-4
3.3.2	Good or service is separately identifiable from other promises in the contract.....	3-5
3.4	Other considerations.....	3-8
3.4.1	Activities that are not performance obligations.....	3-8
3.4.2	Implicit promises in a contract.....	3-9
3.4.3	Product liability and patent infringement protection	3-9
3.4.4	Options to acquire additional goods or services	3-10
3.4.5	Shipment of goods to a customer.....	3-10

Chapter 4: Determining the transaction price

4.1	Chapter overview	4-2
4.2	Determining the transaction price	4-2
4.3	Variable consideration	4-3
4.3.1	Estimating variable consideration.....	4-4
4.3.1.1	Expected value method.....	4-5
4.3.1.2	Most likely amount method.....	4-5
4.3.1.3	Examples of estimating variable consideration	4-5
4.3.2	Constraint on variable consideration	4-6
4.3.2.1	The amount is highly susceptible to factors outside the entity’s influence.....	4-8
4.3.2.2	The uncertainty is not expected to be resolved for a long period of time	4-8
4.3.2.3	The entity’s experience is limited or has limited predictive value.....	4-9
4.3.2.4	The entity has a practice of offering price concessions or changing payment terms	4-9

4.3.2.5	The contract has a large number and broad range of possible consideration amounts	4-9
4.3.2.6	Examples of applying the constraint.....	4-9
4.3.2.7	Recording minimum amounts	4-11
4.3.3	Common forms of variable consideration	4-12
4.3.3.1	Price concessions	4-12
4.3.3.2	Prompt payment discounts	4-13
4.3.3.3	Volume discounts	4-13
4.3.3.4	Rebates.....	4-16
4.3.3.5	Pricing based on index.....	4-17
4.3.3.6	Periods after contract expiration, but prior to contract renewal.....	4-17
4.3.3.7	Price protection and price matching	4-18
4.3.3.8	Guarantees (including service level agreements)	4-19
4.3.4	Changes in the estimate of variable consideration.....	4-20
4.3.5	Exception for licenses of intellectual property (IP) with sales- or usage-based royalties	4-20
4.4	Existence of a significant financing component	4-20
4.4.1	Factors to consider when identifying a significant financing component.....	4-21
4.4.1.1	Timing is at the discretion of the customer	4-22
4.4.1.2	A substantial amount of the consideration is variable and based on the occurrence of a future event.....	4-23
4.4.1.3	The timing difference arises for reasons other than providing financing	4-23
4.4.2	Practical expedient from considering existence of a significant financing component	4-24
4.4.3	Determining the discount rate.....	4-24
4.4.4	Examples of accounting for a significant financing component	4-25
4.5	Noncash consideration.....	4-26
4.6	Consideration payable to a customer.....	4-28
4.6.1	Income statement classification of payments made to a customer	4-29

Chapter 5: Allocating the transaction price to separate performance obligations

5.1	Chapter overview	5-2
5.2	Determining standalone selling price.....	5-2
5.3	Estimating a standalone selling price that is not directly observable.....	5-3

5.3.1	Adjusted market assessment approach	5-4
5.3.2	Expected cost plus a margin	5-5
5.3.3	Residual approach.....	5-7
5.3.3.1	When the residual approach can be used.....	5-7
5.3.3.2	Additional considerations when a residual approach is used	5-7
5.4	Allocating discounts	5-9
5.5	Impact of variable consideration.....	5-11
5.5.1	Allocating variable consideration.....	5-11
5.5.2	Allocating subsequent changes in transaction price	5-13
5.6	Other considerations.....	5-15
5.6.1	Transaction price in excess of the sum of standalone selling prices	5-15
5.6.2	Nonrefundable upfront fees	5-15
5.6.3	No “contingent revenue cap”	5-15

Chapter 6: Recognizing revenue

6.1	Chapter overview	6-2
6.2	Control.....	6-2
6.3	Performance obligations satisfied over time.....	6-3
6.3.1	The customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs	6-3
6.3.2	The entity’s performance creates or enhances an asset that the customer controls	6-4
6.3.3	Entity’s performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance completed to date	6-6
6.3.3.1	No alternative use.....	6-6
6.3.3.2	Right to payment for performance completed to date.....	6-7
6.4	Measures of progress over time.....	6-10
6.4.1	Output methods	6-11
6.4.2	Input methods.....	6-13
6.4.2.1	Input methods based on cost incurred.....	6-13
6.4.2.2	Uninstalled materials	6-15
6.4.2.3	Time-based methods	6-16
6.4.3	Inability to estimate progress.....	6-17
6.5	Performance obligations satisfied at a point in time	6-17
6.5.1	Entity has a present right to payment	6-18

6.5.2	Customer has legal title	6-18
6.5.3	Customer has physical possession	6-19
6.5.4	Customer has significant risks and rewards of ownership.....	6-19
6.5.5	Customer has accepted the asset	6-19

Chapter 7: Options to acquire additional goods or services

7.1	Chapter overview	7-2
7.2	Customer options that provide a material right.....	7-2
7.2.1	Determining the standalone selling price of a customer option.....	7-4
7.2.2	Significant financing component considerations	7-5
7.2.3	Customer loyalty programs	7-5
7.2.3.1	Points redeemed solely by issuer.....	7-6
7.2.3.2	Points redeemed solely by others	7-6
7.2.3.3	Points redeemed by issuer or other third parties	7-8
7.2.4	Noncash and cash incentives	7-9
7.2.5	Incentives offered or modified after inception of an arrangement	7-9
7.3	Renewal and cancellation options	7-10
7.4	Unexercised rights (breakage)	7-11

Chapter 8: Practical application issues

8.1	Chapter overview	8-2
8.2	Rights of return.....	8-2
8.2.1	Exchange rights	8-4
8.3	Warranties	8-5
8.4	Nonrefundable upfront fees	8-7
8.4.1	Accounting for upfront fees when a renewal option exists.....	8-9
8.4.2	Layaway sales.....	8-10
8.4.3	Gift cards.....	8-11
8.5	Bill-and-hold arrangements	8-11
8.6	Consignment arrangements	8-13
8.7	Repurchase rights	8-15
8.7.1	Forwards and call options	8-16
8.7.2	Put options	8-17
8.7.2.1	Significant economic incentive to exercise a put option.....	8-19

Chapter 9: Licenses

9.1	Chapter overview	9-2
9.2	Determining whether a license is distinct.....	9-2
9.3	Nature of the license.....	9-4
9.3.1	Licenses that provide access to an entity's IP.....	9-5
9.3.1.1	The licensor will undertake activities that significantly affect the IP	9-5
9.3.1.2	The rights granted directly expose the customer to the effects of the above activities	9-6
9.3.1.3	The licensor's activities do not otherwise transfer a good or service	9-6
9.3.1.4	Factors that do not impact the nature of the license	9-7
9.3.2	Licenses that provide a right to use an entity's IP	9-8
9.3.3	Licenses and payment terms	9-9
9.4	Exception for licenses of IP with sales- or usage-based royalties	9-9

Chapter 10: Principal versus agent considerations

10.1	Chapter overview	10-2
10.2	Assessing whether an entity is the principal or an agent.....	10-2
10.2.1	Accounting implications.....	10-3
10.2.2	Indicators that an entity is an agent	10-3
10.2.2.1	Primary responsibility for fulfilling the contract	10-4
10.2.2.2	Inventory risk	10-4
10.2.2.3	Discretion in establishing pricing	10-5
10.2.2.4	Form of consideration	10-6
10.2.2.5	Credit risk	10-6
10.2.3	Examples of assessing the principal versus agent indicators.....	10-6
10.3	Shipping and handling fees	10-8
10.4	Out-of-pocket reimbursements	10-9
10.5	Amounts collected from customers and remitted to a third party.....	10-10

Chapter 11: Contract costs

11.1	Chapter overview	11-2
11.2	Incremental costs of obtaining a contract.....	11-2
11.2.1	Assessing recoverability	11-2
11.2.2	Practical expedient.....	11-3

11.2.3	Recognition model overview and examples	11-3
11.3	Costs to fulfill a contract.....	11-5
11.3.1	Recognition model overview	11-7
11.3.2	Learning curve costs	11-7
11.3.3	Set-up and mobilization costs.....	11-8
11.3.4	Abnormal costs	11-9
11.4	Amortization and impairment.....	11-10
11.4.1	Amortization of contract cost assets.....	11-10
11.4.2	Impairment of contract cost assets.....	11-11
11.5	Onerous contract losses	11-13

Chapter 12: Presentation and disclosure

12.1	Chapter overview	12-2
12.2	Presentation.....	12-2
12.2.1	Statement of financial position.....	12-2
12.2.1.1	Contract assets and receivables.....	12-2
12.2.1.2	Contract liabilities.....	12-4
12.2.1.3	Timing of invoicing and performance.....	12-4
12.2.1.4	Netting of contract assets and contract liabilities.....	12-6
12.2.1.5	Statement of financial position descriptions.....	12-6
12.2.1.6	Recognition decision tree	12-6
12.2.2	Statement of comprehensive income.....	12-7
12.3	Disclosure	12-7
12.3.1	Disaggregated revenue	12-9
12.3.2	Reconciliation of contract balances	12-10
12.3.3	Performance obligations	12-11
12.3.4	Significant judgments.....	12-13
12.3.5	Costs to obtain or fulfill a contract.....	12-14
12.3.6	Interim disclosure requirements	12-14
12.3.6.1	Additional interim disclosures (U.S. GAAP only).....	12-14
12.3.6.2	Additional interim disclosures (IFRS only)	12-15
12.3.7	Nonpublic entity considerations (U.S. GAAP only)	12-15

Chapter 13: Effective date and transition

13.1	Chapter overview	13-2
13.2	Effective date.....	13-2
13.2.1	IFRS reporters	13-2

13.2.2 U.S. GAAP reporters..... 13-3

13.2.2.1 U.S. GAAP – public entities.....13-3

13.2.2.2 U.S. GAAP – nonpublic entities13-3

13.3 Transition guidance 13-3

13.3.1 Retrospective application and practical expedients..... 13-4

13.3.1.1 Relief for IFRS reporters electing full retrospective application.....12-4

13.3.2 Modified retrospective application 13-4

Appendices

Appendix A Professional literature.....A-1

Appendix B Technical references and abbreviationsB-1

Appendix C Key termsC-1

Table of examples

Chapter 1: An introduction to revenue from contracts with customers

Examples in the guide

Example 1-1:	Distinction between revenue and income	1-4
---------------------	--	-----

Chapter 2: Scope and identifying the contract

Examples in the guide

Example 2-1:	Scope – exchange of products to facilitate a sale to another party.....	2-3
Example 2-2:	Identifying the customer – collaborative arrangement	2-5
Example 2-3:	Identifying the contract – product delivered without a written contract	2-8
Example 2-4:	Identifying the contract – contract extensions	2-8
Example 2-5:	Contract modifications – unpriced change order	2-14
Example 2-6:	Contract modifications – sale of additional goods.....	2-15
Example 2-7:	Contract modifications – extending a services contract	2-16
Example 2-8:	Contract modifications – extending a services contract	2-16
Example 2-9:	Contract modifications – additional good or service is not distinct.....	2-17

Examples in the Revenue Standard

Example 1:	Collectibility of the consideration ASC 606-10-55-95 through 98; IFRS 15.IE2 through IE6
Example 2:	Consideration is not the stated price—implicit price concession ASC 606-10-55-99 through 101; IFRS 15.IE7 through IE9
Example 3:	Implicit price concession ASC 606-10-55-102 through 105; IFRS 15.IE10 through IE13
Example 4:	Reassessing the criteria for identifying a contract ASC 606-10-55-106 through 109; IFRS 15.IE14 through IE17
Example 5:	Modification of a contract for goods ASC 606-10-55-110 through 116; IFRS 15.IE18 through IE24
Example 6:	Change in the transaction price after a contract modification ASC 606-10-55-117 through 124; IFRS 15.IE25 through IE32
Example 7:	Modification of a services contract ASC 606-10-55-125 through 128; IFRS 15.IE33 through IE36
Example 8:	Modification resulting in a cumulative catch-up adjustment to revenue ASC 606-10-55-129 through 133; IFRS 15.IE37 through IE41

Example 9:	Unapproved change in scope and price ASC 606-10-55-134 through 135; IFRS 15.IE42 through IE43
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Chapter 3: Identifying performance obligations

Examples in the guide

Example 3-1:	Distinct goods or services – customer benefits from the good or service 3-4
Example 3-2:	Distinct goods or services – bundle of goods or services are combined..... 3-6
Example 3-3:	Distinct goods or services – bundle of goods or services are not combined 3-6
Example 3-4:	Distinct goods or services – bundle of goods or services are combined.....3-7
Example 3-5:	Identifying performance obligations – activities 3-8
Example 3-6:	Identifying performance obligations – activities 3-8
Example 3-7:	Identifying performance obligations – shipping services.....3-10

Examples in the Revenue Standard

Example 10:	Goods or services are not distinct ASC 606-10-55-136 through 140; IFRS 15.IE44 through IE48
Example 11:	Determining whether goods or services are distinct ASC 606-10-55-141 through 150; IFRS 15.IE49 through IE58
Example 12:	Explicit and implicit promises in a contract ASC 606-10-55-151 through 157; IFRS 15.IE59 through IE65

Chapter 4: Determining the transaction price

Examples in the guide

Example 4-1:	Estimating variable consideration – performance bonus with multiple outcomes 4-5
Example 4-2:	Estimating variable consideration – performance bonus with two outcomes 4-6
Example 4-3:	Variable consideration – consideration is constrained 4-9
Example 4-4:	Variable consideration – subsequent reassessment4-10
Example 4-5:	Variable consideration – multiple forms of variable consideration4-10
Example 4-6:	Variable consideration – determining a minimum amount 4-11
Example 4-7:	Variable consideration – price concessions4-12
Example 4-8:	Variable consideration – volume discounts4-14
Example 4-9:	Variable consideration – reassessment of estimated volume discounts4-15

Example 4-10:	Variable consideration – customer rebates.....	4-16
Example 4-11:	Variable consideration – price protection guarantee	4-18
Example 4-12:	Variable consideration – profit margin guarantee.....	4-19
Example 4-13:	Significant financing component – prepayment with intent other than to provide financing	4-23
Example 4-14:	Significant financing component – determining the appropriate discount rate	4-25
Example 4-15:	Significant financing component – payment prior to performance.....	4-25
Example 4-16:	Noncash consideration – materials provided by customer to facilitate fulfillment	4-27
Example 4-17:	Noncash consideration – variable due to the form of the consideration	4-27
Example 4-18:	Noncash consideration – variable for other reasons than the form of the consideration.....	4-28
Example 4-19:	Consideration payable to customers – payment to reseller’s customer	4-29
Example 4-20:	Consideration payable to customers – slotting fees	4-30
Example 4-21:	Consideration payable to customers – payment for a distinct service.....	4-30
Example 4-22:	Consideration payable to customers – payment for a distinct service in excess of fair value.....	4-31

Examples in the Revenue Standard

Example 20:	Penalty gives rise to variable consideration ASC 606-10-55-193 through 196; IFRS 15.IE101 through IE104
Example 21:	Estimating variable consideration ASC 606-10-55-197 through 200; IFRS 15.IE105 through IE108
Example 23:	Price concessions ASC 606-10-55-208 through 215; IFRS 15.IE116 through IE123
Example 24:	Volume discount incentive ASC 606-10-55-216 through 220; IFRS 15.IE124 through IE128
Example 25:	Management fees subject to the constraint ASC 606-10-55-221 through 225; IFRS 15.IE129 through IE133
Example 26:	Significant financing component and right of return ASC 606-10-55-226 through 232; IFRS 15.IE134 through IE140

Example 27:	Withheld payments on a long-term contract ASC 606-10-55-233 through 234; IFRS 15.IE141 through IE142
Example 28:	Determining the discount rate ASC 606-10-55-235 through 239; IFRS 15.IE143 through IE147
Example 29:	Advance payment and assessment of the discount rate ASC 606-10-55-240 through 243; IFRS 15.IE148 through IE151
Example 30:	Advance payment ASC 606-10-55-244 through 246; IFRS 15.IE152 through IE154
Example 31:	Entitlement to non-cash consideration ASC 606-10-55-247 through 250; IFRS 15.IE155 through IE158
Example 32:	Consideration payable to a customer ASC 606-10-55-251 through 254; IFRS 15.IE159 through IE162

Chapter 5: Allocating the transaction price to separate performance obligations

Examples in the guide

Example 5-1:	Allocating transaction price – standalone selling prices are directly observable.....	5-3
Example 5-2:	Allocating transaction price – standalone selling prices are not directly observable.....	5-6
Example 5-3:	Estimating standalone selling price – residual approach.....	5-8
Example 5-4:	Allocating transaction price – allocating a discount.....	5-10
Example 5-5:	Allocating transaction price – allocating a discount and applying the residual approach	5-11
Example 5-6:	Allocating variable consideration – distinct goods or services that form a single performance obligation	5-12
Example 5-7:	Allocating transaction price – change in transaction price.....	5-14

Examples in the Revenue Standard

Example 33:	Allocation methodology ASC 606-10-55-255 through 258; IFRS 15.IE163 through IE166
Example 34:	Allocating a discount ASC 606-10-55-259 through 269; IFRS 15.IE167 through IE177
Example 35:	Allocation of variable consideration ASC 606-10-55-270 through 279; IFRS 15.IE178 through IE187

Chapter 6: Recognizing revenue

Examples in the guide

Example 6-1:	Recognizing revenue – simultaneously receiving and consuming benefits	6-4
Example 6-2:	Recognizing revenue – customer controls work in process.....	6-5
Example 6-3:	Recognizing revenue – customer does not control work in process	6-5
Example 6-4:	Recognizing revenue – asset with an alternative use.....	6-8
Example 6-5:	Recognizing revenue – highly specialized asset without an alternative use	6-9
Example 6-6:	Recognizing revenue – right to payment	6-10
Example 6-7:	Measuring progress – output method.....	6-12
Example 6-8:	Measuring progress – “cost-to-cost” method.....	6-14
Example 6-9:	Measuring progress – uninstalled materials.....	6-16
Example 6-10:	Recognizing revenue – legal title retained as a protective right.....	6-18
Example 6-11:	Recognizing revenue – sale of goods with resale restrictions	6-19

Examples in the Revenue Standard

Example 13:	Customer simultaneously receives and consumes the benefits ASC 606-10-55-159 through 160; IFRS 15.IE67 through IE68
Example 14:	Assessing alternative use and right to payment ASC 606-10-55-161 through 164; IFRS 15.IE69 through IE72
Example 15:	Asset has no alternative use to the entity ASC 606-10-55-165 through 168; IFRS 15.IE73 through IE76
Example 16:	Enforceable right to payment for performance completed to date ASC 606-10-55-169 through 172; IFRS 15.IE77 through IE80
Example 17:	Assessing whether a performance obligation is satisfied at a point in time or over time ASC 606-10-55-173 through 182; IFRS 15.IE81 through IE90
Example 18:	Measuring progress when making goods or services available ASC 606-10-55-183 through 186; IFRS 15.IE91 through IE94
Example 19:	Uninstalled materials ASC 606-10-55-187 through 192; IFRS 15.IE95 through IE100

Chapter 7: Options to acquire additional goods or services

Examples in the guide

Example 7-1:	Customer options – option that does not provide a material right	7-3
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Example 7-2:	Customer options – option that provides a material right.....	7-3
Example 7-3:	Customer options – loyalty points redeemed by another party	7-7
Example 7-4:	Customer options – loyalty points redeemed by multiple parties	7-8
Example 7-5:	Customer options – change in incentives offered to customer	7-10
Example 7-6:	Customer options – renewal option that provides a material right.....	7-11
Example 7-7:	Breakage – sale of gift cards	7-13
Example 7-8:	Breakage – customer loyalty points	7-13
Example 7-9:	Breakage – customer loyalty points, reassessment of breakage estimate	7-14

Examples in the Revenue Standard

Example 49:	Option that provides the customer with a material right (discount voucher) ASC 606-10-55-335 through 339; IFRS 15.IE249 through IE253
Example 50:	Option that does not provide the customer with a material right (additional goods or services) ASC 606-10-55-340 through 342; IFRS 15.IE254 through IE256
Example 51:	Option that provides the customer with a material right (renewal option) ASC 606-10-55-343 through 352; IFRS 15.IE257 through IE266
Example 52:	Customer loyalty program ASC 606-10-55-353 through 356; IFRS 15.IE267 through 270

Chapter 8: Practical application issues

Examples in the guide

Example 8-1:	Right of return – sale of products to a distributor	8-3
Example 8-2:	Right of return – refund obligation and return asset	8-4
Example 8-3:	Warranty – assessing whether a warranty is a performance obligation.....	8-7
Example 8-4:	Upfront fee allocated to separate performance obligations.....	8-8
Example 8-5:	Upfront fee – health club joining fees	8-9
Example 8-6:	Bill-and-hold arrangement – industrial products industry	8-12

Example 8-7:	Bill-and-hold arrangement – retail and consumer industry8-13
Example 8-8:	Consignment arrangement – retail and consumer industry8-14
Example 8-9:	Consignment arrangement – industrial products industry8-14
Example 8-10:	Repurchase rights – call option accounted for as lease8-17
Example 8-11:	Repurchase rights – put option accounted for as a right of return8-19
Example 8-12:	Repurchase rights – put option accounted for as lease8-20

Examples in the Revenue Standard

Example 22:	Right of return ASC 606-10-55-201 through 207; IFRS 15.IE109 through IE115
Example 44:	Warranties ASC 606-10-55-308 through 315; IFRS 15.IE222 through IE229
Example 53:	Non-refundable upfront fee ASC 606-10-55-357 through 360; IFRS 15.IE271 through IE274
Example 62:	Repurchase agreements ASC 606-10-55-400 through 407; IFRS 15.IE314 through IE321
Example 63:	Bill-and-hold arrangement ASC 606-10-55-408 through 413; IFRS 15.IE322 through 327

Chapter 9: Licenses

Examples in the guide

Example 9-1:	License that is not distinct 9-3
Example 9-2:	License that is distinct 9-4
Example 9-3:	License that provides a right to access IP.....9-7
Example 9-4:	License that provides a right to use IP 9-8

Examples in the Revenue Standard

Example 54:	Right to use intellectual property ASC 606-10-55-361 through 363; IFRS 15.IE275 through IE277
Example 55:	License of intellectual property ASC 606-10-55-364 through 366; IFRS 15.IE278 through IE280

Example 56:	Identifying a distinct license ASC 606-10-55-367 through 374; IFRS 15.IE281 through IE288
Example 57:	Franchise rights ASC 606-10-55-375 through 382; IFRS 15.IE289 through IE296
Example 58:	Access to intellectual property ASC 606-10-55-383 through 388; IFRS 15.IE297 through IE302
Example 59:	Right to use intellectual property ASC 606-10-55-389 through 392; IFRS 15.IE303 through IE306
Example 60:	Access to intellectual property ASC 606-10-55-393 through 394; IFRS 15.IE307 through IE308
Example 61:	Access to intellectual property ASC 606-10-55-395 through 399; IFRS 15.IE309 through IE313

Chapter 10: Principal versus agent considerations

Examples in the guide

Example 10-1:	Principal versus agent – online retailer10-6
Example 10-2:	Principal versus agent – travel agency10-7
Example 10-3:	Principal versus agent – shipping and handling fees 10-8

Examples in the Revenue Standard

Example 45:	Arranging for the provision of goods or services (entity is an agent) ASC 606-10-55-316 through 319; IFRS 15.IE230 through IE233
Example 46:	Promise to provide goods or services (entity is a principal) ASC 606-10-55-320 through 324; IFRS 15.IE234 through IE238
Example 47:	Promise to provide goods or services (entity is a principal) ASC 606-10-55-325 through 329; IFRS 15.IE239 through IE243
Example 48:	Arranging for the provisions of goods or services (entity is an agent) ASC 606-10-55-330 through 334; IFRS 15.IE244 through IE248

Chapter 11: Contract costs**Examples in the guide**

Example 11-1:	Incremental costs of obtaining a contract – sales commission	11-4
Example 11-2:	Incremental costs of obtaining a contract – construction industry.....	11-4
Example 11-3:	Incremental costs of obtaining a contract – telecommunications industry.....	11-5
Example 11-4:	Set-up costs – technology industry	11-8
Example 11-5:	Costs to fulfill a contract – construction industry.....	11-9
Example 11-6:	Amortization of contract cost assets – telecommunications industry.....	11-10
Example 11-7:	Amortization of contract cost assets – construction industry	11-11
Example 11-8:	Impairment of contract cost assets	11-12

Examples in the Revenue Standard

Example 36:	Incremental costs of obtaining a contract ASC 340-40-55-1 through 4; IFRS 15.IE188 through IE191
Example 37:	Costs that give rise to an asset ASC 340-40-55-5 through 9; IFRS 15.IE192 through IE196

Chapter 12: Presentation and disclosure**Examples in the guide**

Example 12-1:	Distinguishing between a contract asset and a receivable.....	12-3
Example 12-2:	Recording a contract liability.....	12-4
Example 12-3:	Recording a receivable – Noncancellable contract	12-5

Examples in the Revenue Standard

Example 38:	Contract liability and receivable ASC 606-10-55-283 through 286; IFRS 15.IE197 through IE200
Example 39:	Contract asset recognized for the entity's performance ASC 606-10-55-287 through 290; IFRS 15.IE201 through IE204
Example 40:	Receivable recognized for the entity's performance ASC 606-10-55-291 through 294; IFRS 15.IE205 through IE208
Example 41:	Disaggregation of revenue—quantitative disclosure ASC 606-10-55-295 through 297; IFRS 15.IE209 through IE211

- Example 42:** Disclosure of the transaction price allocated to the remaining performance obligations
ASC 606-10-55-298 through 305; IFRS 15.IE212 through IE219
- Example 43:** Disclosure of the transaction price allocated to the remaining performance obligations—qualitative disclosure
ASC 606-10-55-306 through 307; IFRS 15.IE220 through IE221

Chapter 1:
An introduction to
revenue from contracts
with customers

1.1 Background

Revenue is one of the most important financial statement measures to both preparers and users of financial statements. It is used to measure and assess aspects of an entity's past financial performance, future prospects, and financial health. Revenue recognition is therefore one of the accounting topics most scrutinized by investors and regulators. Despite its significance and the increasing globalization of the world's financial markets, revenue recognition requirements prior to issuance of new guidance in 2014 differed in U.S. generally accepted accounting principles ("U.S. GAAP") from those in International Financial Reporting Standards ("IFRS"), at times resulting in different accounting for similar transactions.

Revenue recognition guidance under both frameworks needed improvement. U.S. GAAP comprised wide-ranging revenue recognition concepts and requirements for particular industries or transactions that could result in different accounting for economically similar transactions. The guidance was criticized for being fragmented, voluminous, and complex. While IFRS had less guidance, preparers found the standards sometimes difficult to apply as there was limited guidance on certain important and challenging topics. The disclosures required by U.S. GAAP and IFRS often did not provide the level of detail investors and other users needed to understand an entity's revenue-generating activities.

In October 2002, the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") (collectively, the "boards") initiated a joint project to develop a single revenue standard containing comprehensive principles for recognizing revenue to achieve the following:

- Remove inconsistencies and weaknesses in existing revenue recognition frameworks
- Provide a more robust framework for addressing revenue issues
- Improve comparability across entities, industries, jurisdictions, and capital markets
- Provide more useful information to financial statement users through enhanced disclosures
- Simplify financial statement preparation by streamlining and reducing the volume of guidance

By establishing comprehensive principles, the boards hope that preparers around the globe will find revenue guidance easier to understand and apply.

The FASB issued ASC 606, *Revenue from Contracts with Customers*, and ASC 340-40, *Other Assets and Deferred Costs—Contracts with Customers*, and the IASB issued IFRS 15, *Revenue from Contracts with Customers* (collectively the "revenue standard") in May 2014 along with consequential amendments to existing standards. With the exception of a few discrete areas, as noted in Figure 1-1, the revenue standard

is converged, eliminating most differences between U.S. GAAP and IFRS in accounting for revenue from contracts with customers.

Figure 1-1

Summary of key differences between ASC 606 and IFRS 15

Topic	Difference
Collectibility threshold	One of the criteria that contracts must meet before an entity applies the revenue standard is that collectibility is probable. Probable is defined in U.S. GAAP as “likely to occur,” which is generally considered a 75%-80% threshold. IFRS defines probable as “more likely than not,” which is greater than 50%.
Interim disclosure requirements	The general principles in the U.S. GAAP and IFRS interim reporting standards apply to the revenue standard. The IASB amended its interim disclosure standard to require interim disaggregated revenue disclosures. The FASB amended its interim disclosure standard to require disaggregated revenue information, and added interim disclosure requirements relating to contract balances and remaining performance obligations (for public companies only).
Effective date	There are minor differences in the effective dates between ASC 606 and IFRS 15. ASC 606 is applicable for public entities for annual reporting periods (including interim periods therein) beginning after December 15, 2016 (nonpublic entities can defer adopting for an extra year), whereas IFRS 15 is applicable for all entities for annual periods beginning on or after January 1, 2017.
Early adoption	Entities reporting under U.S. GAAP are not permitted to adopt the revenue standard earlier than annual reporting periods beginning after December 15, 2016. Entities reporting under IFRS are permitted to adopt IFRS 15 early.
Impairment loss reversal	ASC 340 does not permit entities to reverse impairment losses recognized on contract costs (that is, capitalized costs to acquire or fulfill a contract). IFRS 15 requires impairment losses to be reversed in certain circumstances similar to its existing standard on impairment of assets.
Relief for nonpublic entities	ASC 606 gives nonpublic entities relief relating to certain disclosures and effective date. IFRS 15 applies to all IFRS reporters, public or nonpublic, except entities that apply IFRS for Small and Medium-sized Entities.

1.2 What is revenue?

Revenue is defined in the revenue standard as:

Definition from ASC 606-10-20

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

Definition from IFRS 15, Appendix A

Revenue: Income arising in the course of an entity's ordinary activities.

IFRS 15 further defines income as:

Definition from IFRS 15, Appendix A

Income: Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.

The words may be slightly different, but the underlying principle is the same in the two frameworks. Revenue is recognized as a result of an entity satisfying its promise to transfer goods or services in a contract with a customer.

The distinction between revenue and other types of income, such as gains, is important as many users of financial statements focus more on revenue than other types of income. Income comprises revenue and gains, and includes all benefits (enhancements of assets or settlements of liabilities) other than contributions from equity participants. Revenue is a subset of income that arises from the sale of goods or rendering of services as part of an entity's ongoing major or central activities, also described as its ordinary activities. Transactions that do not arise in the course of an entity's ordinary activities do not result in revenue. For example, gains from the disposal of the entity's fixed assets are not included in revenue.

The distinction between revenue and other income is not always clear. Determining whether a transaction results in the recognition of revenue will depend on the specific circumstances as illustrated in Example 1-1.

EXAMPLE 1-1

Distinction between revenue and income

A car dealership has cars available that can be used by potential customers for test drives ("demonstration cars"). The cars are used for more than one year and then sold as used cars. The dealership sells both new and used cars.

Is the sale of a demonstration car accounted for as revenue or as a gain?

Analysis

The car dealership is in the business of selling new and used cars. The sale of demonstration cars is therefore revenue since selling used cars is part of the dealership's ordinary activities.

Many revenue transactions are straightforward, but some can be highly complex. For example, software arrangements, licenses of intellectual property, outsourcing contracts, barter transactions, contracts with multiple elements, and contracts with milestone payments can be challenging to understand. It might be difficult to determine what the entity has committed to deliver, how much and when revenue should be recognized.

Contracts often provide strong evidence of the economic substance, as parties to a transaction generally protect their interests through the contract. Amendments, side letters, and oral agreements, if any, can provide additional relevant information. Other factors, such as local legal frameworks and business practices, should also be considered to fully understand the economics of the arrangement. An entity should consider the substance, not only the form, of a transaction to determine when revenue should be recognized.

1.3 High-level overview

The revenue standard provides principles that an entity applies to report useful information about the amount, timing, and uncertainty of revenue and cash flows arising from its contracts to provide goods or services to customers. The core principle requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it expects to be entitled to in exchange for those goods or services.

1.3.1 Scope

The revenue standard applies to all contracts with customers, except for contracts that are within the scope of other standards, such as leases, insurance, and financial instruments. Other items might also be presented as revenue because they arise from an entity's ordinary activities, but are not within the scope of the revenue standard. Such items include interest and dividends. Changes in the value of biological assets or investment properties under IFRS are scoped out of the revenue standard, as are changes in regulatory assets and liabilities for certain rate-regulated entities under U.S. GAAP. See further discussion of the scope of the revenue standard, and examples of transactions that are outside of the scope, in RR 2.

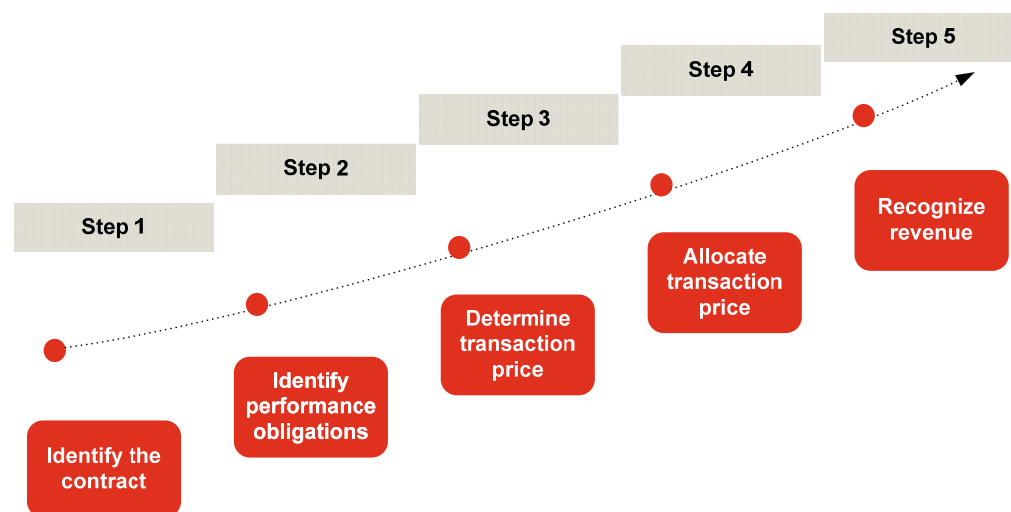
Arrangements may also include elements that are partly in the scope of other standards and partly in the scope of the revenue standard. The elements that are accounted for under other standards are separated and accounted for under those standards.

Only contracts with a customer are in the scope of the revenue standard. Management needs to assess whether a counterparty is a customer to determine if the arrangement is in the scope of this guidance (for example, certain co-development projects).

1.3.2 The five-step model

The boards developed a five-step model for recognizing revenue from contracts with customers:

Figure 1-2
Five-step model



Certain criteria must be met for a contract to be accounted for using the five-step model in the revenue standard. An entity must assess, for example, whether it is “probable” it will collect the amounts it will be entitled to before the guidance in the revenue standard is applied.

A contract contains a promise (or promises) to transfer goods or services to a customer. A performance obligation is a promise (or a group of promises) that is distinct, as defined in the revenue standard. Identifying performance obligations can be relatively straightforward, such as an electronics store’s promise to provide a television. But it can also be more complex, such as a contract to provide a new computer system with a three-year software license, a right to upgrades, and technical support. Entities must determine whether to account for performance obligations separately, or as a group.

The transaction price is the amount of consideration an entity expects to be entitled to from a customer in exchange for providing the goods or services. A number of factors should be considered to determine the transaction price, including whether there is variable consideration, a significant financing component, noncash consideration, or amounts payable to the customer.

The transaction price is allocated to the separate performance obligations in the contract based on relative standalone selling prices. Determining the relative standalone selling price can be challenging when goods or services are not sold on a standalone basis. The revenue standard sets out several methods that can be used to estimate a standalone selling price when one is not directly observable. Allocating discounts and variable consideration must also be considered.

Revenue is recognized when (or as) the performance obligations are satisfied. The revenue standard provides guidance to help determine if a performance obligation is satisfied at a point in time or over time. Where a performance obligation is satisfied over time, the related revenue is also recognized over time.

1.3.3 *Portfolio approach*

An entity generally applies the model to a single contract with a customer. A portfolio approach might be acceptable if an entity reasonably expects that the effect of applying a portfolio approach to a group of contracts or group of performance obligations would not differ materially from considering each contract or performance obligation separately. An entity should use estimates and assumptions that reflect the size and composition of the portfolio when using a portfolio approach.

Some entities enter into contracts with a large number of customers that have the same or similar terms and conditions. It would be appropriate in these situations to consider whether the revenue standard could be applied to a portfolio of contracts or performance obligations. The portfolio approach might be appropriate, for example, in estimating product returns when the goods sold are similar. It is unlikely that a portfolio approach would be acceptable when considering the sale of dissimilar items or contracts where the terms vary widely. Determining when the use of a portfolio approach is appropriate will require judgment and a consideration of all of the facts and circumstances.

1.4 *Implementation guidance*

The revenue standard also provides guidance for common issues arising from accounting for contracts with customers, including the accounting for contract costs.

Incremental costs of obtaining a contract, such as sales commissions, are capitalized if they are expected to be recovered. Incremental costs include only those costs that would not have been incurred if the contract had not been obtained. As a practical expedient, capitalization is not required if the amortization period of the asset would be less than one year.

Costs to fulfill a contract that are not covered by another standard are capitalized if they relate directly to a contract and to future performance, and they are expected to be recovered. Fulfillment costs should be expensed as incurred if these criteria are not met. See RR 11 for further information on contract costs.

Other topics addressed in the implementation guidance and illustrative examples accompanying the revenue standard include:

- Performance obligations satisfied over time (see RR 6.3)
- Methods for measuring progress toward complete satisfaction of a performance obligation (see RR 6.4)
- Right of return (see RR 8.2)
- Warranties (see RR 8.3)
- Principal versus agent considerations (gross versus net presentation) (see RR 10)
- Options to acquire additional goods or services (see RR 7)
- Unexercised rights (breakage) (see RR 7.4)
- Nonrefundable upfront fees (see RR 8.4)
- Licenses (see RR 9)
- Repurchase rights (see RR 8.7)
- Consignment arrangements (see RR 8.6)
- Bill-and-hold arrangements (see RR 8.5)
- Customer acceptance (see RR 6.5.5)
- Disclosure of disaggregated revenue (see RR 12.3.1)

1.5 Disclosures

The revenue standard includes extensive disclosure requirements intended to enable users of financial statements to understand the amount, timing, and judgments related to revenue recognition and related cash flows. The revenue standard requires disclosure of both qualitative and quantitative information about contracts with customers and, for U.S. GAAP only, provides some simplified disclosure options for nonpublic entities.

1.6 Transition and effective date

The revenue standard is applicable for most entities starting in 2017. The effective date and transition guidance varies slightly for companies reporting under U.S. GAAP and those reporting under IFRS. U.S. GAAP requires public entities to apply the revenue standard for annual reporting periods (including interim periods therein) beginning after December 15, 2016. Nonpublic entities reporting under U.S. GAAP are required to apply the revenue standard for annual periods beginning after December 15, 2017. Earlier application is not permitted for public entities but is permitted for

nonpublic entities; however, adoption can be no earlier than annual reporting periods beginning after December 15, 2016. Entities that report under IFRS are required to apply the revenue standard for annual reporting periods beginning on or after January 1, 2017, and early adoption is permitted.

The revenue standard permits entities to apply the guidance retrospectively using any combination of several optional practical expedients. Alternatively, an entity is permitted to recognize the cumulative effect of initially applying the guidance as an opening balance sheet adjustment to equity in the period of initial application. This approach must be supplemented by additional disclosures.

Chapter 2:

Scope and identifying the contract

2.1 Chapter overview

The first step in applying the revenue standard is to determine if a contract exists and whether that contract is with a customer. This assessment is made on a contract-by-contract basis, although as noted in RR 1.3.3, as a practical expedient an entity may apply this guidance to a portfolio of similar contracts (or similar performance obligations) if the entity expects that the effects on the financial statements would not materially differ from applying the guidance to the individual contracts (or individual performance obligations).

Management needs to identify whether the contract counterparty is a customer, since contracts that are not with customers are outside of the scope of the revenue standard. Management also needs to consider whether the contract is explicitly scoped out of the revenue standard, or whether there is another standard that applies to a portion of the contract. Determining whether a contract is in the scope of the revenue standard will not always be straightforward.

Management must also consider whether more than one contract with a customer should be combined and how to account for any subsequent modifications.

2.2 Scope

Management needs to consider all other potentially relevant accounting literature before concluding that the arrangement is in the scope of the revenue standard. The standard specifically excludes from its scope the following types of contracts with customers:

- Leases in the scope of ASC 840, *Leases*, or IAS 17, *Leases*
- Insurance contracts in the scope of ASC 944, *Financial Services—Insurance*, or IFRS 4, *Insurance Contracts*
- Financial instruments and other contractual rights or obligations in the scope of the following guidance:
 - U.S. GAAP: ASC 310, *Receivables*; ASC 320, *Investments—Debt and Equity Securities*; ASC 323, *Investments—Equity Method and Joint Ventures*; ASC 325, *Investments—Other*; ASC 405, *Liabilities*; ASC 470, *Debt*; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*
 - IFRS: IFRS 9, *Financial Instruments*; IFRS 10, *Consolidated Financial Statements*; IFRS 11, *Joint Arrangements*; IAS 27, *Separate Financial Statements*; and IAS 28, *Investments in Associates and Joint Ventures*
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to current or future customers

- Guarantees (other than product or service warranties – see RR 8 for further considerations related to warranties) in the scope of ASC 460, *Guarantees* (U.S. GAAP only)

Revenue from transactions or events that does not arise from a contract with a customer is not in the scope of the revenue standard and should continue to be recognized in accordance with other standards. Such transactions or events include but are not limited to:

- Dividends
- Non-exchange transactions, such as donations or contributions
- Changes in the fair value of biological assets, investment properties, and the inventory of broker-traders (IFRS only)
- Changes in regulatory assets and liabilities arising from alternative revenue programs for rate-regulated activities in the scope of ASC 980, *Regulated Operations* (U.S. GAAP only)

2.2.1 Evaluation of nonmonetary exchanges

Determining whether certain nonmonetary exchanges are in the scope of the revenue standard could require judgment and depends on the facts and circumstances of the arrangement.

EXAMPLE 2-1

Scope – exchange of products to facilitate a sale to another party

Salter is a supplier of road salt. Adverse weather events can lead to a sudden increase in demand, and Salter does not always have a sufficient supply of road salt to meet this demand on short notice. Salter enters into a contract with SaltCo, a supplier of road salt in another region, such that each party will provide road salt to the other during local adverse weather events as they are rarely affected at the same time. No other consideration is provided by the parties.

Is the contract in the scope of the revenue standard?

Analysis

No. This arrangement is not in the scope of the revenue standard because the standard specifically excludes from its scope nonmonetary exchanges in the same line of business to facilitate sales to customers or potential customers.

2.2.2 Contracts with components in and out of the scope of the revenue standard

Some contracts include components that are in the scope of the revenue standard and other components that are in the scope of other standards. An entity should first apply

the separation or measurement guidance in other applicable standards (if any) and then apply the guidance in the revenue standard. An entity applies the guidance in the revenue standard to initially separate and/or measure the components of the contract only if another standard does not include separation or measurement guidance. The transaction price, as defined in RR 4.2, excludes the portion of contract consideration that is initially measured under other guidance.

For example, to account for a contract to provide leased equipment and maintenance services, an entity first applies the separation and/or measurement guidance in the leasing standard to separate and/or measure the contract price that relates to the equipment lease. The entity follows the leasing standard to recognize the amount of revenue associated with the equipment. The guidance in the revenue standard is applied to the maintenance service component of the contract.

2.3 *Sale or transfer of nonfinancial assets*

Some principles of the revenue standard apply to the recognition of a gain or loss on the transfer of certain nonfinancial assets that are not an output of an entity's ordinary activities (such as the sale or transfer of property, plant, and equipment). Although a gain or loss on this type of sale generally does not meet the definition of revenue, an entity should apply the guidance in the revenue standard related to the transfer of control (refer to RR 6) and measurement of the transaction price (refer to RR 4), including the constraint on variable consideration, to evaluate the timing and amount of the gain or loss recognized.

Entities that report under U.S. GAAP also apply the revenue standard to determine whether the parties are committed to perform under the contract and therefore whether a contract exists (refer to RR 2.6).

2.4 *Identifying the customer*

The revenue standard defines a customer as follows.

Definition from ASC 606-10-20 and IFRS 15, Appendix A

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.

In simple terms, a customer is the party that purchases an entity's goods or services. Identifying the customer is straightforward in many instances, but a careful analysis needs to be performed in other situations to confirm whether a customer relationship exists. For example, a contract with a counterparty to participate in an activity where both parties share in the risks and benefits of the activity (such as developing an asset) is unlikely to be in the scope of the revenue guidance because the counterparty is unlikely to meet the definition of a customer. An arrangement where, in substance, the entity is selling a good or service is likely in the scope of the revenue standard, even if it is termed a "collaboration" or something similar.

The revenue standard applies to all contracts, including transactions with collaborators or partners, if they are a transaction with a customer. All of the relationships in a collaboration or partnership agreement must be understood to identify whether all or a portion of the contract is, in substance, a contract with a customer. A portion of the contract might be the sharing of risks and benefits of an activity, which is outside the scope of the revenue standard. Other portions of the contract might be for the sale of goods or services from one entity to the other and therefore in the scope of the revenue standard.

EXAMPLE 2-2

Identifying the customer – collaborative arrangement

Biotech signs an agreement with Pharma to share equally in the development of a specific drug candidate.

Is the arrangement in the scope of the revenue standard?

Analysis

It depends. It is unlikely that the arrangement is in the scope of the revenue standard if the entities will simply work together to develop the drug. It is likely in the scope of the revenue standard if the substance of the arrangement is that Biotech is selling its compound to Pharma and/or providing research and development services to Pharma, if those activities are part of Biotech's ordinary activities.

Entities should consider whether other applicable guidance (such as ASC 808, *Collaborative Arrangements*, or IFRS 11, *Joint Arrangements*) exists that should be applied when an arrangement is a collaboration rather than a contract with a customer.

2.5 Arrangements with multiple parties

Identifying the customer can be more challenging when there are multiple parties involved in a transaction. The analysis should include understanding the substance of the relationship of all parties involved in the transaction.

Consideration might be received from a party other than an entity's direct customer in certain arrangements. Examples include:

- Pharmaceutical products and healthcare services – An entity provides its products and services to a patient, but a portion of the fee is paid by the government or a third party insurer, and the remainder is paid by the patient.
- Coupons – Manufacturers sell products to a retailer, but issue coupons directly to end consumers where the retailer is reimbursed for the coupons by the manufacturer.

- Credit card entities — Credit card entities often issue loyalty points to cardholders and also have separate arrangements with retailers for transaction fees for each transaction made by cardholders.

Arrangements with three or more parties, particularly if there are separate contracts with each of the parties, requires judgment to evaluate the substance of those relationships. Management will need to assess which parties are customers and whether the contracts meet the criteria to be combined, as discussed in RR 2.7, when applying the guidance in the revenue standard.

An entity also needs to assess whether it is the principal or an agent in an arrangement that involves multiple parties. This is because an entity will recognize revenue for the gross amount of consideration it expects to be entitled to when it is the principal, but only the net amount of consideration that it expects to retain after paying the other party for the goods or services provided by that party when it is the agent. Refer to RR 10 for further considerations that an entity should evaluate to determine whether it is the principal or an agent.

2.6 *Identifying the contract*

The revenue standard defines a contract as follows.

Definition from ASC 606-10-20 and IFRS 15, Appendix A

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

Identifying the contract is an important step in applying the revenue standard. A contract can be written, oral, or implied by an entity's customary business practices. A contract can be as simple as providing a single off-the-shelf product, or as complex as an agreement to build a specialized refinery. Generally, any agreement that creates legally enforceable rights and obligations meets the definition of a contract.

Legal enforceability depends on the interpretation of the law and could vary across legal jurisdictions. Evaluating legal enforceability of rights and obligations might be particularly challenging when contracts are entered into across multiple jurisdictions where the rights of the parties are not enforced across those jurisdictions in a similar way. A thorough examination of the facts specific to the contract and the jurisdiction is necessary in such cases.

Sometimes the parties will enter into amendments or "side agreements" to a contract that either change the terms of, or add to, the rights and obligations of that contract. These can be verbal or written changes to a contract. Side agreements could include cancellation, termination, or other provisions. They could also provide customers with options or discounts, or change the substance of the arrangement. All of these items have implications for revenue recognition; therefore, understanding the entire contract, including any amendments, is critical to the accounting conclusion.

2.6.1 *Contracts with customers – required criteria*

All of the following criteria must be met before an entity accounts for a contract with a customer under the revenue standard.

Excerpt from ASC 606-10-25-1 and IFRS 15.9

An entity shall account for a contract with a customer ... only when all of the following criteria are met:

- a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.
- b. The entity can identify each party's rights regarding the goods or services to be transferred.
- c. The entity can identify the payment terms for the goods or services to be transferred.
- d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).
- e. It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

These criteria are discussed further below.

2.6.1.1 *The contract has been approved and the parties are committed*

This first criterion has two separate, but interrelated, components.

The contract has been approved

A contract must be approved by the parties involved in the transaction for it to be accounted for under the revenue standard. Approval might be in writing, but it can also be oral or implied based on an entity's established practice or the understanding between the parties. Without the approval of both parties, it is not clear whether a contract creates rights and obligations that are enforceable against the parties.

It is important to consider all facts and circumstances to determine if a contract has been approved. This includes understanding the rationale behind deviating from customary business practices (for example, having a verbal side agreement where normally all agreements are in writing).

Generally, it is not appropriate to delay revenue recognition in the absence of a written contract if there is sufficient evidence that the agreement has been approved and that the parties to the contract are committed to perform (or have already performed) their respective obligations.

EXAMPLE 2-3

Identifying the contract – product delivered without a written contract

Seller's practice is to obtain written and customer-signed sales agreements. Seller delivers a product to a customer without a signed agreement based on a request by the customer to fill an urgent need.

Can an enforceable contract exist if Seller has not obtained a signed agreement consistent with its customary business practice?

Analysis

It depends. Seller needs to determine if a legally enforceable contract exists without a signed agreement. The fact that it normally obtains written agreements does not necessarily mean an oral agreement is not a contract; however, Seller must determine whether the oral arrangement meets all of the criteria to be a contract.

EXAMPLE 2-4

Identifying the contract – contract extensions

ServiceProvider has a 12-month agreement to provide Customer with services for which Customer pays \$1,000 per month. The agreement does not include any provisions for automatic extensions, and it expires on November 30, 20X6. The two parties sign a new agreement on February 28, 20X7, that requires Customer to pay \$1,250 per month in fees, retroactive to December 1, 20X6.

Customer continued to pay \$1,000 per month during December, January, and February, and ServiceProvider continued to provide services during that period. There are no performance issues being disputed between the parties in the expired period, only negotiation of rates under the new contract.

Does a contract exist in December, January, and February (prior to the new agreement being signed)?

Analysis

A contract appears to exist in this situation because ServiceProvider continued to provide services and Customer continued to pay \$1,000 per month according to the previous contract.

However, since the original arrangement expired and did not include any provision for automatic extension, determining whether a contract exists during the intervening period from December to February requires judgment and analysis of the legal enforceability of the arrangement in the relevant jurisdiction. Revenue recognition should not be deferred until the written contract is signed if there are enforceable rights and obligations established prior to the conclusion of the negotiations.

The parties are committed to perform their obligations

All relevant facts and circumstances should be considered to determine whether the parties are committed to perform under a contract. Termination clauses are a key consideration when determining whether a contract exists. A contract does not yet exist if neither party has performed, and either party can unilaterally terminate the wholly unperformed contract without compensating the other party.

A wholly unperformed contract is one in which the entity has neither transferred the promised goods or services to the customer nor received, or become entitled to receive, any consideration. Wholly unperformed contracts have no effect on an entity's financial position.

This differs from situations where only one party can terminate a wholly unperformed contract without penalty. The entity that cannot cancel is obligated to stand ready to perform at the discretion of the other party. This could have an effect on an entity's financial position and performance. The assets and liabilities in a wholly unperformed, noncancellable contract will offset each other, but an entity will need to consider the disclosure requirements in the revenue standard, such as disclosures about the remaining performance obligations in the contract.

2.6.1.2 *The entity can identify each party's rights*

An entity must be able to identify each party's rights regarding the goods and services promised in the contract to assess its obligations under the contract. Revenue cannot be recognized related to a contract (written or oral) where the rights of each party cannot be identified, because the entity would not be able to assess when it has transferred control of the goods or services.

For example, an entity enters into a contract with a customer and agrees to provide professional services in exchange for cash, but the rights and obligations of the parties are not yet known. The entities have not contracted with each other in the past and are negotiating the terms of the agreement. No revenue should be recognized if the entity provides services to the customer prior to understanding its rights to receive consideration.

2.6.1.3 *The entity can identify the payment terms*

The payment terms for goods or services must be known before a contract can exist, because without that understanding, an entity cannot determine the transaction price. This does not necessarily require that the transaction price be fixed or explicitly stated in the contract. Refer to RR 4 for discussion of determining the transaction price, including variable consideration.

2.6.1.4 *The contract has commercial substance*

A contract has commercial substance if the risk, timing, or amount of the entity's future cash flows will change as a result of the contract. If there is no change, it is unlikely the contract has commercial substance. A change in future cash flows does not only apply to cash consideration. Future cash flows can also be affected when the

entity receives noncash consideration as the noncash consideration might result in reduced cash outflows in the future. There should also be a valid business reason for the transaction to occur. Determining whether a contract has commercial substance can require judgment, particularly in complex arrangements where vendors and customers have several arrangements in place between them.

2.6.1.5 *Collection of the consideration is probable*

An entity only applies the revenue guidance to contracts when it is “probable” that the entity will collect the consideration it is entitled to in exchange for the goods or services it transfers to the customer. The entity’s assessment of this probability must reflect both the customer’s ability and intent to pay as amounts become due. An assessment of the customer’s intent to pay requires management to consider all relevant facts and circumstances including items such as the entity’s past practices with its customers as well as, for example, any collateral obtained from the customer.

The assessment of whether an amount is probable of being collected is made after considering any price concessions expected to be provided to the customer. Management should first determine whether it expects the entity to accept a lower amount of consideration from the customer than the customer is obligated to pay. This might be the case if the entity has a customary business practice of accepting less than the contractually agreed-upon price, either with an individual customer or with customers overall. An entity that expects to provide a price concession should record revenue at the amount it expects to enforce.

The use of a “probable” threshold creates a difference between U.S. GAAP and IFRS. This is because the term “probable” under U.S. GAAP is generally interpreted as a 75-80 percent likelihood, while under IFRS it means more likely than not (that is, greater than 50 percent likelihood). This could result in a difference in the accounting for a contract if there is a likelihood of nonpayment at inception. For example, an IFRS preparer would apply the revenue guidance to a contract that is 70 percent certain of collection, whereas a U.S. GAAP preparer could not account for the contract (unless certain criteria are met, as discussed in RR 2.6.2). Though different thresholds were created, in a majority of transactions, an entity will not enter into a contract with a customer if there is significant credit risk without also having adequate protection to ensure it can collect the consideration to which it is entitled.

2.6.2 *Arrangements where criteria are not met*

An arrangement is not accounted for using the five-step model until all of the criteria in RR 2.6.1 are met. Management will need to reassess the arrangement at each reporting period to determine if the criteria are met.

An entity that is party to an arrangement that does not meet the criteria in RR 2.6.1 should not recognize revenue from consideration received from the customer until one of the following criteria is met.

Excerpt from ASC 606-10-25-7 and IFRS 15.15

When a contract with a customer does not meet the criteria ... and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when either of the following events has occurred:

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

The revenue standard also includes Example 1, which illustrates the accounting for consideration received when the criteria in RR 2.6.1 are not met.

2.6.3 Reassessment of criteria

Once an arrangement has met the criteria in RR 2.6.1, management does not reassess the criteria again unless there are indications of significant changes in facts and circumstances.

For example, an entity determines that a contract with a customer exists, but subsequently the customer's ability to pay deteriorates significantly in relation to goods or services to be provided in the future. Management needs to assess, in this situation, whether it is probable that the customer will pay the amount of consideration for the remaining goods or services to be transferred to the customer. The entity will account for the remainder of the contract as if it had not met the criteria to be a contract if it is not probable that it will collect the consideration for future goods or services. This assessment does not affect assets and revenue recorded relating to performance obligations already satisfied. Such assets are assessed for impairment under the relevant financial instruments standard.

2.7 Combining contracts

Multiple contracts will need to be combined and accounted for as a single arrangement in some situations. This is the case when the economics of the individual contracts cannot be understood without reference to the arrangement as a whole.

Excerpt from ASC 606-10-25-9 and IFRS 15.17

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

- a. The contracts are negotiated as a package with a single commercial objective;
- b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract; [or [IFRS]]

- c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation

The determination of whether to combine two or more contracts is made at contract inception. Contracts must be entered into with the same customer (or related parties of the customer) at or near the same time in order to account for them as a single contract. Contracts between the entity and related parties (as defined in ASC 850, *Related Party Disclosures*, and IAS 24, *Related Party Disclosures*) of the customer should be combined if the criteria above are met. Judgment will be needed to determine what is “at or near the same time,” but the longer the period between the contracts, the more likely circumstances have changed that affect the contract negotiations.

Contracts might have a single commercial objective if a contract would be loss-making without taking into account the consideration received under another contract. Contracts should also be combined if the performance provided under one contract affects the consideration to be paid under another contract. This would be the case when failure to perform under one contract affects the amount paid under another contract.

The guidance on identifying performance obligations (refer to RR 3) should be considered whenever entities have multiple contracts with the same customer that were entered into at or near the same time. Promises in a contract that are not distinct cannot be accounted for as if they are distinct solely because they arise from different contracts. For example, a contract for the sale of specialized equipment should not be accounted for separately from a second contract for significant customization and modification of the equipment. The specialized equipment and customization and modification services are likely a single performance obligation in this situation.

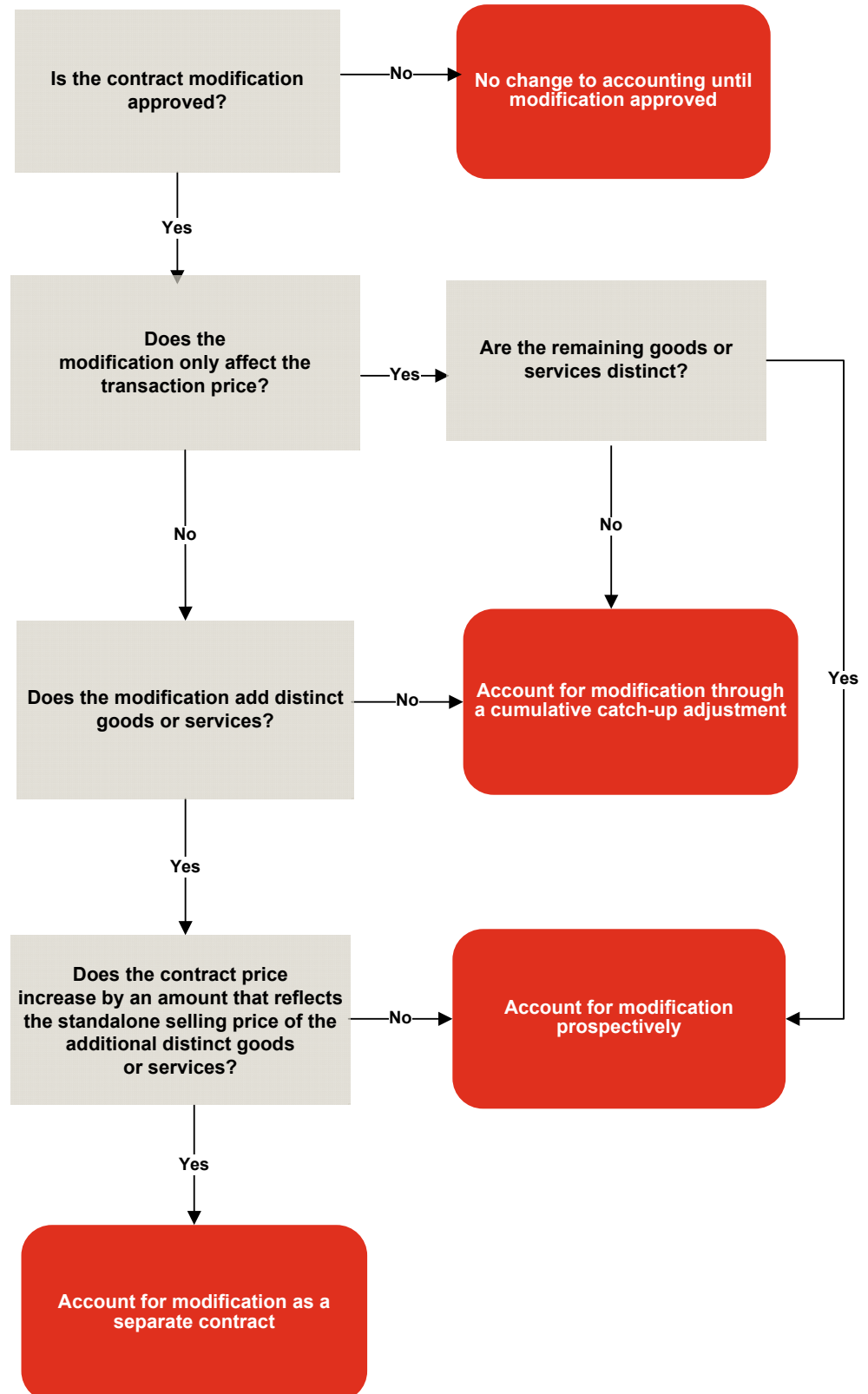
Only contracts entered into at or near the same time are assessed under the contract combination guidance. Promises made subsequently that were not anticipated at contract inception (or implied based on the entity's business practices) are generally accounted for as contract modifications.

2.8 Contract modifications

A change to an existing contract is a modification. A contract modification could change the scope of the contract, the price of the contract, or both. A contract modification exists when the parties to the contract approve the modification either in writing, orally, or based on the parties’ customary business practices. Judgment will often be needed to determine whether changes to existing rights and obligations should have been accounted for as part of the original arrangement (that is, should have been anticipated due to the entity's business practices) or accounted for as a contract modification.

Contract modifications are accounted for as either a separate contract or as part of the existing contract depending on the nature of the modification as summarized in the following figure.

Figure 2-1
Accounting for contract modifications



2.8.1 Assessing whether a contract modification is approved

A contract modification is approved when the modification creates or changes the enforceable rights and obligations of the parties to the contract. Management will need to determine if a modification is approved either in writing, orally, or implied by customary business practices such that it creates enforceable rights and obligations before accounting for the modification. Management should continue to account for the existing terms of the contract until the modification is approved.

Where the parties to an arrangement have agreed to a change in scope, but not the corresponding change in price (for example, an unpriced change order), the entity should estimate the change to the transaction price in accordance with the guidance on estimating variable consideration (refer to RR 4). Management should assess all relevant facts and circumstances (for example, prior experience with similar modifications) to determine whether there is an expectation that the price will be approved.

EXAMPLE 2-5

Contract modifications – unpriced change order

Contractor enters into a contract with a customer to construct a warehouse. Contractor discovers environmental issues during site preparation that must be remediated before construction can begin. Contractor obtains approval from the customer to perform the remediation efforts, but the price for the services will be agreed to in the future (that is, it is an unpriced change order). Contractor completes the remediation and invoices the customer \$2 million, based on the costs incurred plus a profit margin consistent with the overall expected margin on the project.

The invoice exceeds the amount the customer expected to pay, so the customer challenges the charge. Based on consultation with external counsel and the Contractor's customary business practices, Contractor concludes that performance of the remediation services gives rise to enforceable rights and that the amount charged is reasonable for the services performed.

Is the contract modification approved such that Contractor can account for the modification?

Analysis

Yes. Despite the lack of agreement on the specific amount Contractor will receive for the services, the contract modification is approved and Contractor can account for the modification. The scope of work has been approved; therefore, Contractor should estimate the corresponding change in transaction price in accordance with the guidance on variable consideration. Refer to RR 4 for further considerations related to the accounting for variable consideration, including the constraint on variable consideration.

2.8.2 *Modification accounted for as a separate contract*

Accounting for a modification as a separate contract reflects the fact that there is no economic difference between the entities entering into a separate contract or agreeing to the modification.

Excerpt from ASC 606-10-25-12 and IFRS 15.20

An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

- a. The scope of the contract increases because of the addition of promised goods or services that are distinct....
- b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

The following example illustrates a contract modification that is accounted for as a separate contract.

EXAMPLE 2-6

Contract modifications – sale of additional goods

Manufacturer enters into an arrangement with a customer to sell 100 goods for \$10,000 (\$100 per good). The goods are distinct and are transferred to the customer over a six-month period. The parties modify the contract in the fourth month to sell an additional 20 goods for \$95 each. The price of the additional goods represents the standalone selling price on the modification date.

Should Manufacturer account for the modification as a separate contract?

Analysis

Yes. The modification to sell an additional 20 goods at \$95 each should be accounted for as a separate contract because the additional goods are distinct and the price reflects their standalone selling price. The existing contract would not be affected by the modification.

2.8.3 *Modification not accounted for as a separate contract*

A modification that does not meet both of the criteria to be accounted for as a separate contract is accounted for as an adjustment to the existing contract, either prospectively or through a cumulative catch-up adjustment.

EXAMPLE 2-7

Contract modifications – extending a services contract

ServeCo enters into a three-year service contract with Customer for \$450,000 (\$150,000 per year). The standalone selling price for the service at inception of the contract is \$150,000 per year. At the end of the second year, the parties agree to modify the contract as follows: (1) the fee for the third year is reduced to \$120,000; and (2) Customer agrees to extend the contract for another three years for \$300,000 (\$100,000 per year). The standalone selling price of the services at the time of modification is \$120,000.

Should ServeCo account for the modification as a separate contract?

Analysis

The modification should not be accounted for as a separate contract. The price of the contract did not increase by an amount of consideration that reflects the standalone selling price of the additional services, even though the additional services might be distinct.

2.8.3.1 ***Modification accounted for prospectively***

An entity accounts for a modification prospectively if the remaining goods or services are distinct from the goods or services transferred before the modification, but the consideration for those goods or services does not reflect their standalone selling prices. This type of contract modification is effectively treated as the termination of the original contract and the creation of a new contract.

An entity will also account for a contract modification prospectively if the contract contains a single performance obligation that comprises a series of distinct goods or services, such as a monthly cleaning service (refer to RR 3.2.2). In other words, the modification will only affect the accounting for the remaining distinct goods and services to be provided in the future, even if the series of distinct goods or services is accounted for as a single performance obligation.

EXAMPLE 2-8

Contract modifications – extending a services contract

Assume the same facts as Example 2-7.

How should ServeCo account for the modification?

Analysis

The modification is accounted for as if the existing arrangement is terminated and a new contract is created. ServeCo should reallocate the remaining consideration to all of the remaining services to be provided (that is, the obligations remaining from the original contract and the new obligations). ServeCo will recognize a total of \$420,000

(\$120,000 + \$300,000) over the remaining four-year service period (one year remaining under the original contract plus three additional years), or \$105,000 per year.

2.8.3.2 *Modification accounted for through a cumulative catch-up adjustment*

An entity accounts for a modification through a cumulative catch-up adjustment if the goods or services in the modification are not distinct and are part of a single performance obligation that is only partially satisfied when the contract is modified.

This type of contract modification is treated as if it were part of the original contract. Modifications of contracts that include a single performance obligation that is a series of distinct goods or services will not be accounted for using a cumulative catch-up adjustment; rather, these modifications will be accounted for prospectively (refer to RR 2.8.3.1).

EXAMPLE 2-9

Contract modifications – additional good or service is not distinct

Builder enters into a two-year arrangement with Customer to build a manufacturing facility for \$300,000. The construction of the facility is a single performance obligation. Builder and Customer agree to modify the original floor plan at the end of the first year, which will increase the transaction price and expected cost by approximately \$100,000 and \$75,000, respectively.

How should Builder account for the modification?

Analysis

Builder should account for the modification as if it were part of the original contract. The modification does not create a performance obligation because the remaining goods and services to be provided under the modified contract are not distinct. Builder should update its estimate of the transaction price and its measure of progress to account for the effect of the modification. This will result in a cumulative catch-up adjustment at the date of the contract modification.

2.8.4 *Changes in the transaction price*

The transaction price might change as a result of contract modifications. A contract modification that only affects the transaction price is either accounted for prospectively or on a cumulative catch-up basis. It is accounted for prospectively if the remaining goods or services are distinct. There is a cumulative catch-up if the remaining goods or services are not distinct. Thus, a contract modification that only affects the transaction price is accounted for like any other contract modification.

The transaction price might also change as a result of changes in circumstances or the resolution of uncertainties. Changes in the transaction price that do not arise from a contract modification are addressed in RR 4.3.4 and 5.5.2.

The accounting can be complex if the transaction price changes as a result of a change in circumstances or changes in variable consideration after a contract has been modified. The revenue standard provides guidance and an example to address this situation.

Excerpt from ASC 606-10-32-45 and IFRS 15.90

- a. An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for [as if it were a termination of the existing contract and the creation of a new contract].
- b. In all other cases in which the modification was not accounted for as a separate contract..., an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

The revenue standard also includes Example 6, which illustrates the accounting for a change in the transaction price after a contract modification.

Chapter 3:

Identifying performance obligations

3.1 Chapter overview

The second step in accounting for a contract with a customer is identifying the performance obligations. Performance obligations are the unit of account for purposes of applying the revenue standard and therefore determine when and how revenue is recognized. Identifying the performance obligations requires judgment in some situations to determine whether multiple promised goods or services in a contract should be accounted for separately or as a group. The revenue standard provides guidance to help entities develop an approach that best reflects the economic substance of a transaction.

3.2 Promises in a contract

Promises in a contract can be explicit, or implicit if the promises create a valid expectation that the entity will provide a good or service based on the entity's customary business practices, published policies, or specific statements. It is therefore important to understand an entity's policies and practices, representations made during contract negotiations, marketing materials, and business strategies when identifying the promises in an arrangement.

Promised goods or services include, but are not limited to:

- Transferring produced goods or reselling purchased goods
- Arranging for another party to transfer goods or services
- Standing ready to provide goods or services in the future
- Building, designing, manufacturing, or creating an asset on behalf of a customer
- Granting a right to use or access to intangible assets, such as intellectual property (refer to RR 9.3)
- Granting an option to purchase additional goods or services that provides a material right to the customer (refer to RR 3.4.4)
- Performing contractually agreed-upon tasks

Excerpt from ASC 606-10-25-14 and IFRS 15.22

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

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

3.2.1 ***Promise to transfer a distinct good or service***

Each distinct good or service that an entity promises to transfer is a performance obligation (refer to RR 3.3 for guidance on assessing whether a good or service is distinct). Goods and services that are not distinct are bundled with other goods or services in the contract until a bundle of goods or services that is distinct is created. The bundle of goods or services in that case is a single performance obligation.

Promises that appear inconsequential or perfunctory need to be considered when identifying performance obligations as all promises to transfer a distinct good or service meet the definition of a performance obligation. However, an entity can assess whether those performance obligations are immaterial to its financial statements as described in FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, or IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

3.2.2 ***Promise to transfer a series of distinct goods or services***

There might be situations where an entity provides distinct goods or services consecutively over a period of time that are substantially the same (for example, daily cleaning services). These goods or services become a single performance obligation if they have the same pattern of transfer to the customer, as determined by the following criteria.

Excerpt from ASC 606-10-25-15 and IFRS 15.23

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

- a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria...to be a performance obligation satisfied over time. [and [IFRS]]
- b. ...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.

The boards included the concept of a series of distinct goods or services to promote consistency and reduce potential costs to preparers of applying the revenue standard to each increment of a good or service when an entity provides the same good or service consecutively over time. Though the boards provided criteria for entities to apply, judgment is needed to determine whether the criteria are met.

Management will apply the principles in the revenue standard to the single performance obligation when these criteria are met, rather than the individual goods or services that make up the single performance obligation. The exception is that management should consider each distinct good or service in the series, rather than the single performance obligation, when accounting for contract modifications and

allocating variable consideration. See further discussion of contract modifications in RR 2 and allocating variable consideration in RR 5.

3.3 *Assessing whether a good or service is “distinct”*

Management will need to determine whether goods or services are distinct, and therefore separate performance obligations, when there are multiple promises in a contract.

ASC 606-10-25-19 and IFRS 15.27

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

- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct). [and [IFRS]]
- b. The entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

3.3.1 *Customer can benefit from the good or service*

A customer can benefit from a good or service if it can be used, consumed, or sold (for an amount greater than scrap value) to generate economic benefits. A good or service that cannot be used on its own, but can be used with readily available resources, also meets this criterion, as the entity has the ability to benefit from it. Readily available resources are goods or services that are sold separately, either by the entity or by others in the market. They also include resources that the customer has already obtained, either from the entity or through other means.

A customer is typically able to benefit from a good or service on its own or together with readily available resources when the entity regularly sells that good or service on a standalone basis. The timing of delivery of goods or services can impact the assessment of whether the customer can benefit from the good or service. The following example illustrates the assessment of whether a customer can benefit from the good or service.

EXAMPLE 3-1

Distinct goods or services – customer benefits from the good or service

Manufacturer enters into a contract with a customer to sell a custom tool and replacement parts manufactured for the custom tool. Manufacturer sells custom tools and replacement parts together and no other entity sells either product. The customer can use the tool without the replacement parts, but the replacement parts have no use without the custom tool.

How many performance obligations are in the contract?

Analysis

There are two performance obligations if Manufacturer transfers the custom tool first, because the customer can benefit from the custom tool on its own and the customer can benefit from the replacement parts using a resource that is readily available to it (that is, the custom tool was transferred before the replacement parts).

There is a single performance obligation if Manufacturer transfers the replacement parts first, because the customer cannot benefit from those parts without the custom tool.

3.3.2 *Good or service is separately identifiable from other promises in the contract*

Understanding what a customer expects to receive as a final product is necessary to assess whether goods or services should be combined and accounted for as a single performance obligation. Some contracts contain a promise to deliver multiple goods or services, but the customer is not purchasing the individual items. Rather, the customer is purchasing the final good or service that those individual items create when they are combined. Judgment is needed to determine whether there is a single performance obligation or multiple separate performance obligations.

Excerpt from ASC 606-10-25-21 and IFRS 15.29

Factors that indicate that an entity's promise to transfer a good or service to a customer is separately identifiable...include, but are not limited to, the following:

- a. The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted. In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer.
- b. The good or service does not significantly modify or customize another good or service promised in the contract.
- c. The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide not to purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.

The factors above are intended to help an entity determine what the customer is contracting to receive. A good or service that is an input used to create or produce the output specified by the customer is not likely to be distinct. The more the good or

service customizes or modifies other items in the contract, and the more it is interconnected with other goods or services in the contract, the more likely it is that the good or service is part of a bundle of goods, rather than a distinct promise.

Management needs to consider the terms of the contract and all other relevant facts, as well as the economic substance of a transaction, to determine whether goods or services should be combined into a single performance obligation.

EXAMPLE 3-2

Distinct goods or services – bundle of goods or services are combined

Contractor enters into a contract to design and build a house for a new homeowner. Contractor is responsible for the overall management of the project and identifies various goods and services that are provided, including architectural design, site preparation, construction of the home, plumbing and electrical services, and finish carpentry. Contractor regularly sells these goods and services individually to customers.

How many performance obligations are in the contract?

Analysis

The bundle of goods and services should be combined into a single performance obligation in this fact pattern. The promised goods and services are capable of being distinct because the homeowner could benefit from the goods or services either on their own or together with other readily available resources. This is because Contractor regularly sells the goods or services separately to other homeowners and the homeowner could generate economic benefit from the individual goods and services by using, consuming, or selling them.

However, the goods and services are not distinct within the context of the contract because they are not separately identifiable from other promises in the contract. Contractor provides a significant service of integrating the various goods and services into the home that the homeowner has contracted to purchase.

EXAMPLE 3-3

Distinct goods or services – bundle of goods or services are not combined

SoftwareCo enters into a contract with a customer to provide a perpetual software license, installation services, and three years of postcontract customer support (unspecified future upgrades and telephone support). The installation services require the entity to configure certain aspects of the software, but do not significantly modify the software. These services do not require specialized knowledge; and other sophisticated software technicians could perform similar services. The software does not require the upgrades and telephone support in order for it to remain functional.

How many performance obligations are in the contract?

Analysis

There are four performance obligations: (1) software license; (2) installation services; (3) unspecified future upgrades; and (4) telephone support.

The customer can benefit from the software (delivered first) because it is functional without the installation services, unspecified future upgrades, or the telephone support. The customer can benefit from the subsequent installation services, unspecified future upgrades, and telephone support together with the software, which it has already obtained.

SoftwareCo concludes that each good and service is separately identifiable because the installation services, unspecified future upgrades, and telephone support do not significantly modify or customize the software. Additionally the software and services are not being integrated into the output that the customer has contracted to receive.

EXAMPLE 3-4**Distinct goods or services – bundle of goods or services are combined**

Assume the same facts as Example 3-3, however the installation services require SoftwareCo to substantially customize the software by adding significant new functionality enabling the software to function with other computer systems owned by the customer.

How many performance obligations are in the contract?

Analysis

There are three performance obligations: (1) license to customized software; (2) unspecified future upgrades; and (3) telephone support.

SoftwareCo determines that the contractual obligation to provide a customized software solution results in a significant service of integrating the licensed software with the customer's other computer systems. The customer has contracted with SoftwareCo to receive customized software and SoftwareCo is utilizing the license and installation services as inputs to produce the customized software. The nature of the installation services also results in the software being significantly modified and customized by the service. SoftwareCo concludes, based on these considerations, that the customized software license and installation services are not distinct in the context of the contract and bundles the software license with the installation services as a single performance obligation.

The unspecified future upgrades and telephone support are separately identifiable, and therefore separate performance obligations, because they do not significantly modify or customize the software.

3.4 Other considerations

Some common contract terms could represent separate performance obligations, including some types of warranties, options to purchase goods or services in the future, and shipping services. Performance obligations can also result from promises implied by an entity's customary business practices. The assessment of whether certain contract terms or implicit promises create performance obligations requires judgment in some situations.

3.4.1 Activities that are not performance obligations

Activities that an entity undertakes to fulfill a contract that do not transfer goods or services to the customer are not performance obligations. For example, administrative tasks to set up a contract or mobilization efforts are not performance obligations if those activities do not transfer a good or service to the customer. Revenue is not recognized when an entity completes an activity that is not a performance obligation, as illustrated by the following examples.

EXAMPLE 3-5

Identifying performance obligations – activities

FitCo operates health clubs. FitCo enters into contracts with customers for one year of access to any of its health clubs for \$300. FitCo also charges a \$50 nonrefundable joining fee to compensate, in part, for the initial activities of registering the customer.

How many performance obligations are in the contract?

Analysis

There is one performance obligation in the contract, which is the right provided to the customer to access the health clubs. FitCo's activity of registering the customer is not a service to the customer and therefore does not represent satisfaction of a performance obligation. Refer to RR 8 for considerations related to the treatment of the upfront fee paid by the customer.

EXAMPLE 3-6

Identifying performance obligations – activities

CartoonCo is the creator of a new animated television show. It grants a three-year term license to RetailCo for use of the characters' likenesses on consumer products. RetailCo is required to use the latest image of the characters from the television show. There are no other goods or services provided to RetailCo in the arrangement. When entering into the license agreement, RetailCo reasonably expects CartoonCo to continue to produce the show, develop the characters, and perform marketing to enhance awareness of the characters. RetailCo may start selling consumer products with the characters' likenesses once the show first airs on television.

How many performance obligations are in the arrangement?

Analysis

The license is the only performance obligation in the arrangement. CartoonCo's continued production, internal development of the characters, and marketing of the show are not performance obligations as such additional activities do not directly transfer a good or service to RetailCo. Refer to RR 9 for other considerations related to this example, such as the timing of revenue recognition for the license.

3.4.2 *Implicit promises in a contract*

The customer's perspective should be considered when assessing whether an implicit promise gives rise to a performance obligation. Customers might make current purchasing decisions based on expectations implied by an entity's customary business practices or marketing activities. A performance obligation exists if there is a valid expectation, based on the facts and circumstances, that additional goods or services will be delivered.

Customers develop their expectations based on written contracts, customary business practices of certain entities, expected behaviors within certain industries, and the way products are marketed and sold. Customary business practices vary between entities, industries, and jurisdictions. They also vary between classes of customers, nature of the product or service, and other factors. Management will therefore need to consider the specific facts and circumstances of each arrangement to determine whether implied promises exist.

Implied promises do not need to be enforceable by law in order for them to be evaluated as a performance obligation. Implied promises can create a performance obligation under a contractual agreement, even when enforcement is not assured because the customer has an expectation of performance by the entity. The boards noted in the Basis for Conclusions to the revenue standard that failing to account for these implied promises could result in all of the revenue being recognized even when the entity has unsatisfied promises with the customer.

3.4.3 *Product liability and patent infringement protection*

An entity could be required (for example, by law or court order) to pay damages if its products cause damage or harm to others when used as intended. A requirement to pay damages to an injured party is not a separate performance obligation. Such payments should be accounted for in accordance with guidance on loss contingencies (U.S. GAAP) and provisions (IFRS).

Promises to indemnify a customer against claims of patent, copyright, or trademark infringements are also not separate performance obligations, unless the entity's business is to provide such protection. These protections are similar to warranties that ensure that the good or service operates as intended. These types of obligations are accounted for in accordance with the guidance on loss contingencies (U.S. GAAP) and provisions (IFRS). Refer to RR 8 for further considerations related to warranties, including certain types of warranties that are accounted for as performance obligations.

3.4.4 Options to acquire additional goods or services

Contracts with customers might contain rights that provide the customer with an option to purchase additional goods or services for free or at a discount. These options come in many forms including sales incentives, customer awards, contract renewal options, or discounts on future goods or services.

Customer options give rise to a performance obligation if the option provides a material right to the customer that the customer would not receive without entering into the contract. Management needs to allocate a portion of the transaction price to such options, and recognize revenue allocated to the option when the additional goods or services are transferred to the customer, or when the option expires. Refer to RR 7 for further considerations related to customer options.

3.4.5 Shipment of goods to a customer

Arrangements that involve shipment of goods to a customer might include promises related to the shipping service that give rise to a performance obligation. Management should assess the explicit shipping terms to determine when control of the goods transfers to the customer and whether the shipping services are a separate performance obligation.

Management also needs to evaluate its customary business practices relating to shipping, because the entity might take on additional risks outside of the contracted shipping terms. For example, it is common in certain industries for the contract to specify that title and risk of loss transfer to the customer at the shipping point, but the entity has a practice of covering any loss or damage incurred during transport of the goods. This implied promise could result in an additional performance obligation in the arrangement. Revenue needs to be allocated to this service and recognized upon satisfaction of the service if it is a separate performance obligation.

Management should assess whether the entity is the principal or an agent for the shipping service if it is a separate performance obligation. This will determine whether the entity should record the gross amount of revenue allocated to the shipping service or the net amount, after paying the shipper. Refer to RR 10 for further consideration related to this assessment.

The following is an example of shipment of a product with an implied promise to provide risk of loss services.

EXAMPLE 3-7

Identifying performance obligations – shipping services

Manufacturer enters into a contract with a customer to sell five flat screen televisions. The delivery terms state that legal title and risk of loss passes to the customer when the televisions are given to the carrier. Customer requests that Manufacturer arrange for delivery of the televisions. Manufacturer has a history of replacing televisions that are damaged during transit at no additional cost to the customer.

The customer has control of the televisions at the time they are shipped and can sell them to another party. Manufacturer is precluded from selling the televisions to another customer (for example, redirecting the shipment) once the televisions are picked up by the carrier at Manufacturer's shipping dock.

How many performance obligations are in the arrangement?

Analysis

There are at least two performance obligations: (1) sale of the televisions and (2) shipping service. The arrangement may include a performance obligation related to providing risk of loss service during transit of the goods. Manufacturer will need to determine if the shipping service and risk of loss service are distinct or if they are a bundle of services.

The shipping and any risk of loss service do not affect when the customer obtains control of the televisions. Manufacturer will recognize revenue allocated to the sale of the televisions when control transfers to the customer (that is, upon shipment) and recognize revenue allocated to the shipping service and/or risk of loss service when performance occurs.

Chapter 4: Determining the transaction price

4.1 Chapter overview

This chapter addresses the third step of the revenue model, which is determining the transaction price in an arrangement. The transaction price in a contract reflects the amount of consideration to which an entity expects to be entitled in exchange for goods or services transferred. The transaction price includes only those amounts to which the entity has rights under the present contract. Management must take into account consideration that is variable, noncash consideration, and amounts payable to a customer to determine the transaction price. Management also needs to assess whether a significant financing component exists in arrangements with customers.

4.2 Determining the transaction price

The revenue standard provides the following guidance on determining the transaction price.

ASC 606-10-32-2 and IFRS 15.47

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

The transaction price is the amount that an entity allocates to the performance obligations identified in the contract and, therefore, represents the amount of revenue recognized as those performance obligations are satisfied. The transaction price excludes amounts collected on behalf of third parties, such as some sales taxes, as discussed further in RR 10. Determining the transaction price can be straightforward, such as where a contract is for a fixed amount of consideration in return for a fixed number of goods or services in a reasonably short timeframe. Complexities can arise where a contract includes any of the following:

- Variable consideration
- A significant financing component
- Noncash consideration
- Consideration payable to a customer

Contractually stated prices for goods or services might not represent the amount of consideration that an entity expects to be entitled to as a result of its customary business practices with customers. For example, management should consider whether the entity has a practice of providing price concessions to customers (refer to RR 4.3.2.4).

Management should include consideration from all sources when determining the transaction price. For example, a manufacturer might offer a coupon to end customers that will be redeemed by retailers. The retailer should include the consideration received from both the end customer and any reimbursement from the manufacturer in its assessment of the transaction price.

Management should assume that the contract will be fulfilled as agreed upon and not cancelled, renewed, or modified when determining the transaction price. The transaction price also generally does not include estimates of consideration from the future exercise of options for additional goods and services, because until a customer exercises that right, the entity does not have a right to consideration. An exception is provided as a practical alternative for customer options that meet certain criteria (for example, certain contract renewals) that allows management to estimate goods or services to be provided under the option when determining the transaction price (refer to RR 7.3).

The transaction price is generally not adjusted to reflect the customer's credit risk, meaning the risk that the customer will not pay the entity the amount to which the entity is entitled under the contract. The exception is where the arrangement contains a significant financing component, as the financing component is determined using a discount rate that reflects the customer's creditworthiness (refer to RR 4.4).

Impairment losses relating to a customer's credit risk (that is, impairment of a contract asset or receivable) are measured based on the guidance in ASC 310, *Receivables*, or IFRS 9, *Financial Instruments*. Management needs to consider whether billing adjustments are a modification of the transaction price or a credit adjustment (that is, a write-off of an uncollectible amount). A modification of the transaction price reduces the amount of revenue recognized, while a credit adjustment is an impairment assessed under ASC 310 or IFRS 9. The facts and circumstances specific to the adjustment should be considered, including the entity's past business practices, to make this determination.

4.3 Variable consideration

The revenue standard requires an entity to estimate the amount of variable consideration to which it will be entitled.

ASC 606-10-32-5 and IFRS 15.50

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

Variable consideration is common and takes various forms, including (but not limited to) price concessions, volume discounts, rebates, refunds, credits, incentives, performance bonuses, and royalties. An entity's past business practices can cause consideration to be variable if there is a history of providing discounts or concessions after goods are sold.

Consideration is also variable if the amount an entity will receive is contingent on a future event occurring or not occurring, even though the amount itself is fixed. This might be the case, for example, if a customer can return a product it has purchased. The amount of consideration the entity is entitled to receive depends on whether the customer retains the product or not (refer to RR 8.2 for a discussion of return rights). Similarly, consideration might be contingent upon meeting certain performance goals or deadlines.

The amount of variable consideration included in the transaction price may be constrained in certain situations, as discussed at RR 4.3.2.

4.3.1 *Estimating variable consideration*

The objective of determining the transaction price is to predict the amount of consideration to which the entity will be entitled, including amounts that are variable. Management determines the total transaction price, including an estimate of any variable consideration, at contract inception and reassesses this estimate at each reporting date. Management should use all reasonably available information to make its estimate. Judgments made in assessing variable consideration should be disclosed, as discussed in RR 12.

The revenue standard provides two methods for estimating variable consideration.

ASC 606-10-32-8 and IFRS 15.53

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

- a. The expected value—The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
- b. The most likely amount—The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

The method used is not a policy choice. Management should use the method that it expects best predicts the amount of consideration to which the entity will be entitled based on the terms of the contract. The method used should be applied consistently throughout the contract. However, a single contract can include more than one form of variable consideration. For example, a contract might include both a bonus for achieving a specified milestone and a bonus calculated based on the number of transactions processed. Management may need to use the most likely amount to

estimate one bonus and the expected value method to estimate the other if the underlying characteristics of the variable consideration are different.

4.3.1.1 Expected value method

The expected value method estimates variable consideration based on the range of possible outcomes and the probabilities of each outcome. The estimate is the probability-weighted amount based on those ranges. The expected value method might be most appropriate where an entity has a large number of contracts that have similar characteristics. This is because an entity will likely have better information about the probabilities of various outcomes where there are a large number of similar transactions.

Management must, in theory, consider and quantify all possible outcomes when using the expected value method. However, considering all possible outcomes could be both costly and complex. A limited number of discrete outcomes and probabilities can provide a reasonable estimate of the distribution of possible outcomes in many cases.

4.3.1.2 Most likely amount method

The most likely amount method estimates variable consideration based on the single most likely amount in a range of possible consideration amounts. This method might be the most predictive if the entity will receive one of only two (or a small number of) possible amounts. This is because the expected value method could result in an amount of consideration that is not one of the possible outcomes.

4.3.1.3 Examples of estimating variable consideration

The following examples illustrate how the transaction price should be determined where there is variable consideration.

EXAMPLE 4-1

Estimating variable consideration – performance bonus with multiple outcomes

Contractor enters into a contract with Widget Inc to build an asset for \$100,000 with a performance bonus of \$50,000 that will be paid based on the timing of completion. The amount of the performance bonus decreases by 10% per week for every week beyond the agreed-upon completion date. The contract requirements are similar to contracts Contractor has performed previously and management believes that such experience is predictive for this contract. Contractor concludes that the expected value method is most predictive in this case.

Contractor estimates that there is a 60% probability that the contract will be completed by the agreed-upon completion date, a 30% probability that it will be completed one week late, and a 10% probability that it will be completed two weeks late.

How should Contractor determine the transaction price?

Analysis

The transaction price should include management's estimate of the amount of consideration to which the entity will be entitled for the work performed.

Probability-weighted consideration

\$150,000 (fixed fee plus full performance bonus) x 60%	\$ 90,000
\$145,000 (fixed fee plus 90% of performance bonus) x 30%	\$ 43,500
\$140,000 (fixed fee plus 80% of performance bonus) x 10%	\$ 14,000
Total probability-weighted consideration	\$ 147,500

The total transaction price is \$147,500 based on the probability-weighted estimate. Contractor will update its estimate at each reporting date. This example does not consider the potential need to constrain the estimate of variable consideration included in the transaction price. Refer to RR 4.3.2.

EXAMPLE 4-2**Estimating variable consideration – performance bonus with two outcomes**

Contractor enters into a contract to construct a manufacturing facility for Auto Manufacturer. The contract price is \$250 million plus a \$25 million award fee if the facility is completed by a specified date. The contract is expected to take three years to complete. Contractor has a long history of constructing similar facilities. The award fee is binary (that is, there are only two possible outcomes) and is payable in full upon completion of the facility. Contractor will receive none of the \$25 million fee if the facility is not completed by the specified date.

Contractor believes, based on its experience, that it is 95% likely that the contract will be completed successfully and in advance of the target date.

How should Contractor determine the transaction price?

Analysis

It is appropriate for Contractor to use the most likely amount method to estimate the variable consideration. The contract's transaction price is therefore \$275 million, which includes the fixed contract price of \$250 million and the \$25 million award fee. This estimate should be updated each reporting date.

4.3.2 Constraint on variable consideration

The revenue standard includes a constraint on the amount of variable consideration included in the transaction price as follows.

ASC 606-10-32-11 and IFRS 15.56

An entity shall include in the transaction price some or all of an amount of variable consideration...only to the extent that it is [probable [U.S. GAAP]/highly probable [IFRS]] that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

The boards noted in the Basis for Conclusions to the revenue standard that the threshold of “probable” under U.S. GAAP and “highly probable” under IFRS are generally interpreted to have the same meaning.

Determining the amount of variable consideration to record, including any minimum amounts as discussed in RR 4.3.2.7, requires judgment. The assessment of whether variable consideration should be constrained is largely a qualitative one that has two elements: the magnitude and the likelihood of a change in estimate.

Variable consideration is not constrained if the potential reversal of cumulative revenue recognized is not significant. Significance should not be evaluated in relation to the financial position of the entity. However, the revenue standard does not specify the level at which significance should be assessed (that is, at the contract level or performance obligation level).

Management should consider not only the variable consideration in an arrangement, but also any fixed consideration to assess the possible significance of a reversal of cumulative revenue. This is because the constraint applies to the cumulative revenue recognized, not just to the variable portion of the consideration. For example, the consideration for a single performance obligation could include both a variable and a fixed amount. Management needs to assess the significance of a potential reversal relating to the variable amount by comparing that possible reversal to the cumulative combined fixed and variable amounts.

The revenue standard provides factors to consider when assessing whether variable consideration should be constrained. All of the factors should be considered and no single factor is determinative.

Excerpt from ASC 606-10-32-12 and IFRS 15.57

Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

- a. The amount of consideration is highly susceptible to factors outside the entity’s influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.
- b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

- c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
- d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- e. The contract has a large number and broad range of possible consideration amounts.

4.3.2.1 *The amount is highly susceptible to factors outside the entity's influence*

Factors outside an entity's influence can affect an entity's ability to estimate the amount of variable consideration. Examples could include consideration that is based, in whole or in part, on the movement of a market (such as the value of a fund whose assets are based on stock exchange prices), or an index, such as a commodity price index.

Factors outside an entity's influence could also include the judgment or actions of third parties, including customers. An example is an arrangement where consideration varies based on the customer's subsequent sales of a good or service. However, the entity could have predictive information that enables it to conclude that variable consideration is not constrained in some scenarios.

The revenue standard also includes a narrow exception that applies only to licenses of intellectual property with consideration in the form of sales- and usage-based royalties. Revenue is recognized at the later of when (or as) the subsequent sale or usage occurs, or when the performance obligation to which some or all of the royalty has been allocated has been satisfied (or partially satisfied) as discussed in RR 4.3.5.

4.3.2.2 *The uncertainty is not expected to be resolved for a long period of time*

A long period of time until the uncertainty is resolved might make it more challenging to determine a reasonable range of outcomes of that uncertainty, as other variables might be introduced over the period that affect the outcome. This makes it more difficult to assert that it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue recognized will not occur. Management might be able to more easily conclude that variable consideration is not constrained when an uncertainty is resolved in a short period of time. Management should consider all facts and circumstances, however, as in some situations a longer period of time until the uncertainty is resolved could make it easier to conclude that a significant reversal of cumulative revenue will not occur. Consider, for example, a performance bonus that will be paid if a specific sales target is met by the end of a multi-year contract term. Depending on existing and historical sales levels, that target might be considered easier to achieve due to the long duration of the contract.

4.3.2.3 *The entity's experience is limited or has limited predictive value*

An entity with limited experience might not be able to predict the likelihood or magnitude of a revenue reversal if the estimate of variable consideration changes. An entity that does not have its own experience with similar contracts might be able to rely on other evidence, such as similar contracts offered by competitors or other market information. However, management needs to assess whether this evidence is predictive of the outcome of the entity's contract.

4.3.2.4 *The entity has a practice of offering price concessions or changing payment terms*

An entity might enter into a contract with stated terms that include a fixed price, but have a practice of subsequently providing price concessions or other price adjustments (including returns allowed beyond standard return limits). A consistent practice of offering price concessions or other adjustments that are narrow in range might provide the predictive experience necessary to estimate the amount of consideration. An entity that offers a broad range of concessions or adjustments might find it more difficult to predict the likelihood or magnitude of a revenue reversal.

4.3.2.5 *The contract has a large number and broad range of possible consideration amounts*

It might be difficult to determine whether some or all of the consideration should be constrained when a contract has a large number of possible outcomes that span a significant range. A contract that has more than one, but relatively few, possible outcomes might not result in variable consideration being constrained (even if the outcomes are significantly different) if management has experience with that type of contract. For example, an entity that enters into a contract that includes a significant performance bonus with a binary outcome of either receiving the entire bonus if a milestone is met, or receiving no bonus if it is missed, might not need to constrain revenue if management has sufficient experience with this type of contract.

4.3.2.6 *Examples of applying the constraint*

The following examples illustrate the application of the constraint on variable consideration.

EXAMPLE 4-3

Variable consideration – consideration is constrained

Land Owner sells land to Developer for \$1 million. Land Owner is also entitled to receive 5% of any future sales price of the land in excess of \$5 million. Land Owner determines that its experience with similar contracts is of little predictive value, because the future performance of the real estate market will cause the amount of variable consideration to be highly susceptible to factors outside of the entity's influence. Additionally, the uncertainty is not expected to be resolved in a short period of time because Developer does not have current plans to sell the land.

Should Land Owner include variable consideration in the transaction price?

Analysis

No amount of variable consideration should be included in the transaction price. It is not probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue recognized will not occur resulting from a change in estimate of the consideration Land Owner will receive upon future sale of the land. The transaction price at contract inception is therefore \$1 million. Land Owner will update its estimate, including application of the constraint, at each reporting date until the uncertainty is resolved. This includes considering whether any minimum amount should be recorded.

EXAMPLE 4-4

Variable consideration – subsequent reassessment

Assume the same facts as Example 4-3, with the following additional information known to Land Owner two years after contract inception:

- Land prices have significantly appreciated in the market
- Land Owner estimates that it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue recognized will not occur related to \$100,000 of variable consideration based on sales of comparable land in the area
- Developer is actively marketing the land for sale

How should Land Owner account for the change in circumstances?

Analysis

Land Owner should adjust the transaction price to include \$100,000 of variable consideration for which it is probable (U.S. GAAP) or highly probable (IFRS) a significant reversal of cumulative revenue recognized will not occur. Land Owner will update its estimate, either upward or downward, at each reporting date until the uncertainty is resolved.

EXAMPLE 4-5

Variable consideration – multiple forms of variable consideration

Construction Inc. contracts to build a production facility for Manufacturer for \$10 million. The arrangement includes two performance bonuses as follows:

- Bonus A: \$2 million if the facility is completed within six months
- Bonus B: \$1 million if the facility receives a stipulated environmental certification upon completion

Construction Inc. believes that the facility will take at least eight months to complete but that it is probable (U.S. GAAP) or highly probable (IFRS) it will receive the environmental certification, as it has received the required certification on other similar projects.

How should Construction Inc. determine the transaction price?

Analysis

The transaction price is \$11 million. Construction Inc. should assess each form of variable consideration separately. Bonus A is not included in the transaction price as Construction Inc. does not believe it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur. Bonus B should be included in the transaction price as Construction Inc. has concluded it is probable (U.S. GAAP) or highly probable (IFRS), based on the most likely outcome, that a significant reversal in the amount of cumulative revenue recognized will not occur. Construction Inc. will update its estimate at each reporting date until the uncertainty is resolved.

4.3.2.7 Recording minimum amounts

The constraint could apply to a portion, but not all, of an estimate of variable consideration. An entity needs to include a minimum amount of variable consideration in the transaction price if management believes that amount is not constrained, even if other portions are constrained. The minimum amount is the amount for which it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.

Management may need to include a minimum amount in the transaction price even when there is no minimum threshold stated in the contract. Even when a minimum amount is stated in a contract, there may be an amount of variable consideration in excess of that minimum for which it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur if estimates change.

The following example illustrates the inclusion of a minimum amount of variable consideration in the transaction price.

EXAMPLE 4-6

Variable consideration – determining a minimum amount

Service Inc contracts with Manufacture Co to refurbish Manufacture Co's heating, ventilation, and air conditioning (HVAC) system. Manufacture Co pays Service Inc fixed consideration of \$200,000 plus an additional \$5,000 for every 10% reduction in annual costs during the first year following the refurbishment.

Service Inc estimates that it will be able to reduce Manufacture Co's costs by 20%. Service Inc, however, considers the constraint on variable consideration and

concludes that it is probable (U.S. GAAP) or highly probable (IFRS) that estimating a 10% reduction in costs will not result in a significant reversal of cumulative revenue recognized. This assessment is based on Service Inc's experience achieving at least that level of cost reduction in comparable contracts. Service Inc has achieved levels of 20% or above, but not consistently.

How should Service Inc determine the transaction price?

Analysis

The transaction price at contract inception is \$205,000, calculated as the fixed consideration of \$200,000 plus the estimated minimum variable consideration of \$5,000 that will be received for a 10% reduction in customer costs. Service Inc will update its estimate at each reporting date until the uncertainty is resolved.

4.3.3 Common forms of variable consideration

Variable consideration is included in contracts with customers in a number of different forms. The following are examples of types of variable consideration commonly found in customer arrangements.

4.3.3.1 Price concessions

Price concessions are adjustments to the amount charged to a customer that are typically made outside of the initial contract terms. Price concessions are provided for a variety of reasons. For example, a vendor may accept a payment less than the amount contractually due from a customer to encourage the customer to pay for previous purchases and continue making future purchases. Price concessions are also sometimes provided when a customer has experienced some level of dissatisfaction with the good or service (other than items covered by warranty).

Management should assess the likelihood of offering price concessions to customers when determining the transaction price. An entity that expects to provide a price concession, or has a practice of doing so, should reduce the transaction price to reflect the consideration to which it expects to be entitled after the concession is provided.

The following example illustrates the effect of a price concession.

EXAMPLE 4-7

Variable consideration – price concessions

Machine Co sells a piece of machinery to Customer for \$2 million payable in 90 days. Machine Co is aware at contract inception that Customer may not pay the full contract price. Machine Co estimates that Customer will pay at least \$1.75 million, which is sufficient to cover Machine Co's cost of sales (\$1.5 million) and which Machine Co is willing to accept because it wants to grow its presence in this market. Machine Co has granted similar price concessions in comparable contracts.

Machine Co concludes it is probable (U.S. GAAP) or highly probable (IFRS) it will collect \$1.75 million and such amount is not constrained under the variable consideration guidance.

What is the transaction price in this arrangement?

Analysis

Machine Co is likely to provide a price concession and accept an amount less than \$2 million in exchange for the machinery. The consideration is therefore variable. The transaction price in this arrangement is \$1.75 million, as this is the amount to which Machine Co expects to be entitled after providing the concession and it is not constrained under the variable consideration guidance. Machine Co can also conclude that the collectibility threshold is met for the \$1.75 million and therefore, a contract exists, as discussed in RR 2.

4.3.3.2 Prompt payment discounts

Customer purchase arrangements frequently include a discount for early payment. For example, an entity might offer a 2 percent discount if an invoice is paid within 10 days of receipt. A portion of the consideration is variable in this situation as there is uncertainty as to whether the customer will pay the invoice within the discount period. Management needs to make an estimate of the consideration it expects to be entitled to as a result of offering this incentive. Experience with similar customers and similar transactions should be considered in determining the number of customers that are expected to receive the discount.

4.3.3.3 Volume discounts

Contracts with customers often include volume discounts that are offered as an incentive to encourage additional purchases and customer loyalty. Volume discounts typically require a customer to purchase a specified amount of goods or services, after which the price of additional goods or services decrease. These arrangements include variable consideration because the total amount to be paid by the customer is not known at contract inception and is affected by the amount of goods or services ultimately purchased.

Volume discount arrangements affect the timing of revenue recognition if they provide the customer with a material right, as discussed in RR 7. A material right to a free or discounted product in the future is a separate performance obligation to which management must allocate a portion of the transaction price from current sales. Revenue allocated to the right is recognized when the free or discounted goods or services are provided, or the right expires. Management needs to estimate the volume discounts it expects customers to earn based on experience with similar contracts to determine the portion of the transaction price to allocate to the right.

Management also needs to consider the constraint on variable consideration. Management should include at least the minimum price per unit in the estimated transaction price at contract inception if it does not have the ability to estimate the

total units expected to be sold. Including the minimum price per unit meets the objective of the constraint as it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal in the cumulative amount of revenue recognized will not occur. Management should also consider whether amounts above the minimum price per unit are constrained, or should be included in the transaction price. Management will need to update its estimate of the total sales volume at each reporting date until the uncertainty is resolved.

The following examples illustrate how volume discounts affect transaction price.

EXAMPLE 4-8

Variable consideration – volume discounts

Chemical Co has a one-year contract with Municipality to deliver water treatment chemicals. The contract stipulates that the price per container will decrease as sales volume increases as follows:

Price per container	Sales volume
\$100	0–1,000,000 containers
\$90	1,000,001–3,000,000 containers
\$85	3,000,001 containers and above

Volume is determined based on sales during the calendar year. Chemical Co believes that total sales volume for the year will be 2.5 million containers based on its experience with similar contracts and forecasted sales to Municipality.

How should Chemical Co determine the transaction price?

Analysis

The transaction price is \$94 per container calculated as follows:

Total consideration		
\$100 per container * 1,000,000 containers	\$	100,000,000
\$90 per container * 1,500,000 containers	\$	135,000,000
	\$	235,000,000
Total volume		2,500,000 containers
Average price per container	\$	94 per container

Chemical Co concludes that it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal in the amount of cumulative revenue recognized (that is, \$94 per container) will not occur when the uncertainty is resolved. Revenue is therefore recognized at an average selling price of \$94 per container as each container is sold. Chemical Co will recognize a contract liability for cash received in excess of the transaction price for the first one million containers sold at \$100 per container (that is, \$6 per container). This liability will begin to be relieved when sales exceed one million containers and the amount billed is \$90 per container.

Chemical Co will update its estimate of the total sales volume at each reporting date until the uncertainty is resolved.

EXAMPLE 4-9

Variable consideration – reassessment of estimated volume discounts

Assume the same facts as Example 4-8 with the following additional information:

- Chemical Co reduces its estimate of total sales volume to two million containers at the end of the first reporting period within the contract term
- Chemical Co sold 450,000 containers of chemicals during the first reporting period

How should Chemical Co account for the change in estimate?

Analysis

Chemical Co should update its calculation of the transaction price to reflect the change in estimate. The updated transaction price is \$95 per container calculated as follows:

Total consideration

\$100 per container * 1,000,000 containers	\$	100,000,000
\$90 per container * 1,000,000 containers	\$	90,000,000
	\$	190,000,000
Total volume		2,000,000 containers
Average price per container	\$	95 per container

Chemical Co recognizes \$95 per container for subsequent sales and should recognize an additional \$450,000 in revenue related to chemicals sold during the first reporting period (assuming the performance obligation has been satisfied), calculated as the change in transaction price (\$1) multiplied by the number of containers sold (450,000). The cumulative catch-up adjustment reflects the revenue that Chemical Co would have recognized if, at contract inception, it had the information that is now available.

Chemical Co will update its estimate of the total sales volume at each reporting date until the uncertainty is resolved.

4.3.3.4 Rebates

Rebates are a widely used type of sales incentive. Customers typically pay full price for goods or services at contract inception and then receive a cash rebate in the future. This cash rebate is often tied to an aggregate level of purchases. Management needs to consider the volume of expected sales and expected rebates in such cases to determine the revenue to be recognized on each sale. The consideration is variable in these situations because it is based on the volume of eligible transactions.

Rebates are also often provided based on a single consumer transaction, such as a rebate on the purchase of a kitchen appliance if the customer submits a request for rebate to the seller. The uncertainty surrounding the number of customers that will fail to take advantage of the offer (often referred to as “breakage”) causes the consideration for the sale of the appliance to be variable.

Management may be able to estimate expected rebates if the entity has a history of providing similar rebates on similar products. It could be difficult to estimate expected rebates in other circumstances, such as when the rebate is a new program, it is offered to a new customer or class of customers, or it is related to a new product line. It may be possible, however, to obtain marketplace information for similar transactions that could be sufficiently robust to be considered predictive and therefore used by management in making its estimate.

Management needs to estimate the amount of rebates to determine the transaction price. It should include amounts in the transaction price for arrangements with rebates only if it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur if estimates of rebates change. When management cannot reasonably estimate the amount of rebates that customers are expected to earn, it still needs to consider whether there is a minimum amount of variable consideration that should not be constrained.

Management should update its estimate at each reporting date as additional information becomes available.

The following example illustrates how customer rebates affect the transaction price.

EXAMPLE 4-10

Variable consideration – customer rebates

ShaveCo sells electric razors to retailers for \$50 per unit. A rebate coupon is included inside the electric razor package that can be redeemed by the end consumers for \$10 per unit.

ShaveCo estimates that 20% to 25% of eligible rebates will be redeemed based on its experience with similar programs and rebate redemption rates available in the marketplace for similar programs. ShaveCo concludes that the transaction price

should incorporate an assumption of 25% rebate redemption as this is the amount for which it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue will not occur if estimates of the rebates change.

How should ShaveCo determine the transaction price?

Analysis

ShaveCo records sales to the retailer at a transaction price of \$47.50 (\$50 less 25% x \$10). The difference between the per unit cash selling price to the retailers and the transaction price is recorded as a liability for cash consideration expected to be paid to the end customer. Refer to RR 4.6 for further discussion of consideration payable to a customer. ShaveCo will update its estimate of the rebate and the transaction price at each reporting date if estimates of redemption rates change.

4.3.3.5 Pricing based on index

A transaction price includes variable consideration at contract inception if the amount of consideration is calculated based on an index at a specified date. Contract consideration could be linked to indices such as a consumer price index, a commodity index, or financial indices (for example, the S&P 500). For example, a mining entity might sell nickel to a customer with the final price based on the commodity exchange's spot price for nickel at the date of receipt by the customer (expected six weeks after shipment).

Management needs to consider the extent to which a significant reversal of cumulative revenue recognized could occur if such terms are included in arrangements with customers. This assessment requires judgment, and management needs to consider whether a minimum amount needs to be included in the transaction price.

Management should also consider whether the consideration includes both a receivable and a derivative (and therefore it is subject to accounting standards on financial instruments) if the transaction price is linked to changes in an index.

4.3.3.6 Periods after contract expiration, but prior to contract renewal

Situations can arise where an entity continues to perform under the terms of a contract with a customer that has expired while it negotiates an extension or renewal of that contract. The contract extension or renewal could include changes to pricing or other terms, which are frequently retroactive to the period after expiration of the original contract but prior to finalizing negotiations of the new contract. Judgment is needed to determine whether the parties' obligations are enforceable prior to signing an extension or renewal and, if so, the amount of revenue that should be recorded during this period. Refer to an assessment of whether a contract exists in Example 2-4 of RR 2.

Management will need to estimate the transaction price if it concludes that there are enforceable obligations prior to finalizing the new contract. Management should consider the potential terms of the renewal, including whether any adjustments to

terms will be applied retroactively or only prospectively. Anticipated adjustments as a result of renegotiated terms should be assessed under the variable consideration guidance, including the constraint on variable consideration.

This situation differs from contract modifications where the transaction price is not expected to be variable at the inception of the arrangement, but instead changes because of a future event. Refer to RR 2.8 for discussion of contract modifications.

4.3.3.7 Price protection and price matching

Price protection clauses allow a customer to obtain a refund if the seller lowers the product's price to any other customers during a specified period. Price protection clauses ensure that the customer is not charged more by the seller than any other customer during this period. Price matching provisions require an entity to refund a portion of the transaction price if a competitor lowers its price on a similar product. Both of these provisions introduce variable consideration into an arrangement as there is a possibility of subsequent adjustments to the stated transaction price.

The following example illustrates how price protection clauses affect the transaction price.

EXAMPLE 4-11

Variable consideration – price protection guarantee

Manufacturer enters into a contract to sell goods to Retailer for \$1,000. Manufacturer also offers price protection where it will reimburse Retailer for any difference between the sale price and the lowest price offered to any customer during the following six months. This clause is consistent with other price protection clauses offered in the past, and Manufacturer believes it has experience that is predictive for this contract.

Management expects that it will offer a price decrease of 5% during the price protection period. Management concludes it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue will not occur if estimates change.

How should Manufacturer determine the transaction price?

Analysis

The transaction price is \$950, as the expected reimbursement is \$50. The expected payment to Retailer is reflected in the transaction price at contract inception as that is the amount of consideration to which Manufacturer expects to be entitled after the price protection. Manufacturer will recognize a liability for the difference between the invoice price and the transaction price, as this represents the cash it expects to refund to Retailer. Manufacturer will update its estimate of expected reimbursement at each reporting date until the uncertainty is resolved.

Some arrangements allow for price protection only on the goods that remain in a customer's inventory. Management needs to estimate the number of units to which

the price protection guarantee applies in such cases to determine the transaction price, as the reimbursement does not apply to units already sold by the customer.

4.3.3.8 Guarantees (including service level agreements)

Contracts with a customer sometimes include guarantees made by the vendor. For example, an entity might guarantee a customer that is a reseller a minimum margin on sales to its customers. Consideration will be paid to the customer if the specified margin is not achieved. Variable consideration guidance needs to be considered in this situation given the uncertainty in the transaction price created by the guarantee.

Service level agreements (“SLAs”) are a form of guarantee frequently found in contracts with customers. SLA is a generic description often used to describe promises by a seller that include a guarantee of a product’s or service’s performance or a guarantee of warranty service response rates. SLAs are commonly used by companies that sell products or services that are critical to the customer’s operations, where the customer cannot afford to have product failures, service outages, or service interruptions. For example, a vendor might guarantee a certain level of “uptime” for a network (for example, 99.999 percent) or guarantee that service call response times will be below a maximum time limit. SLAs might also include penalty clauses triggered by breach of the guarantees.

The terms and conditions of the SLA determine the accounting model. SLAs that are warranties should be accounted for under the warranty guidance discussed in RR 8. For example, an SLA requiring an entity to repair equipment to restore it to original specified production levels could be a warranty. SLAs that are not warranties and could result in payments to a customer are variable consideration.

The following example illustrates accounting for a guaranteed profit margin.

EXAMPLE 4-12

Variable consideration – profit margin guarantee

ClothesCo sells a line of summer clothing to Department Store for \$1 million. ClothesCo has a practice of providing refunds of a portion of its sales prices at the end of each season to ensure its department store customers meet minimum sales margins. Based on its experience, ClothesCo refunds on average approximately 10% of the invoiced amount. ClothesCo has also concluded that variable consideration is not constrained in these circumstances.

What is the transaction price in this arrangement?

Analysis

ClothesCo’s practice of guaranteeing a minimum margin for its customers results in variable consideration. The transaction price in this arrangement is \$900,000, calculated as the amount ClothesCo bills Department Store (\$1 million) less the estimated refund to provide the Department Store its minimum margin (\$100,000).

ClothesCo will update its estimate at each reporting period until the uncertainty is resolved.

4.3.4 *Changes in the estimate of variable consideration*

Estimates of variable consideration are subject to change as facts and circumstances evolve. Management should revise its estimates of variable consideration at each reporting date throughout the contract period. Any changes in the transaction price are allocated to all performance obligations in the contract unless the variable consideration relates only to one or more, but not all, of the performance obligations. Refer to RR 5.5 for further discussion of allocating variable consideration.

4.3.5 *Exception for licenses of intellectual property (IP) with sales- or usage-based royalties*

The revenue standard includes an exception for the recognition of revenue relating to licenses of IP with sales- or usage-based royalties. Revenue is recognized at the later of when (or as) the subsequent sale or usage occurs, or when the performance obligation to which some or all of the royalty has been allocated has been satisfied (or partially satisfied). Refer to RR 9 for additional information on the accounting for revenue from licenses of IP.

4.4 *Existence of a significant financing component*

The revenue standard provides the following guidance on accounting for arrangements with a significant financing component.

ASC 606-10-32-15 and IFRS 15.60

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

Excerpt from ASC 606-10-32-16 and IFRS 15.61

The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price).

Some contracts contain a financing component (either explicitly or implicitly) because payment by a customer occurs either significantly before or significantly after performance. This timing difference can benefit either the customer, if the entity is financing the customer's purchase, or the entity, if the customer finances the entity's activities by making payments in advance of performance. An entity should reflect the effects of any significant financing benefit on the transaction price.

The amount of revenue recognized differs from the amount of cash received from the customer when an entity determines a significant financing component exists. Revenue recognized will be less than cash received for payments that are received in arrears of performance, as a portion of the consideration received will be recorded as interest income. Revenue recognized will exceed the cash received for payments that are received in advance of performance, as interest expense will be recorded and increase the amount of revenue recognized.

Interest income or interest expense resulting from a significant financing component should be presented separately from revenue from contracts with customers. An entity might present interest income as revenue in circumstances in which interest income represents an entity's ordinary activities.

Interest income or interest expense is recognized only if a contract asset (or receivable) or a contract liability has been recognized. For example, consider a sale made to a customer with terms that require payment at the end of three years, but that includes a right of return. If management does not record a contract asset (or receivable) relating to that sale due to the right of return, no interest income is recorded until the right of return period lapses. This is the case even if a significant financing component exists. Interest income is calculated once the return period lapses in accordance with the applicable financial instruments guidance and considering the remaining contract term.

4.4.1 Factors to consider when identifying a significant financing component

Identifying a significant financing component in a contract can require judgment. It could be particularly challenging in a long-term arrangement where product or service delivery and cash payments occur throughout the term of the contract.

Management does not need to consider the effects of the financing component if the effect would not materially change the amount of revenue that would be recognized under the contract. The determination of whether a financing component is significant should be made at the contract level. A determination does not have to be made regarding the effect on all contracts collectively. In other words, the financing effects can be disregarded if they are immaterial at the contract level, even if the combined effect for a portfolio of contracts would be material to the entity as a whole.

The revenue standard includes the following factors to be considered when assessing whether there is a significant financing component in a contract with a customer.

Excerpt from ASC 606-10-32-16 and IFRS 15.61

An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

- a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services
- b. The combined effect of both of the following:
 1. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
 2. The prevailing interest rates in the relevant market

A significant difference between the amount of contract consideration and the amount that would be paid if cash were paid at the time of performance indicates an implicit financing arrangement exists. The longer the period between when a performance obligation is satisfied and when cash is paid for that performance obligation, the more likely it is that a significant financing component exists.

A significant financing component does not exist in all situations when there is a time difference between when consideration is paid and when the goods or services are transferred to the customer. The revenue standard provides factors that indicate that a significant financing component does not exist.

Excerpt from ASC 606-10-32-17 and IFRS 15.62

A contract with a customer would not have a significant financing component if any of the following factors exist:

- a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.
- b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).
- c. The difference between the promised consideration and the cash selling price of the good or service...arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

4.4.1.1 *Timing is at the discretion of the customer*

This could be the case, for example, when a customer purchases a gift card. The customer uses the gift card at his or her discretion, which could be in the near term or take an extended period of time. Similarly, customers who purchase goods or services and are simultaneously awarded loyalty points or other credits that can be used for

free or discounted products in the future decide when those credits are used. The effects of the financing component do not need to be considered in these types of situations because the purpose is not to provide a financing.

4.4.1.2 *A substantial amount of the consideration is variable and based on the occurrence of a future event*

The amount of consideration to be received when it is variable could vary significantly and might not be resolved for an extended period of time. The substance of the arrangement is not a financing if the amount or timing of the variable consideration is determined by an event that is outside the control of the parties to the contract. An example is in an arrangement for legal services where an attorney is paid only upon a successful outcome. The litigation process might extend for several years. The delay in receiving payment is not a result of providing financing in this situation.

4.4.1.3 *The timing difference arises for reasons other than providing financing*

The intent of payment terms that require payments in advance or in arrears of performance could be for reasons other than providing financing. For example, the intent of the parties might be to secure the right to a specific product or service, or to ensure that the seller performs as specified under the contract. The effects of the financing component do not need to be considered if the primary intent of the payment timing is for reasons other than providing a significant financing benefit to the entity or to the customer.

However, any difference between the consideration and the cash selling price should be a reasonable reflection of the reason for the difference. In other words, management should ensure that the difference between the cash selling price and the price charged in the arrangement does not reflect both a reason other than financing and a financing.

The following example illustrates a situation in which a customer prepayment does not reflect a significant financing component.

EXAMPLE 4-13

Significant financing component – prepayment with intent other than to provide financing

Distiller Co produces a rare whiskey that is released once a year prior to the holidays. Retailer agrees to pay Distiller Co in November 20X4 to secure supply for the December 20X5 release. Distiller Co requires payment at the time the order is placed; otherwise, it is not willing to guarantee production levels. Distiller Co does not offer discounts for early payments.

The advance payment allows Retailer to communicate its supply to customers and Distiller Co to manage its production levels.

Is there a significant financing component in the arrangement between Distiller Co and Retailer?

Analysis

There is no significant financing component in the arrangement between Distiller Co and Retailer. The upfront payment is made to secure the future supply of whiskey and not to provide Distiller Co or Retailer with the provision of finance.

4.4.2 *Practical expedient from considering existence of a significant financing component*

The revenue standard provides a practical expedient that allows entities to disregard the effects of a financing component in certain circumstances.

ASC 606-10-32-18 and IFRS 15.63

As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to the customer and when the customer pays for that good or service will be one year or less.

The practical expedient focuses on when the goods or services are provided compared to when the payment is made, not on the length of the contract. The practical expedient can be used even if the contract length is more than 12 months if the timing difference between performance and payment is less than 12 months. However, an entity cannot use the practical expedient to disregard the effects of a financing in the first 12 months of a longer-term arrangement that includes a significant financing component.

An entity that chooses to apply the practical expedient should apply it consistently to similar contracts in similar circumstances. It must also disclose the use of the practical expedient, as discussed in RR 12.3.

4.4.3 *Determining the discount rate*

The revenue standard requires that the discount rate be determined as follows.

Excerpt from ASC 606-10-32-19 and IFRS 15.64

[W]hen adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract.

Management should adjust the contract consideration to reflect the significant financing benefit using a discount rate that reflects the rate that would be used in a separate financing transaction between the entity and its customer. This rate should

reflect the credit risk of the party obtaining financing in the arrangement (which could be the customer or the entity).

Consideration of credit risk of each customer might result in recognition of different revenue amounts for contracts with similar terms if the credit profiles of the customers differ. For example, a sale to a customer with higher credit risk will result in less revenue and more interest income recognized as compared to a sale to a more creditworthy customer. The rate to be used is determined at contract inception, and is not reassessed.

Some contracts include an explicit financing component. Management should consider whether the rate specified in a contract reflects a market rate, or if the entity is offering financing below the market rate as an incentive. A below-market rate does not appropriately reflect the financing element of the contract with the customer. Any explicit rate in the contract should be assessed to determine if it represents a prevailing rate for a similar transaction, or if a more representative rate should be imputed.

4.4.4 Examples of accounting for a significant financing component

The following examples illustrate how the transaction price is determined when a significant financing component exists.

EXAMPLE 4-14

Significant financing component – determining the appropriate discount rate

Furniture Co enters into an arrangement with Customer for financing of a new sofa purchase. Furniture Co is running a promotion that offers all customers 1% financing. The 1% contractual interest rate is significantly lower than the 10% interest rate that would otherwise be available to Customer at contract inception (that is, the contractual rate does not reflect the credit risk of the customer). Furniture Co concludes that there is a significant financing component present in the contract.

What discount rate should Furniture Co use to determine the transaction price?

Analysis

Furniture Co should use a 10% discount rate to determine the transaction price. It would not be appropriate to use the 1% rate specified in the contract as it represents a marketing incentive and does not reflect the credit characteristics of Customer.

EXAMPLE 4-15

Significant financing component – payment prior to performance

Gym Inc enters into an agreement with Customer to provide a five-year gym membership. Upfront consideration paid by Customer is \$5,000. Gym Inc also offers an alternative payment plan with monthly billings of \$100 (total consideration of \$6,000 over the five-year membership term). The membership is a single

performance obligation that Gym Inc satisfies ratably over the five-year membership period.

Gym Inc determines that the difference between the cash selling price and the monthly payment plan (payment over the performance period) indicates a significant financing component exists in the contract with Customer. Gym Inc concludes that the discount rate that would be reflected in a separate transaction between the two parties at contract inception is 5%.

What is the transaction price in this arrangement?

Analysis

Gym Inc should determine the transaction price using the discount rate that would be reflected in a separate financing transaction (5%). This rate is different than the 7.4% imputed discount rate used to discount payments that would have been received over time (\$6,000) back to the cash selling price (\$5,000).

Gym Inc calculates monthly revenue of \$94.35 using a present value of \$5,000, a 5% annual interest rate, and 60 monthly payments. Gym Inc records a contract liability of \$5,000 at contract inception for the upfront payment that will be reduced by the monthly revenue recognition of \$94.35, and increased by interest expense recognized. Gym Inc will recognize revenue of \$5,661 and interest expense of \$661 over the life of the contract.

4.5 Noncash consideration

Any noncash consideration received from a customer needs to be included when determining the transaction price. Noncash consideration is measured at fair value. This is consistent with the measurement of other consideration that considers the value of what the selling entity receives, rather than the value of what it gives up.

Management might not be able to reliably determine the fair value of noncash consideration in some situations. The value of the noncash consideration received should be measured indirectly in that situation by reference to the standalone selling price of the goods or services provided by the entity.

The fair value of noncash consideration can be variable. Changes in the fair value of noncash consideration can relate to the form of the consideration or to other reasons. For example, an entity might be entitled to receive equity of its customer as consideration, and the value of the equity could change before it is transferred to the entity. Noncash consideration that varies because of the form of the consideration is reflected in the estimate of the transaction price at fair value and is not subject to the constraint on variable consideration.

Noncash consideration that is variable for reasons other than only the form of the consideration is included in the transaction price, but is subject to the constraint on variable consideration. For example, an entity might receive noncash consideration upon reaching certain performance milestones. The amount of the noncash

consideration varies depending on the likelihood that the entity will reach the milestone. The consideration in that situation is subject to the constraint, similar to other variable consideration.

Judgment may be needed to determine the reasons for a change in the value of noncash consideration, particularly when the change relates to both the form of the consideration and to the entity's performance.

Noncash consideration could be provided by a customer to an entity to assist in completion of the contract. For example, a customer might contribute goods or services to facilitate an entity's fulfillment of a performance obligation. An entity should include the customer's contribution of goods or services in the transaction price as noncash consideration if the entity obtains control of those goods or services.

The following examples illustrate the accounting for noncash consideration received in an arrangement.

EXAMPLE 4-16

Noncash consideration – materials provided by customer to facilitate fulfillment

ManufactureCo enters into a contract with TechnologyCo to build a machine. TechnologyCo pays ManufactureCo \$1 million and contributes materials to be used in the development of the machine. The materials have a fair value of \$500,000. ManufactureCo would otherwise need to purchase the materials for the project and, once received, could elect to use the materials for other projects. TechnologyCo will deliver the materials to ManufactureCo approximately three months after development of the machine begins. ManufactureCo concludes that it obtains control of the materials upon delivery by TechnologyCo.

How should ManufactureCo determine the transaction price?

Analysis

ManufactureCo should include the fair value of the materials in the transaction price because it obtains control of them. The transaction price of the arrangement is therefore \$1.5 million.

EXAMPLE 4-17

Noncash consideration – variable due to the form of the consideration

Security Inc enters into a contract to provide security services to Manufacturer over a six-month period in exchange for 12,000 shares of Manufacturer's common stock. The contract is signed and work commences on January 1, 20X1. The performance is satisfied over time and Security Inc is entitled to 2,000 shares upon successful completion of the service each month.

How should Security Inc determine the transaction price?

Analysis

Security Inc should measure progress toward complete satisfaction of the performance obligation each month. The transaction price is the fair value of the shares measured at the time shares are received upon completion of the performance obligation. No adjustment to revenue should be made as a result of subsequent changes in the fair value of the shares received. Security Inc does not apply the guidance on variable consideration as the fair value of the shares varies solely due to the form of the consideration.

EXAMPLE 4-18

Noncash consideration – variable for other reasons than the form of the consideration

MachineCo enters into a contract to build a machine for Manufacturer and is entitled to a bonus in the form of 10,000 shares of Manufacturer common stock if the machine is delivered within six months. MachineCo has not built similar machines in the past and cannot conclude that it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur.

How should MachineCo account for the noncash bonus?

Analysis

Since the consideration varies based on whether the machine is delivered by a specific date, and not based solely on the form of the consideration, MachineCo should consider the guidance on variable consideration. MachineCo should not include the shares in the transaction price as the amount of variable consideration is constrained.

Assume MachineCo later concludes it will deliver the machine within six months. MachineCo will need to estimate the value of the shares, or refer to the standalone selling price of the machine construction if the value of the shares cannot be reasonably estimated, to determine the amount of variable consideration to include in the transaction price when the entity concludes it will receive the performance bonus.

4.6 Consideration payable to a customer

The revenue standard addresses the accounting for consideration payable to a customer as follows.

Excerpt from ASC 606-10-32-25 and IFRS 15.70

Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to a customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes 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). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the

customer is in exchange for a distinct good or service...that the customer transfers to the entity.

An entity might pay, or expect to pay, consideration to its customer or to another party that purchases the entity's goods or services from its customer (the "customer's customer"). Such consideration is typically in the form of a discount or refund on goods or services provided by the seller. The consideration payable can be cash, either in the form of rebates or upfront payments, or alternatively a credit or some other form of incentive that reduces amounts owed to the entity by a customer.

An entity might make payments directly to its customer, or make payments to its customer's customer. Payments made by an entity to its customer's customer are assessed and accounted for the same as those paid directly to the entity's customer if those parties receiving the payments are purchasing the entity's goods and services.

The following example illustrates an arrangement with a payment made by an entity to its reseller's customer.

EXAMPLE 4-19

Consideration payable to customers – payment to reseller's customer

ElectronicsCo sells televisions to Retailer that Retailer sells to end customers. ElectronicsCo runs a promotion during which it will pay a rebate to end customers that purchase a television from Retailer.

How should ElectronicsCo account for the rebate payment to the end customer?

Analysis

ElectronicsCo should account for the rebate in the same manner as if it were paid directly to the Retailer. Payments to a customer's customer are not accounted for differently than payments to a customer under the revenue standard.

4.6.1 Income statement classification of payments made to a customer

Consideration payable to a customer is recorded as a reduction of the arrangement's transaction price, thereby reducing the amount of revenue recognized, unless the payment is for a distinct good or service received from the customer. Refer to RR 3 for a discussion on determining when a good or service is distinct. Consideration paid for a distinct good or service is accounted for in the same way as the entity accounts for other purchases from suppliers.

Determining whether a payment is for a distinct good or service received from a customer requires judgment. An entity might be paying a customer for a distinct good or service if the entity is purchasing something from the customer that is normally sold by that customer. Management also needs to assess whether the consideration it pays for distinct goods or services from its customer represents the fair value of those goods or services. Consideration paid that is in excess of the fair value of the goods or

services received reduces the transaction price of the arrangement with the customer because the excess amounts represent a discount to the customer.

It can be difficult to determine the fair value of the distinct goods or services received from the customer in some situations. An entity that is not able to determine the fair value of the goods or services received should account for all of the consideration paid or payable to the customer as a reduction of the transaction price since it is unable to determine the portion of the payment that is a discount provided to the customer.

The revenue standard provides guidance on when an entity should reduce revenue for consideration paid to a customer.

ASC 606-10-32-27 and IFRS 15.72

Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:

- a. The entity recognizes revenue for the transfer of the related goods or services to the customer [and [IFRS]]
- b. The entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

The following examples illustrate the accounting for consideration payable to a customer.

EXAMPLE 4-20

Consideration payable to customers – slotting fees

Producer sells energy drinks to Retailer, a convenience store. Producer also pays Retailer a fee to ensure that its products receive prominent placement on store shelves. The fee is negotiated as part of the contract for sale of the energy drinks.

How should Producer account for the slotting fees paid to Retailer?

Analysis

Producer should reduce the transaction price for the sale of the energy drinks by the amount of slotting fees paid to Retailer. Producer does not receive a good or service that is distinct in exchange for the payment to Retailer.

EXAMPLE 4-21

Consideration payable to customers – payment for a distinct service

MobileCo sells 1,000 phones to Retailer for \$100,000. The contract includes an advertising arrangement that requires MobileCo to pay \$10,000 toward a specific

advertising promotion that Retailer will provide. Retailer will provide the advertising on strategically located billboards and in local advertisements. MobileCo could have elected to engage a third party to provide similar advertising services at a cost of \$10,000.

How should MobileCo account for the payment to Retailer for advertising?

Analysis

MobileCo should account for the payment to Retailer consistent with other purchases of advertising services. The payment from MobileCo to Retailer is consideration for a distinct service provided by Retailer and reflects fair value. The advertising is distinct because MobileCo could have engaged a third party who is not its customer to perform similar services. The transaction price for the sale of the phones is \$100,000 and is not affected by the payment made by Retailer.

EXAMPLE 4-22

Consideration payable to customers – payment for a distinct service in excess of fair value

Assume the same facts as Example 4-21, except that the fair value of the advertising service is \$8,000.

How should MobileCo account for the payment to Retailer for advertising?

Analysis

The amount of the payment that represents fair value of the advertising service (\$8,000) is accounted for consistent with other purchases of advertising services because it is consideration for a distinct service. The excess amount of the payment over the fair value of the services (\$2,000) is a reduction of the transaction price for the sale of phones. The transaction price for the sale of the phones is \$98,000.

***Chapter 5:
Allocating the
transaction price to
separate performance
obligations***

5.1 Chapter overview

This chapter discusses how to allocate the transaction price to the separate performance obligations in a contract.

ASC 606-10-32-28 and IFRS 15.73

The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

Many contracts involve the sale of more than one good or service. Such contracts might involve the sale of multiple goods, goods followed by related services, or multiple services. The transaction price in an arrangement must be allocated to each separate performance obligation so that revenue is recorded at the right time and in the right amounts. The allocation could be affected by variable consideration or discounts. Refer to RR 3 for further information regarding identifying performance obligations.

5.2 Determining standalone selling price

The transaction price should be allocated to each performance obligation based on the relative standalone selling prices of the goods or services being provided to the customer.

ASC 606-10-32-31 and IFRS 15.76

To allocate the transaction price to each performance obligation on a relative standalone selling price basis, an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those standalone selling prices.

Management should determine the standalone selling price for each item and allocate the transaction price based on each item's relative value to the total value of the goods and services in the arrangement.

The best evidence of standalone selling price is the price an entity charges for that good or service when the entity sells it separately in similar circumstances to similar customers. However, goods or services are not always sold separately. The standalone selling price needs to be estimated or derived by other means if the good or service is not sold separately. This estimate often requires judgment, such as when specialized goods or services are sold only as part of a bundled arrangement.

The relative standalone selling price of each performance obligation is determined at contract inception. The transaction price is not reallocated after contract inception to reflect subsequent changes in standalone selling prices.

A contractually stated price or list price for a good or service may be, but should not be presumed to be, the standalone selling price of the good or service. Entities often provide discounts or other adjustments to list prices to customers. An entity's customary business practices should be considered, including adjustments to list prices, when determining the standalone selling price of an item.

The following example illustrates the allocation of transaction price when the goods and services are also sold separately.

EXAMPLE 5-1

Allocating transaction price – standalone selling prices are directly observable

Marine sells boats and provides mooring facilities for its customers. Marine sells the boats for \$30,000 each and provides mooring facilities for \$5,000 per year. Marine sells these goods and services separately; therefore, they are distinct and accounted for as separate performance obligations. Marine enters into a contract to sell a boat and one year of mooring services to a customer for \$32,500.

How should Marine allocate the transaction price of \$32,500 to the performance obligations?

Analysis

Marine should allocate the transaction price of \$32,500 to the boat and the mooring services based on their relative standalone selling prices as follows:

Boat: \$27,857 ($\$32,500 \times (\$30,000 / \$35,000)$)

Mooring services: \$4,643 ($\$32,500 \times (\$5,000 / \$35,000)$)

The allocation results in the \$2,500 discount being allocated proportionately to the two performance obligations.

5.3 Estimating a standalone selling price that is not directly observable

The standalone selling price of an item that is not directly observable must be estimated. The revenue standard does not prescribe or prohibit any particular method for estimating the standalone selling price, as long as the method results in an estimate that faithfully represents the price an entity would charge for the goods or services if they were sold separately.

There is also no hierarchy for how to estimate or otherwise determine the standalone selling price for goods or services that are not sold separately. Management should consider all information that is reasonably available and should maximize the use of observable inputs. For example, if an entity does not sell a particular good on a standalone basis, but its competitors do, that might provide data useful in estimating the standalone selling price.

Standalone selling prices can be estimated in a number of ways. Management should consider the entity's pricing policies and practices, and the data used in making pricing decisions, when determining the most appropriate estimation method. The method used should be applied consistently to similar arrangements. Suitable methods include, but are not limited to:

- Adjusted market assessment approach (RR 5.3.1)
- Expected cost plus a margin approach (RR 5.3.2)
- Residual approach, in limited circumstances (RR 5.3.3)

5.3.1 *Adjusted market assessment approach*

A market assessment approach considers the market in which the good or service is sold and estimates the price that a customer in that market would be willing to pay. Management should consider the competitor's pricing for similar goods or services in the market, adjusted for entity-specific factors, when using this approach. Entity-specific factors might include:

- Position in the market
- Expected profit margin
- Customer or geographic segments
- Distribution channel
- Cost structure

An entity that has a greater market share, for example, may charge a lower price because of those higher volumes. An entity that has a smaller market share may need to consider the profit margins it would need to receive to make the arrangement profitable. Management should also consider the customer base in a particular geography. Pricing of goods and services might differ significantly from one area to the next, depending on, for example, distribution costs.

Market conditions can also affect the price for which an entity would sell its product including:

- Supply and demand
- Competition
- Market perception
- Trends
- Geography-specific factors

A single good or service could have more than one standalone selling price if it is sold in multiple markets. For example, the standalone selling price of a good in a densely populated area could be different from the standalone selling price of a similar good in a rural area. A large number of competitors in a market can result in an entity having to charge a lower price in that market to stay competitive, while it can charge a higher price in regions where customers have fewer options.

Entities might also employ different marketing strategies in different regions and therefore be willing to accept a lower price in a certain market. An entity whose brand is perceived as top-of-the-line may be able to charge a price that provides a higher margin on goods or services than one that has a less well-known brand name.

Discounts offered by an entity when a good or service is sold separately should be considered when estimating standalone selling prices. For example, a sales force may have a standard list price for products and services, but regularly enter into sales transactions at amounts below the list price. Management should consider whether it is appropriate to use the list price in its analysis of standalone selling price if the entity regularly provides a discount.

Management should also consider whether the entity has a practice of providing price concessions. An entity with a history of providing price concessions on certain goods or services needs to determine the potential range of prices it expects to charge for a product or service on a standalone basis when estimating standalone selling price.

The significance of each data point in the analysis will vary depending on an entity's facts and circumstances. Certain information could be more relevant than others depending on the entity, the location, and other factors.

5.3.2 *Expected cost plus a margin*

An expected cost plus a margin approach (“cost-plus approach”) could be the most appropriate estimation method in some circumstances. Costs included in the estimate should be consistent with those an entity would normally consider in setting standalone prices. Both direct and indirect costs should be considered, but judgment is needed to determine the extent of costs that should be included. Internal costs, such as research and development costs that the entity would expect to recover through its sales, might also need to be considered.

Factors to consider when assessing if a margin is reasonable could include:

- Margins achieved on standalone sales of similar products
- Market data related to historical margins within an industry
- Industry sales price averages
- Market conditions
- Profit objectives

The objective is to determine what factors and conditions affect what an entity would be able to charge in a particular market. Judgment will often be needed to determine an appropriate margin, particularly when sufficient historical data is not readily available or when a product or service has not been previously sold on a standalone basis. Estimating a reasonable margin will often require an assessment of both entity-specific and market factors.

The following example illustrates some of the approaches to estimating standalone selling price.

EXAMPLE 5-2

Allocating transaction price – standalone selling prices are not directly observable

Biotech enters into an arrangement to provide a license and research services to Pharma. The license and the services are each distinct and therefore accounted for as separate performance obligations, and neither is sold individually.

What factors might Biotech consider when estimating the standalone selling prices for these items?

Analysis

Biotech analyzes the transaction as follows:

License

The best model for determining standalone selling price will depend on the rights associated with the license, the stage of development of the technology, and the nature of the license itself.

An entity that does not sell comparable licenses may need to consider factors such as projected cash flows from the license to estimate the standalone selling price of a license, particularly when that license is already in use or is expected to be exploited in a relatively short timeframe. A cost-plus approach may be more relevant for licenses in the early stage of their life cycle where reliable forecasts of revenue or cash flows do not exist. Determining the most appropriate approach will depend on facts and circumstances as well as the extent of observable selling-price information.

Research services

A cost-plus approach that considers the level of effort necessary to perform the research services would be an appropriate method to estimate the standalone selling price of the research services. This could include costs for full-time equivalent (FTE) employees and expected resources to be committed. Key areas of judgment include the selection of FTE rates, estimated profit margins, and comparisons to similar services offered in the marketplace.

5.3.3 **Residual approach**

Use of a residual approach to estimate standalone selling price is permitted in certain circumstances.

ASC 606-10-32-34-c and IFRS 15.79.c

Residual approach—an entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate ... the standalone selling price of a good or service only if one of the following criteria is met:

1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).
2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

5.3.3.1 **When the residual approach can be used**

A residual approach should *only* be used when the entity sells the same good or service to different customers for a broad range of prices, making them highly variable, or when the entity has not yet established a price for a good or service because it has not been previously sold. This might be more common for sales of intellectual property or other intangible assets as compared to sales of other goods or services.

The circumstances where the residual approach can be used are intentionally limited. Management should consider whether another method provides a reasonable estimate of the standalone selling price before using the residual approach.

The residual approach involves deducting from the total transaction price the sum of the estimated standalone selling prices of other goods and services in the contract to estimate a standalone selling price for the remaining goods or services. This approach can be used to determine the standalone selling price of either satisfied or unsatisfied performance obligations in an arrangement.

5.3.3.2 **Additional considerations when a residual approach is used**

The amount allocated to a performance obligation under the residual approach is not the total transaction price less the standalone selling price of all other goods or services in the arrangement when there is a discount inherent in the arrangement. If the discount specifically relates to only certain performance obligations in the arrangement that are typically sold together as a bundle, the discount is allocated to those performance obligations before deducting their standalone selling price from

the total transaction price. Refer to RR 5.4 for further discussion of allocating discounts.

Arrangements could include three or more performance obligations with more than one of the obligations having a standalone selling price that is highly variable or uncertain. A residual approach can be used in this situation to allocate a portion of the transaction price to those performance obligations with prices that are highly variable or uncertain, as a group. Management will then need to use another method to estimate the individual standalone selling prices of those obligations. The revenue standard does not provide specific guidance about the technique or method that should be used to make this estimate.

Excerpt from ASC 606-10-32-35 and IFRS 15.80

A combination of methods may need to be used to estimate the standalone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain standalone selling prices. For example, an entity may use a residual approach to estimate the aggregate standalone selling price for those promised goods or services with highly variable or uncertain standalone selling prices and then use another method to estimate the standalone selling prices of the individual goods or services relative to that estimated aggregate standalone selling price determined by the residual approach.

When a residual approach is used, management still needs to compare the results obtained to all reasonably available observable evidence to ensure the method meets the objective of allocating the transaction price based on standalone selling prices. Allocating little or no consideration to a performance obligation suggests the method used might not be appropriate, because a good or service that is distinct is presumed to have value to the purchaser.

The following example illustrates the use of the residual approach to estimate standalone selling price.

EXAMPLE 5-3

Estimating standalone selling price – residual approach

Seller enters into a contract with a customer to sell Products A, B, and C for a total transaction price of \$100,000. Seller regularly sells Product A for \$25,000 and Product B for \$45,000 on a standalone basis. Product C is a new product that has not been sold previously, has no established price, and is not sold by competitors in the market. Products A and B are not regularly sold together at a discounted price. Product C is delivered on March 1, and Products A and B are delivered on April 1.

How should Seller determine the standalone selling price of Product C?

Analysis

Seller can use the residual approach to estimate the standalone selling price of Product C because Seller has not previously sold or established a price for Product C.

Prior to using the residual approach, Seller should assess whether any other observable data exists to estimate the standalone selling price. For example, although Product C is a new product, Seller may be able to estimate a standalone selling price through other methods, such as using expected cost plus a margin.

Seller has observable evidence that Products A and B sell for \$25,000 and \$45,000, respectively, for a total of \$70,000. The residual approach results in an estimated standalone selling price of \$30,000 for Product C (\$100,000 total transaction price less \$70,000).

5.4 *Allocating discounts*

Customers often receive a discount for purchasing multiple goods and/or services as a bundle. Discounts are typically allocated to all of the performance obligations in an arrangement based on their relative standalone selling prices, so that the discount is allocated proportionately to all performance obligations.

ASC 606-10-32-36 and IFRS 15.81

A customer receives a discount for purchasing a bundle of goods or services if the sum of the standalone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract. Except when an entity has observable evidence ... that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract. The proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the transaction price to each performance obligation on the basis of the relative standalone selling prices of the underlying distinct goods or services.

It may be appropriate in some instances to allocate the discount to only one or more performance obligations in the contract rather than all performance obligations. This could occur when an entity has observable evidence that the discount relates to one or more, but not all, of the performance obligations in the contract.

All of the following conditions must be met for an entity to allocate a discount to one or more, but not all, performance obligations.

ASC 606-10-32-37 and IFRS 15.82

An entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

- a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.

- b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.
- c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

The above criteria indicate that a discount will typically be allocated only to bundles of two or more performance obligations in an arrangement. Allocation of an entire discount to a single item is therefore expected to be rare.

The following examples illustrate the allocation of a discount.

EXAMPLE 5-4

Allocating transaction price – allocating a discount

Retailer enters into an arrangement with its customer to sell a chair, a couch, and a table for \$5,400. Retailer regularly sells each product on a standalone basis: the chair for \$2,000, the couch for \$3,000, and the table for \$1,000. The customer receives a \$600 discount (\$6,000 sum of standalone selling prices less \$5,400 transaction price) for buying the bundle of products. The chair and couch will be delivered on March 28 and the table on April 3. Retailer regularly sells the chair and couch together as a bundle for \$4,400 (that is, at a \$600 discount to the standalone selling prices of the two items). The table is not normally discounted.

How should Retailer allocate the transaction price to the products?

Analysis

Retailer has observable evidence that the \$600 discount should be allocated to only the chair and couch. The chair and couch are regularly sold together for \$4,400, and the table is regularly sold for \$1,000. Retailer therefore allocates the \$5,400 transaction price as follows:

Chair and couch: \$4,400

Table: \$1,000

If, however, the table and the couch in the above example were also regularly discounted when sold as a pair, it would not be appropriate to allocate the discount to any combination of two products. The discount would instead be allocated proportionately to all three products.

EXAMPLE 5-5**Allocating transaction price – allocating a discount and applying the residual approach**

Assume the same facts as Example 5-3, except Products A and B are regularly sold as a bundle for \$60,000 (that is, at a \$10,000 discount). Seller concludes the residual approach is appropriate for determining the standalone selling price of Product C.

How should Seller allocate the transaction price between Products A, B, and C?

Analysis

Seller regularly sells Products A and B together for \$60,000, so it has observable evidence that the \$10,000 discount relates entirely to Products A and B. Therefore, Seller allocates \$60,000 to Products A and B. Seller uses the residual approach and allocates \$40,000 to Product C (\$100,000 total transaction price less \$60,000).

5.5 Impact of variable consideration

Some contracts contain an element of consideration that is variable or contingent upon certain thresholds or events being met or achieved. The variable consideration included in the transaction price is measured using a probability-weighted or most likely amount, and it is subject to a constraint. Refer to RR 4 for further discussion of variable consideration.

Variable consideration adds additional complexity when allocating the transaction price. The amount of variable consideration might also change over time as more information becomes available.

5.5.1 Allocating variable consideration

Variable consideration is generally allocated to all performance obligations in a contract based on their relative standalone selling prices. However, variable consideration might be attributable to one or more, but not all, of the performance obligations in an arrangement.

For example, an entity could have the right to additional consideration upon early delivery of a particular product in an arrangement that includes multiple products. Allocating the variable consideration to all of the products in the arrangement might not reflect the substance of the arrangement in this situation.

Variable consideration (and subsequent changes in the measure of that consideration) should be allocated entirely to a single performance obligation only if both of the following criteria are met.

ASC 606-10-32-40 and IFRS 15.85

An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation ... if both of the following criteria are met:

- a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective ... when considering all of the performance obligations and payment terms in the contract.

This allocation guidance is a requirement, not a policy election.

A series of distinct goods or services is accounted for as a single performance obligation if it meets certain criteria (see further discussion in RR 3). When a contract includes a series accounted for as a single performance obligation and also includes an element of variable consideration, management should consider the distinct goods or services (rather than the series) for the purpose of allocating variable consideration. In other words, the series is not treated as a single performance obligation for purposes of allocating variable consideration.

The following example illustrates the allocation of variable consideration in an arrangement that is a series of distinct goods and services.

EXAMPLE 5-6

Allocating variable consideration – distinct goods or services that form a single performance obligation

Air Inc enters into a three-year contract to provide air conditioning to the operator of an office building using its proprietary geo-thermal heating and cooling system. Air Inc is paid based on the customer's system usage per day, and is also entitled to a semi-annual performance bonus if the customer's cost to heat and cool the building is decreased by at least 10% compared to its prior cost. The comparison of current cost to prior cost is made semi-annually, using the average of the most recent six-months compared to the same six-month period in the prior year.

Air Inc accounts for the series of distinct services provided over the three-year contract as a single performance obligation satisfied over time.

Air Inc has not previously used its systems for buildings in this region. Air Inc therefore does not include any variable consideration related to the performance bonus in the transaction price during the first six-months of providing service, as it does not believe that it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue recognized will not occur if its estimate of

customer cost savings changes. At the end of the first six-months, the customer's costs have decreased by 12% over the prior comparative period and Air Inc becomes entitled to the performance bonus.

How should Air Inc account for the performance bonus?

Analysis

Air Inc should recognize the performance bonus (the change in the estimate of variable consideration) immediately because it relates to distinct services that have already been performed. It would not be appropriate to allocate the change in variable consideration to the entire performance obligation (that is, recognize the amount over the entire three-year contract).

5.5.2 Allocating subsequent changes in transaction price

The estimate of variable consideration is updated at each reporting date, potentially resulting in changes to the transaction price after inception of the contract. Any change to the transaction price (excluding those resulting from contract modifications as discussed in RR 2) is allocated to the performance obligations in the contract.

ASC 606-10-32-43 and IFRS 15.88

An entity shall allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Consequently, an entity shall not reallocate the transaction price to reflect changes in standalone selling prices after contract inception. Amounts allocated to a satisfied performance obligation shall be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

Changes in transaction price are allocated to the performance obligations on the same basis as at contract inception (that is, based on the standalone selling prices determined at contract inception). Changes in the amount of variable consideration that relate to one or more specific performance obligations will be allocated only to that (those) performance obligation(s), as discussed in RR 5.5.1.

Amounts allocated to satisfied performance obligations are recognized as revenue immediately on a cumulative catch-up basis. A change in the amount allocated to a performance obligation that is satisfied over time is also adjusted on a cumulative catch-up basis. The result is either additional or less revenue in the period of change for the satisfied portion of the performance obligation. The amount related to the unsatisfied portion is recognized as that portion is satisfied over time.

An entity's standalone selling prices might change over time. Changes in standalone selling prices differ from changes in the transaction price. Entities should not reallocate the transaction price for subsequent changes in the standalone selling prices of the goods or services in the contract.

The following example illustrates the accounting for a change in transaction price after the inception of an arrangement.

EXAMPLE 5-7

Allocating transaction price – change in transaction price

On July 1, Contractor enters into an arrangement to build an addition onto a building, re-pave a parking lot, and install outdoor security cameras for \$5,000,000. The building, parking lot, and security cameras are distinct, and accounted for as separate performance obligations. Contractor can earn a \$500,000 bonus if it completes the addition by February 1. Contractor will earn a \$250,000 bonus if it completes the addition by March 1. No bonus will be earned if the addition is completed after March 1.

Contractor allocates the transaction price, on a relative standalone price basis, before considering the potential bonus as follows:

Building addition:	\$4,000,000
Parking lot:	\$ 600,000
Security cameras:	\$ 400,000

Contractor anticipates completing the building addition by March 1 and allocates an additional \$250,000 to just the building addition performance obligation, resulting in an allocated transaction price of \$4,250,000.

At December 31, Contractor determines that the addition will be complete by February 1 and therefore changes its estimate of the bonus to \$500,000. Contractor recognizes revenue on a percentage-of-completion basis, and 75% of the addition was complete as of December 31.

How should Contractor account for the change in estimated bonus as of December 31?

Analysis

As of December 31, Contractor should allocate an incremental bonus of \$250,000 to the building addition performance obligation, for a total of \$4,500,000. Contractor should recognize \$3,375,000 ($75\% \times 4,500,000$) as revenue on a cumulative basis for the building addition as of December 31.

5.6 *Other considerations*

Other matters that could arise when allocating transaction price are discussed below.

5.6.1 *Transaction price in excess of the sum of standalone selling prices*

The total transaction price is typically equal to or less than the sum of the standalone selling prices of the individual performance obligations. A transaction price that is greater than the sum of the standalone selling prices suggests the customer is paying a premium for purchasing the goods or services together. This could indicate that the amounts identified as the standalone selling prices are too low, or that additional performance obligations exist and need to be identified. A premium is allocated to the performance obligations using a relative standalone selling price basis if, after further assessment, a premium still exists.

5.6.2 *Nonrefundable upfront fees*

Many contracts include nonrefundable upfront fees such as joining fees (common in health club memberships, for example), activation fees (common in telecommunications contracts, for example), or other initial/set-up fees. An entity should assess whether the activities related to such fees satisfy a performance obligation. When those activities do not satisfy a performance obligation, because no good or service is transferred to the customer, none of the transaction price should be allocated to those activities. Rather, the upfront fee is included in the transaction price that is allocated to the performance obligations in the contract. Refer to RR 8 for further discussion of upfront fees.

5.6.3 *No “contingent revenue cap”*

An entity should allocate the transaction price to all of the performance obligations in the arrangement, irrespective of whether additional goods or services need to be provided before the customer pays the consideration. For example, a wireless phone entity enters into a two-year service agreement with a customer and provides a free mobile phone, but does not require any upfront payment. The entity should allocate the transaction price to both the mobile phone and the two-year service arrangement, based on the relative standalone selling price of each performance obligation, despite the customer only paying consideration as the services are rendered.

Concerns about whether the customer intends to pay the transaction price are considered in either the collectibility assessment (that is, whether a contract exists) or assessment of customer acceptance of the good or service. Refer to RR 2 for further information on collectibility and RR 6 for further information on customer acceptance clauses.

Chapter 6:

Recognizing revenue

6.1 Chapter overview

This chapter addresses the fifth step of the revenue model, which is recognizing revenue. Revenue is recognized when or as performance obligations are satisfied by transferring control of a promised good or service to a customer. Control either transfers over time or at a point in time, which affects when revenue is recorded. Judgment might be needed in some circumstances to determine when control transfers. Various methods can be used to measure the progress toward satisfying a performance obligation when revenue is recognized over time.

6.2 Control

Revenue is recognized when the customer obtains control of a good or service.

ASC 606-10-25-23 and IFRS 15.31

An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

A performance obligation is satisfied when “control” of the promised good or service is transferred to the customer. This concept of transferring control of a good or service aligns with authoritative guidance on the definition of an asset. The concept of control might appear to apply only to the transfer of a good, but a service also transfers an asset to the customer, even if that asset is consumed immediately.

A customer obtains control of a good or service if it has the ability to direct the use of and obtain substantially all of the remaining benefits from that good or service. A customer could have the future right to direct the use of the asset and obtain substantially all of the benefits from it (for example, upon making a prepayment for a specified product), but the customer must have actually obtained those rights for control to have transferred.

Directing the use of an asset refers to a customer’s right to deploy that asset, allow another entity to deploy it, or restrict another entity from using it. An asset’s benefits are the potential cash inflows (or reduced cash outflows) that can be obtained in various ways. Examples include using the asset to produce goods or provide services, selling or exchanging the asset, and using the asset to settle liabilities or reduce expenses. Another example is the ability to pledge the asset (such as land) as collateral for a loan or to hold it for future use.

Management should evaluate transfer of control primarily from the customer’s perspective. Considering the transaction from the customer’s perspective reduces the risk that revenue is recognized for activities that do not transfer control of a good or service to the customer.

Management also needs to consider whether it has an option or a requirement to repurchase an asset when evaluating whether control has transferred. See further discussion of repurchase arrangements in RR 8.7.

6.3 *Performance obligations satisfied over time*

Management needs to determine, at contract inception, whether control of a good or service transfers to a customer over time or at a point in time. Arrangements where the performance obligations are satisfied over time are not limited to services arrangements. Complex assets or certain customized goods constructed for a customer, such as a complex refinery or specialized machinery, could also transfer over time, depending on the terms of the arrangement.

Revenue is recognized over time if any of the following three criteria are met.

Excerpt from ASC 606-10-25-27 and IFRS 15.35

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:

- a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs...
- b. The entity's performance creates or enhances an asset (for example, work in [process [U.S. GAAP]/progress [IFRS]]) that the customer controls as the asset is created or enhanced...
- c. 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

6.3.1 *The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs*

This criterion primarily applies to contracts for the provision of services, such as transaction processing or security services. An entity transfers the benefit of the services to the customer as it performs and therefore satisfies its performance obligation over time.

The customer receives and consumes the benefits as the entity performs if another entity would not need to substantially reperform the work completed to date to satisfy the remaining obligations. The fact that another entity would not have to reperform work already performed indicates that the customer receives and consumes the benefits throughout the arrangement.

Contractual or practical limitations that prevent an entity from transferring the remaining obligations to another entity are not considered in this assessment. The objective is to determine whether control transfers over time using a hypothetical

assessment of whether another entity would have to reperform work completed to date. Limitations that would prevent an entity from practically transferring a contract to another entity are therefore disregarded.

The following example illustrates a customer simultaneously receiving and consuming the benefits provided by an entity's performance.

EXAMPLE 6-1

Recognizing revenue – simultaneously receiving and consuming benefits

RailroadCo is a freight railway entity that enters into a contract with Shipper to transport goods from location A to location B for \$1,000. Shipper has an unconditional obligation to pay for the service when the goods reach point B.

When should RailroadCo recognize revenue from this contract?

Analysis

RailroadCo recognizes revenue as it transports the goods, because the performance obligation is satisfied over that period. RailroadCo will determine the extent of transportation at each reporting period and recognize revenue in proportion to the shipping performed.

Shipper receives benefit as the goods are moved from location A to location B, since another entity will not need to reperform transporting of goods to their current location if RailroadCo fails to transport the goods the entire distance. There might be practical limitations to another entity taking over the shipping obligation partway through the contract, but these are ignored in the assessment.

6.3.2 ***The entity's performance creates or enhances an asset that the customer controls***

This criterion applies in situations where the customer controls the work in process as the entity manufactures goods or provides services. The asset being created can be tangible or intangible. Such arrangements could include construction or manufacturing contracts where the customer controls the work in process, or research and development contracts where the customer owns the findings.

Management should apply the principle of control to determine whether the customer obtains control of an asset as it is created. Determining if the customer controls the work in process could require judgment in some arrangements. For example, a government might control work in process if a contractor is building a specialized military aircraft, while a commercial airline entity might not control the work in process for a standard commercial airplane.

The following examples illustrate the assessment of whether an entity's performance creates or enhances an asset that the customer controls.

EXAMPLE 6-2**Recognizing revenue – customer controls work in process**

Contractor enters into a contract with Refiner to build an oil refinery on land Refiner owns. The contract has the following characteristics:

- The oil refinery is built to Refiner's specifications and Refiner can make changes to these specifications over the contract term.
- Progress payments are made by Refiner throughout construction.
- Refiner can cancel the contract at any time (with a termination penalty); any work in process is the property of Refiner.

The goods and services in the contract are not distinct, so the arrangement is accounted for as a single performance obligation.

When should Contractor recognize revenue from this contract?

Analysis

Contractor recognizes revenue as it builds the refinery because the performance obligation is satisfied over time. Refiner controls the work in process because any work performed is owned by Refiner if the contract is terminated, and it can make changes to the design specifications over the contract term.

EXAMPLE 6-3**Recognizing revenue – customer does not control work in process**

Carpenter enters into a contract to manufacture several desks for OfficeCo. The contract has the following characteristics:

- OfficeCo can cancel the contract at any time (with a termination penalty), and any work in process remains the property of Carpenter.
- The work in process can be completed and sold to another customer if the contract is cancelled.
- Physical possession and title do not pass until completion of the contract.
- A deposit is collected at the outset of the transaction, but the majority of the payments are due after the products have been delivered.

When should Carpenter recognize revenue from this contract?

Analysis

Carpenter should recognize revenue when the desks are delivered to OfficeCo because control is transferred and the performance obligation is satisfied at that point in time.

The terms of the contract indicate that control of the desks is not transferred as they are built. In particular, OfficeCo does not retain the work in process if the contract is cancelled and Carpenter can sell the completed goods to another customer. The timing of payments does not determine whether Carpenter has met the criteria for revenue recognition over time.

6.3.3 *Entity's performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance completed to date*

This last criterion was developed to assist entities in their assessment of control in situations where applying the first two criteria for recognizing revenue over time discussed in RR 6.3.1 and RR 6.3.2 is challenging. Entities that create assets with no alternative use that have a right to payment for performance to date recognize revenue as the assets are produced, rather than at a point in time (for example, upon delivery).

This criterion might also be useful in evaluating services that are specific to a customer. An example is a contract to provide consulting services where the customer receives a written report when the work is completed and is obligated to pay for the work completed to date if the contract is cancelled. Revenue is recognized over time in this situation since no asset with an alternative use is created; assuming the right to payment compensates the entity for performance to date.

6.3.3.1 *No alternative use*

An asset has an alternative use if an entity can redirect that asset for another use or to another customer. An asset does not have an alternative use if the entity is unable, because of contractual restrictions or practical limitations, to redirect the asset for another use or to another customer. Contractual restrictions and practical limitations could exist in a broad range of contracts. Judgment is needed in many situations to determine whether an asset has an alternative use.

Management should assess at contract inception whether any asset created during fulfillment of the contract has an alternative use. This assessment is only updated if there is a contract modification that substantively changes the terms of the arrangement.

Contractual restrictions on an entity's ability to redirect an asset are common in some industries. A contractual restriction exists if the customer has the ability to enforce its right to a specific product or products in the event the entity attempts to use that product for another purpose, such as a sale to a different customer.

One type of restriction is a requirement to deliver to a specific customer certain specified units manufactured by the entity (for example, the first ten units manufactured). Such a restriction could indicate that the asset has no alternative use, regardless of whether the product might otherwise be a standard inventory item or not highly customized. This is because the customer has the ability to restrict the entity from using it for other purposes.

Practical limitations can also indicate that an asset has no alternative use. An asset that requires significant rework (at a significant cost) for it to be suitable for another customer or for another purpose will likely have no alternative use. For example, a highly specialized part that can only be used by a specific customer is unlikely to be used for other purposes.

6.3.3.2 *Right to payment for performance completed to date*

This criterion is met if an entity is entitled to payment for performance completed to date, at all times during the contract term, if the customer terminates the contract for reasons other than the entity's nonperformance.

An entity's right to payment does not have to be a present unconditional right. Many arrangements include terms where payments are only contractually required at specified intervals, or upon completion of the contract. Management needs to determine whether the entity would have an enforceable right to demand payment if the customer cancelled the contract for other than a breach or nonperformance. A right to payment would also exist if the customer does not have a stated right to cancel the contract, but the contract (or other laws) entitles the entity to continue fulfilling the contract and demand payment from the customer under the terms of the contract in the event the customer attempts to terminate the contract.

Management should consider relevant laws or regulations in addition to the contract terms, such as:

- Legal precedent that confers upon an entity a right to payment even in the event that right is not specified in the contract
- Legal precedent that indicates a contractual right to payment has no binding effect
- A customary business practice of not enforcing a right to payment that renders the right unenforceable in a particular legal environment

The amount of the payment must at least compensate the entity for performance to date at any point during the contract. The amount should reflect the selling price of the goods or services provided to date, rather than provide compensation for only costs incurred to date or the entity's potential loss of profit if the contract is terminated. This would be an amount that covers an entity's cost plus a reasonable profit margin for work completed. An entity that is entitled only to costs incurred does not have a right to payment for the work to date.

The revenue standard describes a reasonable profit margin as follows.

Excerpt from ASC 606-10-55-11 and IFRS 15.B9

Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

- a. A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party) [or [IFRS]]
- b. A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

A specified payment schedule does not necessarily indicate that the entity has a right to payment for performance. This could be the case in situations where milestone payments are not based on performance. Management should assess whether the payments at least compensate the entity for performance to date. The payments should also be nonrefundable in the event of a contract cancellation (for reasons other than nonperformance).

Customer deposits and other upfront payments should also be assessed to determine if they cover both costs incurred and a reasonable profit. A significant nonrefundable upfront payment could meet the requirement if the entity has the right to retain that payment in the event the customer terminates the contract, and the payment would at least compensate the entity for work performed to date throughout the contract. The requirement would also be met even if a portion of the customer deposit is refundable as long as the amount retained by the entity provides compensation for work performed to date throughout the contract.

The following examples illustrate the assessment of alternative use and right to payment.

EXAMPLE 6-4

Recognizing revenue – asset with an alternative use

Manufacturer enters into a contract to manufacture an automobile for Car Driver. Car Driver specifies certain options such as color, trim, electronics, etc. Car Driver makes a nonrefundable deposit to secure the automobile, but does not control the work in process. Manufacturer could choose at any time to redirect the automobile to another customer and begin production on another automobile for Car Driver with the same specifications.

How should Manufacturer recognize revenue from this contract?

Analysis

Manufacturer should recognize revenue at a point in time, when control of the automobile passes to Car Driver. The arrangement does not meet the criteria for a performance obligation satisfied over time. Car Driver does not control the asset during the manufacturing process. Car Driver did specify certain elements of the automobile, but these do not create a practical or contractual restriction on Manufacturer's ability to transfer the car to another customer. Manufacturer is able to redirect the automobile to another customer at little or no additional cost and therefore it has an alternative use to Manufacturer.

Now assume the same facts, except Car Driver has an enforceable right to the first automobile produced by Manufacturer. Manufacturer could practically redirect the automobile to another customer, but would be contractually prohibited from doing so. The asset would not have an alternative use to Manufacturer in this situation. The arrangement meets the criteria for a performance obligation satisfied over time assuming Manufacturer is entitled to payment for the work it performs as the automobile is built.

EXAMPLE 6-5**Recognizing revenue – highly specialized asset without an alternative use**

Cruise Builders enters into a contract to manufacture a cruise ship for Cruise Line. The ship is designed and manufactured to Cruise Line's specifications. Cruise Builders could redirect the ship to another customer, but only if Cruise Builders incurs significant cost to reconfigure the ship. Assume the following additional facts:

- Cruise Line does not take physical possession of the ship as it is being built.
- The contract contains one performance obligation as the goods and services to be provided are not distinct.
- Cruise line is obligated to pay Cruise Builder an amount equal to the costs incurred plus an agreed profit margin if Cruise Line cancels the contract.

How should Cruise Builder recognize revenue from this contract?

Analysis

Cruise Builder should recognize revenue over time as it builds the ship. The asset is constructed to Cruise Line's specifications and would require substantive rework to be useful to another customer. Cruise Builder cannot sell the ship to another customer without significant cost and therefore, the ship does not have an alternative use. Cruise Builder also has a right to payment for performance completed to date. The criteria are met for a performance obligation satisfied over time.

EXAMPLE 6-6**Recognizing revenue – right to payment**

Design Inc enters into a contract with EquipCo to deliver the next piece of specialized equipment produced. EquipCo can terminate the contract at any time. EquipCo makes a nonrefundable deposit at contract inception to cover the cost of materials that Design Inc will procure to produce the specialized equipment. The contract precludes Design Inc from redirecting the equipment to another customer. EquipCo does not control the equipment as it is produced.

How should Design Inc recognize revenue for this contract?

Analysis

Design Inc should recognize revenue at a point in time, when control of the equipment transfers to EquipCo. The specialized equipment does not have an alternative use to Design Inc because the contract has substantive terms that preclude it from redirecting the equipment to another customer. Design Inc, however, is only entitled to payment for costs incurred, not for costs plus a margin. The criterion for a performance obligation satisfied over time is not met because Design Inc does not have a right to payment for performance completed to date.

6.4 Measures of progress over time

Once management determines that a performance obligation is satisfied over time, it must measure its progress toward completion to determine the timing of revenue recognition.

ASC 606-10-25-31 and IFRS 15.39

For each performance obligation satisfied over time..., an entity shall recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, satisfaction of an entity's performance obligation).

The purpose of measuring progress toward satisfaction of a performance obligation is to recognize revenue in a pattern that reflects the transfer of control of the promised good or service to the customer. Management can employ various methods for measuring progress, but should select the method that best depicts the transfer of control of goods or services.

Methods for measuring progress include:

- Output methods, that recognize revenue based on direct measurements of the value transferred to the customer

- Input methods, that recognize revenue based on the entity's efforts to satisfy the performance obligation

Each of these methods has advantages and disadvantages, which should be considered in determining which is the most appropriate in a particular arrangement. The method selected for measuring progress toward completion should be consistently applied to arrangements with similar performance obligations and similar circumstances.

Circumstances affecting the measurement of progress often change for performance obligations satisfied over time, such as an entity incurring more costs than expected. Management should update its measure of progress and the revenue recognized to date as a change in estimate when circumstances change to accurately depict the entity's performance completed to date.

The boards noted in the Basis for Conclusions to the revenue standard that selection of a method is not simply an accounting policy election. Management should select the method of measuring progress that best depicts the transfer of goods or services to the customer.

Excerpt from ASU 2014-09 BC159 and IFRS 15 BC159

That does not mean that an entity has a “free choice.” The [guidance states [U.S. GAAP]/requirements state [IFRS]] that an entity should select a method of measuring progress that is consistent with the clearly stated objective of depicting the entity's performance—that is, the satisfaction of an entity's performance obligation in transferring control of goods or services to the customer.

6.4.1 Output methods

Output methods measure progress toward satisfying a performance obligation based on results achieved and value transferred.

Excerpt from ASC 606-10-55-17 and IFRS 15.B15

Output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract.

Examples of output measures include surveys of work performed, units produced, units delivered, and contract milestones. Output methods directly measure performance and are therefore often the most faithful representation of progress. It can be difficult to obtain directly observable information about the output of performance without incurring undue costs in some circumstances, in which case use of an input method might be necessary.

The measure selected should depict the entity's performance to date, and should not exclude a material amount of goods or services for which control has transferred to

the customer. Measuring progress based on units produced or units delivered, for example, might be a reasonable proxy for measuring the satisfaction of performance obligations in some, but not all, circumstances. These measures should not be used if they do not take into account work in process for which control has transferred to the customer.

A method based on units delivered could provide a reasonable proxy for the entity's performance if the value of any work in process and the value of any units produced, but not yet transferred to the customer, is immaterial to both the contract and the financial statements as a whole at the end of the reporting period.

Measuring progress based on contract milestones is unlikely to be appropriate if there is significant performance between milestones. Material amounts of goods or services that are transferred between milestones should not be excluded from the entity's measure of progress, even though the next milestone has not yet been met.

Some arrangements include a right to invoice a customer based on the value of goods or services transferred. Management can, as a practical expedient, recognize revenue at the amount invoiced in these situations, but only if the amount invoiced represents the value transferred to the customer (for example, an entity is able to bill a fixed amount for each hour of service performed).

The following example illustrates measuring progress toward satisfying a performance obligation using an output method.

EXAMPLE 6-7

Measuring progress – output method

ConstructionCo lays railroad track and enters into a contract with Railroad to replace a stretch of track for a fixed fee of \$100,000. All work in process is the property of Railroad.

ConstructionCo has replaced 75 units of track of 100 total units of track to be replaced through year end. The effort required of ConstructionCo is consistent across each of the 100 units of track to be replaced.

ConstructionCo determines that the performance obligation is satisfied over time as Railroad controls the work in process asset being created.

How should ConstructionCo recognize revenue?

Analysis

An output method using units of track replaced to measure ConstructionCo's progress under the contract would appear to be most representative of services performed as the effort is consistent across each unit of track replaced. The progress toward completion is 75% (75 units/100 units), so ConstructionCo recognizes revenue equal to 75% of the total contract price, or \$75,000.

6.4.2 *Input methods*

Input methods measure progress toward satisfying a performance obligation indirectly.

Excerpt from ASC 606-10-55-20 and IFRS 15.B18

Input methods recognize revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation.

Input methods measure progress based on resources consumed or efforts expended relative to total resources expected to be consumed or total efforts expected to be expended. Examples of input methods include costs incurred, labor hours expended, machine hours used, time elapsed, and quantities of materials.

Judgment is needed to determine which input measure is most indicative of performance, as well as which inputs should be included or excluded. An entity using an input measure should include only those inputs that depict the entity's performance toward satisfying a performance obligation. Inputs that do not reflect performance should be excluded from the measure of progress.

Management should exclude from its measure of progress any costs incurred that do not result in the transfer of control of a good or service to a customer. For example, mobilization or set-up costs, while necessary for an entity to be able to perform under a contract, might not transfer any goods or services to the customer. Management should consider whether such costs should be capitalized as a fulfillment cost as discussed in RR 11.

6.4.2.1 *Input methods based on cost incurred*

One common input method uses costs incurred relative to total estimated costs to determine the extent of progress toward completion. It is often referred to as the "cost-to-cost" method.

Costs that might be included in measuring progress in the "cost-to-cost" method if they represent progress under the contract include:

- ☐ Direct labor
- ☐ Direct materials
- ☐ Subcontractor costs
- ☐ Allocations of costs related directly to contract activities if those depict the transfer of control to the customer

- Costs explicitly chargeable to the customer under the contract
- Other costs incurred solely due to the contract

Some items included in the “cost-to-cost” method, such as direct labor and materials costs, are easily identifiable. It can be more challenging to determine if other types of costs should be included, for example insurance, depreciation, and other overhead costs. Management needs to ensure that any cost allocations include only those costs that contribute to the transfer of control of the good or service to the customer.

Costs that are not related to the contract or that do not contribute toward satisfying a performance obligation are not included in measuring progress. Examples of costs that do not depict progress in satisfying a performance obligation include:

- General and administrative costs that are not directly related to the contract (unless explicitly chargeable to the customer under the contract)
- Selling and marketing costs
- Research and development costs that are not specific to the contract
- Depreciation of idle plant and equipment

These costs are general operating costs of an entity, not costs to progress a contract toward completion.

Other costs that do not depict progress, unless they are planned or budgeted when negotiating the contract, include:

- Wasted materials
- Abnormal amounts of labor or other costs

These items represent inefficiencies in the entity’s performance rather than progress in transferring control of a good or service, and should be excluded from the measure of progress.

The following example illustrates measuring progress toward satisfying a performance obligation using an input method.

EXAMPLE 6-8

Measuring progress – “cost-to-cost” method

Contractor enters into a contract with Government to build an aircraft carrier for a fixed price of \$4 billion. The contract contains a single performance obligation that is satisfied over time.

Additional contract characteristics are:

- Total estimated contract costs are \$3.6 billion, excluding costs related to wasted labor and materials.
- Costs incurred in year one are \$740 million, including \$20 million of wasted labor and materials.

Contractor concludes that the performance obligation is satisfied over time as Government controls the aircraft carrier as it is created. Contractor also concludes that an input method using costs incurred to total cost expected to be incurred is an appropriate measure of progress toward satisfying the performance obligation.

How much revenue and cost should Contractor recognize as of the end of year one?

Analysis

Contractor recognizes revenue of \$800 million based on a calculation of costs incurred relative to the total expected costs. Contractor recognizes revenue as follows (\$ million):

Total transaction price	\$	4,000
Progress toward completion	20% (\$720 / \$3,600)	
Revenue recognized	\$	800
Cost recognized	\$	740
Gross profit	\$	60

Wasted labor and materials of \$20 million should be excluded from the calculation, as the costs do not represent progress toward completion of the aircraft carrier.

6.4.2.2 Uninstalled materials

Uninstalled materials are materials acquired by a contractor that will be used to satisfy its performance obligations in a contract for which the cost incurred does not depict transfer to the customer. The cost of uninstalled materials should be excluded from measuring progress toward satisfying a performance obligation if the entity is only providing a procurement service. A faithful depiction of an entity's performance might be to recognize revenue equal to the cost of the uninstalled materials if all of the following conditions are met:

Excerpt from ASC 606-10-55-21(b) and IFRS 15.B19(b)

1. The good is not distinct.
2. The customer is expected to obtain control of the good significantly before receiving services related to the good.
3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation. [and [IFRS]]
4. The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal...)

The following example illustrates accounting for an arrangement that includes uninstalled materials.

EXAMPLE 6-9

Measuring progress – uninstalled materials

Contractor enters into a contract to build a power plant for UtilityCo. The contract specifies a particular type of turbine to be procured and installed in the plant. The contract price is \$200 million. Contractor estimates that the total costs to build the plant are \$160 million, including costs of \$50 million for the turbine.

Contractor procures and obtains control of the turbine and delivers it to the building site. UtilityCo has control over any work in process. Contractor has determined that the contract is one performance obligation that is satisfied over time as the power plant is constructed, and that it is the principal in the arrangement (as discussed in RR 10).

How much revenue should Contractor recognize upon delivery of the turbine?

Analysis

Contractor will recognize revenue of \$50 million and costs of \$50 million when the turbine is delivered. Contractor has retained the risks associated with installing the turbine as part of the construction project. UtilityCo has obtained control of the turbine because it controls work in process, and the turbine's cost is significant relative to the total expected contract costs. Contractor was not involved in designing and manufacturing the turbine and therefore concludes that including the costs in the measure of progress would overstate the extent of its performance. The turbine is an uninstalled material and Contractor can therefore only recognize revenue equal to the cost of the turbine.

6.4.2.3 Time-based methods

Time-based methods can be used to measure progress toward satisfying a performance obligation. These measures might be appropriate in situations where a

performance obligation is satisfied evenly over a period of time or the entity has a stand-ready obligation to perform over a period of time. Revenue might be recognized on a straight-line basis over the contract period in such circumstances. Examples include a contract to provide technical support related to a product sold to customers or a contract to provide a customer membership to a health club.

6.4.3 *Inability to estimate progress*

Circumstances can exist where an entity is not able to reasonably determine the outcome of a performance obligation or its progress toward satisfaction of that obligation. It is appropriate in these situations to recognize revenue over time as the work is performed, but only to the extent of costs incurred (that is, with no profit recognized) as long as the entity expects to at least recover its costs.

Management should discontinue this practice once it has better information and can estimate a reasonable measure of performance. A cumulative catch-up adjustment should be recognized in the period of the change in estimate to recognize revenue related to prior performance that had not been recognized due to the inability to measure progress.

6.5 *Performance obligations satisfied at a point in time*

A performance obligation is satisfied at a point in time if none of the criteria for satisfying a performance obligation over time are met. The guidance on control should be considered to determine when the performance obligation is satisfied by transferring control of the good or service. The revenue standard provides five indicators that a customer has obtained control of an asset:

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

This is a list of indicators, not criteria. Not all of the indicators need to be met for management to conclude that control has transferred and revenue can be recognized. Management needs to use judgment to determine whether the factors collectively indicate that the customer has obtained control. This assessment should be focused primarily on the customer's perspective.

6.5.1 Entity has a present right to payment

A customer's present obligation to pay could indicate that the entity has transferred the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset.

6.5.2 Customer has legal title

A party that has legal title is typically the party that can direct the use of and receive the benefits from an asset. The benefits of holding legal title include the ability to sell an asset, exchange it for another good or service, or use it to secure or settle debt, which indicates that the holder has control.

An entity that has not transferred legal title, however, might have transferred control in certain situations. An entity could retain legal title as a protective right, such as to secure payment. Legal title retained solely for payment protection does not indicate that the customer has not obtained control. All indicators of transfer of control should be considered in these situations.

The following example illustrates retention of legal title as a protective right.

EXAMPLE 6-10

Recognizing revenue – legal title retained as a protective right

Equipment Dealer enters into a contract to deliver construction equipment to Landscaping Inc. Equipment Dealer operates in a country where it is common to retain title to construction equipment and other heavy machinery as protection against nonpayment by a buyer. Equipment Dealer's normal practice is to retain title to the equipment until the buyer pays for it in full. Retaining title enables Equipment Dealer to more easily recover the equipment if the buyer defaults on payment.

Equipment Dealer concludes that there is one performance obligation in the contract that is satisfied at a point in time when control transfers. Landscaping Inc has the ability to use the equipment and move it between various work locations once it is delivered. Normal payment and credit terms apply.

When should Equipment Dealer recognize revenue for the sale of the equipment?

Analysis

Equipment Dealer should recognize revenue upon delivery of the equipment to Landscaping Inc because control has transferred. Landscaping Inc has the ability to direct the use of and receive benefits from the equipment, which indicates that control has transferred. Equipment Dealer's retention of legal title until it receives payment does not change the substance of the transaction.

6.5.3 *Customer has physical possession*

Physical possession of an asset typically gives the holder the ability to direct the use of and obtain benefits from that asset, and is therefore an indicator of which party controls the asset. However, physical possession does not, on its own, determine which party has control. Management needs to carefully consider the facts and circumstances of each arrangement to determine whether physical possession coincides with the transfer of control.

The following example illustrates a fact pattern where a customer has physical possession, but does not have control of an asset.

EXAMPLE 6-11

Recognizing revenue – sale of goods with resale restrictions

Publisher ships copies of a new book to Retailer. Publisher's terms of sale restrict Retailer's right to resell the book for several weeks to ensure a consistent release date across all retailers.

Does Publisher's time-based restriction on Retailer's resale of the book affect the timing of revenue recognition?

Analysis

Yes. Publisher will not recognize revenue until the time-based restriction lapses and Retailer can sell the book. Retailer does not have the ability to direct the use of and receive the benefit from the books since it is unable to sell them before that date, despite the fact that Retailer has physical possession of the books.

6.5.4 *Customer has significant risks and rewards of ownership*

An entity that has transferred risks and rewards of ownership of an asset has typically transferred control to a customer, but not in all cases. Management will need to apply judgment to determine whether control has transferred in the event the seller has retained some of the risks or rewards.

Retained risks could result in separate performance obligations in some fact patterns. This would require management to allocate some of the transaction price to the additional obligation. Management should exclude any risks that give rise to a separate performance obligation when evaluating the risks and rewards of ownership. Refer to Example 3-7 in RR 3 for an example of a situation where retained risk results in a separate performance obligation.

6.5.5 *Customer has accepted the asset*

A customer acceptance clause provides protection to a customer by allowing it to either cancel a contract or force a seller to take corrective actions if goods or services do not meet the requirements in the contract. Judgment can be required to determine

when control of a good or service transfers if a contract includes a customer acceptance clause.

Customer acceptance that is only a formality does not affect the assessment of whether control has transferred. An acceptance clause that is contingent upon the goods meeting certain objective specifications could be a formality if the entity has performed tests to ensure those specifications are met before the good is shipped. Management should consider whether the entity routinely manufactures and ships products of a similar nature, and the entity's history of customer acceptance upon receipt of products. The acceptance clause might not be a formality if the product being shipped is unique, as there is no history to rely upon.

An acceptance clause that relates primarily to subjective specifications is not likely a formality because the entity cannot ensure the specifications are met prior to shipment. Management might not be able to conclude that control has transferred to the customer until the customer accepts the goods in such cases. A customer also does not control products received for a trial period if it is not committed to pay any consideration until it has accepted the products. This accounting differs from a right of return, as discussed in RR 8, which is considered in determining the transaction price.

Customer acceptance, as with all indicators of transfer of control, should be viewed from the customer's perspective. Management should consider not only whether it believes the acceptance is a formality, but also whether the customer views the acceptance as a formality.

Chapter 7: Options to acquire additional goods or services

7.1 Chapter overview

This chapter discusses customer options to acquire additional goods or services. Customer options to acquire additional goods or services include sales incentives, customer loyalty points, contract renewal options, and other discounts. Volume discounts are also a form of customer option and are discussed in RR 4. Management should assess each arrangement to determine if there are options embedded in the agreement, either explicit or implicit, and the accounting effect of any options identified.

Customer options are additional performance obligations in an arrangement if they provide the customer with a material right that it would not otherwise receive without entering into the arrangement. The customer is purchasing two things in the arrangement: the good or service originally purchased and the right to a free or discounted good or service in the future. The customer is effectively paying in advance for future goods or services.

Refunds, rebates, and other obligations to pay cash to a customer are not customer options. They affect measurement of the transaction price. Refer to RR 4 for information on measuring transaction price.

7.2 Customer options that provide a material right

The revenue standard provides the following guidance on customer options.

ASC 606-10-55-42 and IFRS 15.B40

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

An option that provides a customer with free or discounted goods or services in the future might be a material right. A material right is a promise embedded in a current contract that should be accounted for as a separate performance obligation.

An option to purchase additional goods or services at their standalone selling prices is a marketing offer and therefore not a material right. This is true regardless of whether the customer obtained the option only as a result of entering into the prior arrangement. An option to purchase additional goods or services in the future at a current standalone selling price could be a material right, however, if prices are expected to increase. This is because the customer is being offered a discount on

future goods compared to what others will have to pay as a result of entering into the current transaction.

The following examples illustrate how to assess whether an option provides a material right.

EXAMPLE 7-1

Customer options – option that does not provide a material right

Manufacturer enters into an arrangement to provide machinery and 200 hours of consulting services to Retailer for \$300,000. The standalone selling price is \$275,000 for the machinery and \$250 per hour for the consulting services. The machinery and consulting services are distinct and accounted for as separate performance obligations.

Manufacturer also provides Retailer an option to purchase ten additional hours of consulting services at a rate of \$225 per hour during the next 14 days, a 10% discount off the standalone selling price. Manufacturer offers a similar 10% discount on consulting services as part of a promotional campaign during the same period.

How should Manufacturer account for the option to purchase additional consulting services?

Analysis

Manufacturer should not account for the option as a separate performance obligation because the discount is not a material right. The discount is not incremental to the discount offered to a similar class of customers because it reflects the standalone selling price of hours offered to similar customers during the period. The option is a marketing offer that is not part of the current contract. The option is accounted for when it is exercised by the customer.

EXAMPLE 7-2

Customer options – option that provides a material right

Retailer sells a good to Customer for \$1,000. Retailer provides Customer a coupon for a 60% discount off a future purchase during the next 90 days as part of the transaction. Retailer intends to offer a 10% discount on all customer sales as part of a promotional campaign during the same period. Retailer estimates that, on average, 75% of customers that receive the coupon will exercise the option for the purchase of, on average, \$400 of discounted additional product.

How should Retailer account for the option provided by the coupon?

Analysis

Retailer should account for the option as a separate performance obligation, as the discount represents a material right. It is a material right because it is incremental to the discount offered to a similar class of customers during the period (only a 10%

discount is offered more widely). Customer is in effect paying Retailer in advance for future goods or services. The standalone selling price of the option is \$150, calculated as the estimated average purchase price of additional products (\$400) multiplied by the incremental discount (50%) multiplied by the likelihood of exercise (75%). The transaction price allocated to the discount, based on its relative standalone selling price, will be recognized upon exercise (that is, purchase of the additional product) or expiry.

7.2.1 *Determining the standalone selling price of a customer option*

Management needs to determine the standalone selling price of an option that is a material right in order to allocate a portion of the transaction price to it. Refer to RR 5 for discussion of allocating the transaction price.

The observable standalone selling price of the option should be used, if available. The standalone selling price of the option should be estimated if it is not directly observable, which is often the case. For example, management might estimate the standalone selling price of customer loyalty points as the average standalone selling price of the underlying goods or services purchased with the points.

The revenue standard provides the following guidance on estimating the standalone selling price of an option that provides a material right.

Excerpt from ASC 606-10-55-44 and IFRS 15.B42

If the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity [should [U.S. GAAP]/shall [IFRS]] estimate it. That estimate [should [U.S. GAAP] /shall [IFRS]] reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

- a. Any discount that the customer could receive without exercising the option [and [IFRS]]
- b. The likelihood that the option will be exercised.

Adjusting for discounts available to any other customer ensures that the standalone selling price reflects only the incremental value the customer has received as a result of the current purchase.

The standalone selling price of the options should also reflect only those options that are expected to be redeemed. In other words, the estimated standalone selling price is reduced for expected "breakage." Breakage is the extent to which future performance is not expected to be required because the customer does not redeem the option (refer to RR 7.4). The transaction price is therefore only allocated to obligations that are expected to be satisfied.

Management should consider the indicators discussed in RR 4.3.2 (variable consideration), as well as the entity's history and the history of others with similar arrangements, when assessing its ability to estimate the number of options that will

not be exercised. An entity should recognize a reduction for breakage only if it is probable (U.S. GAAP) or highly probable (IFRS) that doing so will not result in a subsequent significant reversal of cumulative revenue recognized. Refer to RR 4 for further discussion of the constraint on variable consideration.

Judgment is needed to estimate the standalone selling price of options in many cases, as no one method is prescribed. Management may use option-pricing models to estimate the standalone selling price of an option. An option's price should include its intrinsic value, which is the value of the option if it were exercised today. Option-pricing models typically include time value, but the revenue standard does not require entities to include time value in the estimate of the standalone selling price of the option.

Certain options, such as customer loyalty points, are not typically sold on a standalone basis and, when they are, they are sometimes sold at premium prices. Management should consider, in these situations, whether the premium price is reflective of the standalone selling price in an arrangement with multiple goods or services.

7.2.2 Significant financing component considerations

Options to acquire additional goods and services (such as point and loyalty programs) are often outstanding for periods extending beyond one year. Management is not required to consider whether there is a significant financing component associated with options to acquire additional goods or services, because the timing of redemption is at the discretion of the customer.

However, if the option can only be exercised on a defined date(s) one year or more after the date cash is received, management should consider whether there is a significant financing component associated with the option, considering all relevant facts and circumstances. Refer to RR 4.4 for further discussion of significant financing components.

7.2.3 Customer loyalty programs

Customer loyalty programs are used to build brand loyalty and increase sales volume. Examples of customer loyalty programs are varied and include airlines that offer "free" air miles and retail stores that provide future discounts after a specified number of purchases. The incentives may go by different names (for example, points, rewards, air miles, or stamps), but they all represent discounts that the customer can choose to use in the future to acquire additional goods or services. Obligations related to customer loyalty programs can be significant even where the value of each individual incentive is insignificant.

A portion of the transaction price should be allocated to the material right (that is, the points). The amount allocated is based on the estimated standalone selling price of the points calculated in accordance with RR 7.2.1, not the cost of fulfilling awards earned. Revenue is recognized when the entity has satisfied its performance obligation relating to the points or when the points expire.

Some arrangements allow a customer to earn points that the customer can choose to redeem in a variety of ways. For example, a customer that earns points from purchases may be able to redeem those points to acquire free or discounted goods or services, or use them to offset outstanding amounts owed to the seller. Refer to RR 7.2.4 for accounting considerations when a customer is offered cash as an incentive. The accounting for these arrangements can be complex.

Customer loyalty programs typically fall into one of three types:

- Points earned from the purchase of goods or services can only be redeemed for goods and services provided by the issuing entity.
- Points earned from the purchase of goods or services can be used to acquire goods or services from other entities, but cannot be redeemed for goods or services sold by the issuing entity.
- Points earned from the purchase of goods or services can be redeemed either with the issuing entity or with other entities.

Management needs to consider the nature of its performance obligation in each of these situations to determine the accounting for the loyalty program.

7.2.3.1 *Points redeemed solely by issuer*

An entity that operates a program where points can only be redeemed with the entity recognizes revenue when the customer redeems the points or the points expire (refer to further discussion of accounting for breakage at RR 7.4). The entity is typically the principal for both the sale of the goods or services and satisfying the performance obligation relating to the loyalty points in this situation.

7.2.3.2 *Points redeemed solely by others*

An entity that operates a program where points can only be redeemed with a third party needs to consider whether it is the principal or an agent in the arrangement as it relates to the customer loyalty points redeemed by others. This requires management to first consider the nature of the entity's performance obligation. The entity should recognize revenue for the net fee or commission retained in the exchange if it is an agent in the arrangement. Refer to RR 10 for further discussion of principal and agent considerations.

The entity recognizes revenue when it satisfies its performance obligation relating to the points and recognizes a liability for the amount the entity expects to pay to the party that will redeem the points. The boards noted in the Basis for Conclusions to the revenue standard that in instances where the entity is the agent, the entity might satisfy its performance obligation when the points are transferred to the customer, as opposed to when the customer redeems the points with the third party.

Excerpt from ASU 2014-09 BC383 and IFRS 15 BC383

For example, an entity might satisfy its promise to provide customers with loyalty points when those points are transferred to the customer if:

- a. The entity's promise is to provide loyalty points to customers when the customer purchases goods or services from the entity.
- b. The points entitle the customers to future discounted purchases with another party (that is, the points represent a material right to a future discount). [and [IFRS]]
- c. The entity determines that it is an agent (that is, its promise is to arrange for the customers to be provided with points) and the entity does not control those points before they are transferred to the customer.

The following example illustrates the accounting where a customer is able to redeem points solely with others.

EXAMPLE 7-3**Customer options – loyalty points redeemable by another party**

Retailer offers a customer loyalty program in partnership with Airline that awards one air travel point for each dollar a customer spends on goods purchased from Retailer. Program members can redeem the points for air travel with Airline. The transaction price allocated to each point based on its relative estimated standalone selling price is \$.01. Retailer pays Airline \$.009 for each point redeemed.

Retailer sells goods totaling \$1 million and grants one million points during the period. Retailer allocates \$10,000 of the transaction price to the points, calculated as the number of points issued (one million) multiplied by the allocated transaction price per point (\$0.01).

Retailer concludes that it is an agent in this transaction in accordance with the guidance in the revenue standard (refer to RR 10).

How should Retailer account for points issued to its customers?

Analysis

Retailer measures its revenue as the commission it retains for each point redeemed because it concluded that it is an agent in the transaction. The commission is \$1,000, which is the difference between the transaction price allocated to the points (\$10,000) and the \$9,000 paid to Airline. Retailer will recognize its commission when it transfers the points to the customer (upon purchase of goods from Retailer) because Retailer has satisfied its performance obligation by transferring control of the air travel points to the customer.

7.2.3.3 Points redeemed by issuer or other third parties

Management needs to consider the nature of the entity's performance obligation if it issues points that can be redeemed either with the issuing entity or with other entities. The issuing entity satisfies its performance obligation relating to the points when it transfers the goods or services to the customer, it transfers the obligation to a third party (and the entity therefore no longer has a stand-ready obligation), or the points expire.

Management will need to assess whether the entity is the principal or an agent in the arrangement if the customer subsequently chooses to redeem the points for goods or services from another party. The entity should recognize revenue for the net fee or commission retained in the exchange if it is an agent in the arrangement. Refer to RR 10 for further discussion of principal and agent considerations.

The following example illustrates the accounting where a customer is able to redeem points with multiple parties.

EXAMPLE 7-4

Customer options – loyalty points redeemable by multiple parties

Retailer offers a customer loyalty program in partnership with Hotel whereby Retailer awards one customer loyalty point for each dollar a customer spends on goods purchased from Retailer. Program members can redeem the points for accommodation with Hotel or discounts on future purchases with Retailer. The transaction price allocated to each point based on its relative estimated standalone selling price is \$.01.

Retailer sells goods totaling \$1 million and grants one million points during the period. Retailer allocates \$10,000 of the transaction price to the points, calculated as the number of points issued (one million) multiplied by the allocated transaction price per point (\$.01). Retailer concludes that it has not satisfied its performance obligation as it must stand ready to transfer goods or services if the customer elects not to redeem points with Hotel.

How should Retailer account for points issued to its customers?

Analysis

Retailer should not recognize revenue for the \$10,000 allocated to the points when they are issued as it has not satisfied its performance obligation. Retailer should recognize revenue upon redemption of the points by the customer with Retailer, when the obligation is transferred to Hotel, or when the points expire. Retailer will need to assess whether it is the principal or an agent in the arrangement if the customer elects to redeem the points with Hotel.

7.2.4 *Noncash and cash incentives*

Incentives can include a "free" product or service, such as a free airline ticket provided to a customer upon reaching a specified level of purchases, which may or may not be honored by an unrelated entity. Management needs to consider whether it is providing more than one promise in the arrangement and therefore needs to account for the "noncash" incentive as a separate performance obligation similar to the accounting for customer loyalty points. Management should also consider whether it is the principal or an agent in the transaction if it concludes that the incentive is a separate performance obligation and it is fulfilled by another party.

Cash incentives are not performance obligations, but are accounted for as a reduction of the transaction price. Refer to RR 4 for discussion of determining transaction price. It may require judgment in certain situations to determine whether an incentive is "cash" or "noncash." An incentive that is in substance a cash payment to the customer is a reduction of the transaction price, and is not a promise of future products or services. Management also needs to consider whether items such as gift certificates or gift cards that can be broadly used in the same manner as cash are in-substance cash payments.

7.2.5 *Incentives offered or modified after inception of an arrangement*

An entity may offer a certain type of incentive when items are originally offered for sale, but then decide to provide a different or additional incentive on that item if it is not sold in an expected timeframe. This is particularly common where entities sell their goods through distributors to end customers and sales to end customers are not meeting expectations. This can occur even after revenue has been recorded for the initial sale to the distributor.

Management needs to consider the nature of changes to incentives. A change to an incentive that provides cash (or additional cash) back to a customer (or a customer's customer) is a contract modification that affects the measurement of the transaction price.

The accounting for a change in the incentive offered that adds a new performance obligation depends on whether there is a corresponding change in the transaction price. The additional performance obligation is accounted for as a separate contract if the increase in the transaction price reflects the standalone selling price of the performance obligation. The additional performance obligation is accounted for as an adjustment to the existing contract if the increase in the transaction price does not reflect the standalone selling price. Additional goods or services promised without additional consideration might not be performance obligations if those promises did not exist at contract inception (explicitly or implicitly based on the entity's customary business practice). Refer to RR 2 for further information on contract modifications.

The following example illustrates the accounting for a change in incentive offered by a vendor.

EXAMPLE 7-5

Customer options – change in incentives offered to customer

Electronics Co sells televisions to Retailer. Electronics Co provides Retailer a free Blu-ray player to be given to customers that purchase the television to help stimulate sales. Retailer then sells the televisions with the free Blu-ray player to end customers. Control transfers and revenue is recognized when the televisions and Blu-ray players are delivered to Retailer.

Electronics Co subsequently adds a \$200 rebate to the end customer to assist Retailer with selling the televisions in its inventory in the weeks leading up to a popular sporting event. The promotion applies to all televisions sold during the week prior to the event. Electronics Co has not offered a customer rebate previously and had no expectation of doing so when the televisions were sold to Retailer.

How should Electronics Co account for the offer of the additional \$200 rebate?

Analysis

The offer of the additional customer rebate is a contract modification that affects only the transaction price. Electronics Co should account for the \$200 rebate as a reduction to the transaction price for the televisions held in stock by Retailer that are expected to be sold during the rebate period, considering the guidance on contract modifications as discussed in RR 2.8.4 and variable consideration as discussed in RR 4.3.

Electronics Co will need to consider whether it plans to offer similar rebates in future transactions (or that the customer will expect such rebates to be offered) and whether those rebates impact the transaction price at the time of initial sale.

7.3 *Renewal and cancellation options*

Entities often provide customers the option to renew their existing contracts. For example, a customer may be allowed to extend a two-year contract for an additional year under the same terms and conditions as the original contract. A cancellation option that allows a customer to cancel a multi-year contract after each year might effectively be the same as a renewal option, because a decision is made annually whether to continue under the contract.

Management should assess a renewal or cancellation option to determine if it provides a material right similar to other types of customer options. For example, a renewal option that is offered for an extended period of time without price increases might be a material right if prices for the product in that market are expected to increase.

Contracts that include multiple renewal options introduce complexity, as management would theoretically need to assess the standalone selling price of each option. The revenue standard provides the following practical alternative regarding customer renewals.

ASC 606-10-55-45 and IFRS 15.B43

If a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, then an entity may, as a practical alternative to estimating the standalone selling price of the option, allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration. Typically, those types of options are for contract renewals.

Arrangements involving customer loyalty points or discount vouchers are unlikely to qualify for the practical alternative associated with contract renewals. The goods or services provided in the future in such arrangements often differ from those provided in the initial contract and/or are provided under different pricing terms (for example, a hotel chain may change the number of points a customer must redeem to receive a free stay).

The following example illustrates the accounting for a contract renewal option.

EXAMPLE 7-6**Customer options – renewal option that provides a material right**

SpaMaker enters into an arrangement with Retailer to sell an unlimited number of hot tubs for \$3,000 per hot tub for 12 months. Retailer has the option to renew the contract at the end of the year for an additional 12 months. The contract renewal will be for the same products and under the same terms as the original contract. SpaMaker typically increases its prices 15% each year.

How should SpaMaker account for the renewal option?

Analysis

The renewal option represents a material right to Retailer as it will be charged a lower price for the hot tubs than similar customers if the contract is renewed. SpaMaker is not required to determine a standalone selling price for the renewal option as both criteria for the use of the practical expedient have been met. SpaMaker could instead elect to include the estimated total number of hot tubs to be sold at \$3,000 per hot tub over 24 months (the initial period and the renewal period) in the initial measurement of the transaction price.

7.4 Unexercised rights (breakage)

Customers sometimes do not exercise all of their rights or options in an arrangement. These unexercised rights are often referred to as “breakage” or forfeiture. Breakage applies to not only sales incentive programs, but also to any situations where an entity receives prepayments for future goods or services. The revenue standard requires breakage to be recognized as follows.

ASC 606-10-55-48 and IFRS 15.B46

If an entity expects to be entitled to a breakage amount in a contract liability, the entity [should [U.S. GAAP]/shall [IFRS]] recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, the entity [should [U.S. GAAP]/shall [IFRS]] recognize the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote. To determine whether an entity expects to be entitled to a breakage amount, the entity [should [U.S. GAAP]/shall [IFRS]] consider the guidance in paragraphs [606-10-32-11 through 32-13 [U.S. GAAP]/56-58 [IFRS]] on constraining estimates of variable consideration.

Receipt of a nonrefundable prepayment creates an obligation for an entity to stand ready to perform under the arrangement by transferring goods or services when requested by the customer. A common example is the purchase of gift cards. Gift cards are often not redeemed for products or services in their full amount. Another common example is “take-or-pay” arrangements, in which a customer pays a specified amount and is entitled to a specified number of units of goods or services. The customer pays the same amount whether they take all of the items to which they are entitled or leave some rights unexercised.

Both prepayments and customer options create obligations for an entity to transfer goods or services in the future. All or a portion of the transaction price should be allocated to those performance obligations and recognized as revenue when those obligations are satisfied. An entity should recognize revenue when control of the goods or services is transferred to the customer in satisfaction of the performance obligations.

An entity should recognize estimated breakage as revenue in proportion to the pattern of exercised rights. For example, an entity would recognize 50 percent of the total estimated breakage upon redemption of 50 percent of customer rights. Management that cannot conclude whether there will be any breakage, or the extent of such breakage, should consider the constraint on variable consideration, including the need to record any minimum amounts of breakage. Refer to RR 4 for further discussion of variable consideration. Breakage that is not expected to occur should be recognized as revenue when the likelihood of the customer exercising its remaining rights becomes remote.

The assessment of estimated breakage should be updated at each reporting period. Changes in estimated breakage should be accounted for by adjusting the contract liability to reflect the remaining rights expected to be redeemed.

Legal requirements for unexercised rights vary among jurisdictions. Certain jurisdictions require entities to remit payments received from customers for rights that remain unexercised to a governmental entity (for example, unclaimed property or “escheat” laws). An entity should not recognize estimated breakage as revenue related to consideration received from a customer that must be remitted to a governmental entity if the customer never demands performance. Management must understand its legal rights and obligations when determining the accounting model to follow.

The following examples illustrate the accounting for breakage.

EXAMPLE 7-7

Breakage – sale of gift cards

Restaurant Inc sells 1,000 gift cards in 20X1, each with a face value of \$50, that are redeemable at any of its locations. Any unused gift card balances are not subject to escheatment to a government entity. Restaurant Inc expects breakage of 10%, or \$5,000 of the face value of the cards, based on history with similar gift cards.

Customers redeem \$22,500 worth of gift cards during 20X2.

How should Restaurant Inc account for the gift cards redeemed during 20X2?

Analysis

Restaurant Inc should recognize revenue of \$25,000 in 20X2, calculated as the value of the gift cards redeemed (\$22,500) plus breakage in proportion to the total rights exercised (\$2,500). This amount is calculated as the total expected breakage (\$5,000) multiplied by the proportion of gift cards redeemed ($\$22,500 \text{ redeemed} / \$45,000 \text{ expected to be redeemed}$).

EXAMPLE 7-8

Breakage – customer loyalty points

Hotel Inc has a loyalty program that rewards its customers with two loyalty points for every \$25 spent on lodging. Each point is redeemable for a \$1 discount on a future stay at the hotel in addition to any other discount being offered. Customers collectively spend \$1 million on lodging in 20X1 and earn 80,000 points redeemable for future purchases. The standalone selling price of the purchased lodging is \$1 million, as the price charged to customers is the same whether the customer participates in the program or not. Hotel Inc expects 75% of the points granted will be redeemed. Hotel Inc therefore estimates a standalone selling price of \$0.75 per point (\$60,000 in total), which takes into account the likelihood of redemption.

Hotel Inc concludes that the points provide a material right to customers that they would not receive without entering into a contract; therefore, the points provided to the customers are separate performance obligations.

Hotel Inc allocates the transaction price of \$1 million to the lodging and points based on their relative standalone selling prices as follows:

Lodging ($\$1,000,000 \times (\$1,000,000 / \$1,060,000)$)	\$ 943,396
Points ($\$1,000,000 \times (\$60,000 / \$1,060,000)$)	\$ 56,604
Total transaction price	\$ 1,000,000

Customers redeem 40,000 points during 20X2 and Hotel Inc continues to expect total redemptions of 60,000 points.

How should Hotel Inc account for the points redeemed during 20X2?

Analysis

Hotel Inc should recognize revenue of \$37,736, calculated as the total transaction price allocated to the points (\$56,604) multiplied by the ratio of points redeemed during 20X2 (40,000) to total points expected to be redeemed (60,000). Hotel Inc will maintain a contract liability of \$18,868 for the consideration allocated to the remaining points expected to be redeemed.

EXAMPLE 7-9

Breakage – customer loyalty points, reassessment of breakage estimate

Assume the same facts as Example 7-8, with the following additional information:

- Hotel Inc increases its estimate of total points to be redeemed from 60,000 to 70,000
- Customers redeem 20,000 points during 20X3

How should Hotel Inc account for the points redeemed during 20X3?

Analysis

Hotel Inc should recognize revenue of \$10,782 calculated as follows:

Total points redeemed cumulatively	60,000
Divided by	/
Total points expected to be redeemed	70,000
Multiplied by	X
Amount originally allocated to the points (per Example 7-8)	\$ 56,604
Cumulative revenue to be recognized	\$ 48,518
Less: Revenue previously recognized (per Example 7-8)	\$ 37,736
Revenue recognized in 20X3	\$ 10,782

The remaining contract liability of \$8,086 (1/7 of the amount originally allocated to the points) will be recognized as revenue as the outstanding points are redeemed.

The above examples illustrate the manner in which breakage is accounted for related to a customer prepayment (gift cards) and customer options. The above examples also illustrate that management does not consider the presence of a significant financing component, as discussed in RR 7.2.2, nor does it adjust the standalone selling price for the change in estimate of total points to be redeemed.

Chapter 8:

Practical application issues

8.1 Chapter overview

The revenue standard provides implementation guidance to assist entities in applying the guidance to more complex arrangements or specific situations. The revenue standard includes specific guidance on rights of return, warranties, nonrefundable upfront fees, bill-and-hold arrangements, consignments, and repurchase rights.

8.2 Rights of return

Many entities offer their customers a right to return products they purchase. Return privileges can take many forms, including:

- The right to return products for any reason
- The right to return products if they become obsolete
- The right to rotate stock
- Trade-in agreements for newer products
- The right to return products upon termination of an agreement

Some of these rights are explicit in the contract, while others are implied. Implied rights can arise from statements or promises made to customers during the sales process, statutory requirements, or an entity's customary business practice. These practices are generally driven by the buyer's desire to mitigate risk (risk of dissatisfaction, technological risk, or the risk that a distributor will not be able to sell the products) and the seller's desire to ensure customer satisfaction.

A right of return often entitles a customer to a full or partial refund of the amount paid or a credit against the value of previous or future purchases. Some return rights only allow a customer to exchange one product for another. Understanding the rights and obligations of both parties in an arrangement when return rights exist is critical to determining the accounting.

A right of return is not a separate performance obligation, but it affects the estimated transaction price for transferred goods. Revenue is only recognized for those goods that are not expected to be returned.

The estimate of expected returns should be calculated in the same way as other variable consideration. The estimate should reflect the amount that the entity expects to repay or credit customers, using either the expected value method or the most-likely amount method, whichever provides more reliable information. See RR 4 for further details about these methods. The transaction price should include amounts subject to return only if it is probable (U.S. GAAP) or highly probable (IFRS) that there will not be a significant reversal of cumulative revenue if the estimate of expected returns changes.

It could be probable (U.S. GAAP) or highly probable (IFRS) that some, but not all, of the variable consideration will not result in a significant reversal of cumulative revenue recognized. The entity must consider, as illustrated in Example 8-1, whether there is some minimum amount of revenue that would not be subject to significant reversal if the estimate of returns changes. Management should consider all available information to estimate its expected returns.

EXAMPLE 8-1

Right of return – sale of products to a distributor

Producer utilizes a distributor network to supply its product to end consumers. Producer allows distributors to return any products for up to 120 days after the distributor has obtained control of the products. Producer has no further obligations with respect to the products and distributors have no further return rights after the 120-day period. Producer is uncertain about the level of returns for a new product that it is selling through the distributor network.

How should Producer recognize revenue in this arrangement?

Analysis

Producer must consider the extent to which it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue will not occur from a change in the estimate of returns. Producer needs to assess, based on its historical information and other relevant evidence, if there is a minimum level of sales for which it is probable (U.S. GAAP) or highly probable (IFRS) there will be no significant reversal of cumulative revenue, as revenue needs to be recorded for those sales.

For example, if at inception of the contract Producer estimates that including 70% of its sales in the transaction price will not result in a significant reversal of cumulative revenue, Producer will record revenue for that 70%. Producer needs to update its estimate of expected returns at each period end.

An entity will recognize revenue, a refund liability, and an asset when it sells products with a right of return.

ASC 606-10-55-23 and IFRS 15.B21

To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity [should [U.S. GAAP]/shall [IFRS]] recognize all of the following:

- a. Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for the products expected to be returned)
- b. A refund liability [and [IFRS]]

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

The refund liability represents the amount of consideration that the entity does not expect to be entitled to because it will be refunded to customers. The refund liability is remeasured at each reporting date to reflect changes in the estimate, with a corresponding adjustment to revenue.

The asset represents the entity's right to receive goods back from the customer. The asset is initially measured at the carrying amount of the goods at the time of sale, less any expected costs to recover the goods and any expected reduction in value. The return asset is presented separately from the refund liability. The amount recorded as an asset should be updated whenever the refund liability changes and for other changes in circumstances that might suggest an impairment of the asset. This is illustrated in the following example.

EXAMPLE 8-2

Right of return – refund obligation and return asset

Game Co sells 1,000 video games to Distributor for \$50 each. Distributor has the right to return the video games for a full refund for any reason within 180 days of purchase. The cost of each game is \$10. Game Co estimates, based on the expected value method, that 6% of sales of the video games will be returned and it is probable (U.S. GAAP) or highly probable (IFRS) that returns will not be higher than 6%. Game Co has no further obligations after transferring control of the video games.

How should Game Co record this transaction?

Analysis

Game Co should recognize revenue of \$47,000 ($\50×940 games) and cost of sales of \$9,400 ($\10×940 games) when control of the games transfers to Distributor. Game Co should also recognize an asset of \$600 ($\10×60 games) for expected returns, and a liability of \$3,000 (6% of the sales price) for the refund obligation.

The return asset will be presented and assessed for impairment separately from the refund liability. Game Co will need to assess the return asset for impairment, and adjust the value of the asset if it becomes impaired.

8.2.1 *Exchange rights*

Some contracts allow customers to exchange one product for another.

Excerpt from ASC 606-10-55-28 and IFRS 15.B26

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

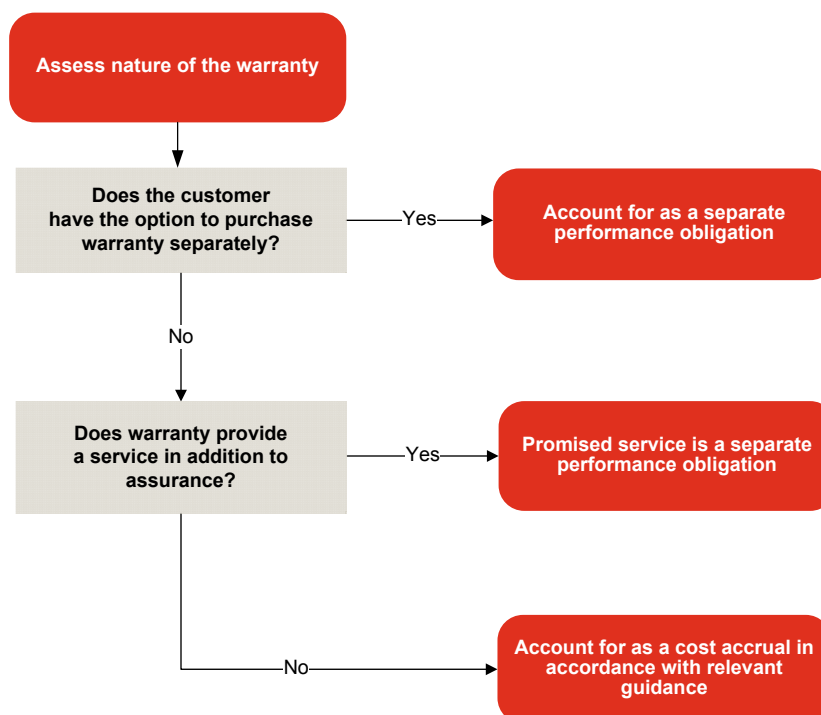
No adjustment of the transaction price is made for exchange rights. A right to exchange an item that does not function as intended for one that is functioning properly is a warranty, not a right of return. Refer to RR 8.3 for further information on accounting for warranties.

8.3 Warranties

Entities often provide customers with a warranty in connection with the sale of a good or service. The nature of a warranty can vary across entities, industries, products, or contracts. It could be called a standard warranty, a manufacturer's warranty, or an extended warranty. Warranties might be written in the contract, or they might be implicit as a result of either customary business practices or legal requirements.

Figure 8-1

Accounting for warranty obligations



Some warranties provide assurance that a product will function as expected and in accordance with certain specifications. The warranty is intended to safeguard the customer against existing defects and does not provide any incremental service to the

customer. Costs incurred to either repair or replace the product are additional costs of providing the initial good or service. These warranties are accounted for in accordance with other guidance (ASC 460, *Guarantees*, or IAS 37, *Provisions, Contingent Liabilities, and Contingent Assets*) if the customer does not have the option to purchase the warranty separately. The estimated costs are recorded as a liability when the entity transfers the product to the customer.

Other warranties provide a customer with a service in addition to the assurance that the product will function as expected. The service provides a level of protection beyond defects that existed at the time of sale. It might protect against wear and tear for a period of time after sale or against certain types of damage. The additional service is accounted for as a separate performance obligation in the contract. An entity that cannot reasonably account for a service element of a warranty separately from the assurance element should account for both together as a single performance obligation that provides a service to the customer.

A warranty that a customer can purchase separately from the related good or service (that is, it is priced or negotiated separately) is a separate performance obligation. The fact that it is sold separately indicates that a service is being provided beyond ensuring that the product will function as intended. Revenue allocated to the warranty is recognized over the warranty period.

A number of factors need to be considered when assessing whether a warranty provides a service that should be accounted for as a separate performance obligation.

ASC 606-10-55-33 and IFRS 15.B31

In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity [should [U.S. GAAP]/shall [IFRS]] consider factors such as:

- a. Whether the warranty is required by law—If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.
- b. The length of the warranty coverage period—The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.
- c. The nature of the tasks that the entity promises to perform—If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

The following example illustrates the assessment of whether a warranty provides assurance or additional services.

EXAMPLE 8-3

Warranty – assessing whether a warranty is a performance obligation

Telecom enters into a contract with Customer to sell a smart phone and provide a one-year warranty against both manufacturing defects and customer-inflicted damages (for example, dropping the phone into water).

How should Telecom account for the warranty?

Analysis

This arrangement includes the following goods or services: (1) the smart phone; (2) product warranty; and (3) repair and replacement service.

Telecom will account for the product warranty (against manufacturing defect) in accordance with other guidance on product warranties, and record an expense and liability for expected repair or replacement costs related to this obligation. Telecom will account for the repair and replacement service (that is, protection against customer-inflicted damages) as a separate performance obligation, with revenue recognized as that obligation is satisfied.

If Telecom cannot reasonably separate the product warranty and repair and replacement service, it should account for the two warranties together as a single performance obligation.

8.4 *Nonrefundable upfront fees*

It is common in some industries for entities to charge customers a fee at or near inception of a contract. These upfront fees are often nonrefundable and could be labeled as fees for set up, access, activation, initiation, joining, or membership.

An entity needs to analyze each arrangement involving upfront fees to determine whether any revenue should be recognized when the fee is received.

Excerpt from ASC 606-10-55-51 and IFRS 15.B49

To identify performance obligations in such contracts, an entity [should [U.S. GAAP]/shall [IFRS]] assess whether the fee relates to the transfer of a promised good or service. In many cases, even though a nonrefundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfill the contract, that activity does not result in the transfer of a promised good or service to the customer... Instead, the upfront fee is an advance payment for future goods or services and, therefore, would be recognized as revenue when those future goods or services are provided. The revenue recognition period would extend beyond the initial contractual period if the entity grants the customer the option to renew the contract and that option provides the customer with a material right.

No revenue should be recognized upon receipt of an upfront fee, even if it is nonrefundable, if the fee does not relate to the satisfaction of a performance obligation. Nonrefundable upfront fees are included in the transaction price and allocated to the separate performance obligations in the contract. Revenue is recognized as the performance obligations are satisfied.

There could be situations, as illustrated in Example 8-4, where an upfront fee relates to separate performance obligations satisfied at different points in time.

EXAMPLE 8-4

Upfront fee allocated to separate performance obligations

Biotech enters into a contract with Pharma for the license and development of a drug compound. The contract requires Biotech to perform research and development (R&D) services to get the drug compound through regulatory approval. Biotech receives an upfront fee of \$50 million, fees for R&D services, and milestone-based payments upon the achievement of specified acts.

Biotech concludes that the arrangement includes two separate performance obligations: (1) license of the intellectual property and (2) R&D services. There are no other performance obligations in the arrangement.

How should Biotech allocate the consideration in the arrangement, including the \$50 million upfront fee?

Analysis

Biotech needs to determine the transaction price at the inception of the contract which will include both the fixed and variable consideration. The fixed consideration is the upfront fee. The variable consideration includes the fees for R&D services and the milestone-based payments and is estimated based on the principles discussed in RR 4. Once Biotech determines the total transaction price, it should allocate that amount to the two performance obligations. See RR 5 for further information on allocation of the transaction price to performance obligations.

Entities sometimes perform set-up or mobilization activities at or near contract inception to be able to fulfill the obligations in the contract. These activities could involve system preparation, hiring of additional personnel, or mobilization of assets to where the service will take place. Nonrefundable fees charged at the inception of an arrangement are often intended to compensate the entity for the cost of these activities. Set-up or mobilization efforts might be critical to the contract, but they typically do not satisfy performance obligations, as no good or service is transferred to the customer. The nonrefundable fee, therefore, is an advance payment for the future goods and services to be provided.

Set-up or mobilization costs should be disregarded in the measure of progress for performance obligations satisfied over time if they do not depict the transfer of services to the customer. Some mobilization costs might be capitalized as fulfillment

costs, however, if certain criteria are met. See RR 11 for further information on capitalization of contract costs.

8.4.1 Accounting for upfront fees when a renewal option exists

Contracts that include an upfront fee and a renewal option often do not require a customer to pay another upfront fee if and when the customer renews the contract. The renewal option in such a contract might provide the customer with a material right, as discussed in RR 7.3. An entity that provides a customer a material right should determine its standalone selling price and allocate a portion of the transaction price to that right because it is a separate performance obligation. Alternatively, transactions that meet the requirements can apply the practical alternative for contract renewals discussed in RR 7.3 and estimate the total transaction price based on the expected number of renewals.

Determining the appropriate amount to allocate to the material right and the period over which to recognize the portion of the upfront fee attributable to a material right requires judgment. Factors that management might consider when estimating the amount to allocate to the material right and the period over which to recognize revenue allocated to the material right include:

- Historical data (adjusted to reflect current factors)
- Expected renewal rates
- Budgets
- Marketing studies
- Data used to set the pricing terms of the arrangement
- Discussions with customer during or after negotiations about the arrangement
- Industry data, particularly if the service is homogenous

The following example illustrates the accounting for upfront fees and a renewal option.

EXAMPLE 8-5

Upfront fee – health club joining fees

FitCo operates health clubs. FitCo enters into contracts with customers for one year of access to any of its health clubs. The entity charges an annual membership fee of \$60 as well as a \$150 nonrefundable joining fee. The joining fee is to compensate, in part, for the initial activities of registering the customer. Customers can renew the contract each year and are charged the annual membership fee of \$60 without paying the joining fee again. If customers allow their membership to lapse, they are required to pay a new joining fee.

How should FitCo account for the nonrefundable joining fees?

Analysis

The customer does not have to pay the joining fee if the contract is renewed and has therefore received a material right. That right is the ability to renew the annual membership at a lower price than the range of prices typically charged to newly joining customers.

The joining fee is included in the transaction price and allocated to the separate performance obligations in the arrangement, which are providing access to health clubs and the option to renew the contract, based on their standalone selling prices. FitCo's activity of registering the customer is not a service to the customer and therefore does not represent satisfaction of a performance obligation. The amount allocated to the right to access the health club is recognized over the first year, and the amount allocated to the renewal right is recognized when that right is exercised or expires.

As a practical alternative to determining the standalone selling price of the renewal right, FitCo could allocate the transaction price to the renewal right by reference to the future services expected to be provided and the corresponding expected consideration. For example, if FitCo determined that a customer is expected to renew for an additional two years, then the total consideration would be \$330 (\$150 joining fee and \$180 annual membership fees). FitCo would recognize this amount as revenue ratably as services are provided over the three years. See RR 7.3 for further information about the practical alternative and customer options.

8.4.2 Layaway sales

Layaway sales (sometimes referred to as "will call") involve the seller setting aside merchandise and collecting a cash deposit from the customer. The seller may specify a time period within which the customer must finalize the purchase, but there is often no fixed payment commitment. The merchandise is typically released to the customer once the purchase price is paid in full. The cash deposit and any subsequent payments are forfeited if the customer fails to pay the entire purchase price. The seller must refund the cash paid by the customer for merchandise that is lost, damaged, or destroyed before control of the merchandise transfers to the customer.

An entity will first need to determine whether a contract exists in a layaway arrangement. A contract does not exist if the customer is not committed to perform its obligation (that is, payment of the full purchase price). To determine if a customer is committed to the purchase, an entity should consider, in addition to those factors discussed in RR 2.6, historical customer behavior, including the frequency of forfeitures, and the amount of the cash deposit.

An entity that concludes a contract exists will need to determine whether control of the good is transferred to the customer when the deposit and subsequent payments are made. An entity that can use the selected goods to satisfy other customer orders and replace them with similar goods during the layaway period likely has retained control of those goods. The entity should not recognize revenue until the customer receives the goods in that instance.

An entity that is restricted from using the goods to fulfill current orders needs to consider whether it has transferred control of the goods to the customer, even though it retains physical possession. The entity should consider the bill-and-hold criteria discussed in RR 8.5 to determine when control of the goods on layaway has transferred.

8.4.3 *Gift cards*

Entities often sell gift cards that can be redeemed for goods or services at the customer's request. An entity should not record revenue at the time a gift card is sold, as the performance obligation is to provide goods or services in the future when the card is redeemed. The payment for the gift card is an upfront payment for goods or services in the future. Revenue is recognized when the card is presented for redemption and the goods or services are transferred to the customer.

Often a portion of gift certificates sold are never redeemed for goods or services. The amounts never redeemed are known as "breakage." An entity should recognize revenue for amounts not expected to be redeemed proportionately as other gift card balances are redeemed. An entity should not recognize revenue, however, for consideration received from a customer that must be remitted to a governmental entity if the customer never demands performance. Refer to RR 7.4 for further information on breakage and an example illustrating the accounting for gift card sales.

8.5 *Bill-and-hold arrangements*

Bill-and-hold arrangements arise when a customer is billed for goods that are ready for delivery, but the entity does not ship the goods to the customer until a later date. Entities must assess in these cases whether control has transferred to the customer, even though the customer does not have physical possession of the goods. Revenue is recognized when control of the goods transfers to the customer. An entity will need to meet certain additional criteria for a customer to have obtained control in a bill-and-hold arrangement in addition to the criteria related to determining when control transfers (refer to RR 6.2).

Excerpt from ASC 606-10-55-83 and IFRS 15.B81

For a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

- a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).
- b. The product must be identified separately as belonging to the customer.
- c. The product currently must be ready for physical transfer to the customer. [and [IFRS]]
- d. The entity cannot have the ability to use the product or to direct it to another customer.

A bill-and-hold arrangement should have substance. A substantive purpose could exist, for example, if the customer requests the bill-and-hold arrangement because it lacks the physical space to store the goods, or if goods previously ordered are not yet needed due to the customer's production schedule.

The goods must be identified as belonging to the customer, and they cannot be used to satisfy orders for other customers. Substitution of the goods for use in other orders indicates that the goods are not controlled by the customer and therefore revenue should not be recognized until the goods are delivered, or the criterion is satisfied. The goods must also be ready for delivery upon the customer's request.

A customer that can redirect or determine how goods are used, or that can otherwise benefit from the goods, is likely to have obtained control of the goods. Limitations on the use of the goods, or other restrictions on the benefits the customer can receive from those goods, indicates that control of the goods may not have transferred to the customer.

An entity that has transferred control of the goods and met the bill-and-hold criteria to recognize revenue needs to consider whether it is providing custodial services in addition to providing the goods. If so, a portion of the transaction price should be allocated to each of the separate performance obligations (that is, the goods and the custodial service).

The following examples illustrate these considerations in bill-and-hold transactions.

EXAMPLE 8-6

Bill-and-hold arrangement – industrial products industry

Drill Co orders a drilling pipe from Steel Producer. Drill Co requests the arrangement be on a bill-and-hold basis because of the frequent changes to the timeline for developing remote gas fields and the long lead times needed for delivery of the drilling equipment and supplies. Steel Producer has a history of bill-and-hold transactions with Drill Co and has established standard terms for such arrangements.

The pipe, which is separately warehoused by Steel Producer, is complete and ready for shipment. Steel Producer cannot utilize the pipe or direct the pipe to another customer once the pipe is in the warehouse. The terms of the arrangement require Drill Co to remit payment within 30 days of the pipe being placed into Steel Producer's warehouse. Drill Co will request and take delivery of the pipe when it is needed.

When should Steel Producer recognize revenue?

Analysis

Steel Producer should recognize revenue when the pipe is placed into its warehouse because control of the pipe has transferred to Drill Co. This is because Drill Co requested the transaction be on a bill-and-hold basis, which suggests that the reason for entering the bill-and-hold arrangement is substantive, Steel Producer is not

permitted to use the pipe to fill orders for other customers, and the pipe is ready for immediate shipment at the request of Drill Co. Steel Producer should also evaluate whether a portion of the transaction price should be allocated to the custodial services (that is, whether the custodial service is a separate performance obligation).

EXAMPLE 8-7

Bill-and-hold arrangement – retail and consumer industry

Game Maker enters into a contract during 20X6 to supply 100,000 video game consoles to Retailer. The contract contains specific instructions from Retailer about where the consoles should be delivered. Game Maker must deliver the consoles in 20X7 at a date to be specified by Retailer. Retailer expects to have sufficient shelf space at the time of delivery.

As of December 31, 20X6, Game Maker has inventory of 120,000 game consoles, including the 100,000 relating to the contract with Retailer. The 100,000 consoles are stored with the other 20,000 game consoles, which are all interchangeable products; however, Game Maker will not deplete its inventory below 100,000 units.

When should Game Maker recognize revenue for the 100,000 units to be delivered to Retailer?

Analysis

Game Maker should not recognize revenue until the bill-and-hold criteria are met or if Game Maker no longer has physical possession and all of other criteria related to the transfer of control have been met. Although the reason for entering into a bill-and-hold transaction is substantive (lack of shelf space), the other criteria are not met as the game consoles produced for Retailer are not separated from other products.

8.6 Consignment arrangements

Some entities ship goods to a distributor, but retain control of the goods until a predetermined event occurs. These are known as consignment arrangements. Revenue is not recognized upon delivery of a product if the product is held on consignment. Management should consider the following indicators to evaluate whether an arrangement is a consignment arrangement.

ASC 606-10-55-80 and IFRS 15.B78

Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:

- a. The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.
- b. The entity is able to require the return of the product or transfer the product to a third party (such as another dealer). [and [IFRS]]

- c. The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

Revenue is recognized when the entity has transferred control of the goods to the distributor. The distributor has physical possession of the goods, but might not control them in a consignment arrangement. For example, a distributor that is required to return goods to the manufacturer upon request might not have control over those goods; however, an entity should assess whether these rights can be enforced.

A consignment sale differs from a sale with a right of return or put right. The customer has control of the goods in a sale with right of return or a sale with a put right, and can decide whether to put the goods back to the seller.

The following examples illustrate the assessment of consignment arrangements.

EXAMPLE 8-8

Consignment arrangement – retail and consumer industry

Manufacturer provides household products to Retailer on a consignment basis. Retailer does not take title to the products until they are scanned at the register and has no obligation to pay Manufacturer until they are sold to the consumer, unless the goods are lost or damaged while in Retailer's possession. Any unsold products, excluding those that are lost or damaged, can be returned to Manufacturer, and Manufacturer has discretion to call products back or transfer products to another customer.

When should Manufacturer recognize revenue?

Analysis

Manufacturer should recognize revenue when control of the products transfers to Retailer. Control has not transferred if Manufacturer is able to require the return or transfer of those products. Revenue should be recognized when the products are sold to the consumer, or lost or damaged while in Retailer's possession.

EXAMPLE 8-9

Consignment arrangement – industrial products industry

Steel Co develops a new type of cold-rolled steel sheet that is significantly stronger than existing products, providing increased durability. The newly developed product is not yet widely used.

Manufacturer enters into an arrangement with Steel Co whereby Steel Co will provide 50 rolled coils of the steel on a consignment basis. Manufacturer must pay a deposit upon receipt of the coils. Title transfers to Manufacturer upon shipment and the remaining payment is due when Manufacturer consumes the coils in the manufacturing process. Each month, both parties agree on the amount consumed by

Manufacturer. Manufacturer can return, and Steel Co can demand return of, unused products at any time.

When should Steel Co recognize revenue?

Analysis

Steel Co should recognize revenue when the coils are used by Manufacturer. Although title transfers when the coils are shipped, control of the coils has not transferred to Manufacturer because Steel Co can demand return of any unused product.

Control of the steel would transfer to Manufacturer upon shipment if Steel Co did not retain the right to demand return of the inventory, even if Manufacturer had the right to return the product. However, Steel Co needs to assess the likelihood of the steel being returned and might need to recognize a refund liability in that case. Refer to RR 8.2.

8.7 Repurchase rights

Repurchase rights are an obligation or right to repurchase a good after it is sold to a customer. Repurchase rights could be included within the sales contract, or in a separate arrangement with the customer. The repurchased good could be the same asset, a substantially similar asset, or a new asset of which the originally purchased asset is a component.

There are three forms of repurchase rights:

- A seller's obligation to repurchase the good (a forward)
- A seller's right to repurchase the good (a call option)
- A customer's right to require the entity to repurchase the good (a put option)

An arrangement to repurchase a good that is negotiated between the parties after transferring control of that good to a customer is not a repurchase agreement because the customer is not obligated to resell the good to the entity as part of the initial contract. The subsequent decision to repurchase the item does not affect the customer's ability to direct the use of or obtain the benefits of the good.

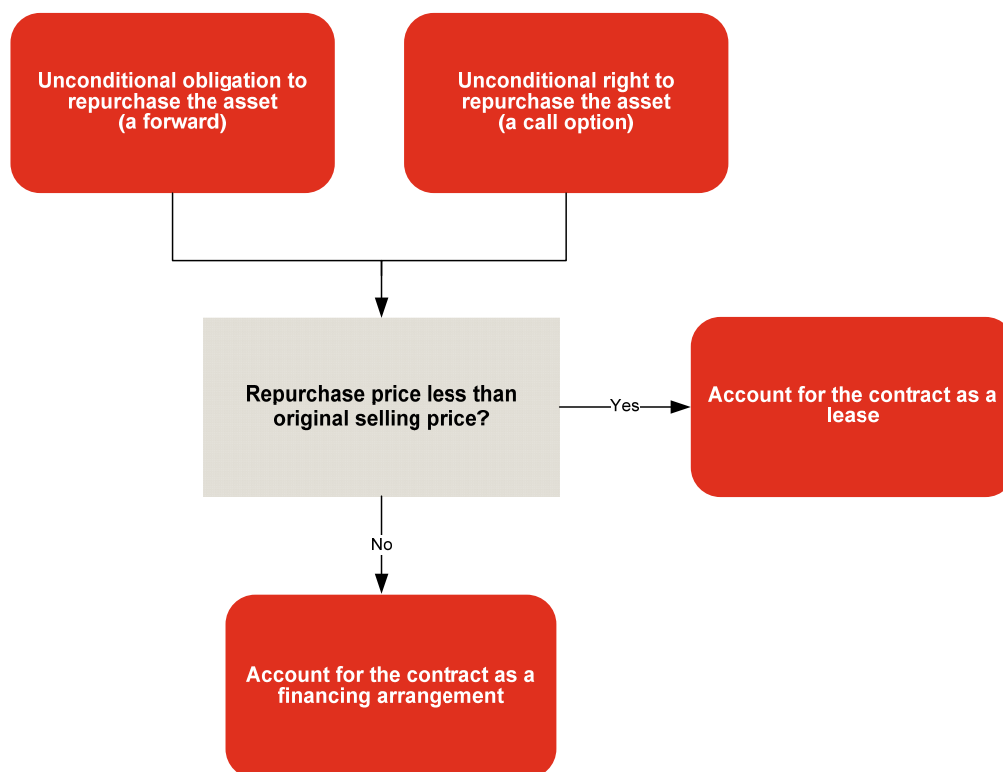
For example, a car manufacturer that decides to repurchase inventory from one dealership to meet an inventory shortage at another dealership has not entered into a forward, call option, or put option unless the original contract requires the dealership to sell the cars back to the manufacturer upon request. However, when such repurchases are common, even if not specified in the contract, management needs to consider if control transferred to the customer upon initial delivery.

8.7.1 *Forwards and call options*

An entity that transfers a good with a substantive forward or call option should not recognize revenue when the good is transferred because the repurchase right limits the customer's ability to control the good.

Figure 8-2

Accounting for forwards and call options



The accounting for an arrangement with a forward or a call option depends on the amount the entity can or must pay to repurchase the good. The likelihood of exercise is not considered in this assessment. The arrangement is accounted for as:

- a lease, if the repurchase price is less than the original sales price of the asset and, for U.S. GAAP reporters, the arrangement is not part of a sale-leaseback transaction (in which case the entity is the lessor); or
- a financing arrangement, if the repurchase price is equal to or more than the original sales price of that good (in which case the customer is providing financing to the entity).

An entity that enters into a financing arrangement continues to recognize the transferred asset and recognizes a financial liability for the consideration received from the customer. The entity recognizes any amounts that it will pay upon repurchase in excess of what it initially received as interest expense over the period between the initial agreement and the subsequent repurchase and, in some situations,

as processing or holding costs. The entity derecognizes the liability and recognizes revenue if it does not exercise a call option and it lapses.

The comparison of the repurchase price to the original sales price of the good should include the effect of the time value of money, including contracts with terms of less than one year. This is because the effects of time value of money could change the determination of whether the forward or call option is a lease or financing arrangement. For example, if an entity enters into an arrangement with a call option and the stated repurchase price, excluding the effects of the time value of money, is equal to or greater than the original sales price, the arrangement might be a financing arrangement. Including the effect of the time value of money might result in a repurchase price that is less than the original sale price, and the arrangement would be accounted for as a lease.

Example 8-10 illustrates the accounting for an arrangement that contains a call option.

EXAMPLE 8-10

Repurchase rights – call option accounted for as lease

Machine Co sells machinery to Manufacturer for \$200,000. The arrangement includes a call option that gives Machine Co the right to repurchase the machinery in five years for \$150,000. The arrangement is not part of a sale-leaseback (U.S. GAAP).

Should Machine Co account for this transaction as a lease or a financing transaction?

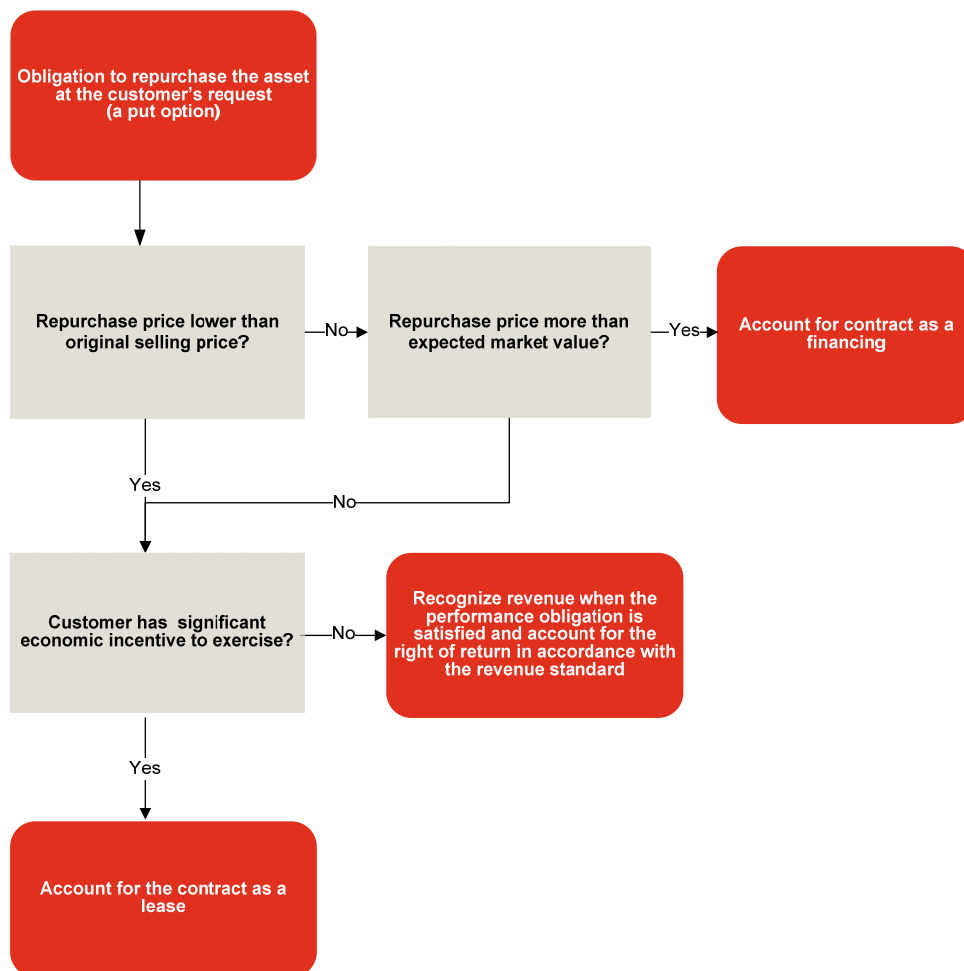
Analysis

Machine Co should account for the arrangement as a lease. The five-year call period indicates that the customer is limited in its ability to direct the use of or obtain substantially all of the remaining benefits from the machinery. Machine Co can repurchase the machinery for an amount less than the original selling price of the asset; therefore, the transaction is a lease. Machine Co would account for the arrangement in accordance with ASC 840, *Leases*, or IAS 17, *Leases*.

8.7.2 Put options

A put option allows a customer, at its discretion, to require the entity to repurchase a good and indicates that the customer has control over that good. The customer has the choice of retaining the item, selling it to a third party, or selling it back to the entity.

Figure 8-3
Accounting for put options



The accounting for an arrangement with a put option depends on the amount the entity must pay when the customer exercises the put option, and whether the customer has a significant economic incentive to exercise its right. An entity accounts for a put option as:

- a financing arrangement, if the repurchase price is equal to or more than the original sales price and more than the expected market value of the asset (in which case the customer is providing financing to the entity);
- a lease, if the repurchase price is less than the original sales price and the customer has a significant economic incentive to exercise that right and, for U.S. GAAP reporters, the arrangement is not part of a sale-leaseback transaction (in which case the entity is the lessor);
- a sale of a product with a right of return, if the repurchase price is less than the original sales price and the customer does not have a significant economic incentive to exercise its right; or

- a sale of a product with a right of return, if the repurchase price is equal to or more than the original sales price, but 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.

An entity that enters into a financing arrangement continues to recognize the transferred asset and recognize a financial liability for the consideration received from the customer. The entity recognizes any amounts that it will pay upon repurchase in excess of what it initially received as interest expense (over the term of the arrangement) and, in some situations, as processing or holding costs. An entity derecognizes the liability and recognizes revenue if the put option lapses unexercised.

Similar to forwards and calls, the comparison of the repurchase price to the original sales price of the good should include the effect of the time value of money, including the effect on contracts whose term is less than one year. The effect of the time value of money could change the determination of whether the put option is a lease or financing arrangement because it affects the amount of the repurchase price used in the comparison.

8.7.2.1 Significant economic incentive to exercise a put option

The accounting for certain put options requires management to assess at contract inception whether the customer has a significant economic incentive to exercise its right. A customer that has a significant economic incentive to exercise its right is effectively paying the entity for the right to use the good for a period of time, similar to a lease.

Management should consider various factors in its assessment, including the following:

- How the repurchase price compares to the expected market value of the good at the date of repurchase
- The amount of time until the right expires

A customer has a significant economic incentive to exercise a put option when the repurchase price is expected to significantly exceed the market value of the good at the time of repurchase.

The following examples illustrate the accounting for arrangements that contain a put option.

EXAMPLE 8-11

Repurchase rights – put option accounted for as a right of return

Machine Co sells machinery to Manufacturer for \$200,000. Manufacturer can require Machine Co to repurchase the machinery in five years for \$75,000. The market value of the machinery at the repurchase date is expected to be greater than \$75,000. Machine Co offers Manufacturer the put option because an overhaul is typically

required after five years. Machine Co can overhaul the equipment, sell the refurbished equipment to a customer, and receive a significant margin on the refurbished goods. Assume the time value of money would not affect the overall conclusion.

Should Machine Co account for this transaction as a sale with a return right, a lease, or a financing transaction?

Analysis

Machine Co should account for the arrangement as the sale of a product with a right of return. Manufacturer does not have a significant economic incentive to exercise its right since the repurchase price is less than the expected market value at date of repurchase. Machine Co should account for the transaction consistent with the model discussed in RR 8.2.

EXAMPLE 8-12

Repurchase rights – put option accounted for as lease

Machine Co sells machinery to Manufacturer for \$200,000 and stipulates that Manufacturer can request Machine Co to repurchase the machinery in five years for \$150,000. The repurchase price is expected to significantly exceed the market value at the date of the repurchase. Assume the time value of money would not affect the overall conclusion.

Should Manufacturer account for this transaction as a sale with a return right, a lease, or a financing transaction?

Analysis

Machine Co should account for the arrangement as a lease in accordance with ASC 840 or IAS 17. Manufacturer has a put option to resell the machinery to Machine Co and has a significant economic incentive to exercise this right, because the guarantee price significantly exceeds the expected market value at date of repurchase. Lease accounting is required given the repurchase price is less than the original selling sales price of the machinery.

Chapter 9:

Licenses

9.1 Chapter overview

A license arrangement establishes a customer's rights related to an entity's intellectual property ("IP") and the obligations of the entity to provide those rights. Licenses are common in the following industries:

- Technology – software and patents
- Entertainment and media – motion pictures, music, and copyrights
- Pharmaceuticals and life sciences – drug compounds, patents, and trademarks
- Retail and consumer – trade names and franchises

Licenses come in a variety of forms, and can be term-based or perpetual, as well as exclusive or nonexclusive. Consideration received for licenses can also vary significantly from fixed to variable and from upfront (or lump sum) to over time in installments.

Management should assess each arrangement where licenses are sold with other goods or services to conclude whether the license is distinct and therefore a separate performance obligation. Management will need to determine whether a license that is distinct provides *a right to access* IP or *a right to use* IP, since this will determine when revenue is recognized. Revenue recognition will also be affected if a license arrangement includes sales- or usage-based royalties.

9.2 Determining whether a license is distinct

Management should consider the guidance for identifying performance obligations to determine if a license is distinct when it is included in an arrangement with other goods or services. Refer to RR 3 for a discussion of identifying separate performance obligations. The accounting model discussed in this chapter only applies to distinct licenses. For licenses that are not distinct, an entity should combine the license with other goods and services in the contract and recognize revenue when (or as) it satisfies the combined, single performance obligation.

Licenses that are not distinct include:

Excerpt from ASC 606-10-55-56 and IFRS 15.B54

- a. A license that forms a component of a tangible good and that is integral to the functionality of the good.
- b. A license that the customer can benefit from only in conjunction with a related service (such as an online service provided by the entity that enables, by granting a license, the customer to access content).

The boards noted in the Basis for Conclusions to the revenue standard that even when a license is not distinct from other goods and services in the contract, the license could

be the primary or dominant component of the combined good or service transferred to the customer.

Excerpt from ASU 2014-09 BC407 and IFRS 15 BC407

The boards noted that in some cases the combined good or service transferred to the customer may have a license as its primary or dominant component. When the output that is transferred is a license or when the license is distinct, the entity applies the criteria [for determining the nature of the entity's promise in granting a license] to determine whether the promised license provides the customer with access to the entity's intellectual property or a right to use the entity's intellectual property.

Management should account for a bundle of goods or services that is a combined, single performance obligation as a license when the license is the primary or dominant component. In these situations, the criteria discussed in RR 9.3 should be used to determine whether the combined performance obligation containing the license is satisfied over time or at a point in time.

The following examples illustrate arrangements with licenses that are and are not distinct.

EXAMPLE 9-1

License that is not distinct

Biotech licenses IP to an early-stage drug compound to Pharma. Biotech also provides research and development ("R&D") services as part of the arrangement. Biotech is the only vendor able to provide the R&D services based on its specialized knowledge of the technology.

Is the license in this arrangement distinct?

Analysis

The license is not distinct because Pharma cannot benefit from the license on its own or with resources readily available to Pharma. This is because Pharma cannot perform the R&D services on its own or obtain them from another vendor. The license and the R&D services should be combined and accounted for as a single performance obligation.

Alternatively, if Pharma could perform the R&D services on its own or obtain them from another vendor, the license and R&D services could be distinct. Pharma would also need to consider in that situation whether the license is separately identifiable from the R&D services in the context of the contract to determine if the license and R&D services should be accounted for separately or together. For example, the license might not be separately identifiable from the R&D services if Pharma contracts with Biotech for a fully developed drug (the combined output of the license and R&D services), or the R&D services significantly modify the IP granted to Pharma. Management will need to apply judgment based on the specific facts and

circumstances. See RR 3.3.2 for further guidance on assessing whether a good or service is separable from other promises in a contract.

The revenue standard also includes Example 56, which illustrates an arrangement with a license and manufacturing services for additional illustrative purposes.

EXAMPLE 9-2

License that is distinct

SoftwareCo provides a perpetual software license to Engineer. SoftwareCo will also install the software as part of the arrangement. SoftwareCo offers the software license to its customers with or without installation services, and Engineer could select a different vendor for installation. The installation does not result in significant customization or modification of the software.

Is the license in this arrangement distinct?

Analysis

The software license is distinct because Engineer can benefit from the license on its own, and the license is separable from other promises in the contract. This conclusion is supported by the fact that SoftwareCo licenses the software separately (without installation services) and other vendors are able to install the software. The license is separately identifiable because the installation services do not significantly modify the software. The license is therefore a separate performance obligation that should be accounted for in accordance with the guidance in RR 9.3.

9.3 Nature of the license

Rights provided through licenses of IP can vary significantly due to the different features and underlying economic characteristics of licensing arrangements. Recognition of revenue in arrangements with a distinct license differs depending on the nature of the license. The revenue standard identifies two types of distinct licenses.

Excerpt from ASC 606-10-55-58 and IFRS 15.B56

- a. A right to access the entity's intellectual property as it exists throughout the license period
- b. A right to use the entity's intellectual property as it exists at the point in time at which the license is granted.

Licenses that provide access to an entity's IP are performance obligations satisfied over time, and therefore revenue is recognized over time once the license period begins. Licenses that provide a right to use an entity's IP are performance obligations satisfied at the point in time when the customer can first use the IP. Revenue cannot be recognized in either case before the beginning of the period the customer is able to

use and benefit from the license. This is typically the beginning of the stated license period, assuming the customer has the ability to access the IP at that time.

9.3.1 Licenses that provide access to an entity's IP

The IP to which a customer has rights in a licensing arrangement can change over time as a result of an entity's continuing involvement with and ongoing activities that affect its IP. A license of IP that changes over time as a result of an entity's activities likely provides a customer (the licensee) access to the IP as it exists throughout the arrangement. This is because the customer is not able to direct the use of and obtain substantially all of the remaining benefits from the license when it initially transfers. Rather, the benefit is consumed as the entity provides access to the IP over the license period. This can be the case even where the right granted by the license is unchanged (for example, the right to use a brand name), but its value to the customer is affected by an entity's activities during the license period, as explained in RR 9.3.1.2.

Licenses that meet all of the following criteria provide access to an entity's IP.

Excerpt from ASC 606-10-55-60 and IFRS 15.B58

- a. The contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights.
- b. The rights granted by the license directly expose the customer to any positive or negative effects of the entity's activities identified in [the] paragraph [above].
- c. Those activities do not result in the transfer of a good or a service to the customer as those activities occur.

Revenue allocated to licenses that provide access to an entity's IP should be recognized over time as the customer is simultaneously receiving and consuming the benefit over the period it has access to the IP. Once management determines that revenue should be recognized over time, it must determine the most appropriate measure of progress. A straight-line approach may often be an appropriate method for recognizing revenue because the benefit to the customer often transfers ratably throughout a license period. There might be circumstances where the IP or the related activities indicate that another method of progress better reflects the transfer to the customer. Refer to RR 6 for discussion of measures of progress.

9.3.1.1 The licensor will undertake activities that significantly affect the IP

The first criterion requires an assessment of whether the licensor will undertake activities that significantly affect the IP to which the customer has rights, but that are not otherwise performance obligations. These activities could be specified in the contract, or they could be expected by the customer based on the entity's published policies or customary business practices. The types of activities that significantly affect the IP will vary depending on the nature of the IP itself. "Activities" could include

marketing activities, further development of the IP, or simply the licensor's ordinary business activities that either positively or negatively affect the IP.

For example, if a popular sporting goods entity licenses the rights to a retailer to use the entity's logo on t-shirts, the retailer will typically expect that the entity will continue to undertake activities such as protecting and promoting the entity's brand and image through advertising and association with quality sporting. Similarly, a franchisor may grant a franchise license to a restaurant where the franchisor will continue to perform activities such as marketing to enhance customer awareness, and research and development to continue to develop food product offerings.

The existence of a shared economic interest between the entity and customer relating to the license could also indicate that the entity will undertake activities that significantly affect the license. Determining whether a shared economic interest exists may require judgment.

The revenue standard does not define "significantly affect," so judgment will be required in making this determination. Judgment could also be needed to distinguish between activities that do and do not represent additional performance obligations. An "activity" for purposes of this assessment is not a performance obligation and does not represent a promise to transfer a good or service to the customer.

9.3.1.2 *The rights granted directly expose the customer to the effects of the above activities*

The second criterion requires that the effects, either positive or negative, of any activities identified in the first criterion affect the customer (licensee). Activities that do not affect what the license provides to the customer, or what the customer controls, do not meet this criterion. An entity is only changing its own asset if its activities do not affect the customer; therefore, the rights that the license provides are not affected.

For example, a customer may have the right to use a university's logo on apparel. The university performs activities such as research, selective admissions, and athletics that affect its public reputation and hence the value of the IP, and the customer is directly exposed to those effects.

9.3.1.3 *The licensor's activities do not otherwise transfer a good or service*

The third criterion requires that the activities that might affect the IP are not additional performance obligations in the contract. The assessment of whether a license provides a right to use or a right to access IP is performed only for distinct licenses; therefore, the assessment is not affected by other goods or services promised in the arrangement (that is, other performance obligations).

Judgment could be required to determine whether an activity undertaken by a licensor is a separate performance obligation. IP might be significantly affected by activities undertaken by the licensor. However, this criterion would not be satisfied if those activities provide a distinct good or service to the customer.

The following is an example of a license that provides a right to access IP.

EXAMPLE 9-3

License that provides a right to access IP

CartoonCo is the creator of a new animated television show. It grants a three-year license to Retailer for use of the characters on consumer products. Retailer is required to use the latest image of the characters from the television show. There are no other goods or services provided to Retailer in the arrangement. When entering into the license agreement, Retailer reasonably expects CartoonCo will continue to produce the show, develop the characters, and perform marketing to enhance awareness of the characters. Retailer may start selling consumer products with the characters once the show first airs on television.

What is the nature of the license in this arrangement?

Analysis

The license provides access to CartoonCo's IP and CartoonCo will therefore recognize revenue over time. CartoonCo's continued production and marketing of the show, and development of the characters, indicates that CartoonCo will undertake activities that significantly affect the IP (the character images). Retailer is directly exposed to any positive or negative effects of CartoonCo's activities, as Retailer must use the latest images that could be more or less positively received by the public as a result of CartoonCo's activities. These activities are not separate performance obligations because they do not transfer a good or service to Retailer separate from the license. Revenue recognition will commence when the show first airs because this is when the customer is able to benefit from the license.

9.3.1.4 ***Factors that do not impact the nature of the license***

Many contracts include specifications or restrictions on the license that do not impact the nature of the license. The following provisions should not be considered when assessing the nature of the license provided.

Excerpt from ASC 606-10-55-64 and IFRS 15.B62

- a. Restrictions of time, geographical region, or use...
- b. Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorized use...

For example, a television broadcaster may license the rights to show a particular movie for a limited number of showings in a specified period, or a pharmaceutical entity may license the marketing rights for a drug in a particular jurisdiction. These types of restrictions relate to the characteristics of a license granted rather than the timing of when the performance obligation is satisfied. Nor do the restrictions represent ongoing activities of the licensor that significantly affect the form and function of the IP. Therefore, they do not affect the nature of the license.

The license period does not affect whether revenue is recognized at a point in time or over time. Both perpetual and term licenses must be assessed to determine if they provide access to an entity's IP or a right to use an entity's IP. The criteria specified in the revenue standard do not take into account the term of the license. An entity should recognize revenue at the point in time when control transfers (and the license period begins) if a perpetual or term license provides a right to use the entity's IP (refer to RR 9.3.2).

Guarantees to defend a patent are also disregarded in the assessment of the nature of a license. Maintaining a valid patent and defending that patent from unauthorized use are important aspects in supporting an entity's IP. However, the guarantee to do so is not a performance obligation or an activity for purposes of assessing the nature of a license. Rather, it represents assurance that the customer is utilizing a license with the contractually agreed-upon specifications.

9.3.2 Licenses that provide a right to use an entity's IP

Licenses that do not meet all three criteria to be accounted for as a right to access IP are accounted for as a right to use IP. Revenue is recognized in those circumstances at a point in time, because the customer is able to direct the use of and obtain substantially all of the benefits from the license at the time that control of the license is transferred to the licensee. The following is an example of a license that provides a right to use IP.

EXAMPLE 9-4

License that provides a right to use IP

SoftwareCo provides a fixed-term software license to TechCo. The terms of the arrangement allow TechCo to download the software by using a unique digital key provided by SoftwareCo. TechCo can use the software on its own server. The software is functional when it transfers to TechCo. TechCo also purchases post-contract customer support (PCS) with the software license. There is no expectation for SoftwareCo to undertake any activities other than the PCS. The license and PCS are distinct as TechCo can benefit from the license on its own and the license is separable from the PCS.

What is the nature of the license in this arrangement?

Analysis

The license provides a right to use the IP (software). SoftwareCo will recognize revenue at a point in time when TechCo is able to use and benefit from the license (when SoftwareCo provides the digital key and the license term begins). PCS is a performance obligation in this arrangement and is not considered an activity. SoftwareCo is not expected to perform any other activities that affect the IP; therefore, the three criteria required for a right to access IP over time are not met.

9.3.3 *Licenses and payment terms*

Licenses are often long-term arrangements, and payment schedules between a licensee and licensor may not coincide with the pattern of revenue recognition. Payments made over a period do not necessarily indicate that the license provides a right to access the IP.

Management will need to consider whether a significant financing component exists when the time between recognition of revenue and cash receipt (other than sales- or usage-based royalties) is expected to exceed one year. For example, consider a license that provides a right to use IP for which revenue is recognized when control transfers to the licensee, but payment for the license is made over a five-year period. Management needs to consider whether the intent of the installment payments is to provide a financing, and therefore whether a significant financing component exists. See RR 4.4 for further discussion of accounting for a significant financing component.

9.4 *Exception for licenses of IP with sales- or usage-based royalties*

The revenue standard includes an exception for the recognition of revenue relating to licenses of IP with sales- or usage-based royalties. Consideration from a license of IP that is based on future sales or usages by the customer is included in the transaction price when the subsequent sales or usages occur. Revenue is recognized at the later of when the performance obligation is satisfied or when the sales or usages occur. This exception applies to both licenses that provide access to an entity's IP and licenses that provide a right to use an entity's IP.

This exception is intended to be narrowly applied, as it only relates to licenses of IP. The exception cannot be applied to other situations by analogy, as it is an exception to the principle for recognizing variable consideration. Additionally, it cannot be applied to outright sales of IP, as sales do not qualify for the exception.

Distinguishing between a license of IP and a sale of IP will be important because entities that sell, rather than license, IP will not be able to use the exception for excluding sales- and usage-based royalties from the transaction price. These entities instead need to apply the guidance for recognizing variable consideration (refer to RR 4.3). Management will need to consider whether to recognize a minimum amount of royalty revenue when IP is sold if it is probable (U.S. GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue will not occur, and update this estimate each reporting period.

There are certain fact patterns involving a sales- or usage-based royalty that are not specifically addressed by the revenue standard. Management will need to apply judgment in these situations and use an approach that is consistent with the guidance in the revenue standard and appropriately reflects the economics of the specific transaction.

For example, the revenue standard does not explain whether the exception applies to arrangements in which the royalty relates to both the license and other promises in

the arrangement. There may be situations, such as in the pharmaceutical and life sciences industry, where a license is distinct from other promises in the contract, but the royalties apply to both the license and the other performance obligations. It is not clear in these situations whether the entity should allocate a portion of the royalty to the license (subject to the exception) and a portion to the other performance obligations (not subject to the exception), or whether the exception does not apply to the arrangement as a whole.

Judgment will be needed to determine how or whether the exception applies in situations where a license is bundled with other goods or services because the license is not distinct.

Management will need to consider the nature of any variable consideration to determine if, in substance, the variable consideration is a sales- or usage-based royalty. An example is an arrangement that requires a licensee to make a fixed payment that is subject to “claw back” if the licensee does not meet certain sales or usage targets.

Chapter 10:

Principal versus agent considerations

10.1 Chapter overview

Arrangements often involve two or more unrelated parties that contribute to providing a good or service to a customer. It might not be clear which party has promised to fulfill the obligations to the customer in the arrangement in some situations.

Management needs to determine whether the nature of its promise is to provide goods and services to a customer (that is, it is the principal in the arrangement) or to arrange for another party to provide the goods and services (that is, it is an agent for the other party). This determination requires judgment in some circumstances, and different conclusions can result in significantly different amounts and timing of revenue recognition.

This chapter discusses principal versus agent considerations and related practical application issues, including accounting for shipping and handling fees, out-of-pocket reimbursements, and amounts collected from a customer to be remitted to a third party.

Entities that issue “points” under customer loyalty programs that are satisfied by other parties also need to assess whether they are the principal or an agent for transfer and redemption of the points. Refer to RR 7.2.3 for further discussion of the accounting for customer loyalty points.

10.2 Assessing whether an entity is the principal or an agent

The principal is the entity that has promised to provide goods or services to its customers. An agent arranges for goods or services to be provided by the principal to an end customer. An agent normally receives a commission or fee for these activities. An agent will, in some cases, deduct the amount it is owed from the gross consideration received from the end customer and remit a net amount to the principal.

Management must consider who is the entity’s customer, what it has promised to its customer, and if it has control of the promised good or service before control transfers to the customer to determine whether it is the principal or the agent in an arrangement. An entity is the principal in a transaction if it obtains control of the goods or services of another party before it transfers control of those goods or services to the customer. The control needs to be substantive. For example, obtaining legal title of a product only momentarily before it is transferred to the customer does not necessarily indicate that the entity is the principal. The revenue standard provides indicators to help with this assessment.

The assessment of whether an entity is the principal or an agent can be challenging in some situations, and require a careful analysis of the facts and circumstances. Examples of arrangements that frequently require this assessment include internet and catalog sales (where the entity does not hold inventory and arranges for another party to ship the merchandise), sales of virtual goods (such as those sold in a video

game), consignment sales, travel and ticket agency sales, sales where subcontractors are used to fulfill some or all of the contractual obligations, and services provided by a third-party service provider.

10.2.1 Accounting implications

The difference in the amount and timing of revenue recognized can be significant depending on the conclusion of whether an entity is the principal in a transaction or an agent. This conclusion determines whether the entity recognizes revenue on a “gross” or “net” basis.

The principal recognizes as revenue the “gross” amount paid by the customer for the good or service. The principal records a corresponding expense for the commission or fee it has to pay any agent in addition to the direct costs of satisfying the contract.

An agent records as revenue the commission or fee earned for facilitating the transfer of goods or services (the “net” amount retained). In other words, it records as revenue the net consideration it retains after paying the principal for the goods or services that were provided to the customer.

The timing of revenue recognition can also differ depending on whether the entity is the principal or an agent. Once an entity identifies its promises in a contract and determines whether it is a principal or an agent for those promises, it recognizes revenue when the performance obligations are satisfied. An agent might satisfy its performance obligation (facilitating the transfer of goods or services) before the end customer receives the good or service from the principal in some situations.

10.2.2 Indicators that an entity is an agent

Identifying an entity’s promise (that is, its performance obligation) in the contract is fundamental to determining if the entity is the principal or an agent. Management must understand the nature of the entity’s promise to determine whether the entity controls the goods or services it has promised before they are transferred to the customer. It is not always clear what the entity has promised and whether it has obtained control of the goods or services in a multi-party contract. The revenue standard provides indicators to help entities determine if they obtain control of the goods or services before transferring control of those goods or services to the customer.

ASC 606-10-55-39 and IFRS 15.B37

Indicators that an entity is an agent (and therefore does not control the good or service before it is provided to a customer) include the following:

- a. Another party is primarily responsible for fulfilling the contract.
- b. The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping, or on return.

- c. The entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited.
- d. The entity's consideration is in the form of a commission. [and [IFRS]]
- e. The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

Determining whether an entity is the principal or an agent is not a policy choice. Management needs to apply judgment when assessing the indicators to determine the appropriate accounting for a particular arrangement.

No single indicator is determinative or weighted more heavily than other indicators, although some indicators may provide stronger evidence than others, depending on the circumstances. Physical receipt of cash on a net or gross basis, however, is not an indicator of which party is the principal in an arrangement.

10.2.2.1 *Primary responsibility for fulfilling the contract*

The terms of the agreement and other information communicated to the customer (for example, marketing materials) often provide evidence of which party is primarily responsible for fulfilling the obligations in the contract. Management should consider who the customer views as primarily responsible for fulfilling the contract, including which entity will be providing customer support, resolving customer complaints, and accepting responsibility for the quality or suitability of the product or service.

The fact that customers may complain to a party and seek its help does not necessarily indicate that party is the principal. An agent might facilitate responding to customer complaints in some situations. For example, a customer might call a travel agent to complain about poor service provided by a hotel booked by the agent; however, the underlying responsibility remains with the hotel.

10.2.2.2 *Inventory risk*

Inventory risk exists when the entity bears the risk of loss due to factors such as physical damage, decline in value, or obsolescence either before or during shipment, or when the product is returned. An entity's risk is reduced if it has the ability to return unsold products to the supplier. Noncancellable purchase commitments may expose an entity to inventory risk if the entity bears the risk of being able to monetize the inventory.

Inventory risk might exist even if no physical product is sold. For example, an entity might have inventory risk in a service arrangement if it is required to pay the service provider even if the customer cancels or refuses to accept the service.

Taking physical possession of a product and bearing risk of loss for a period of time does not, on its own, result in an entity being the principal. The entity needs to have control of the product to be the principal. For example, an entity might hire a third-

party shipping provider to deliver its product to a customer. The shipping provider takes responsibility for any damage to the goods during delivery, but does not take other risks associated with inventory such as obsolescence risk, return risk, and valuation risk. The fact that the shipping provider has physical possession of the goods and takes responsibility for damage during shipping does not necessarily indicate the shipping provider is the principal for the sale of the goods, but it may be an indicator that it is the principal for the shipping service.

10.2.2.3 Discretion in establishing pricing

The purpose of this indicator is to assess whether the benefit the entity can receive from the transaction is limited due to the entity's lack of discretion in establishing pricing. Management must assess the benefit the entity can receive as a result of the arrangement. Earning a fixed percentage of the consideration for each sale might indicate that an entity is an agent, as a fixed percentage limits the benefit an entity can receive from the transaction.

Sometimes, an entity allows another entity (such as a reseller) to sell its product or services for a range of prices instead of a single set price. The reseller has some ability to set prices (within the range), but this does not necessarily indicate that the reseller is the principal in the transaction with the end customer. If the range of prices that an intermediary can charge is narrow, this could indicate that the intermediary is an agent because the benefit it can derive from selling the goods or services is limited. An intermediary having complete discretion over what price it charges end customers for a good could indicate that it is the principal for the sale of the good to the end customer. Where the range of prices that the intermediary charges is so broad that an entity cannot make a reasonable estimate of the price charged by the intermediary to the end customers, the entity may need to reconsider its determination that it is the principal in the sale to the end customer, taking into account all of the indicators, some of which could still support a conclusion that the entity is the principal.

Having limited visibility into the pricing charged to the end customer does not, by itself, indicate that an entity is not the principal in a transaction. An example of an arrangement where an entity might not have full visibility into the amount charged to an end customer is a video game developer. Large internet-based platforms often offer credits to incentivize customers to download games from their platforms, even though they are an agent acting on behalf of the developer to distribute its game. The video game developer may not have full visibility into credits issued by a platform to a customer, which could make it challenging to determine the consideration paid by the customer if the games are not offered at publicly available prices.

A similar situation exists where an entity sets the price at which its agent can purchase its goods. The agent then has some flexibility in the amount it charges when it sells the product or services to the end customer. The ability to determine the price charged to the end customer, by itself, does not indicate that an entity is a principal in the sale to the end customer. Management needs to consider all of the facts of each arrangement and analyze the indicators based on those facts.

10.2.2.4 Form of consideration

Similar to the pricing indicator, an entity that receives a commission (either a fixed amount or a fixed percentage of the sales price) may be an agent. Earning a fixed percentage margin does not always indicate that an entity is an agent. For example, an entity might enter into a contract with a fee that is based on cost plus a fixed margin percentage, but still be the principal in the arrangement because it controls the goods or services before control transfers to the customer.

10.2.2.5 Credit risk

Credit risk exists if an entity bears the risk of loss upon customer default, or if it must pay a supplier regardless of whether payment is collected from the customer. Management should consider other indicators when none of the parties to the arrangement has credit risk or credit risk is substantially mitigated. Credit risk does not exist if payment is received prior to shipping a product or providing a service. Credit risk is substantially mitigated if a customer pays by credit card and the entity obtains preauthorization for the charge.

10.2.3 Examples of assessing the principal versus agent indicators

The following examples illustrate analysis of the principal versus agent indicators.

EXAMPLE 10-1

Principal versus agent – online retailer

WebCo operates a website selling used books. WebCo enters into a contract with Bookstore, a used bookshop, to sell books sold by Bookstore. The terms and conditions of the contract include:

- ☐ WebCo will transport the books sold to the end customer
- ☐ WebCo does not take possession of the books sold to the customers; however, the customer returns the books back to WebCo if they are dissatisfied
- ☐ WebCo has the right to return books to Bookstore without penalty if they are returned by the customer
- ☐ WebCo will invoice the customer for the sale
- ☐ WebCo earns a fixed margin on the books sold, and has no flexibility in establishing the sales price of the book
- ☐ Bookstore retains credit risk for sales to the customer

Should WebCo recognize revenue on the transfer of the books to the customer on a gross or net basis?

Analysis

WebCo should recognize commission revenue for the sales made on Bookstore's behalf; that is, it should recognize revenue on a net basis. WebCo does not control the books prior to sale to the customer based on its assessment of the indicators, as follows:

- Fulfillment: Bookstore is responsible for providing the books to the end customer.
- Inventory risk: Bookstore bears the inventory risk.
- Pricing: WebCo does not have discretion in establishing prices for the books. Bookstore sets the sales price.
- Form of consideration: WebCo earns a fixed commission on each book sold.
- Credit risk: Bookstore retains all credit risk.

The majority of the indicators point to WebCo not obtaining control of the books, and therefore being the agent for Bookstore in the arrangement.

EXAMPLE 10-2**Principal versus agent – travel agency**

TravelCo negotiates with major airlines to obtain access to airline tickets at reduced rates and sells the tickets to its customers through its website. TravelCo contracts with the airlines to buy a specific number of tickets at agreed-upon rates and must pay for those tickets regardless of whether it is able to resell them. Customers visiting TravelCo's website search TravelCo's inventory of tickets and TravelCo has latitude to set the prices for the tickets it sells to its customers.

Customers pay for airline tickets using credit cards, and TravelCo is the merchant of record. Credit card charges are preauthorized; however, TravelCo incurs occasional losses as a result of disputed charges.

TravelCo is responsible for delivering the ticket to the customer. TravelCo will also assist the customer in resolving complaints with the service provided by the airlines. The airline is responsible for fulfilling all other obligations associated with the ticket, including the air travel and related services (that is, the flight), and remedies for service dissatisfaction.

Should TravelCo recognize revenue for the fee charged to customers on a gross basis or net of the amounts paid to the airlines?

Analysis

TravelCo should recognize revenue for the gross fee charged to customers. The preponderance of evidence indicates that TravelCo's performance obligation is providing the customer with a ticket that provides the right to fly on the selected flight (or another flight if the selected one is changed or cancelled). TravelCo is therefore the

principal in this example. TravelCo takes control of the right to the flight and delivers those rights to the customer at the time of sale. The analysis of the indicators is as follows:

- **Fulfillment:** Another party is *not* responsible for fulfilling the contract. TravelCo is responsible for fulfilling its performance obligation, which is providing the right to fly (that is, the ticket). The airline is, however, responsible for providing the flight itself.
- **Inventory risk:** TravelCo holds inventory risk for the tickets as it purchases the tickets in advance and is exposed to any loss if it cannot sell the tickets for more than its purchase price.
- **Pricing:** TravelCo has discretion in setting prices for the tickets (that is, it could choose to accept a loss on the sale of the ticket if necessary to recover some of its costs).
- **Form of consideration:** TravelCo does not earn a set commission, but rather sells the tickets to its customer at an amount it is willing to sell them for.
- **Credit risk:** TravelCo has credit risk for the amount charged to customers (although partially mitigated because credit card payments are preauthorized).

TravelCo is the principal in this transaction; however, changing just a few facts could result in a different answer.

10.3 *Shipping and handling fees*

Entities that sell products often deliver them via third-party shipping service providers. Entities sometimes charge customers a separate fee for shipping and handling costs, or shipping and handling might be included in the price of the product. Separate fees may be a direct reimbursement of costs paid to the third-party, or they could include a profit element.

Management needs to consider whether the entity is the principal for the shipping service or is an agent arranging for the shipping service to be provided to the customer when control of the goods transfers at shipping point. Management could conclude that the entity is the principal for both the sale of the goods and the shipping service, or that it is the principal for the sale of the goods, but an agent for the service of shipping those goods. All relevant facts and circumstances should be considered, as illustrated in the following example.

EXAMPLE 10-3

Principal versus agent – shipping and handling fees

ToyCo operates retail stores and a website where customers can purchase toys. Customers that make online purchases can choose to pick their order up at the retail store for no additional cost or have the order delivered to their home for a fee. Toys

can be delivered via standard delivery or overnight delivery with a specified delivery company. The customer is charged for the cost of the delivery (as established by the delivery company) and given a tracking number so it can track the status of the delivery and contact the delivery company with any questions or concerns. Risk of loss transfers once the order leaves the warehouse. All online orders must be paid by credit card.

Should ToyCo recognize the shipping fees it charges to its customers gross (as revenue and expense) or net of the amount paid to the shipping provider?

Analysis

ToyCo should not recognize revenue for the shipping fees charged to the customers. ToyCo is an agent for the delivery company as it is merely arranging the shipping services on behalf of its customer and does not control the shipping service. The indicators that ToyCo is an agent are:

- **Fulfillment:** The delivery company is responsible for shipping the toys.
- **Inventory risk:** ToyCo has no inventory risk during shipping. The delivery company takes inventory risk during shipping.
- **Pricing:** ToyCo does not have discretion in setting shipping prices. The shipping prices are set by the delivery company.
- **Form of consideration:** ToyCo charges the customer the rate specified by the delivery company, therefore this indicator is not applicable.
- **Credit risk:** Since all online orders must be paid by a credit card, credit risk is substantially mitigated.

10.4 Out-of-pocket reimbursements

Expenses are often incurred by service providers while performing work for their customers. These can include costs for travel, meals, accommodations, and miscellaneous supplies. It is common in service arrangements for the parties to agree that the customer will reimburse the service provider for some or all of the out-of-pocket costs. Alternatively, such expenses may be incorporated into the price of the service instead of being charged separately.

Management needs to assess whether the entity should record the reimbursement as revenue or as a reduction of the associated costs. An entity records the gross amount of the reimbursement when it is the principal, or at the net amount retained when it is an agent. Out-of-pocket reimbursements should be evaluated considering the

principal versus agent indicators discussed above. Some of factors that might be considered include:

- Which party has discretion in selecting the third-party vendor
- Which party takes inventory risk (although this indicator might not be applicable in many situations)
- Which party works with the third party in negotiating prices
- Which party is primarily responsible for paying the third-party vendor

Determining whether an entity is the principal or an agent in these arrangements could require judgment.

10.5 Amounts collected from customers and remitted to a third party

Entities often collect amounts from customers that must be remitted to a third party (for example, collecting and remitting taxes to a governmental agency). Taxes collected from customers could include sales, use, value-added, and some excise taxes. Amounts collected on behalf of third parties, such as certain sales taxes, are not included in the transaction price as they are collected from the customer on behalf of the government. The entity is the agent for the government in these situations.

Taxes that are based on production, rather than sales, are typically imposed on the seller, not the customer. An entity that is obligated to pay taxes based on their production are the principal for those taxes, and therefore recognizes the tax as an operating expense, with no effect on revenue.

Management needs to assess each type of tax, on a jurisdiction-by-jurisdiction basis, to conclude whether to net these amounts against revenue or to recognize them as an operating expense. The intent of the tax, as written into the tax legislation in the particular jurisdiction, should also be considered.

The name of the tax (for example, sales tax or excise tax) is not always determinative when assessing whether the entity is the principal or the agent for the tax. Whether or not the customer knows the amount of tax also does not necessarily impact the analysis. Management needs to look to the underlying characteristics of the tax and the tax laws in the relevant jurisdiction to determine whether the entity is primarily obligated to pay the tax or whether the tax is levied on the customer. This could be a significant undertaking for some entities, particularly those that operate in numerous jurisdictions with different tax regimes.

Chapter 11:

Contract costs

11.1 Chapter overview

Entities sometimes incur costs to obtain a contract that otherwise would not have been incurred. Entities also may incur costs to fulfill a contract before a good or service is provided to a customer. The revenue standard provides guidance on costs to obtain and fulfill a contract that should be recognized as assets. Costs that are recognized as assets are amortized over the period that the related goods or services transfer to the customer, and are periodically reviewed for impairment.

11.2 Incremental costs of obtaining a contract

Entities sometimes incur costs to obtain a contract with a customer, such as selling and marketing costs, bid and proposal costs, sales commissions, and legal fees.

Excerpt from ASC 340-40-25-1 and IFRS 15.91

An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

Only incremental costs should be recognized as assets. Incremental costs of obtaining a contract are those costs that the entity would not have incurred if the contract had not been obtained (for example, sales commissions). Bid, proposal, and selling and marketing costs (including advertising costs) are not incremental, as the entity would have incurred those costs even if it did not obtain the contract. Fixed salaries of employees are also not incremental because those salaries are paid regardless of whether a sale is made.

Costs of obtaining a contract that are not incremental should be expensed as incurred unless those costs are explicitly chargeable to the customer, even if the contract is not obtained. Amounts incurred that are explicitly chargeable to a customer are a receivable if an entity's right to reimbursement is unconditional.

Incremental costs of obtaining a contract with a customer are recognized as assets if they are recoverable. Expensing these costs as they are incurred is not permitted unless they qualify for the practical expedient discussed at RR 11.2.2.

Contract cost assets are amortized on a systematic basis consistent with the expected pattern of transfer of the related goods or services under the contract. See RR 11.4 for additional discussion of amortization.

11.2.1 Assessing recoverability

Management should assess recoverability of the incremental costs of obtaining a contract either on a contract-by-contract basis, or for a group of contracts if those costs are associated with the group of contracts. Management may be able to support the recoverability of costs for a particular contract based on its experience with other transactions if those transactions are similar in nature.

Management should evaluate various factors to support recoverability, including potential renewals or follow on contracts. Variable consideration that is constrained for revenue recognition purposes should also be included in assessing recoverability. Costs that are expected not to be recoverable, after considering these factors, should be expensed as incurred.

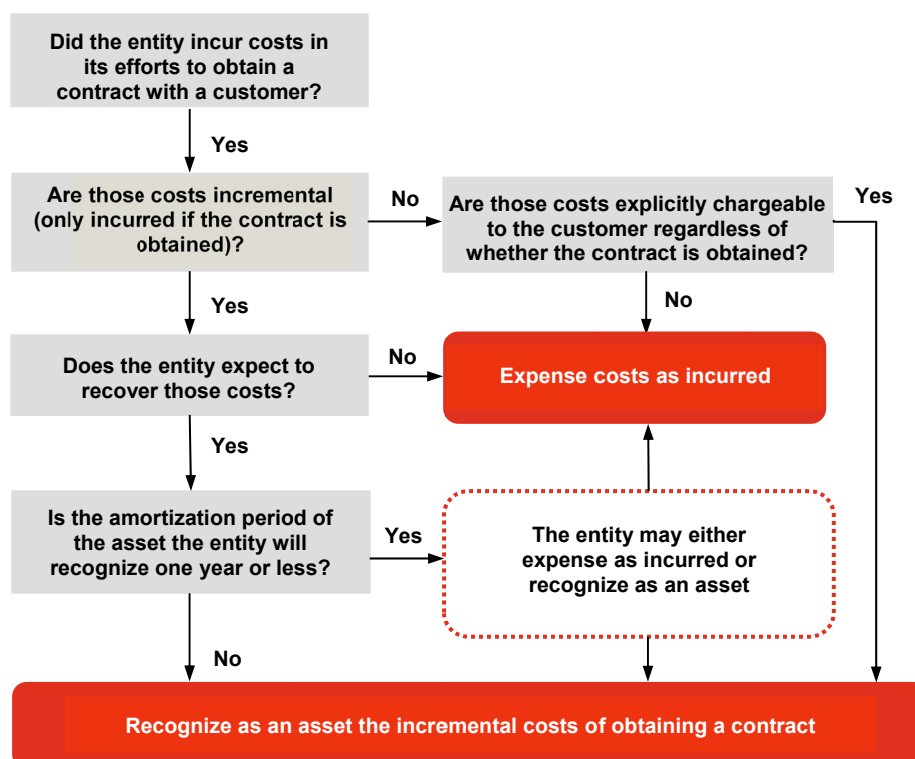
11.2.2 *Practical expedient*

There is a practical expedient that permits an entity to expense the costs to obtain a contract as incurred when the expected amortization period is one year or less. Anticipated contract renewals, amendments, and follow-on contracts with the same customer must be considered when determining whether the period of benefit, and therefore the period of amortization, is one year or less. These factors might result in an amortization period that is beyond one year, in which case the practical expedient is not available.

11.2.3 *Recognition model overview and examples*

The following figure summarizes the accounting for incremental costs to obtain a contract.

Figure 11-1
Costs to obtain a contract overview



The following are examples of applying this model.

EXAMPLE 11-1**Incremental costs of obtaining a contract – sales commission**

A salesperson for ProductCo earns a 5% commission on a contract that was signed in January. ProductCo will deliver the purchased products throughout the year. The contract is not expected to be renewed the following year. ProductCo expects to recover this cost.

How should ProductCo account for the commission?

Analysis

ProductCo can either recognize the commission payment as an asset or expense the cost as incurred under the practical expedient. The commission is a cost to obtain a contract that would not have been incurred had the contract not been obtained. Since ProductCo expects to recover this cost, it can recognize the cost as an asset and amortize it as revenue is recognized during the year. The commission payment can also be expensed as incurred because the amortization period of the asset is one year or less.

The practical expedient would not be available; however, if management expects the contract to be renewed such that products will be delivered over a period longer than one year, as the amortization period of the asset would also be longer than one year.

EXAMPLE 11-2**Incremental costs of obtaining a contract – construction industry**

ConstructionCo incurs costs in connection with winning a successful bid on a contract to build a bridge. The costs were incurred during the proposal and contract negotiations, and include the initial bridge design.

How should ConstructionCo account for the costs?

Analysis

ConstructionCo should expense the costs incurred during the proposal and contract negotiations as incurred. The costs are not incremental because they would have been incurred even if the contract was not obtained. The costs incurred during contract negotiations could be recognized as an asset if they are explicitly chargeable to the customer regardless of whether the contract is obtained.

Even though the costs incurred for the initial design of the bridge are not incremental costs to obtain a contract, some of the costs might be costs to fulfill a contract and recognized as an asset under that guidance (refer to RR 11.3).

EXAMPLE 11-3**Incremental costs of obtaining a contract – telecommunications industry**

Telecom sells wireless mobile phone and other telecom service plans from a retail store. Sales agents employed at the store signed 120 customers to two-year service contracts in a particular month. Telecom pays its sales agents commissions for the sale of service contracts in addition to their salaries. Salaries paid to sales agents during the month were \$12,000, and commissions paid were \$2,400. The retail store also incurred \$2,000 in advertising costs during the month.

How should Telecom account for the costs?

Analysis

The only costs that qualify as incremental costs of obtaining a contract are the commissions paid to the sales agents. The commissions are costs to obtain a contract that Telecom would not have incurred if it had not obtained the contracts. Telecom should record an asset for the costs, assuming they are recoverable.

All other costs are expensed as incurred. The sales agents' salaries and the advertising expenses are expenses Telecom would have incurred whether or not it obtained the customer contracts.

11.3 Costs to fulfill a contract

Entities often incur costs to fulfill their obligations under a contract once it is obtained, but before transferring goods or services to the customer. Some costs could also be incurred in anticipation of winning a contract. Management must first determine whether the accounting for costs is addressed by other standards and if so, apply that guidance. Costs that are required to be expensed in accordance with other standards cannot be recognized as an asset under the revenue standard. Fulfillment costs not addressed by other standards qualify for capitalization if the following criteria are met.

Excerpt from ASC 340-40-25-5 and IFRS 15.95

- a. The costs relate directly to a contract or an anticipated contract that the entity can specifically identify (for example, services to be provided under the renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved);
- b. The costs generate or enhance resources of the entity that will be used in satisfying or continuing to satisfy future performance obligations; and
- c. The costs are expected to be recovered.

Fulfillment costs that meet all three of the above criteria must be recognized as an asset; expensing the costs as they are incurred is not permitted.

Costs that relate directly to a contract include the following.

Excerpt from ASC 340-40-25-7 and IFRS 15.97

- a. Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer)
- b. Direct materials (for example, supplies and wages of employees who provide the promised services to a customer)
- c. Allocation of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract)
- d. Costs that are explicitly chargeable to the customer under the contract [and [IFRS]]
- e. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

Judgment is needed to determine the costs that should be recognized as assets in some situations. Some of the costs listed above (for example, direct labor and materials) are straightforward and easy to identify. However, determining costs that should be allocated to a contract could be more challenging.

Certain costs might relate directly to a contract, but neither generate nor enhance resources of an entity, nor relate to the satisfaction of future performance obligations.

Excerpt from ASC 340-40-25-8 and IFRS 15.98

An entity shall recognize the following costs as expenses when incurred:

- a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract...)
- b. Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract
- c. Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)
- d. Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

It can be difficult in some situations to determine whether incurred costs relate to satisfied performance obligations or to obligations still remaining. Costs that relate to satisfied or partially satisfied performance obligations are expensed as incurred. This

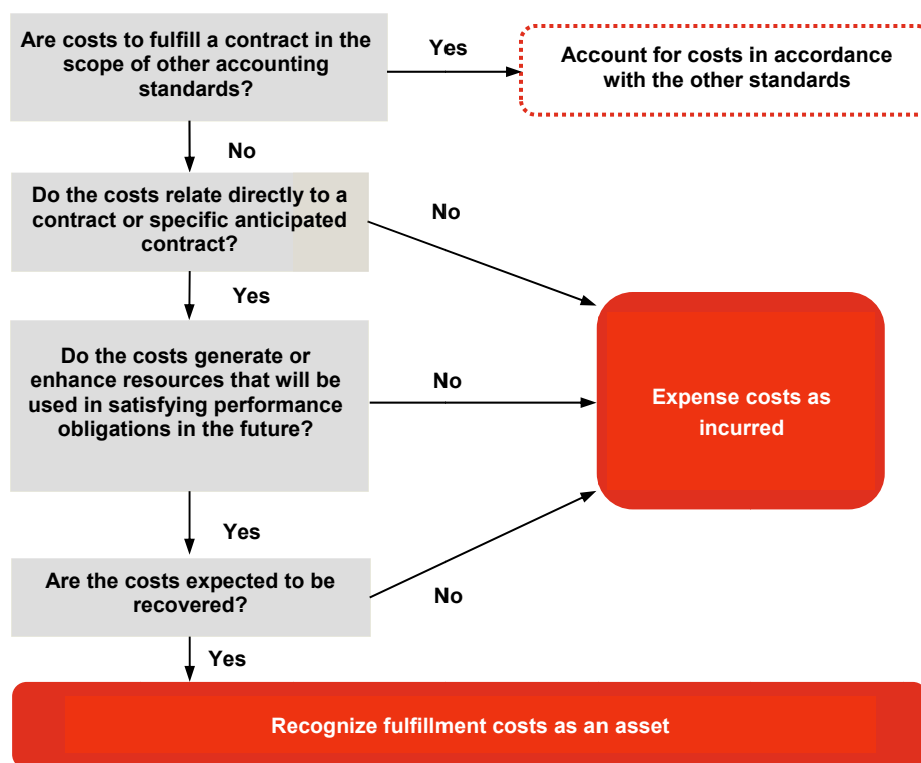
is the case even if the related revenue has not been recognized (for example, because it is variable consideration that has been constrained). Costs cannot be deferred solely to match costs with revenue, nor can they be deferred to normalize profit margins. An entity should expense all incurred costs if it is unable to distinguish between those that relate to past performance and those that relate to future performance.

Costs to fulfill a contract are only recognized as an asset if they are recoverable, similar to costs to obtain a contract. Refer to RR 11.2.1 for further discussion of assessing recoverability.

11.3.1 Recognition model overview

The following figure summarizes accounting for costs to fulfill a contract.

Figure 11-2
Recognition model overview



11.3.2 Learning curve costs

Learning curve costs are costs an entity incurs to provide a service or produce an item in early periods before it has gained experience with the process. Over time, the entity typically becomes more efficient at performing a task or manufacturing a good when done repeatedly and no longer incurs learning curve costs for that task or good. Such costs usually consist of labor, overhead, rework, or other special costs that must be incurred to complete the contract other than research and development costs.

Judgment is required to determine the accounting for learning curve costs. Learning curve costs incurred for a single performance obligation that is satisfied over time are recognized in cost of sales, but they may need to be considered in the measure of progress toward satisfying a performance obligation, depending on the nature of the cost.

Learning curve costs incurred for a performance obligation satisfied at a point in time are either capitalized as an asset or expensed as incurred. Learning curve costs should be assessed to determine if they are addressed by other standards (such as inventory). Costs not addressed by other standards are assessed to determine if they meet the criteria for capitalization under the revenue standard. Demonstrating that learning curve costs relate to future performance obligations could be difficult in some situations, and therefore, such costs might be expensed as incurred.

11.3.3 Set-up and mobilization costs

Set-up and mobilization costs are direct costs typically incurred at a contract's inception to enable an entity to fulfill its obligations under the contract. For example, outsourcing entities often incur costs relating to the design, migration, and testing of data centers when preparing to provide service under a new contract. Set-up costs may include labor, overhead, or other specific costs. Some of these costs might meet the definition of assets under other standards, such as property, plant, and equipment. Costs not addressed by other standards should be assessed under the revenue standard.

Mobilization costs are a type of set-up cost incurred to move equipment or resources to prepare to provide the services in an arrangement. Such costs generally include transportation and other expenses incurred prior to commencement of a service that would not have been incurred absent the contract.

Costs incurred to move newly acquired equipment to its intended location could meet the definition of the cost of an asset under property, plant, and equipment guidance. Costs incurred subsequently to move equipment for a future contract that meet the criteria in RR 11.3 are costs to fulfill a contract and therefore assessed to determine if they qualify to be recognized as an asset.

The following example illustrates the accounting for set-up costs.

EXAMPLE 11-4

Set-up costs – technology industry

TechCo enters into a contract with a customer to track and monitor payment activities for a five-year period. A prepayment is required from the customer at contract inception. TechCo incurs costs at the outset of the contract consisting of uploading data and payment information from existing systems. The ongoing tracking and monitoring is automated after customer set up. There are no refund rights in the contract.

How should TechCo account for the set-up costs?

Analysis

TechCo should recognize the set-up costs incurred at the outset of the contract as an asset since they (1) relate directly to the contract, (2) enhance the resources of the company to perform under the contract, and relate to future performance, and (3) are expected to be recovered.

An asset is recognized and amortized on a systematic basis consistent with the pattern of transfer of the tracking and monitoring services to the customer.

11.3.4 Abnormal costs

Abnormal costs are fulfillment costs that are incurred from excessive resources, wasted or spoiled materials, and unproductive labor costs (that is, costs not otherwise anticipated in the contract price). Such costs may arise due to delays, changes in project scope, or other factors. They differ from learning curve costs, which are typically reflected in the price of the contract. Abnormal costs, as further illustrated in the following example, should be expensed as incurred.

EXAMPLE 11-5**Costs to fulfill a contract – construction industry**

Construction Co enters into a contract with a customer to build an office building. Construction Co incurs directly related mobilization costs to bring heavy equipment to the location of the site. During the build phase of the contract, Construction Co incurs direct costs related to supplies, equipment, material, and labor. Construction Co also incurs some abnormal costs related to wasted materials that were purchased in connection with the contract. Construction Co expects to recover all incurred costs under the contract.

How should Construction Co account for the costs?

Analysis

Construction Co should recognize an asset for the mobilization costs as these costs (1) relate directly to the contract, (2) enhance the resources of the entity to perform under the contract and relate to satisfying a future performance obligation, and (3) are expected to be recovered.

The direct costs incurred during the build phase are accounted for in accordance with other standards if those costs are in the scope of those standards. Certain supplies and materials, for example, might be capitalized in accordance with inventory guidance. The equipment might be capitalized in accordance with property, plant, and equipment guidance. Any other direct costs associated with the contract that relate to satisfying performance obligations in the future and are expected to be recovered are recognized as an asset.

Construction Co should expense the abnormal costs as incurred.

11.4 *Amortization and impairment*

The revenue standard provides guidance on the subsequent accounting for contract cost assets, including amortization and periodic assessment of the asset for impairment.

11.4.1 *Amortization of contract cost assets*

The asset recognized from capitalizing the costs to obtain or fulfill a contract is amortized on a systematic basis consistent with the pattern of the transfer of the goods or services to which the asset relates.

The amortization period could be longer than the contract term in some circumstances. For example, a contract might include a renewal option that is anticipated to be exercised. In that case, the asset recognized for contract costs might relate to the transfer of goods or services under both the initial contract and its renewal and therefore, should be amortized over both the initial and renewal periods. The amortization period should not be longer than the initial contract if the entity also pays a commensurate cost for contract renewals. In that situation, the costs incurred to obtain the initial contract do not relate to the subsequent contract renewal.

Management should apply an amortization method that is consistent with the pattern of transfer of goods or services to the customer. An asset related to an obligation satisfied over time should be amortized using a method consistent with the method used to measure progress and recognize revenue (that is, an input or output method). Straight-line amortization may be appropriate if goods or services are transferred to the customer ratably throughout the contract, but not if the goods or services do not transfer ratably.

An entity should update the amortization of a contract asset if there is a significant change in the expected pattern of transfer of the goods or services to which the asset relates. Such a change is accounted for as a change in accounting estimate.

The following examples illustrate the amortization of contract cost assets.

EXAMPLE 11-6

Amortization of contract cost assets – telecommunications industry

Telecom sells prepaid wireless services to a customer. The customer purchases up to 1,000 minutes of voice services and any unused minutes expire at the end of the month. The customer can purchase an additional 1,000 minutes of voice services at the end of the month or once all the voice minutes are used. Telecom pays commissions to sales agents for initial sales of prepaid wireless services, but does not pay a commission for subsequent renewals. Telecom concludes the commission payment is an incremental cost of obtaining the contract and recognizes an asset.

The contract is a one-month contract and Telecom expects the customer, based on the customer's demographics (for example, geography, type of plan, and age), to renew for 16 additional months.

What period should Telecom use to amortize the commission costs?

Analysis

Telecom should amortize the costs to obtain the contract over 17 months in this example (the initial contract term and expected renewal periods). Management needs to use judgment to determine the period that the entity expects to provide services to the customer, including expected renewals, and amortize the asset over that period. In this fact pattern, Telecom cannot expense the commission payment under the practical expedient because the amortization period is greater than one year.

EXAMPLE 11-7

Amortization of contract cost assets – construction industry

ConstructionCo enters into a construction contract to build an oil refinery. ConstructionCo concludes that its performance creates an asset that the customer controls and that control is transferred over time. ConstructionCo also concludes that “cost-to-cost” is a reasonable method for measuring its progress toward satisfying its performance obligation.

ConstructionCo pays commissions totaling \$100,000 to its sales agent for securing the oil refinery contract. ConstructionCo concludes that the commission is an incremental cost of obtaining the contract and recognizes an asset. As of the end of the first year, ConstructionCo estimates its performance is 50% complete and recognizes 50% of the transaction price as revenue.

How much of the contract asset should be amortized as of the end of the first year?

Analysis

The pattern of amortization should be consistent with the method ConstructionCo uses to measure progress toward satisfying its performance obligation for recognizing revenue. ConstructionCo should amortize 50%, or \$50,000, of the commission costs as of the end of the first year.

11.4.2 Impairment of contract cost assets

Assets recognized from the costs to obtain or fulfill a contract are subject to impairment testing. Prior to recognizing an impairment loss on the asset, management should first evaluate recovery of the carrying value of other assets related to the contract according to the guidance in other accounting standards, such as:

- Inventory (ASC 330 or IAS 2)
- Property, plant, and equipment (ASC 360 or IAS 16)
- Intangible assets (ASC 350 or IAS 38)

After recording any asset impairment from applying other standards, an entity should apply the impairment guidance in the revenue standard to the contract cost asset.

Excerpt from ASC 340-40-35-3 and IFRS 15.101

An entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset... exceeds:

- a. The remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less
- b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses

The remaining amount of consideration the entity expects to receive should be determined based on the transaction price and adjusted for the effects of the customer's credit risk. Management should also include any variable consideration that has not been included in the transaction price due to the constraint (refer to RR 4).

Previously recognized impairment losses cannot be reversed under U.S. GAAP. Entities applying IFRS will reverse previously recognized impairment losses when the conditions that caused the impairment cease to exist. Any reversal should not result in the asset exceeding the amortized balance of the asset that would have been recognized if no impairment loss had been recognized.

The following example illustrates the impairment test for a contract cost asset.

EXAMPLE 11-8

Impairment of contract cost assets

DataCo enters into a two-year contract with a customer to build a data center in exchange for consideration of \$1,000,000. DataCo incurs incremental costs to obtain the contract and costs to fulfill the contract that are recognized as assets and amortized over the expected period of benefit.

The economy subsequently deteriorates and the parties agree to renegotiate the pricing in the contract, resulting in a modification of the contract terms. The remaining amount of consideration to which DataCo expects to be entitled is \$650,000. The carrying value of the asset recognized for contract costs is \$600,000. An expected cost of \$150,000 would be required to complete the data center.

How should DataCo account for the asset after the contract modification?

Analysis

DataCo should recognize an impairment loss of \$100,000. The carrying amount of the asset recognized for contract asset (\$600,000) exceeds the remaining amount of consideration to which the entity expects to be entitled less the costs that relate

directly to providing the data center (\$650,000 less \$150,000). Therefore, an impairment loss of that amount is recognized.

This conclusion assumes that the entity previously recognized any necessary impairment loss for inventory or other assets related to the contract prior to recognizing an impairment loss under the revenue standard. Impairment of other assets could impact the remaining costs required to complete the data center.

11.5 Onerous contract losses

Onerous contracts are those where the cost to fulfill the contract exceed the consideration expected to be received under the contract. The revenue standard does not provide guidance on the accounting for onerous contracts or onerous performance obligations. Both U.S. GAAP and IFRS contain guidance on the accounting for onerous contract losses, and those requirements should be used to identify and measure onerous contracts.

Chapter 12: ***Presentation and*** ***disclosure***

12.1 Chapter overview

The revenue standard provides guidelines for presenting and disclosing revenue from contracts with customers, including revenue that is expected to be recognized. This chapter provides an overview of these requirements.

The revenue standard provides guidance on the presentation of contract assets and receivables, including how to distinguish between the two, and on the presentation of contract liabilities in the statement of financial position. The revenue standard also provides some guidance on the presentation of revenue and related items (for example, receivables impairment losses) in the statement of comprehensive income.

Detailed quantitative and qualitative disclosure requirements are included in the revenue standard that cover a range of topics, including significant judgments made when measuring and recognizing revenue. The disclosure requirements can be extensive and some will require significant judgment in application.

Practical expedients are available that permit entities to omit certain disclosures, but those expedients are limited. All disclosures required by the revenue standard are subject to materiality judgments. U.S. GAAP requires more disclosure requirements in interim financial statements than IFRS, but allows reduced disclosure requirements for nonpublic entities reporting under U.S. GAAP.

12.2 Presentation

The revenue standard provides guidance on presentation of assets and liabilities generated from contracts with customers.

ASC 606-10-45-1 and IFRS 15.105

When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.

12.2.1 Statement of financial position

An entity will recognize an asset or liability if one of the parties to a contract has performed before the other. For example, when an entity performs a service or transfers a good in advance of receiving consideration, the entity will recognize a contract asset or receivable in its statement of financial position. A contract liability is recognized if the entity receives consideration (or if it has the unconditional right to receive consideration) in advance of performance.

12.2.1.1 Contract assets and receivables

The revenue standard distinguishes between a contract asset and a receivable based on whether receipt of the consideration is conditional on something other than passage of time.

Excerpt from ASC 606-10-45-3 and IFRS 15.107

A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for impairment in accordance with [ASC 310, *Receivables* [U.S. GAAP] or IFRS 9, *Financial Instruments* [IFRS]].

Excerpt from ASC 606-10-45-4 and IFRS 15.108

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due.... An entity shall account for a receivable in accordance with [ASC 310 [U.S. GAAP] or IFRS 9 [IFRS]].

The revenue standard does not address impairment of contract assets or receivables. Other guidance exists for accounting for receivables (ASC 310 and IFRS 9), and entities should follow those standards when considering impairment.

The revenue standard requires that a contract asset is reclassified as a receivable when the entity's right to consideration is unconditional. The following example illustrates the distinction between a contract asset and a receivable.

EXAMPLE 12-1**Distinguishing between a contract asset and a receivable**

Manufacturer enters into a contract to deliver two products to Customer (Products X and Y), which will be delivered at different points in time. Product X will be delivered before Product Y. Manufacturer has concluded that delivery of each product is a separate performance obligation and that control transfers to Customer upon delivery. No performance obligations remain after the delivery of Product Y. Customer is not required to pay for the products until one month after both are delivered. Assume for purposes of this example that no significant financing component exists.

How should Manufacturer reflect the transaction in the statement of financial position upon delivery of Product X?

Analysis

Manufacturer should record a contract asset and corresponding revenue upon satisfying the first performance obligation (delivery of Product X) based on the portion of the transaction price allocated to that performance obligation. A contract asset is recorded rather than a receivable because Manufacturer does not have an unconditional right to the contract consideration until both products are delivered. A receivable and the remaining revenue under the contract should be recorded upon delivery of Product Y, and the contract asset related to Product X should also be reclassified to a receivable. Manufacturer has an unconditional right to the consideration at that time since payment is due based only upon the passage of time.

12.2.1.2 Contract liabilities

An entity should recognize a contract liability if the customer's payment of consideration precedes the entity's performance (for example, by paying a deposit).

ASC 606-10-45-2 and IFRS 15.106

If a customer pays consideration or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

The following example illustrates when an entity should record a contract liability.

EXAMPLE 12-2**Recording a contract liability**

Producer enters into a contract to deliver a product to Customer for \$5,000. Customer pays a deposit of \$2,000, with the remainder due upon delivery (assume delivery will occur three weeks later and a significant financing component does not exist). Revenue will be recognized upon delivery as that is when control of the product transfers to the customer.

How should Producer present the advance payment prior to delivery in the statement of financial position?

Analysis

The \$2,000 deposit was received in advance of delivery, so Producer should recognize a contract liability for that amount. The contract liability will be reversed and recognized as revenue (along with the \$3,000 remaining balance) upon delivery of the product.

12.2.1.3 Timing of invoicing and performance

The timing of when an entity satisfies its performance obligation and when it invoices its customer can affect the presentation of assets and liabilities on the statement of financial position. An unconditional right to receive consideration typically arises after an entity transfers control of a good or performs a service and invoices the customer.

An entity could, however, have an unconditional right to consideration before it has satisfied a performance obligation. For example, an entity might enter into a noncancellable contract requiring advance payment. The entity has an unconditional right to consideration on the date the payment is due even though it has not yet performed under the contract. A receivable is recorded in these situations; however,

revenue is not recognized until the entity has transferred control of the goods or services promised in the contract. The following example illustrates this concept.

EXAMPLE 12-3

Recording a receivable – noncancellable contract

On January 1, Producer enters into a contract to deliver a product to Customer on March 31. The contract is noncancellable and requires Customer to make an advance payment of \$5,000 on January 31. Customer does not pay the consideration until March 1.

How should Producer reflect the transaction in the statement of financial position?

Analysis

On January 31, Producer should record the advance payment due as of that date as follows:

Receivable	\$5,000	
Contract liability		\$5,000

On March 1, upon receipt of the cash, Producer should record the following:

Cash	\$5,000	
Receivable		\$5,000

On March 31, upon satisfying the performance obligation, Producer should recognize revenue as follows:

Contract liability	\$5,000	
Revenue		\$5,000

Producer has an unconditional right to the consideration when the advance payment is due because the contract is noncancellable. As a result, Producer records a receivable on January 31.

Producer would not record a receivable on January 31 if the contract were cancellable because, in that case, it does not have an unconditional right to the consideration. Producer would instead record the cash receipt and a contract liability on the date the advance payment is received.

The fact that an entity invoices its customer does not necessarily mean it has an unconditional right to consideration. An entity that invoices the customer before performing under the contract cannot gross-up its balance sheet (that is, record both a receivable and a contract liability) unless the payment is nonrefundable and the contract is noncancellable.

An entity could, on the other hand, have an unconditional right to consideration before it invoices its customer. An entity should record an unbilled receivable if there is nothing but the passage of time required before it can issue an invoice. This could occur if an entity has satisfied its performance obligations, but has not yet issued the invoice.

12.2.1.4 *Netting of contract assets and contract liabilities*

Entities often enter into complex arrangements with their customers with payments due at different times throughout the arrangement. Entities sometimes receive consideration from their customers in advance of performance on a portion of the contract and, on another portion of the contract, perform in advance of receiving consideration. Contract assets and liabilities related to rights and obligations in a contract are interdependent and therefore should be recorded net in the statement of financial position. Entities should look to other standards on financial statement presentation to conclude if it is appropriate to net contract assets and contract liabilities if they arise from separate contracts.

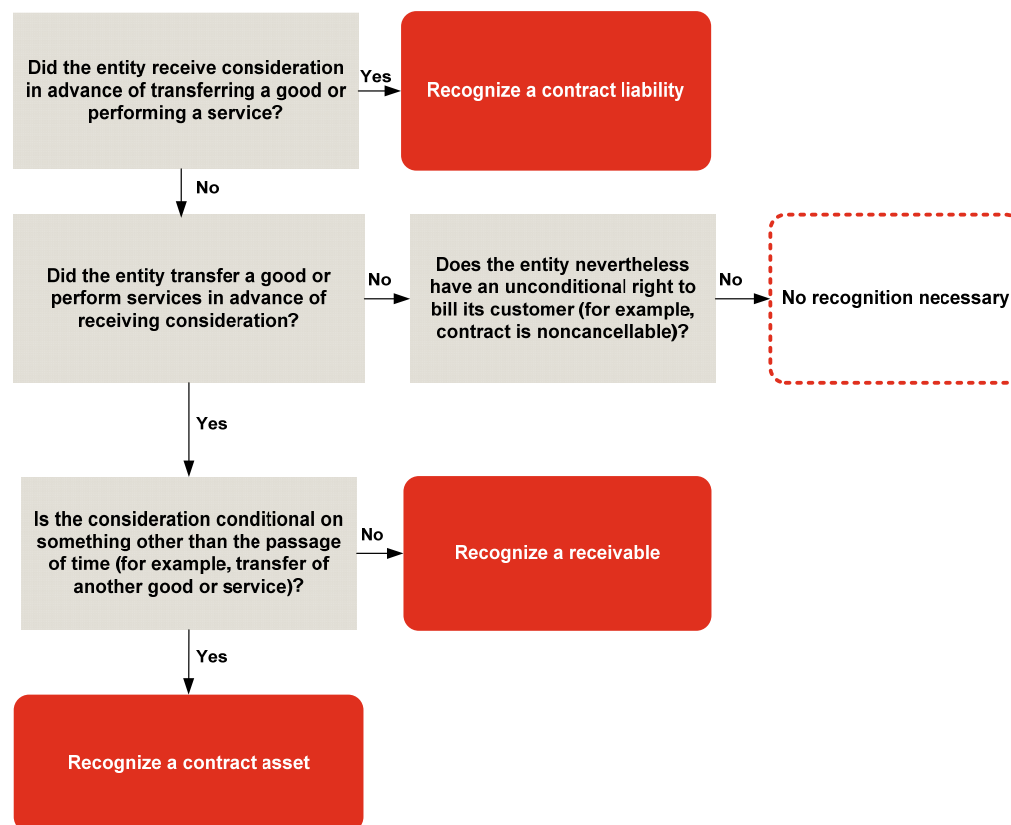
12.2.1.5 *Statement of financial position descriptions*

While the revenue standard uses the terms “contract asset” and “contract liability,” entities can use alternative descriptions in the statement of financial position (for example, deferred revenue). Certain industries, for example, have common terms that are used for these situations. Entities can use these alternative descriptions as long as they provide sufficient information to distinguish between those rights to consideration that are conditional (that is, contract assets) from those that are unconditional (that is, receivables).

12.2.1.6 *Recognition decision tree*

The following figure illustrates the decision tree used to determine when to recognize a contract asset, receivable, or contract liability.

Figure 12-1
Recognition decision tree



12.2.2 *Statement of comprehensive income*

The revenue standard requires entities to separately present or disclose revenue from contracts with customers from other sources of revenue. Other sources of revenue include, for example, revenue from interest, dividends, leases, etc. Interest income and interest expense recorded when a significant financing component exists (see RR 4.4) must be presented separately from revenue from contracts with customers in the statement of comprehensive income. An entity might present interest income as revenue in circumstances in which interest income represents an entity's ordinary activities.

Impairment losses from contracts with customers (for example, impairments of contract assets or receivables) are presented separately from impairment losses from other types of contracts, and are not recorded as a reduction of revenue. The measurement of the impairment loss is not addressed by the revenue standard. Entities should refer to other accounting standards addressing measurement and impairment of receivables for this guidance.

12.3 *Disclosure*

Entities must disclose certain qualitative and quantitative information so that financial statement users can understand the nature, amount, timing, and uncertainty of revenue and cash flows generated from their contracts with customers. These

disclosures can be extensive, may be challenging to compile, and may require significant management judgment.

Excerpt from ASC 606-10-50-1 and IFRS 15.110

An entity shall disclose qualitative and quantitative information about all of the following:

- a. Its contracts with customers...
- b. The significant judgments, and changes in those judgments, made in applying [the revenue standard] to those contracts...
- c. Any asset recognized from the costs to obtain or fulfill a contract with a customer

Management should consider the level of detail necessary to meet the disclosure objective. For example, an entity should aggregate or disaggregate information, as appropriate, to provide clear and meaningful information to a financial statement user. The level of disaggregation is subject to judgment.

Management must also disclose the use of certain practical expedients. An entity that uses the practical expedient regarding the existence of a significant financing component (RR 4) or the practical expedient for expensing certain costs of obtaining a contract (RR 11), for example, must disclose that fact.

Disclosures are included for each period for which a statement of comprehensive income is presented and as of each reporting period for which a statement of financial position is presented. The requirements only apply to material items. Materiality judgments could affect whether certain disclosures are necessary or the extent of the information provided in the disclosure. Entities need not repeat disclosures if the information is already presented as required by other accounting standards.

The following figure summarizes the annual disclosure requirements.

Figure 12-2
Annual disclosure requirements

Disclosure type	Required information
Disaggregated revenue	Disaggregation of revenue into categories that show how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows
Reconciliation of contract balances	<ul style="list-style-type: none"> □ Opening and closing balances and revenue recognized during the period from changes in contract balances □ Qualitative and quantitative information about the significant changes in contract balances

Disclosure type	Required information
Performance obligations	<ul style="list-style-type: none"> □ Descriptive information about an entity's performance obligations □ Information about the transaction price allocated to remaining performance obligations and when revenue will be recognized
Significant judgments	<ul style="list-style-type: none"> □ Method used to recognize revenue for performance obligations satisfied over time and why the method is appropriate □ Significant judgments related to transfer of control for performance obligations satisfied at a point in time □ Information about the methods, inputs, and assumptions used to determine and allocate transaction price
Costs to obtain or fulfill a contract	<ul style="list-style-type: none"> □ Judgments made to determine costs to obtain or fulfill a contract, and method of amortization □ Closing balances of assets and amount of amortization/impairment
Practical expedients	<p>Use of either of the following:</p> <ul style="list-style-type: none"> □ The practical expedient regarding the existence of a significant financing component; see RR 4.4.2 □ The practical expedient for expensing certain costs of obtaining a contract; see RR 11.2.2

Disclosure requirements are discussed in more detail below.

12.3.1 Disaggregated revenue

The revenue standard does not prescribe specific categories for disaggregation, but instead provides examples of categories that might be appropriate. An entity may need to disaggregate revenue by more than one type of category to meet the disclosure objective.

ASC 606-10-55-90 and IFRS 15.B88

When selecting the type of category (or categories) to use to disaggregate revenue, an entity [should [U.S. GAAP]/shall [IFRS]] consider how information about the entity's revenue has been presented for other purposes, including all of the following:

- a. Disclosures presented outside the financial statements (for example, in earnings releases, annual reports, or investor presentations)
- b. Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments

- c. Other information that is similar to the types of information identified in (a) and (b) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.

ASC 606-10-55-91 and IFRS 15.B89

Examples of categories that might be appropriate include, but are not limited to, all of the following:

- a. Type of good or service (for example, major product lines)
- b. Geographical region (for example, country or region)
- c. Market or type of customer (for example, government and nongovernment customers)
- d. Type of contract (for example, fixed-price and time-and-materials contracts)
- e. Contract duration (for example, short-term and long-term contracts)
- f. Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)
- g. Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

The revenue standard also requires entities to explain the relationship between the disaggregated revenue required by the revenue standard and the information required by the accounting standard on operating segments. Management should not assume the two disclosures will be disaggregated at the same level. More disaggregation might be needed in the revenue footnote, for example, because the operating segments standard permits aggregation in certain situations. The revenue standard does not have similar aggregation criteria. However, if management concludes that the disaggregation level is the same in both standards and segment revenue is measured on the same basis as the revenue standard, then the segment disclosure would not need to be repeated in the revenue footnote.

12.3.2 Reconciliation of contract balances

The purpose of these disclosures is to provide information about the amount of revenue that is recognized in the current period that is not a result of current period performance. The revenue standard provides for flexibility in how this information is presented from a formatting perspective (that is, it does not mandate a tabular presentation), but it does require certain items to be disclosed.

ASC 606-10-50-8 and IFRS 15.116

An entity shall disclose all of the following:

- a. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed
- b. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period
- c. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).

ASC 606-10-50-10 and IFRS 15.118

An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

- a. Changes due to business combinations
- b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained), or a contract modification
- c. Impairment of a contract asset
- d. A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable)
- e. A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability).

An entity should also explain how the timing of satisfaction of its performance obligations compares to the typical timing of payment and how that affects contract asset and liability balances. This information can be provided qualitatively.

12.3.3 Performance obligations

Entities must include information to help readers understand its performance obligations. These disclosures should not be “boilerplate” and should supplement the entity’s revenue accounting policy disclosures.

ASC 606-10-50-12 and IFRS 15.119

An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:

- a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement
- b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained...)
- c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)
- d. Obligations for returns, refunds, and other similar obligations
- e. Types of warranties and related obligations.

The revenue standard also requires information about remaining performance obligations and when revenue will be recognized related to these obligations. This could require judgment, as it might not always be clear when performance obligations will be satisfied, especially when performance can be affected by factors outside the entity's control.

ASC 606-10-50-13 and IFRS 15.120

An entity shall disclose the following information about its remaining performance obligations:

- a. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period
- b. An explanation of when the entity expects to recognize as revenue the amount disclosed [in (a) above], which the entity shall disclose in either of the following ways:
 1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations
 2. By using qualitative information.

As a practical expedient, entities can omit disclosure of remaining performance obligations when:

- the related contract has a duration of one year or less; or
- the entity recognizes revenue equal to what it has the right to invoice when that amount corresponds directly with the value to the customer of the entity's performance to date (refer to RR 6.5.1).

An entity that omits the disclosures should explain that it is using the practical expedient and must also disclose whether any amounts have been excluded from the transaction price, such as variable consideration that has been constrained.

12.3.4 Significant judgments

An entity must disclose its judgments, as well as changes in those judgments, that significantly impact the amount and timing of revenue from its contracts with customers.

ASC 606-10-50-18 and IFRS 15.24

For performance obligations that an entity satisfies over time, an entity shall disclose both of the following:

- a. The methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied)
- b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

ASC 606-10-50-19 and IFRS 15.25

For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when a customer obtains control of promised goods or services.

ASC 606-10-50-20 and IFRS 15.26

An entity shall disclose information about the methods, inputs, and assumptions used for all of the following:

- a. Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration
- b. Assessing whether an estimate of variable consideration is constrained
- c. Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)
- d. Measuring obligations for returns, refunds, and other similar obligations.

12.3.5 Costs to obtain or fulfill a contract

Entities must provide information about how assets are recognized from costs to obtain or fulfill a contract with a customer, and how the assets are subsequently amortized or impaired.

ASC 340-40-50-2 and IFRS 15.127

An entity shall describe both of the following:

- a. The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer...
- b. The method it uses to determine the amortization for each reporting period.

ASC 340-40-50-3 and IFRS 15.128

An entity shall disclose all of the following:

- a. The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer..., by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs)
- b. The amount of amortization and any impairment losses recognized in the reporting period.

12.3.6 Interim disclosure requirements

Interim financial reporting standards require entities to provide certain disclosures about revenue from contracts with customers in interim financial statements. Entities reporting under both U.S. GAAP and IFRS must disclose disaggregated revenue information in interim financial statements; see RR 12.3.1. Interim reporting standards also require disclosure about significant changes in an entity's financial position, which includes changes relating to revenue.

Other interim disclosure requirements differ between U.S. GAAP and IFRS, as described below.

12.3.6.1 Additional interim disclosures (U.S. GAAP only)

Public entities reporting under U.S. GAAP must include many of the same disclosures in their interim financial statements that are required in annual financial statements.

Excerpt from ASC 270-10-50-1A

- a. A disaggregation of revenue for the period...
- b. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers (if not otherwise separately presented or disclosed)...
- c. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period...
- d. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price)...
- e. Information about the entity's remaining performance obligations as of the end of the reporting period

12.3.6.2 Additional interim disclosures (IFRS only)

Entities that issue IFRS interim financial statements must also disclose impairment losses generated from contract costs (that is, costs to obtain a contract and costs to fulfill a contract).

12.3.7 Nonpublic entity considerations (U.S. GAAP only)

Certain exemptions are provided in the revenue standard to simplify the disclosure requirements for nonpublic entities that report under U.S. GAAP. Such entities must follow the disclosure requirements described in RR 12.3.1 through RR 12.3.5 with some modifications. The following figure summarizes the modifications for nonpublic entities.

Figure 12-3

Nonpublic entity disclosure considerations (U.S. GAAP only)

Disclosure type	Related information
Disaggregated revenue	<p>Nonpublic entities may elect to not apply the quantitative disaggregation or revenue disclosure guidance discussed in RR 12.3.1; however, if this election is made, the entity must at a minimum disclose:</p> <ul style="list-style-type: none"> □ Revenue disaggregated according to the timing of transfer of goods or services (for example, at a point in time and 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

Disclosure type	Related information
Reconciliation of contract balances	Nonpublic entities can elect to disclose only the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with its customers. The other disclosures described in RR 12.3.2 (contract assets and contract liabilities) are optional.
Performance obligations	Descriptive disclosures of an entity's performance obligations are required for nonpublic entities; however, disclosures regarding remaining unsatisfied or partially satisfied performance obligations are optional. See RR 12.3.3.
Significant judgments	<p>Nonpublic entities must disclose the following:</p> <ul style="list-style-type: none"> □ The methods used to recognize revenue (for example, a description of the input method or output method) for performance obligations satisfied over time □ The methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained <p>The other disclosures of significant judgments as described in RR 12.3.4 are optional.</p>
Practical expedients	Disclosures on the use of practical expedients described in RR 12.3 are optional.
Interim financial statement disclosures	The interim financial statement disclosures described in RR 12.3.6 are optional.

Chapter 13: ***Effective date and*** ***transition***

13.1 Chapter overview

The revenue standard is applicable for most entities starting in 2017. This chapter discusses the effective date and transition guidance, which can vary between entities reporting in accordance with IFRS and those reporting in accordance with U.S. GAAP. There are different transition methods available to certain entities, and some entities are permitted to early adopt the revenue standard.

Adopting the revenue standard could be a significant undertaking and some entities may need several years to embed necessary changes into their systems and processes. Some practical expedients are provided to ease transition.

13.2 Effective date

The following table summarizes the effective dates for adopting the revenue standard.

Figure 13-1
Summary effective date chart

	IFRS	U.S. GAAP
Public entities	Annual reporting periods beginning on or after January 1, 2017, including interim periods therein	Annual reporting periods beginning after December 15, 2016, including interim periods therein
Nonpublic entities	Annual reporting periods beginning on or after January 1, 2017, including interim periods therein	Annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018
Early adoption permitted?	Yes	No, for public companies. Yes, for nonpublic companies, but no earlier than the effective date for public entities

13.2.1 IFRS reporters

Public and nonpublic entities that prepare IFRS financial statements will apply the revenue standard for annual reporting periods beginning on or after January 1, 2017 (subject to local regulatory endorsement). Calendar year-end entities will therefore first report in accordance with the revenue standard in their 2017 interim and annual financial statements. Early adoption is permitted (subject to local regulatory requirements), as long as it is disclosed.

13.2.2 U.S. GAAP reporters

The effective date for entities that prepare U.S. GAAP financial statements differs depending on whether they are public or nonpublic entities.

13.2.2.1 U.S. GAAP – public entities

Public entities for U.S. GAAP reporting purposes are entities that are any of the following:

- A public business entity (refer to the definition in ASC 606-10-20)
- 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
- An employee benefit plan that files or furnishes financial statements to the SEC

Public entities will first apply the revenue standard for annual reporting periods beginning after December 15, 2016, including the interim periods therein (that is, January 1, 2017, for calendar year-end entities). Calendar year-end public entities will therefore first report in accordance with the revenue standard in their 2017 interim and annual financial statements. Public entities reporting under U.S. GAAP are not permitted to early adopt the revenue standard.

13.2.2.2 U.S. GAAP – nonpublic entities

Nonpublic entities (that is, all entities other than public entities, as defined) have an additional year to comply with the revenue standard. Nonpublic entities are required to apply the revenue standard for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Calendar year-end entities will therefore first report revenue in accordance with the revenue standard in their 2018 annual financial statements and 2019 interim financial statements. However, unlike their public counterparts, nonpublic entities can elect to apply the guidance earlier. Any of the following dates are permitted:

- The public entity effective date (that is, annual reporting periods beginning after December 15, 2016, including interim periods therein)
- Annual reporting periods beginning after December 15, 2016, and interim periods beginning after December 15, 2017
- Annual reporting periods beginning after December 15, 2017, including interim periods therein

13.3 Transition guidance

The revenue standard permits entities to apply the guidance in the revenue standard retrospectively using any combination of three practical expedients. Alternatively, in the year of adoption, an entity can recognize the cumulative effect of initially applying

the guidance as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate), supplemented by additional disclosures.

13.3.1 *Retrospective application and practical expedients*

Entities are permitted to adopt the revenue standard by restating all prior periods (that is, full retrospective adoption) following IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* (IFRS) or ASC 250, *Accounting Changes and Error Corrections* (U.S. GAAP). However, entities are also permitted to use any combination of the following practical expedients.

Excerpt from ASC 606-10-65-1-f and IFRS 15.C5

1. For completed contracts, an entity need not restate contracts that begin and end within the same annual reporting period.
2. For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods. [and; [IFRS]]
3. For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.

Any of the expedients used must be applied consistently to all contracts in all reporting periods presented. Entities that choose to use any practical expedients must disclose that they have used the expedients and provide a qualitative assessment of the estimated effect of applying each expedient, to the extent reasonably possible.

13.3.1.1 *Relief for IFRS reporters electing full retrospective application*

The IASB granted some relief to IFRS reporters that adopt the revenue standard through retrospective application (as discussed in RR 13.3.1). The effect of adopting the revenue standard on each financial statement line item and the effect on basic and diluted earnings per share (if applicable) is only required for the immediately preceding reporting period (that is, the year prior to the date of initial application). Entities are not required, but are permitted, to present this information for the current or earlier comparative periods.

13.3.2 *Modified retrospective application*

Entities can elect to use a modified retrospective application approach for transition to the revenue standard. The entity will recognize the cumulative effect of initially applying the revenue standard as an adjustment to the opening balance of retained earnings (or other appropriate component of equity) in the period of initial application. Comparative prior year periods are not adjusted.

Entities only need to consider the effects of applying the revenue standard to contracts that are not completed as of the date of initial application (that is, they will ignore the effects of applying the revenue standard to contracts that were completed prior to transition). Calendar year-end companies, for example, will only apply the revenue standard to contracts that are not completed as of January 1, 2017, and will recognize the cumulative effect adjustment of applying the revenue standard in the opening balance of retained earnings as of January 1, 2017.

This transition approach allows an entity to avoid restating comparative years. Only contracts that are not completed at the date of initial application (that is, the beginning of the year the revenue standard is first applied) will be adjusted.

Entities that choose to use this approach must provide the following additional disclosures in the reporting period that includes the date of initial application:

- The amount by which each financial statement line item is affected in the current year as a result of applying the revenue standard (as compared to the previous revenue guidance)
- A qualitative explanation of the significant changes between the reported results under the revenue standard and the previous revenue guidance

These additional disclosures effectively require an entity to apply both the new revenue standard and the previous revenue guidance in the year of initial application. Several financial statement line items may be affected by the change and therefore require disclosure. Line items that could be affected, beyond revenue, gross margin, operating profit, and net income, include:

- Assets for costs to obtain or fulfill a contract to the extent that such costs were expensed under prior guidance but should now be capitalized (or conversely, had been capitalized under previous guidance but would no longer meet the criteria to be capitalized under the revenue standard)
- Employee compensation, including bonuses and share-based compensation, linked to revenue-related metrics, to the extent that the compensation charge determined in accordance with the relevant accounting standard and benefit plan terms would have been different if the previous revenue guidance had been applied
- Current and deferred tax balances, depending on the tax law

Entities must explain the extent of the effects of the change in revenue on all line items that are affected.

Overall, there are likely to be a number of challenges for entities that select the modified retrospective transition approach, but it could still be simpler than full retrospective application. Entities should consider the needs of investors and other users of the financial statements when deciding which transition method to follow.

Appendices

Appendix A: Professional literature

The PwC guides provide in-depth accounting and financial reporting guidance for various topics, as outlined in the preface to this guide. The PwC guides summarize the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification) and standards issued by the IASB. They also provide our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues. The PwC guides supplement the authoritative accounting literature. This appendix provides further information on authoritative U.S. generally accepted accounting principles and International Financial Reporting Standards.

U.S. generally accepted accounting principles

The Codification is the primary source of authoritative U.S. financial accounting and reporting standards (U.S. GAAP) for nongovernmental reporting entities (hereinafter referred to as "reporting entities"). Additionally, guidance issued by the SEC is a source of authoritative guidance for SEC registrants.

Updates and amendments to the Codification arising out of the FASB's standard-setting processes are communicated through *Accounting Standards Updates* (ASUs). The Codification is updated concurrent with the release of a new ASU, or shortly thereafter. PwC has developed a *FASB Accounting Standards Codification Quick Reference Guide* which is available on CFOdirect. The quick reference guide explains the structure of the Codification, including examples of the citation format, how new authoritative guidance will be released and incorporated into the Codification, and where to locate other PwC information and resources on the Codification. The quick reference guide also includes listings of the Codification's "Topics" and "Sections" and a list of frequently-referenced accounting standards and the corresponding Codification Topics where they now primarily reside.

In the absence of guidance for a transaction or event within a source of authoritative U.S. GAAP (i.e., the Codification and SEC guidance), a reporting entity should first consider accounting principles for similar transactions or events within a source of authoritative U.S. GAAP for that reporting entity and then consider non-authoritative guidance from other sources. Sources of non-authoritative accounting guidance and literature include:

- FASB Concepts Statements
- AICPA Issues Papers
- International Financial Reporting Standards issued by the International Accounting Standards Board
- Pronouncements of other professional associations or regulatory agencies

- Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
- PwC accounting and financial reporting guides
- Accounting textbooks, guides, handbooks, and articles
- Practices that are widely recognized and prevalent either generally or in the industry

While other professional literature can be considered when the Codification does not cover a certain type of transaction or event, we do not expect this to occur frequently in practice.

SEC guidance

The content contained in the SEC sections of the FASB's Codification is provided for convenience and relates only to SEC registrants. The SEC sections do not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance. Also, there is typically a lag between when SEC guidance is issued and when it is reflected in the SEC sections of the Codification. Therefore, reference should be made to the actual documents published by the SEC and SEC Staff when addressing matters related to public reporting entities.

International Financial Reporting Standards

International Financial Reporting Standards (IFRS) is a single set of accounting standards currently used in whole or in part in over 100 countries worldwide.

IFRS are developed by the International Accounting Standards Board (IASB), an independent standard setting body. Members of the IASB are appointed by international trustees and are responsible for the development and publication of IFRS standards as well as approving interpretations of the IFRS Interpretations Committee. The IFRS Interpretations Committee is responsible for evaluating the impact of implementing IFRS and other emerging issues that result from application of IFRS and undertaking projects to provide supplemental guidance or amend existing guidance.

The authoritative guidance issued by the IASB (and its predecessor organizations) are in the form of:

- IFRS pronouncements
- International Accounting Standards (IAS) pronouncements

- IFRS interpretations issued by the IFRS Interpretations Committee
- Standing Interpretation Committee of the IASC (SIC) interpretations
- IFRS for small and medium-sized entities (SMEs) – restricted application by small and medium-sized entities as defined

The IASB has a variety of advisory organizations representing different constituents who provide insight into implementation issues for completed standards, feedback on draft standards, and suggestions on potential agenda items as examples. The IFRS Advisory Council and the Accounting Standards Advisory Forum are examples of such organizations.

IFRS standards may automatically apply upon publication in certain jurisdictions, while others require endorsement or undergo other modifications prior to application. For example, companies in the European Union (EU) would not apply a newly issued IFRS to their consolidated, public financial statements until the pronouncement was endorsed.

In addition to the authoritative guidance, PwC's Manual of Accounting is published annually, and may be used along with each of the PwC global accounting guides to assist in interpreting IFRS. While not authoritative guidance, the Manual of Accounting can be used as a practical guide in applying IFRS.

Appendix B: Technical references and abbreviations

The following tables provide a list of the technical references and definitions for the abbreviations and acronyms used within this guide.

Technical references

ASC 250	Accounting Standards Codification 250, <i>Accounting Changes and Error Corrections</i>
ASC 270	Accounting Standards Codification 270, <i>Interim Reporting</i>
ASC 310	Accounting Standards Codification 310, <i>Receivables</i>
ASC 320	Accounting Standards Codification 320, <i>Investments – Debt and Equity Securities</i>
ASC 323	Accounting Standards Codification 323, <i>Investments – Equity Method and Joint Ventures</i>
ASC 325	Accounting Standards Codification 325, <i>Investments – Other</i>
ASC 330	Accounting Standards Codification 330, <i>Inventory</i>
ASC 340	Accounting Standards Codification 340, <i>Other Assets and Deferred Costs</i>
ASC 350	Accounting Standards Codification 350, <i>Intangibles – Goodwill and Other</i>
ASC 360	Accounting Standards Codification 360, <i>Property, Plant and Equipment</i>
ASC 405	Accounting Standards Codification 405, <i>Liabilities</i>
ASC 450	Accounting Standards Codification 450, <i>Contingencies</i>
ASC 460	Accounting Standards Codification 460, <i>Guarantees</i>
ASC 470	Accounting Standards Codification 470, <i>Debt</i>
ASC 606	Accounting Standards Codification 606, <i>Revenue from Contracts with Customers</i>
ASC 808	Accounting Standards Codification 808, <i>Collaborative Agreements</i>

Technical references

ASC 815	Accounting Standards Codification 815, <i>Derivatives and Hedging</i>
ASC 825	Accounting Standards Codification 825, <i>Financial Instruments</i>
ASC 840	Accounting Standards Codification 840, <i>Leases</i>
ASC 850	Accounting Standards Codification 850, <i>Related Party Disclosures</i>
ASC 860	Accounting Standards Codification 860, <i>Transfers and Servicing</i>
ASC 944	Accounting Standards Codification 944, <i>Financial Services – Insurance</i>
CON 8	FASB Concepts Statement No. 8, <i>Conceptual Framework for Financial Reporting</i>
IAS 2	International Accounting Standards 2, <i>Inventories</i>
IAS 8	International Accounting Standards 8, <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>
IAS 16	International Accounting Standards 16, <i>Property, Plant and Equipment</i>
IAS 17	International Accounting Standards 17, <i>Leases</i>
IAS 24	International Accounting Standards 24, <i>Related Party Disclosures</i>
IAS 27	International Accounting Standards 27, <i>Separate Financial Statements</i>
IAS 28	International Accounting Standards 28, <i>Investments in Associates and Joint Ventures</i>
IAS 31	International Accounting Standards 31, <i>Interests in Joint Ventures</i>
IAS 37	International Accounting Standards 37, <i>Provisions, Contingent Liabilities and Contingent Assets</i>
IAS 38	International Accounting Standards 38, <i>Intangible Assets</i>
IFRS 4	International Financial Reporting Standard 4, <i>Insurance Contracts</i>

Technical references

IFRS 9	International Financial Reporting Standard 9, <i>Financial Instruments</i>
IFRS 10	International Financial Reporting Standard 10, <i>Consolidated Financial Statements</i>
IFRS 11	International Financial Reporting Standard 11, <i>Joint Arrangements</i>
IFRS 15	International Financial Reporting Standard 15, <i>Revenue from Contracts with Customers</i>

Abbreviation / Acronym	Definition
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
BC	Basis for Conclusions
FASB	Financial Accounting Standards Board
FTE	Full time equivalents
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IP	Intellectual property
PCS	Postcontract customer support
R&D	Research & development
RR	PwC's guide: <i>Revenue from contracts with customers, global edition</i>
SEC	Securities and Exchange Commission
U.S. GAAP	U.S. generally accepted accounting principles

Appendix C: Key terms

The following table provides definitions for key terms used within this guide.

Term	Definition
Agent	An entity that arranges for another party to provide goods or services.
Bill-and-hold arrangement	A contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future.
Boards	FASB and IASB
Breakage	Rights or options in an arrangement that the customer does not exercise.
Constraint on variable consideration	A limit on the amount of variable consideration included in the transaction price. Variable consideration is included only to the extent that it is probable (U.S. GAAP)/highly probable (IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.
Contract	As defined in the ASC Glossary and IFRS 15 Appendix A: “An agreement between two or more parties that creates enforceable rights and obligations.”
Contract asset	As defined in the ASC Glossary and IFRS 15 Appendix A: “An entity’s right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity’s future performance).”
Contract liability	As defined in the ASC Glossary and IFRS 15 Appendix A: “An entity’s obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.”
Contract modification	A change in the scope or price (or both) of a contract that is approved by the parties to the contract. A contract modification exists when the parties to a contract approve a modification that

Term	Definition
	either creates new or changes existing enforceable rights and obligations of the parties to the contract.
Control	The ability to direct the use of, and obtain substantially all of the remaining benefits from, a good or service. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.
Costs to fulfill a contract	<p>Costs incurred in fulfilling a contract that are recognized as an asset if they meet all of the following criteria:</p> <ul style="list-style-type: none"> □ The costs relate directly to a contract or anticipated contract and can be specifically identified □ The costs generate or enhance resources that will be used in satisfying or continuing to satisfy future performance obligations □ The costs are expected to be recovered
Customer	As defined in the ASC Glossary and IFRS 15 Appendix A: “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.”
Customer option	A customer’s ability to acquire additional goods or services.
Distinct good or service	<p>A good or service that is promised to a customer that meets both of the following criteria:</p> <ul style="list-style-type: none"> □ The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct) □ The entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract)
Expected value	The sum of probability-weighted amounts in a range of possible consideration amounts.
Highly probable (IFRS)	IFRS defines highly probable as significantly more likely than probable. This generally equates to the U.S. GAAP definition of probable.

Term	Definition
Income (IFRS)	As defined in IFRS 15 Appendix A: “Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants”
Incremental costs of obtaining a contract	Costs an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained.
Material right	A promise to deliver goods or services in the future embedded in a current contract that the customer would not receive without entering into that contract. A material right is a separate performance obligation.
Most likely amount	The single most likely amount in a range of possible consideration amounts.
Nonpublic entity (U.S. GAAP)	An entity that does not meet the definition of a public entity.
Not-for-profit entity (U.S. GAAP)	<p>An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:</p> <ul style="list-style-type: none"> □ Significant contributions from contributors who do not expect commensurate or proportionate return □ Operating purposes other than to provide goods or services at a profit □ Absence of ownership interests like those of business entities <p>Entities that fall outside this definition include</p> <ul style="list-style-type: none"> □ All investor-owned entities □ Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans
Performance obligation	<p>A promise in a contract with a customer to transfer to the customer either of the following:</p> <ul style="list-style-type: none"> □ A good or service (or a bundle of goods or services) that is distinct □ A series of distinct goods or services that are

Term	Definition
	substantially the same and that have the same pattern of transfer to the customer
Principal	An entity in a multiparty transaction that provides the specified goods or services to the customer (that is, it controls the promised goods or services before transferring them to the customer).
Probable	<p>U.S. GAAP defines probable as “likely to occur,” which is generally considered to be a 75 percent-80 percent threshold.</p> <p>IFRS defines probable as “more likely than not,” which is greater than 50 percent.</p>
Public business entity (U.S. GAAP)	<p>A business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.</p> <ul style="list-style-type: none"> □ It is required to, or does (including voluntarily), file or furnish financial statements with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing). □ It is required by the Securities Exchange Act of 1934 (the “Act”) or by regulations promulgated under the Act, to file or furnish financial statements with another regulatory agency. □ 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. □ 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. □ 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 (with footnotes) and make them publicly available on a periodic basis. <p>An entity that meets the definition of a public business entity only because its financial statements or financial information is included in another entity’s filing with the SEC is only a</p>

Term	Definition
	public business entity for purposes of financial statements that are filed or furnished with the SEC.
Public entity (U.S. GAAP)	Public entities for U.S. GAAP reporting purposes are entities that are any of the following: <ul style="list-style-type: none"> □ A public business entity □ A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market □ An employee benefit plan that files or furnishes financial statements to the SEC
Readily available resource	A good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity or from other transactions or events.
Refund liability	The amount of consideration received (or receivable) for which the entity does not expect to be entitled (that is, amounts not included in the transaction price).
Revenue	U.S. GAAP defines revenue as inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations [ASC Glossary]. IFRS defines revenue as income arising in the course of an entity's ordinary activities [IFRS 15 Appendix A].
Revenue standard	ASC 606, ASC 340-40, and IFRS 15
Significant financing component	A significant benefit of financing the transfer of goods or services to the customer. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.
Standalone selling price	As defined in the ASC Glossary and IFRS 15 Appendix A: "The price at which an entity would sell a promised good or service separately to a customer."
Transaction price	As defined in the ASC Glossary and IFRS 15 Appendix A: "The amount of consideration to which an entity expects to be entitled in exchange

Term	Definition
	for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.”
Variable consideration	A transaction price amount that is variable or contingent on the outcome of future events, including but not limited to: discounts, refunds, rebates, credits, incentives, performance bonuses, royalties, fixed consideration contingent on a future event, and price concessions.

Index

Acceptance:

customer acceptance clause, 6.5.5

Adjusted market assessment approach, estimating standalone selling price,
5.3.1**Administrative costs, cost-to-cost method,**
6.4.2.1**Advance payment, nonrefundable upfront fees as,** 8.4**Agent:**

amounts collected from customers and remitted to a third party, 10.5

assessment, 10.2

credit risk, 10.2.2.5

discretion in establishing pricing, 10.2.2.3

identify the customer, 2.5

indicators, 10.2.2

inventory risk, 10.2.2.2

out-of-pocket reimbursements, 10.4

primary responsibility for fulfilling the contract, 10.2.2.1

principal considerations versus. *See* Principal versus agent considerations

shipping, 3.4.5, 10.3, Example 10–3 at 10.3

Allocation of transaction price. *See*

Transaction price, allocating

Alternative use, asset with no:

contract inception, 6.3.3.1

revenue recognition over time

entity's performance creates an asset with alternative use to the entity, Example 6–4 at 6.3.3.2

entity's performance does not create an asset with alternative use to the entity, 6.3.3, Example 6–5 at 6.3.3.2

Amendments to contract, 2.6**Amortization of contract cost assets,** 11.4.1**Approval:**

unpriced change order, Example 2–5 at 2.8.1

accounting for contract modifications, 2.8.1, Figure 2–1 at 2.8

of contract, identifying, 2.6.1.1

contract extensions, Example 2–4 at 2.6.1.1

product delivered without a written contract, Example 2–3 at 2.6.1.1

Assets:

contract asset

disclosure, 12.3.5

distinguishing between contract assets and receivables, Example 12–1 at 12.2.1.1

netting of contract assets and contract liabilities, 12.2.1.4

presentation of, 12.2.1.1

recognition decision tree, , Figure 12–1 at 12.2.1.6

statement of financial position descriptions, 12.2.1.5

contract costs

amortization of, 11.4.1, Example 11–6 at 11.4.1, Example 11–6 and 11–7 at 11.4.1,

impairment of, 11.4.2, Example 11–8 at 11.4.2 nonfinancial. *See* Nonfinancial assets

presentation of, 12.2

Bill-and-hold arrangements, Example 8.5
layaway sales, 8.4.2**Bonus, estimating variable consideration,**
4.3.1, 4.3.1.3, 4.3.2.2, 4.3.2.5, Example 4–1 and 4–2 at 4.3.1.3**Breakage (unexercised rights),** 7.4

customer loyalty points, Example 7–8 and 7–9 at 7.4

reassessment of breakage estimate, Example 7–9 at 7.4

gift cards, 7.4, 8.4.3, Example 7–7 at 7.4

rebates, 4.3.3.4

standalone selling price reduced for, 7.2.1

Bundle of combined goods or services, assessment of distinct good or service,
3.3.2, Example 3–2 to 3–4 at 3.2.1, 3.3.2**Call option:**

as a lease, Example 8–10 at 8.7.1

as seller's right to repurchase, 8.7, 8.7.1, Figure 8–2 at 8.7.1

Cancellation rights:

commitment to performance, 2.6.1.1

goods or services, options for acquisition of additional, 7.3

right to payment for performance completed to date, 6.3.3.2

Capitalization:

costs to fulfill a contract, 11.3

incremental costs of obtaining a contract, 11.2

Cash:

as payments to customers, 4.6, Example 4–19 to 4–22 at 4.6, 7.2.4

incentives, 7.2.4

received, identifying significant financing component, 4.4

Catch-up. *See* Cumulative catch-up adjustment**Change order, unpriced, modification approval,** Example 2–5 at 2.8.1**Collaborative arrangement,** identifying the customer, 2.4, Example 2–2 at 2.4**Collectibility,** 2.6.1.5, Example 4–7 at 4.3.3.1**Combined goods or services,** Example 3–2 to 3–4 at 3.3.1, 3.3.2. *See also* Bundle**Combining contracts with customers,** 2.7**Commercial substance,** identifying contracts with customers, 2.6.1.4**Commissions**

agent considerations, 10.2.2.4

- sales. *See* Sales commissions
- Commitment of parties, identifying the contract**, 2.6.1.1
 - trial period, 6.5.5
 - layaway sales, 8.4.2
- Components of contracts, in and out of the scope of the revenue standard**, 2.2.2
- Comprehensive income, statement of comprehensive income**, 12.2.2
- Consideration:**
 - collection as probable, identifying contracts, 2.6.1.5
 - discount rate to adjust for significant financing component, 4.4.3
 - nonmonetary exchanges, 2.2.1
 - payable to a customer, 4.2, 4.6
 - income statement classification of payments made to customer, 4.6.1
 - payment for a distinct service, Example 4–21 at 4.6.1
 - payment for a distinct service in excess of fair value, Example 4–22 at 4.6.1
 - payment to reseller's customer, Example 4–19 at 4.6
 - slotting fees, Example 4–20 at 4.6.1
 - variable. *See* Variable consideration
- Consignment arrangements**, 8.6, Example 8-8 to 8-9 at 8.6
- Constraint on variable consideration**, 4.3.2:
 - amount is highly susceptible to factors outside the entity's influence, 4.3.2.1
 - consideration is constrained, Example 4–3 at 4.3.2.6
 - contract has a large number and broad range of possible consideration amounts, 4.3.2.5
 - entity has a practice of offering price concessions or changing payment terms, 4.3.2.4
 - entity's experience is limited or has limited predictive value, 4.3.2.3
 - multiple forms of variable consideration, Example 4–5 at 4.3.2.6
 - minimum amounts, 4.3.2.7, Example 4–6 at 4.3.2.7
 - subsequent reassessment, Example 4–4 at 4.3.2.6
 - uncertainty is not expected to be resolved for a long period of time, 4.3.2.2
- Contingent revenue cap**, 5.6.3
- Contract:**
 - assets. *See* Contract assets
 - combining, 2.7
 - components in and out of the scope of the revenue standard, 2.2.2
 - costs, 11.1–11.5, *See also* Contract costs
 - defined, 2.6
 - disclosure, 12.3
 - identifying, 2.6
 - approved contract, 2.6.1.1, Example 2-3 at 2.6.1.1
 - approved contract extensions, Example 2–4 at 2.6.1.1
 - consideration collection is probable, 2.6.1.5
 - contract has commercial substance, 2.6.1.4
 - criteria not met, arrangements where, 2.6.2
 - criteria reassessment, 2.6.3
 - entity can identify each party's rights, 2.6.1.2
 - entity can identify the payment terms, 2.6.1.3
 - required criteria, 2.6.1
 - scope, 2.2
 - inception. *See* Contract inception
 - liabilities. *See* Contract liabilities
 - milestones, output method to recognize income, 6.4.1
 - modifications, 2.8, Figure 2–1 at 2.8
 - noncancellable,
 - assets in a, 2.6.1
 - recording a receivable for, Example 12–3 at 12.2.1.3
 - onerous, 11.5
 - performance obligations. *See* Performance obligations
 - primary responsibility for fulfilling, 10.2.2.1
 - promises in. *See* Promises
 - reconciliation of contract balances
 - annual disclosure requirements, Figure 12–2 at 12.3, 12.3.2
 - nonpublic entity disclosure considerations (U.S. GAAP only), Figure 12–3 at 12.3.7
- Contract assets:**
 - disclosure, 12.3.2
 - distinguishing between contract assets and receivables, Example 12–1 at 12.2.1.1
 - netting of contract assets and contract liabilities, 12.2.1.4
 - presentation of, 12.2.1.1
 - recognition decision tree, 12.2.1.6, Figure 12–1 at 12.2.1.6
 - statement of financial position descriptions, 12.2.1.5
- Contract costs**, 11.1–11.5
 - abnormal 6.4.2.1, 11.3.4, Example 11–5 at 11.3.4
 - amortization, 11.4
 - capitalization cost, *See* Capitalization
 - expensed when incurred, 11.3
 - to fulfill a contract, 11.3
 - disclosures 12.3, Figure 12–2 at 12.3
 - recognition model overview, 11.3.1, Figure 11–2 at 11.3.1
 - impairment, 11.4
 - to obtain a contract, 11.2
 - assessing recoverability of, 11.2.1
 - disclosures 12.3, Figure 12-2 at 12.3
 - practical expedient, 11.2.2

- recognition model overview and examples,
 - 11.2.3, Figure 1-1 at 11.2.3, Example 11-1 at 11.2.3, Example 11-2 at 11.2.3, Figure 1-1 at 11.2.3
 - sales commission, Example 11-1 at 11.2.3
 - learning curve costs, 11.3.2
 - onerous contract losses, 11.5 set-up and mobilization costs, 11.3.3, Example 11-4 at 11.3.3
- Contract liabilities:**
 - disclosure, 12.3.2
 - netting of contract assets and contract liabilities, 12.2.1.4
 - presentation of, 12.2.1.2, Example 12-2 at 12.2.1.2
 - recognition decision tree, 12.2.1.6, Figure 12-1 at 12.2.1.6
 - recording,
 - statement of financial position descriptions, 12.2.1.5
- Control:**
 - of goods or services to customer, 6.2-6.5
- Copyright infringement protection,** 3.4.3
- Cost incurred, as input method to recognize revenue,** 6.4.2.1, 6.4.2.2
- Cost-plus approach, estimating standalone selling price,** 5.3.2, Example 5-2 at 5.3.2
- Cost-to-cost method, as input method to recognize revenue,** 6.4.2.1, Example 6-8 at 6.4.2.1
- Counterparty:**
 - identify the customer, 2.1, 2.4
- Coupons,** 2.5, 4.2, Example 4-10, 4.6, Example 7-2
- Credit risk:**
 - collection of consideration is probable, 2.6.1.5
 - discount rate to adjust for financing component, 4.4.3, Example 4-14 at 4.4.4
 - principal versus agent criteria, 10.2.2.5
 - transaction price, 4.2
- Cumulative catch-up adjustment:**
 - allocating changes in transaction prices, 5.5.2
 - inability to estimate progress measurement, 6.4.3
 - modifications to contracts with customers, 2.8.3.2, 2.8.4, Figure 2-1 at 2.8, Example 2-9 at 2.8.3.2
 - variable consideration, 4.3.3.3, Example 4-9 at 4.3.3.3
- Customary business practice:**
 - implicit promises, 3.4.2
 - right to payment for performance completed to date, 6.3.3.2
 - shipment, 3.4.5
 - standalone selling price, determining, 5.2
 - transaction price, 4.2
- Customer:**
 - defined, 2.4
 - identifying the, 2.4, Example 2-2 at 2.4
- Customer acceptance clause,** 6.5.5
- Customer loyalty programs,** 7.2.3
 - points redeemed by issuer or other third parties, 7.2.3.3
 - points redeemed by multiple parties, Example 7-4 at 7.2.3.3
 - points redeemed solely by issuer, 7.2.3.1
 - points redeemed solely by others, 7.2.3.2, Example 7-3 at 7.2.3.2
- Customer options to acquire additional goods or services,** 7.1-7.4, 3.4.4
 - breakage, 7.4, Example 7-7, 7-8, and 7-9 at 7.4
 - cancellation options, 7.3
 - material right provided, 7.2
 - customer loyalty programs, 7.2.3
 - option that does not provide a material right, Example 7-1 and 7-2 in at 7.2
 - significant financing component considerations, 7.2.2
 - standalone selling price of customer option, determining, 7.2.1
 - renewal options, 7.3, Example 7-6 at 7.3
 - unexercised rights, 7.4
- Damages, patent infringement or product liability,** 3.4.3
- Delivery:**
 - bill-and-hold arrangements, 8.5
 - units delivered, output method to recognize income, 6.4.1
- Deposits,**
 - right to payment for performance completed to date, 6.3.3.2
 - non-returnable upfront fees, 8.4
 - layaway sales, 8.4.2
 - contract abilities, 12.2.1.2
- Depreciation, See** amortization
- Disclosure,** 12.3
 - additional interim disclosures
 - U.S. GAAP, 12.3.6.1
 - IFRS, 12.3.6.2
 - annual requirements, Figure 12-2 at 12.3
 - costs to obtain or fulfill a contract, 12.3.5
 - disaggregated revenue, 12.3.1
 - interim requirements, 12.3.6
 - differences between ASC 606 and IFRS 15, Figure 1-1 at 1.1
 - nonpublic entity considerations, 12.3.7, Figure 12-3 at 12.3.7
 - performance obligations, 12.3.3
 - reconciliation of contract balances, 12.3.2
 - significant judgments, 12.3.4

Discount:

- for goods or services
 - contract renewals, 7.3
 - customer options that provide a material right, 7.2, Example 7-2 at 7.2
 - customer loyalty programs, 7.2.3
 - volume discounts, 4.3.3.3, Example 4-8 and 4-9 at 4.3.3.3
 - options to acquire additional, 3.4.4
 - timing, identifying significant financing component, 4.4.1.1
 - transaction price allocation, 5.3, 5.4, Example 5-4 and 5-5 at 5.4, Example 5-1 at 5.2, Example 5-3 at 5.3.3.2
 - variable consideration, 4.3
 - prompt payment, 4.3.3.2
- discount rate
 - determining, significant financing component, 4.4.3, Example 4-14 at 4.4.4
- transaction price, 4.2

Distinct goods or services:

- assessment of, 3.3
 - customer benefits from good or service, 3.3.1, Example 3-1 at 3.3.1
 - good or service is separately identifiable from other promises in contract, 3.3.2
- combination of, Example 3-2, Example 3-3, Example 3-4 at 3.3.2
- consideration payable to a customer, 4.6.1, Example 4-22 at 4.6.1
- payment for, Example 4-21 at 4.6.1
- promise to transfer, 3.2.1
- promise to transfer series, 3.2.2
- series of
 - promise to transfer, 3.2.2
 - variable consideration allocation, 5.5.1, Example 5-6 at 5.5.1

Distributors:

- Incentives offered or matched after inception, 7.2.5
- consignment arrangements, 8.6
- sale of products to a, rights of return, Example 8-1 at 8.2

Dividends, excluded from revenue recognition scope, 2.2

- Presentation in statement of comprehensive income, 12.2.2

Early adoption:

- differences between ASC 606 and IFRS 15, Figure 1-1 at 1.1
- effective date, Figure 13-1 at 13.2

Early payment, discounts, as variable consideration, 4.3.3.2**Effective date, 13.2**

- differences between ASC 606 and IFRS 15, Figure 1-1 at 1.1

- for IFRS reporters, 13.2.1
- summary chart, Figure 13-1 at 13.2
- for U.S. GAAP reporters, 13.2.2

Embedded derivatives, pricing based on index, 4.3.3.5**Estimating transaction price. See Transaction price, estimating****Exchange. See Right to exchange****Expected cost plus a margin approach, estimating standalone selling price, 5.3.2****Expected value method, estimating variable consideration, 4.3.1.1****Expiration:**

- customer loyalty programs, 7.2.3
- of put option, 8.7.2.1

Extension: See also Renewals

- service contract, Example 2-7 and 2-8 at 2.8.3
- variable consideration in transaction price, 4.3.3.6

Fair value:

- consideration payable to a customer for distinct good or service, 4.6.1, Example 4-21 at 4.6.1, Example 4-22 at 4.6.1
- noncash consideration, 4.5
- changes in, biological assets, investment properties, inventory or broker-trader transactions excluded from revenue recognition scope, 2.2

FASB, generally. See Financial Accounting Standards Board**FASB ASC 310, Receivables, 2.2, 4.2, 12.2.1.1****FASB ASC 320, Investments--Debt and Equity Securities, 2.2****FASB ASC 323, Investments--Equity Method and Joint Ventures, 2.2****FASB ASC 325, Investments--Other, 2.2****FASB ASC 340, Other Assets and Deferred Costs,, 1.1, Figure 1-1 at 1.1, 11.2, 11.3, 11.4.2, 12.3.5****FASB ASC 405, Liabilities, 2.2****FASB ASC 460, Guarantees, 2.2, 8.3****FASB ASC 470, Debt, 2.2****FASB ASC 606, Revenue from Contracts with Customers, 1.1, Figure 1-1 at 1.1**

- 606-10-20, 1.2, 2.4, 2.6, 13.2.2.1

- 606-10-25-1, 2.6.1

- 606-10-25-7, 2.6.2

- 606-10-25-9, 2.7

- 606-10-25-12, 2.8.2

- 606-10-25-14, 3.2

- 606-10-25-15, 3.2.2

- 606-10-25-19, 3.3

- 606-10-25-21, 3.3.2

- 606-10-25-23, 6.2

- 606-10-25-27, 6.3

- 606-10-25-31, 6.4
- 606-10-32-2, 4.2
- 606-10-32-5, 4.3
- 606-10-32-8, 4.3.1
- 606-10-32-11, 4.3.2
- 606-10-32-12, 4.3.2
- 606-10-32-15, 4.4
- 606-10-32-16, 4.4, 4.4.1
- 606-10-32-17, 4.4.1
- 606-10-32-18, 4.4.2
- 606-10-32-19, 4.4.3
- 606-10-32-25, 4.6
- 606-10-32-27, 4.6.1
- 606-10-32-28, 5.1
- 606-10-32-31, 5.2
- 606-10-32-34-c, 5.3.3
- 606-10-32-35, 5.3.3.2
- 606-10-32-36, 5.4
- 606-10-32-37, 5.4
- 606-10-32-40, 5.5.1
- 606-10-32-43, 5.5.2
- 606-10-32-45, 2.8.4
- 606-10-55-11, 6.3.3.2
- 606-10-55-17, 6.4.1
- 606-10-55-20, 6.4.2
- 606-10-55-21(b), 6.4.2.2
- 606-10-55-23, 8.2
- 606-10-55-28, 8.2.1
- 606-10-55-33, 8.3
- 606-10-55-42, 7.2
- 606-10-55-44, 7.2.1
- 606-10-55-45, 7.3
- 606-10-55-48, 7.4
- 606-10-55-51, 8.4
- 606-10-55-80, 8.6
- 606-10-55-83, 8.5
- 606-10-55-56, 9.2
- 606-10-55-58, 9.3
- 606-10-55-60, 9.3.1
- 606-10-55-64, 9.3.1.4
- 606-10-55-39, 10.2.2
- 606-10-45-1, 12.2
- 606-10-45-3, 12.2.1.1
- 606-10-45-4, 12.2.1.2
- 606-10-50-1, 12.3
- 606-10-55-90, 12.3.1
- 606-10-55-91, 12.3.1
- 606-10-50-8, 12.3.2
- 606-10-55-91, 12.3.2
- 606-10-50-12, 12.3.3
- 606-10-50-13, 12.3.3
- 606-10-50-18, 12.3.4
- 606-10-50-19, 12.3.4
- 606-10-50-20, 12.3.4
- 606-10-65-1-f, 13.3.1
- FASB ASC 815, *Derivatives and Hedging*,**
2.2
- FASB ASC 825, *Financial Instruments*,** 2.2
- FASB ASC 840, *Leases*,** 2.2, Example 8-1 at
8.7.1, Example 8-12 at 8.7.2.1
- FASB ASC 850, *Related Party Disclosures*,**
2.7
- FASB ASC 860, *Transfers and Servicing*,**
2.2
- FASB ASC 944, *Financial Services--***
***Insurance*,** 2.2
- FASB ASC 980, *Regulated Operations*,** 2.2
- FASB Concepts Statement No 8,** 3.2.1
- FASB Accounting Standards Board**
(FASB):
Accounting Standards Codification. *See* FASB
ASC
Accounting Standards Updates. *See* FASB ASU
No. 2014-09 BC159, BC383, BC407
joint project for revenue recognition guidance,
1.1
- Financial instruments, excluded from**
revenue recognition scope, 2.2
- Financial statements:**
disclosures, 12.3 *see also* Disclosures
presentation, 12.2 *see also* Presentation
- Financing:**
See also Significant financing components
See also Receivables
repurchase 8.7
as call, 8.7.1, Example 8–10 at 8.7.1
as put, 8.7.2
- Five-step model for recognizing revenue,**
1.3.2
- Forfeiture.** *See also* Breakage
layaway sales, 8.4.2
- Forward, as seller's obligation to**
repurchase, 8.7, 8.7.1, Figure 8–2 at 8.7.1
- Free goods or services:**
non cash and cash incentive, 7.2.4, 7.2.5,
Example 7-5 at 7.2.5
option to acquire, 3.4.4
volume discounts, 4.3.3.3
timing at discretion of customer, 4.4.1.1
customer loyalty programs, 7.2.3
- Free or discounted goods or services,**
4.3.3.3, 4.4.1.2, 7.1, 7.2.3
- Fulfillment:**
See contract costs, fulfillment
- Gain:**
defined, 1.2
or loss on sale or transfer of nonfinancial
assets, 2.3
- Gift cards:**
breakage, 7.4, Example 7–7 at 7.4
nonrefundable upfront fees, 8.4.3

Goods or services:

- assessment of distinct good or service, 3.3
 - bundle of combined goods or services,
 - Example 3–2 at 3.3.2, Example 3–4 at 3.3.2
 - bundle of goods or services not combined,
 - Example 3–3 at 3.3.2
 - customer benefits from good or service, 3.3.1,
 - Example 3–1 at 3.3.1
 - good or service is separately identifiable from other promises in contract, 3.3.2
- bill-and-hold arrangements, 8.5
- consignment arrangements, 8.6
- control of, 6.2–6.5
 - revenue recognition, 6.2
- multiple. *See* Transaction price, allocating
- options to acquire additional, 7.1–7.4
 - breakage, 7.4
 - cancellation options, 7.3
 - customer options that provide a material right, 7.2
 - overview, 3.2, 3.4.4, 4.1
 - renewal options, 7.3, Example 7–6 at 7.3
 - unexercised rights, 7.4
- performance obligations satisfied at a point in time, 6.5
- prices for. *See* Transaction price
- promise to transfer
 - a distinct good or service, 3.2.1
 - a series of distinct good or service, 3.2.2
- repurchase rights, 8.7
- returns. *See* Right to return
- transaction prices for. *See* Transaction price
- warranties, 8.3

Goods or services, options to acquire additional:

- customer options that provide a material right
 - customer loyalty programs, 7.2.3
 - option that does not provide a material right,
 - Example 7–1 at 7.2
 - significant financing component
 - considerations, 7.2.2
 - standalone selling price of customer option,
 - determining, 7.2.1

Guarantees:

- excluded from revenue recognition scope, 2.2
- profit margin guarantee, Example 4–12 at 4.3.3.8
- as variable consideration 4.3.3.8

Highly probable *See also* Variable consideration constraint on variable consideration, 4.3.2,

- 4.3.2.2, 4.3.2.6, 4.3.2.7, 4.3.3.3, 5.5.1, 8.2, 9.4
- highly variable or uncertain, residual approach, 5.3.3, 5.3.3.1, 5.3.3.2

IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors, 3.2.1, 13.3.1

IAS 24, Related Party Disclosures, 2.7

IAS 27, Separate Financial Statements, 2.2

IAS 28, Investments in Associates and Joint Ventures (2011), 2.2

IAS 37, Provisions, Contingent Liabilities and Contingent Assets, 8.3

IASB, generally. *See* International Accounting Standards Board

IFRS, generally. *See* International Financial Reporting Standards

IFRS 4, Insurance Contracts, 2.2

IFRS 9, Financial Instruments, 2.2, 4.2, 12.2.1.1

IFRS 10, Consolidated Financial Statements, 2.2

IFRS 11, Joint Arrangements, 2.2, 2.4

IFRS 15, Revenue from Contracts with Customers, 1.1, Figure 1–1 at 1.1

15.9, 2.6.1

15.15, 2.6.2

15.17, 2.7

15.20, 2.8.2

15.22, 3.2

15.23, 3.2.2

15.27, 3.3

15.29, 3.3.2

15.31, 6.2

15.35, 6.3

15.39, 6.4

15.47, 4.2

15.50, 4.3

15.53, 4.3.1

15.56, 4.3.2

15.57, 4.3.2

15.60, 4.4

15.61, 4.4, 4.4.1

15.62, 4.4.1

15.63, 4.4.2

15.64, 4.4.3

15.70, 4.6

15.72, 4.6.1

15.73, 5.1

15.76, 5.2

15.79.c, 5.3.3

15.80, 5.3.3.2

15.81, 5.4

15.82, 5.4

15.85, 5.5.1

15.88, 5.5.2

15.90, 2.8.4

15.B9, 6.3.3.2

15.B15, 6.4.1

15.B18, 6.4.2

15.B19(b), 6.4.2.2

- 15.B21, 8.2
- 15.B26, 8.2.1
- 15.B31, 8.3
- 15.B37, 10.2.2
- 15.B40, 4.2
- 15.B42, 4.2.1
- 15.B43, 4.3
- 15.B46, 4.4
- 15.B49, 8.4
- 15.B54, 9.2
- 15.B56, 9.3
- 15.B58, 9.3.1
- 15.B62, 9.3.1.4
- 15.B78, 8.6
- 15.B81, 8.5
- 15.91, 11.2
- 15.95, 11.3
- 15.97, 11.3
- 15.98, 11.3
- 15.101, 11.4.2
- 15.105, 12.2
- 15.107.108, 12.2.1.1
- 15.106, 12.2.1.2
- 15.110, 12.3
- 15.B88, 12.3.1
- 15.B89, 12.3.1
- 15.116, 12.2
- 15.118, 12.2
- 15.119, 12.3.3
- 15.120, 12.3.3
- 15.127, 12.3.5
- 15.128, 12.3.5
- 15.C5, 13.3.1
- 15.BC159, 6.4
- 15.BC407, 7.9.2
- 15.BC383, 4.2.3.2
- 15.BC407, 9.2
- Appendix A, 1.2, 2.4, 2.6
- Impairment:**
 - of contract cost assets, 11.4
 - loss reversal, differences between ASC 340 and IFRS 15, Figure 1–1 at 1.1
 - losses, transaction price, 4.2
- Implicit promises in a contract, 3.2, 3.4.2**
- Incentives:**
 - free goods or services, 7.2.4
 - in loyalty programs. *See* Customer loyalty programs
 - performance obligations, 7.2.4–7.2.5
 - principal versus agent considerations, 7.2.4
 - prompt payment discounts, 4.3.3.2
 - rebates, 4.3.3.4
 - volume discounts, 4.3.3.3
- Income, revenue compared to, 1.2, Example 1–1 at 1.2**
- Income, statement of comprehensive income, 12.2.2**
- Inconsequential promises, 3.2.1**
- Incremental costs of obtaining a contract, 11.2:** *See* Contract Costs
 - assessing recoverability of, 11.2.1
 - practical expedient, 11.2.2
 - recognition model overview and examples, 11.2.3, Example 11–1 at 11.2.3, Example 11–2 at 11.2.3, Figure 1–1 at 11.2.3
 - sales commission, Example 11–1 at 11.2.3
- Index, pricing based on, 4.3.3.5**
- Industry sales price averages, cost-plus approach, 5.3.2**
- Input methods to recognize revenue:**
 - based on cost incurred, 6.4.2.1
 - cost-to-cost method, Example 6–8 at 6.4.2.1
 - measures of progress over time, 6.4, 6.4.2
 - time-based methods, 6.4.2.3
 - uninstalled materials, 6.4.2.2
- Insurance contracts, excluded from revenue recognition scope, 2.2**
 - See also* Licenses
 - licenses with sales- or usage-based royalties as transaction price exception, 4.3.5, 9.4
 - right to access
 - assessment of activities that do not otherwise transfer goods or services, 9.3.1.3
 - assessment of activities that significantly affect the IP, 9.3.1.1
 - assessment of exposure to effects of activities that significantly affect the IP, 9.3.1.2
 - assessment of licenses that provide, 9.1, 9.3.1.4
 - distinct licenses that provide, 9.3, Example 9–3 at 9.3.1
 - licenses of IP with sales- or usage-based royalties, 9.4
 - right to use
 - assessment of licenses that provide, 9.1
 - distinct licenses that provide, 9.3, Example 9–4 at 9.3.2
 - licenses of IP with sales- or usage-based royalties, 9.4
 - variable consideration, exception, 4.3.2.1
- Interest income or expense, significant financing component, 4.4**
- International Accounting Standards Board (IASB):**
 - International Accounting Standards (IAS). *See* IAS No.
- International Financial Reporting Standards (IFRS):**
 - additional interim disclosures, 12.3.6.2
 - collection as probable, 2.6.1.5
 - joint project for revenue recognition guidance, 1.1, Figure 1–1 at 1.1
 - patent infringement or product liability, 3.4.3
 - reporters
 - effective date, 13.2.1

- transition relief, 13.3.1.1
- revenue recognition scope, 1.3.1
- right to return, 8.2
- standalone selling price reduced for breakage, 7.2.1
- transition and effective date, 1.6
- variable consideration, recording minimum amounts, 4.3.2.7
- variable consideration as probable, 4.3.2, 4.3.2.2, Example 4–6 at 4.3.2.7
- estimate rebates, to determine transaction price, 4.3.3.4
- volume discounts, 4.3.3.3
- Intrinsic value, standalone selling price,** 7.2.1
- Inventory, stock rotation, right to return,** 8.2
- Inventory risk, principal versus agent considerations,** 10.2.2.2
- Invoicing, timing of invoicing and performance,** 12.2.1.3, Example 12–3 at 12.2.1.3
- IP.** *See* Intellectual property
- Labor, cost-to-cost method,** 6.4.2.1
- Layaway sales,** 8.4.2
- Learning curve costs,** 11.3.2
- Leases:**
 - excluded from revenue recognition scope, 2.2
 - repurchase price
 - as forward call, 8.7.1, Example 8–10 at 8.7.1
 - as put, 8.7.2
- Legal:**
 - precedent, right to payment for performance
 - completed to date, 6.3.3.2
 - requirements, enforceability of contract, 2.6
 - unexercised rights (breakage), 7.4
 - title, customer has, recognizing revenue at a point in time, 6.5, 6.5.2
 - legal title retained as a protective right, Example 6–10 at 6.5.2
 - revenue recognition at a point in time, 6.5, 6.5.2
- Liabilities, contract:**
 - netting of contract assets and contract liabilities, 12.2.1.4
 - presentation of, 12.2, 12.2.1.2
 - reorganizing and rewording decision tree, 12.2.1.6, Figure 12–1 at 12.2.1.6, Example 12–2 at 12.2.1.2
 - statement of financial position descriptions, 12.2.1.5
 - reconciliation of 12.3.2
- Licenses, 9.1–9.4**
 - assessment of distinct licenses, 9.1
 - licenses that are distinct, 9.2, Example 9–2 at 9.2, Example 9–3 at 9.3.1, Example 9–4 at 9.3.2
 - licenses that are not distinct, 9.2, Example 9–1 at 9.2
 - payment terms and significant of financing component, 9.3.3
 - intellectual property access
 - assessment of, 9.1
 - criteria for, 9.3.1
 - intellectual property right to use
 - assessment of, 9.1
 - licenses of IP with sales- or usage-based royalties, 9.4
 - intellectual property with sales- or usage-based royalties, 4.3.5, 9.4
 - nature of, 9.3
 - factors that do not impact, 9.3.1.4
- List price in contract, standalone selling price, determining,** 5.2
- Loss:**
 - on sale or transfer of nonfinancial assets, 2.3
 - on onerous contracts, 11.5
- contingencies, patent infringement or product liability,** 3.4.3
- adjusted market assessment approach,** 5.3.1
- impairment, *See* Impairment loss
- reversal, impairment** 11.4.2
- Loyalty programs.** *See* Customer loyalty programs
- Loyalty points.** *See* Customer loyalty programs
- Margin.** *See also* Profit margin
 - cost plus a margin approach, 5.3.2
- Market:**
 - adjusted market assessment approach, 5.3.1
 - cost-plus approach, 5.3.2
- Marketing, 6.4.2.1**
 - costs, 6.4.2.1
 - offer, 7.2
 - studies, 8.4.1
- Material rights:**
 - defined, 7.2
 - free or discounted goods or services, 4.3.3.3
 - nonrefundable upfront fees, 8.4.1
 - nonrefundable upfront fees accounting, when renewal option exists, 8.4.1
 - options to acquire additional goods or services, 3.4.4, 7.2
 - customer loyalty programs, 7.2.3
 - option that does not provide a material right, Example 7–1 at 7.2
 - significant financing component
 - considerations, 7.2.2
 - standalone selling price of customer option, determining, 7.2, 7.2.1
 - renewal and cancellation options, 7.3
- Materials:**
 - uninstalled, 6.4.2.2

Measures of progress over time, 6.4

- inability to estimate progress, 6.4.3
- input methods, 6.4, 6.4.2
- output methods, 6.4, 6.4.1, Example 6–7 at 6.4.1

Minimum amounts:

- constraint on variable consideration, Example 4–6 at 4.3.2.7
- recording, constraint on variable consideration, 4.3.2.7

Mobilization costs:

- contract costs, 11.3.3, Example 11–5 at 11.3.3
- nonrefundable upfront fees, 8.4
- activities that are not performance obligations, 3.4.1
- input methods, 6.4.2

Modifications to contracts with customers, 2.8

- accounting for, Figure 2–1 at 2.8
 - as a separate contract, 2.8.2
- additional good or service is not distinct, Example 2–9 at 2.8.3.2
- approval assessment, 2.8.1
 - unpriced change order, Example 2–5 at 2.8.1
- changes in transaction price, 2.8.4, 4.3.4
- defined, 2.8
- not accounting for as a separate contract, 2.8.3
 - accounting for through a cumulative catch-up adjustment, 2.8.3.2, 2.8.4
 - extending a service contract, Example 2–7 and 2–8 at 2.8.3
 - prospective accounting, 2.8.3.1, 2.8.4, Figure 2–1 at 2.8
- variable consideration, periods after contract expiration, but prior to contract renewal, 4.3.3.6

Most likely amount method, 4.3.1, 4.3.1.2, 5.5, Example 4–2 at 4.3.1**Multiple goods or services. See** Performance obligations and *See* Transaction price, allocating**Non-exchange transactions, excluded from revenue recognition scope, 2.2****Noncancellable contracts,**

- assets and liabilities in a, 2.6.1.1
- recording a receivable for, Example 12–3 at 12.2.1.3

Noncash consideration, transaction price, 4.5

- materials provided by customer to facilitate fulfillment, Example 4–16 at 4.5
- variable due to the form of the consideration, Example 4–17 at 4.5
- variable for other reasons than the form of the consideration, Example 4–18 at 4.5

Nonfinancial assets, sale or transfer of, 2.3**Nonmonetary exchange:**

- evaluation of, and scope, 2.2.1
- excluded from revenue recognition scope, 2.2

Nonpublic entities:

- disclosure, U.S. GAAP only, 12.3.7, Figure 12–3 at 12.3.7
- effective date, Figure 13–1 at 13.2
- U.S. GAAP reporter effective date, 13.2.2.2
- relief for, differences between ASC 606 and IFRS 15, Figure 1–1 at 1.1

Nonrefundable upfront fees or payments, 8.4

- accounting for, when renewal option exists, 8.4.1
- breakage, 7.4
- gift cards, 8.4.3
- health club joining fees, Example 8–5 at 8.4
- layaway sales, 8.4.2
- right to payment for performance completed to date, 6.3.3.2
- transaction price allocated to separate performance obligations, 5.6.2
- upfront fee allocated to separate performance obligations, Example 8–4 at 8.4

Option-pricing models, to estimate standalone selling price, 7.2.1**Options. See** Customer options to acquire additional goods or services**Oral contract, 2.6:**

- agreements, 1.2
- approval, 2.6.1.1, Example 2–3 at 2.6.1.1
- identifying each parties rights, 2.6.1.2
- modifications, 2.8.1

Out-of-pocket reimbursements, principal versus agent considerations, 10.4**Output:**

- good or service as separately identifiable from other promises in contract, 3.3.2
- methods to recognizing revenue, measures of progress over time, 6.4, 6.4.1, Example 6–7 at 6.4.1

Over time, revenue recognition, 6.3

- customer controls/does not control the work in process as the good or service is created, 6.3.2, Examples 6–2 and 6–3 at 6.3.2
- customer simultaneously receives and consumes benefits, 6.3.1, Example 6–1 at 6.3.1
- entity has enforceable right to payment for performance completed to date, 6.3.3, 6.3.3.2
- entity's performance
 - creates an asset with alternative use to the entity, Example 6–4 at 6.3.3.2
 - creates an asset with no alternative use, Example 6–5 at 6.3.3.2

- creates or enhances an asset that the customer controls, 6.3.2, Examples 6–2 and 6–3 at 6.3.2
- does not create an asset with alternative use to the entity, 6.3.3
- highly specified asset with no alternative use, Example 6–5 at 6.3.3.2
- right to payment, 6.3.3, 6.3.3.2, Example 6–6 at 6.3.3.2
- Ownership, significant risks and rewards, revenue recognition at a point in time, 6.5, 6.5.4**
- Patent infringement protection, identifying performance obligations, 3.4.3**
- Payment:**
 - prepayment. *See* Upfront fees or payments prior to performance, significant financing component, Example 4–15 at 4.4.4
 - right to. *See* Right to payment
 - terms for
 - assessment of licenses and payment terms, 9.3.3
 - changing, constraint on variable consideration, 4.3.2.4
 - entity can identify the, 2.6.1.3
 - timing differences for reasons other than financing, 4.4.1.3
- Performance obligations:**
 - additional good or service is not distinct, modifications to contracts with customers, Example 2–9 at 2.8.3.2
 - combining contracts, 2.7
 - commitment of parties, 2.6.1.1
 - control transfer, 6.3, 6.3.1
 - disclosure, 12.3.3
 - annual requirements, Figure 12–2 at 12.3
 - nonpublic entity considerations (U.S. GAAP only), Figure 12–3 at 12.3.7
 - distinct goods or services, 3.2.2, 3.3, 3.3.1, 3.3.2, Example 3–1 at 3.3.1, Example 3–2 at 3.3.2, Example 3–3 at 3.3.2, Example 3–4 at 3.3.2
 - identifying, 3.1, 3.2, 10.2.2, Example 3–5 at 3.4.1, Example 3–6 at 3.4.1, Example 3–7 at 3.4.5
 - activities that are not performance obligations, 3.4.1, Examples 3–5 to 3–6 at 3.4.1
 - implicit promises in contract, 3.4.2
 - options to acquire additional goods or services, 3.2, 3.4.4, 7.1–7.4
 - other considerations, 3.4, 5.6
 - overview, 1.3, 3.1
 - patent infringement protection, 3.4.3
 - product liability protection, 3.4.3
 - promises in a contract, 3.2, 3.2.1, 3.2.1.3, 3.2.2
 - shipment of goods to customer, 3.4.5
 - implicit promise as, 3.4.2
 - incentives, 7.2.4–7.2.5
 - material right, 7.2, Example 7–1 at 7.2, Example 7–2 at 7.2, Example 7–6 at 7.3, Example 7–8 at 7.4
 - recognizing revenue, 6.1–6.5
 - renewal and cancellation options, 7.3
 - satisfied over time, 6.3
 - timing of invoicing and performance, 12.2.1.3, Example 12–3 at 12.2.1.3
 - transaction price allocating to separate, 5.1–5.6
 - warranties as, 8.3, Example 8–3 at 8.3
- Perfunctory promises, 3.2.1**
- Physical possession:**
 - bill-and-hold, 8.5
 - layaway, 8.4.2
 - revenue recognition at a point in time, 6.5, 6.5.3
 - sale of goods with resale restrictions, Example 6–11 at 6.5.3
- Point in time, revenue recognition at a, 6.5**
 - customer has accepted the asset, 6.5, 6.5.5
 - customer has legal title, 6.5, 6.5.2
 - customer has physical possession, 6.5, 6.5.3
 - customer has significant ownership risks and rewards, 6.5, 6.5.4
 - entity has a right to payment, 6.5, 6.5.1
- Points in loyalty programs. *See* Customer loyalty programs**
- Portfolio approach to contracts:**
 - contract, identifying and scope, 2.1
 - overview, 1.3.3
- Practical application issues, 8.1–8.7**
 - bill-and-hold arrangements, 8.5
 - layaway sales, 8.4.2
 - consignment arrangements, 8.6
 - nonrefundable upfront fees, 8.4
 - accounting for, when renewal option exists, 8.4.1
 - gift cards, 8.4.3
 - health club joining fees, Example 8–5 at 8.4.1
 - layaway sales, 8.4.2
 - upfront fee allocated to separate performance obligations, Example 8–4 at 8.4
- principal versus agent, 10.1
- repurchase rights, 8.7
 - call option (seller's right to repurchase), 8.7, 8.7.1, Figure 8–2 at 8.7.1
 - forward (seller's obligation to repurchase), 8.7, 8.7.1, Figure 8–2 at 8.7.1
 - put option (customer's right to require the entity to repurchase), 8.7, 8.7.2, Figure 8–3 at 8.7.2
- rights of return, 8.2
 - exchange rights, 8.2.1
 - refund obligation and return asset, Example 8–2 at 8.2
 - sale of products to a distributor, Example 8–1 at 8.2
- warranties, 8.3

accounting for warranty obligations, Figure 8–1 at 8.2

assessing as performance obligation, 8.3, Example 8–3 at 8.3

Practical expedients:

from considering significant financing component, 4.4.2

disclosure

annual requirements, Figure 12–2 at 12.3

nonpublic entity considerations, Figure 12–3 at 12.3.7

for expensing costs to obtain a contract as incurred, 11.2.2, Example 11–1 at 11.2.3

transition, 13.3.1

Prepayment. *See* Upfront fees or payments

Presentation, 12.2

of contract assets and receivables, 12.2.1.1, Example 12–1 at 12.2.1.1

of contract liabilities, 12.2.1.2, Example 12–2 at 12.2.1.2

netting of contract assets and contract liabilities, 12.2.1.4

overview, 12.1

recognition decision tree, 12.2.1.6, Figure 12–1 at 12.2.1.6

recording

a contract liability, Example 12–2 at 12.2.1.2

a contract receivable for a noncancellable contract, Example 12–3 at 12.2.1.3

statement of comprehensive income, 12.2.2

statement of financial position, 12.2.1

statement of financial position descriptions, 12.2.1.5

timing of invoicing and performance, 12.2.1.3, Example 12–3 at 12.2.1.3

Price:

accounting for contract modifications, 2.8.2, Figure 2–1 at 2.8

to repurchase versus original sales price, 8.7.1, 8.7.2

standalone selling. *See* Standalone selling price

transaction. *See* Transaction price

unpriced change order, modification approval, Example 2–5 at 2.8.1

constraint on variable consideration, 4.3.2.4

as variable consideration in transaction price, 4.3.3.1, Example 4–7 at 4.3.3.1

Price matching, as variable consideration in transaction price, 4.3.3.7

Price protection, as variable consideration in transaction price, 4.3.3.7, Example 4–11 at 4.3.3.7

Pricing:

based on index, as variable consideration in transaction price, 4.3.3.5

discretion in establishing, 10.2.2.3

Principal versus agent considerations, 10.1–10.5

accounting implications, 10.2.1

amounts collected from customers and remitted to a third party, 10.5

assessing whether an entity is principal or agent, 10.2, Example 10–1 at 10.2.3, Example 10–2 at 10.2.3

credit risk, 10.2.2.5

discretion in establishing pricing, 10.2.2.3

form of consideration, 10.2.2.4

inventory risk, 10.2.2.2

noncash and cash incentives, 7.2.4

out-of-pocket reimbursements, 10.4

primary responsibility for fulfilling the contract, 10.2.2.1

shipping and handling fees, 10.3, Example 10–3 at 10.3

shipping service, 3.4.5

Probability-weighted method, estimating variable consideration in transaction price, 4.3.1, 4.3.1.1, 7.5, Example 4–1 at 4.3.1.3

Probable: *See also* Collectibility and Variable consideration differences between ASC 606 and IFRS 15, Figure 1–1 at 1.1

five-step model, 1.3.2

contracts with customers, 2.6.1

collection of consideration, 2.6.1.5

reassessment of criteria, 2.6.3

constraint on variable consideration, 4.3.3.3,

4.3.2.7, 4.3.3.4, 7.2.1, 8.2, 9.4, 4.3.2, 4.3.2.2

collection threshold as, identifying contracts,

2.6.1.5

variable consideration constraint as, 4.3.2,

4.3.2.2, 4.3.2.1

Product liability protection, identifying performance obligations, 3.4.3

Products. *See* Goods or services

Profit margin:

cost-plus approach, 5.3.2

expected, adjusted market assessment approach, 5.3.1

guarantee, as variable consideration in

transaction price, Example 4–12 at 4.3.3.8

right to payment for performance completed to date, 6.3.3.2

Promises:

goods or services, 1.3.2

are separately identifiable from other, 3.3.2

identifying performance obligations, 3.2

transfer, 3.2.1, 3.2.2

implicit, 3.2, 3.4.2

Prompt payment discounts, as variable consideration in transaction price, 4.3.3.2

Prospective accounting, modifications to contracts with customers, 2.8.3.1, 2.8.4, Figure 2–1 at 2.8

Protective right:

legal title retained as a, 6.5.2, Example 6–10 at 6.5.2
warranties, 8.3

Public entities:

effective date, Figure 13–1 at 13.2
U.S. GAAP reporter effective date, 13.2.2.1
IFRS reporter effective date, 13.2.1

Put option:

accounted as a lease, Example 8–12 at 8.7.2.1
accounted as a right to return, Example 8–11 at 8.7.2.1
as customer's right to require the entity to repurchase, 8.7, 8.7.2, Figure 8–3 at 8.7.2
significant economic incentive to exercise, 8.7.2.1

Rate-regulated activities, excluded from revenue recognition scope, 2.2

Readily available resources, defined, 3.3.1, 3.3.2

Reassessment:

criteria, identifying contracts with customers, 2.6.3
of estimated volume discounts, Example 4–9 at 4.3.3.3
subsequent, constraints on variable consideration, Example 4–4 at 4.3.2.6
of breakage estimates, Example 7–9 at 7.4

Rebates, as variable consideration in transaction price, 4.3.3.4, Example 4–10 at 4.3.3.4

Receivables. *See also* Contract assets and receivables
distinguishing between contract assets and receivables, Example 12–1 at 12.2.1.1
presentation of, 12.2.1.1
recognition decision tree, 12.2.1.6, Figure 12–1 at 12.2.1.6
recording, for a noncancellable contract, Example 12–3 at 12.2.1.3
recording noncancellable, Example 12–3 at 12.2.1.3
statement of financial position descriptions, 12.2.1.5

Reconciliation of contract balances, disclosure, 12.3.2

annual requirements, Figure 12–2 at 12.3
nonpublic entity considerations, U.S. GAAP, Figure 12–3 at 12.3.7

Redemption of points. *See* Customer loyalty programs

Refunds:

consideration payable to a customer, 4.6

nonrefundable upfront fees, 5.6.2
not customer options, 7.1
price protection, 4.3.3.7, Example 4–11 at 4.3.3.7
profit margin guarantee, Example 4–12 at 4.3.3.8
refund liability, 8.2
right to payment for performance completed to date, 6.3.3.2, Example 6–4 at 6.3.3.2
rights to return, 8.2, Example 8–2 at 8.2
variable consideration, 4.3

Renewal options:

accounting for nonrefundable upfront fees, 8.4.1, Example 8–5 at 8.4.1
consideration of, in amortization and impairment, 11.4.1, 11.4.2, 11.4, Example 11–6 at 11.4.1, Example 11–7 at 11.4.1, Example 11–8 at 11.4.2
options to acquire additional goods or services, 3.4.4
goods or services, options for acquisition of additional, 7.3, Example 7–6 at 7.3
rates for, nonrefundable upfront fees, 8.4.1
variable consideration in transaction price, 4.3.3.6

Repurchase rights. *See* Right to repurchase

Resale:

sale of goods with restrictions, Example 6–11 at 6.5.3

Research and development:

cost-to-cost method, 6.4.2.1, Example 9–1 at 9.2, Example 8–4 at 8.4
expected costs, 8.3.2
identifying the customer controls the asset, Example 2–2 at 2.4
activities that affect it, 9.3.1.1
learning curve costs, 11.3.2

Residual approach:

discount allocation, Example 5–5 at 5.4
estimating standalone selling price, Example 5–3 at 5.3.3

Resources readily available, 9.2

Residual approach use of additional considerations, Example 5–3

Retrospective application:

full, transition relief for IFRS reporters, 13.3.1.1
modified, transition, 13.3.2
transition, 13.3.1

Return. *See* Right of return

Revenue:

defined, 1.2
income compared to, 1.2, Example 1–1 at 1.2

Revenue from contracts with customers, 1.1–1.6

acquisition of additional goods or services, options for, 7.1–7.4
background, 1.1, Figure 1–1 at 1.1
bill-and-hold arrangements, 8.5
combining contracts, 2.7

- consignment arrangements, 8.6
- contract modifications, 2.8
- differences between ASC 606 and IFRS 15, 1.1, Figure 1–1 at 1.1
- disclosure, 1.5, 12.3
- effective date, 1.6, 13.1–13.2, Figure 13–1 at 13.2
- five-step model for recognizing revenue, 1.3.2
- high-level overview, 1.3
- identifying
 - the contract, 2.6
 - the customer, 2.4
 - performance obligations, 3.1–3.4
- implementation guidance, 1.4
- introduction, 1.1–1.6
- licenses, 9.1–9.4
- multiple party arrangements, 2.5
- nonfinancial asset transfers, 2.3
- nonrefundable upfront fees, 8.4
- practical application issues, 8.1–8.7
- presentation, 12.1–12.2
- principal versus agent considerations, 10.1–10.5
 - accounting implications, 10.2.1
 - assessing whether an entity is principal or agent, 10.2
 - overview, 10.1
- recognizing revenue, 6.1–6.5
- repurchase rights, 8.7
- revenue, defined, 1.2
- right to return, 8.2
- sale of nonfinancial assets, 2.3
- scope
 - high-level overview, 1.3.1
 - identifying the contract and, 2.2
- transaction price
 - allocating to separate performance obligations, 5.1–5.6
 - determining the, 4.1–4.6
- transition, 1.6, 13.3
- warranties, 8.3
- Revenue recognition, 6.1–6.5**
 - control of a good or service, 6.2–6.5
 - performance obligations satisfied at a point in time, 6.5
 - five step model, 1.3.2, Figure 1–1 at 1.3.2
 - measures of progress over time, 6.4
 - inability to estimate progress, 6.4.3
 - input methods, 6.4, 6.4.2
 - output methods, 6.4, 6.4.1, Example 6–7 at 6.4.1
 - over time, 6.3
 - customer controls the work in process as the good or service is created, 6.3.2, Examples 6–2 and 6–3 at 6.3.2
 - customer simultaneously receives and consumes benefits, 6.3.1, Example 6–1 at 6.3.1
 - entity has enforceable right to payment for performance completed to date, 6.3.3, 6.3.3.2
 - entity's performance creates or enhances an asset that the customer controls, 6.3.2, Examples 6–2 and 6–3 at 6.3.2
 - entity's performance does not create an asset with alternative use to the entity, 6.3.3, Example 6–5 at 6.3.3.2
 - right to payment, Example 6–6 at 6.3.3.2
 - overview, 6.1
 - at a point in time, 6.5
 - customer has accepted the asset, 6.5, 6.5.5
 - customer has legal title, 6.5, 6.5.2
 - customer has physical possession, 6.5, 6.5.3
 - customer has significant ownership risks and rewards, 6.5, 6.5.4
 - entity has a right to payment, 6.5, 6.5.1
 - satisfied, performance obligations as, 6.2
- Reversal of revenue:**
 - variable consideration constraint, *See* variable consideration in transaction price.
- Right, unexercised, options for acquisition of additional goods or services, 7.4**
- Right to:**
 - access intellectual property, assessment of activities that do not otherwise transfer goods or services, 9.3.1.3
 - assessment of activities that significantly affect the IP, 9.3.1.1
 - assessment of exposure to effects of activities that significantly affect the IP, 9.3.1.2
 - assessment of licenses that provide, 9.1, 9.3.1.4
 - distinct licenses that provide, 9.3, Example 9–3 at 9.3.1
 - licenses of IP with sales- or usage-based royalties, 9.4
 - exchange, application of, 8.2.1
 - payment, enforceable, for performance completed to date, 6.3.3, 6.3.3.2
 - revenue recognition at a point in time, 6.5, 6.5.1
 - revenue recognition over time, 6.3.3, 6.3.3.2, Example 6–6 at 6.3.3.2
 - repurchase, 8.7
 - call option (seller's right to repurchase), 8.7, 8.7.1, Figure 8–2 at 8.7.1
 - forward (seller's obligation to repurchase), 8.7, 8.7.1, Figure 8–2 at 8.7.1
 - put option (customer's right to require the entity to repurchase), 8.7, 8.7.2, Figure 8–3 at 8.7.2
 - return, 8.2
 - exchange rights, 8.2.1
 - forms of, 8.2

- refund obligation and return asset, Example 8–2 at 8.2
 - repurchase and, 8.7.2
 - sale of products to a distributor, Example 8–1 at 8.2
 - variable consideration, 4.3
 - scope of contracts, Example 2–1 at 2.2.1
- use intellectual property,
 - assessment of licenses that provide, 9.1
 - distinct licenses that provide, 9.3, Example 9–4 at 9.3.2
 - licenses of IP with sales- or usage-based royalties, 9.4
- Royalties:** *See also* Sales based royalties
 - intellectual property (IP) licenses, 4.3.5
 - Variable consideration, 4.3
- Sale:**
 - of additional goods, modifications to contracts, Example 2–6 at 2.8.2
 - of gift cards, 7.4, 8.4.3, Example 7–7 at 7.4
 - of goods with resale restrictions, Example 6–11 at 6.5.3
 - of nonfinancial assets, 2.3
 - of products to a distributor, rights of return, Example 8–1 at 8.2
 - standalone selling price of customer option, determining, 7.2.1
- Sales-based royalties:**
 - intellectual property (IP) licenses, 4.3.5
 - variable consideration, 4.3
 - exception for licenses of IP, 9.4
- Sales commissions, as incremental cost of obtaining a contract,** Example 11–1 at 11.2.3, *See also* Commissions
- Sales incentives.** *See* Incentives
- Sales taxes,** 4.2, 10.5
- Scope:**
 - accounting for contract modifications, 2.8.1, 2.8.2, Figure 2–1 at 2.8
 - contracts with components in and out of the scope of the revenue standard, 2.2.2
 - exclusions, 2.2
 - identifying the contract and, 2.6
 - nonmonetary exchange evaluation, 2.2.1
 - exchange of products, Example 2–1 at 2.2.1
- Selling price, standalone.** *See* Standalone selling price
- Separate contracts:**
 - accounting for contract modifications, 2.8.2, 2.8.3, Figure 2–1 at 2.8
 - contract combinations, *See* combining contracts with customers
 - sale of additional goods, Example 2–6 at 2.8.2
- Separate performance obligations, *See* Performance obligations**
- Series of distinct goods or services, *See* distinct goods or services**
- Service level agreements (SLA), as variable consideration,** 4.3.3.8
- Set-up activities, nonrefundable upfront fees,** 8.4
- Set-up costs,** 11.3.3
- Shipping and handling, principal versus agent considerations,** 10.3, Example 10–3 at 10.3
- Shipping services, identifying performance obligations,** Example 3–7 at 3.4.5
- Side agreements,** 2.6
- Significant financing component:**
 - customer options, 7.2.2
 - transaction price, 4.4
 - discount rate, determining, 4.4.3, Example 4–14 at 4.4.4
 - payment prior to performance, Example 4–15 at 4.4.4
 - practical expedient from considering, 4.4.2
 - transaction price, identifying, 4.4.1
 - prepayment with intent other than to provide financing, Example 4–13 at 4.4.1.3
 - timing difference arises for reasons other than providing financing, 4.4.1.3
 - timing is at customer discretion, 4.4.1.1
 - variable consideration, based on future event occurrence, 4.4.1.2
- Significant judgments, disclosure,** 12.3.4
 - annual requirements, Figure 12–2 at 12.3
 - nonpublic entity considerations, Figure 12–3 at 12.3.7
- Simultaneously receives and consumes benefits, revenue recognition over time,** 6.3.1, Example 6–1 at 6.3.1
- SLA.** *See* Service level agreements
- Slotting fees, consideration payable to customer,** Example 4–20 at 4.6.1
- Standalone selling price:**
 - best evidence for, 5.2
 - customer loyalty programs, 7.2.3
 - of customer option
 - determining, 7.2.1
 - customer options to acquire additional goods or services, 7.2
 - estimate with option-pricing models, 7.2.1
 - prospective accounting for contract modification, 2.8.3.1
 - transaction price allocated to separate performance obligations, 5.2–5.3
 - adjusted market assessment approach, 5.3.1
 - determining, as directly observable, Example 5–1 at 5.2
 - expected cost plus a margin approach, 5.3.2
 - as not directly observable, estimating, 5.3
 - residual approach, 5.3.3

- total transaction price exceeds the sum of, 5.6.1
- Standards.** *See specific standards and regulatory bodies*
- Stated price in contract, standalone selling price, determining,** 5.2
- Statement of comprehensive income,** 12.2.2
- Statement of financial position,** 12.2.1
 - descriptions, 12.2.1.5
- Subcontractor costs, cost-to-cost method,** 6.4.2.1
- Subsequent changes in transaction price, allocated to separate performance obligations,** 5.5.2, Example 5–7 at 5.5.2
- Supply and demand, adjusted market assessment approach,** 5.3.1
- Taxation, amounts collected from customers and remitted to a third party,** 10.5
- Tax implications,** 13.3.2
- Termination clauses:**
 - arrangements where criteria are not met, 2.6.2
 - commitment to performance, 2.6.1.1
 - right to return, 8.2
- Terminology, statement of financial position descriptions,** 12.2.1.5
- Third parties:**
 - amounts collected from customers and remitted to, 10.5
 - points redeemed by, customer loyalty programs, 7.2.3.3
 - variable consideration, influences on, 4.3.2.1
- Time-based methods, to recognize revenue,** 6.4.2.3
- Time value of money, repurchase versus original sales price,** 8.7.1, 8.7.2, *See also* Significant financing component
- Timing:**
 - identifying significant financing component
 - at customer discretion, 4.4.1.1
 - difference arises for reasons other than providing financing, 4.4.1.3
 - of invoicing and performance, 12.2.1.3, Example 12–3 at 12.2.1.3
- Trade-in agreements, right of return,** 8.2
- Trademark infringement protection,** 3.4.3
- Transaction price:**
 - allocating. *See* Transaction price, allocating
 - changes in, modifications to contracts with customers, 2.8.4
 - defined, 4.2
 - determining the. *See* Transaction price, determining
 - estimating. *See* Transaction price, estimating
 - exception for intellectual property (IP) licenses with sales- or usage-based royalties, 4.3.5, 9.4
 - exclusions, 4.2
 - nonrefundable upfront fees, 8.4
 - sale or transfer of nonfinancial assets, 2.3
 - total, and estimating variable consideration, 4.3.1
 - variable consideration in. *See* Variable consideration in transaction price
- Transaction price, allocating,** 5.1–5.6
 - amounts collected from customers and remitted to a third party, 10.5
 - customer loyalty programs, 7.2.3
 - discounts, allocating, 5.4, Example 5–4 and 5–5 at 5.4,
 - contingent revenue cap, 5.6.3
 - nonrefundable upfront fees, 5.6.2
 - standalone selling price
 - determining, as directly observable, Example 5–1 at 5.2
 - estimating, when not directly observable, 5.3
 - total transaction price exceeds the sum of, 5.6.1
 - standalone selling price, estimating when not directly observable
 - adjusted market assessment approach, 5.3.1
 - expected cost plus a margin approach, 5.3.2
 - residual approach, 5.3.3
 - total transaction price exceeds the sum of standalone selling prices, 5.6.1
 - variable consideration allocations, 5.5
 - distinct goods or services that form a single performance obligation, Example 5–6 at 5.5.1
 - subsequent changes in transaction price, 5.5.2, Example 5–7 at 5.5.2
- Transaction price, determining and estimating,** 4.1–4.6
 - consideration payable to a customer, 4.6
 - income statement classification of payments made to customer, 4.6.1
 - payment for a distinct service, Example 4–21 at 4.6.1
 - payment for a distinct service in excess of fair value, Example 4–22 at 4.6.1
 - payment to reseller's customer, Example 4–19 at 4.6
 - slotting fees, Example 4–20 at 4.6.1
 - exception for intellectual property (IP) licenses with sales- or usage-based royalties, 4.3.5, 9.4
 - noncash consideration, 4.5
 - materials provided by customer to facilitate fulfillment, Example 4–16 at 4.5
 - variable due to the form of the consideration, Example 4–17 at 4.5

- variable for other reasons than the form of the consideration, Example 4–187 at 4.5
- variable consideration, *See* Variable consideration in transaction price
- rebates, to determine transaction price, 4.3.3.4
- rights of return, 8.2
- significant financing component, *See* significant financing component
- variable consideration in transaction price, 4.3.1
 - bonus, 4.3.1, 4.3.1.3, , Example 4–1 and 4–2 at 4.3.1.3
 - changes in estimate, 4.3.4
 - expected value method, 4.3.1.1
 - most likely amount method, , 4.3.1.2, probability-weighted, , 4.3.1.1, , Example 4–1 at 4.3.1.3
- volume discounts, reassessment of estimated, Example 4–9 at 4.3.3.3, Example 4-9, Example 4-10 at 4.3.3.3
- Transfers of control:**
 - bill-and-hold arrangements, 8.5
 - consignment arrangements, 8.6
 - to customer, 6.2–6.5
 - measures of progress over time, 6.4
 - performance obligations satisfied at a point in time, 6.5
 - performance obligations satisfied over time, 6.3
 - of nonfinancial assets, 2.3
 - promised goods or services, 3.2
 - a distinct good or service, 3.2.1
 - a series of distinct good or service, 3.2.2
- Transition, 13.3**
 - U.S. GAAP and IFRS, 1.6, 13.3
 - modified retrospective application, 13.3.2
 - practical expedients, 13.3.1
 - relief for IFRS reporters electing full retrospective application, 13.3.1.1
 - retrospective application, 13.3.1
- Uncertainty:**
 - Prompt payments as incentives, 4.3.3.2
 - of renewal and cash flows, 1.3, 12.3, Figure 12-2 at 12.3
 - rebates, as incentives, 4.3.3.4
 - recording minimum amounts, 4.3.2.7
 - resolution of, constraint on variable consideration, 4.3.2, 4.3.2.2, Example 4-3, 4-4 and 4-5 at 4.3.2
- Unexercised rights, options for acquisition of additional goods or services, 7.4**
- Uninstalled materials:**
 - defined, 6.4.2.2
 - input methods to recognize revenue, 6.4.2.2, Example 6–9 at 6.4.2.2
- Units delivered, output method to recognize income, 6.4.1**
- Upfront fees or payments:**
 - with intent other than to provide financing, significant financing component, Example 4–13 at 4.4.1.3
 - nonrefundable. *See* Nonrefundable upfront fees or payments
- U.S. GAAP:**
 - additional interim disclosures, 12.3.6.1
 - collection as probable, 2.6.1.5
 - disclosure, 1.5
 - effective date, 13.2.2
 - nonpublic entity disclosure considerations, GAAP, 12.3.7, Figure 12–3 at 12.3.7
 - sale or transfer of nonfinancial assets, 2.3
 - transition and effective date, 1.6
 - variable consideration
 - estimate rebates, to determine transaction price, 4.3.3.4
 - as probable, 4.3.2, 4.3.2.2, Example 4–6 at 4.3.2.7
 - recording minimum amounts, 4.3.2.7
 - volume discounts, 4.3.3.3
- Usage-based royalties:**
 - intellectual property (IP) licenses, 4.3.5, 9.3.3, 9.4
 - variable consideration, 4.3
- Variable consideration, 4.3**
 - allocated to separate performance obligations, 5.5
 - distinct goods or services that form a single performance obligation, Example 5–6 at 5.5.1
 - subsequent changes in transaction price, 5.5.2, Example 5–7 at 5.5.2
 - common forms, 4.3.3
 - guarantees, 4.3.3.8
 - periods after contract expiration, but prior to contract renewal, 4.3.3.6
 - price concessions, 4.3.3.1, Example 4–7 at 4.3.3.1
 - price matching, 4.3.3.7
 - price protection, 4.3.3.7, Example 4–11 at 4.3.3.7
 - pricing based on index, 4.3.3.5
 - profit margin guarantee, Example 4–12 at 4.3.3.8
 - prompt payment discounts, 4.3.3.2
 - rebates, 4.3.3.4, Example 4–10 at 4.3.3.4
 - service level agreements (SLA), 4.3.3.8
 - volume discounts, 4.3.3.3, Example 4–8 at 4.3.3.3
 - volume discounts, reassessment of estimated, Example 4–9 at 4.3.3.3
 - constraint on, *See* constraints on variable consideration
 - estimating, 4.3.1

- changes in estimate, 4.3.4
- expected value method, 4.3.1.1
- most likely amount method, *See* Most likely amount method
- probability-weighted, 4.3.1, 4.3.1.1, 5.5, Example 4-1 at 4.3.1.3
- fair value of noncash consideration, 4.5
- Volume discounts, as variable consideration**, 4.3.3.3, Example 4-8 and 4-9 at 4.3.3.3,
- Warranties**, 8.3
 - accounting for warranty obligations, Figure 8-1 at 8.3
 - assessing as performance obligation, 8.3, Example 8-3 at 8.3
- Will call.** *See* Layaway sales
- Work in process:**
 - control, 6.3.2, Examples 6-2 and 6-3 at 6.3.2
 - cost-to-cost method, 6.4.2.1, Example 6-8 at 6.4.2.1
- Written contract:**
 - approval, 2.6.1.1
 - modifications, 2.8.1
 - product delivered without a, Example 2-3 at 2.6.1.1

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