

**FINANCIAL ACCOUNTING
STANDARDS BOARD**

**REVENUE RECOGNITION
IMPLEMENTATION Q&As**

Compiled from Previously Issued Educational Materials

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OVERVIEW

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. Topic 606 establishes the principles to report useful information to users of financial statements about the nature, timing, and uncertainty of revenue from contracts with customers.

The Update:

- Removes inconsistencies and weaknesses in existing revenue requirements
- Provides a more robust framework for addressing revenue issues
- Improves comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets
- Provides users of financial statements with more useful information through improved disclosure requirements
- Simplifies the preparation of financial statements by reducing the number of requirements to which organizations must refer.

The FASB announced the formation of the Transition Resource Group for Revenue Recognition (TRG) in June 2014. The purpose of the TRG was to:

- Solicit, analyze, and discuss stakeholder issues arising from implementation of the new guidance
- Inform the FASB and the IASB about those implementation issues, which will help the Boards determine what, if any, action will be needed to address those issues
- Provide a forum for stakeholders to learn about the new guidance from others involved with implementation.

During the meetings, the TRG members shared their views on the issues. The TRG did not issue any authoritative guidance. The *FASB Accounting Standards Codification*[®] is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied to nongovernmental entities.

The FASB issued the following Accounting Standards Updates to clarify the application of Topic 606 for several issues discussed by the TRG:

- On December 21, 2016, the Board issued Accounting Standards Update No. 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*.

- On May 9, 2016, the Board issued Accounting Standards Update No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*.
- On April 14, 2016, the Board issued Accounting Standards Update No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*.
- On March 17, 2016, the Board issued Accounting Standards Update No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*.

TRG meetings were held jointly with the IASB in 2014 and 2015. TRG meetings in 2016 were held by the FASB.

Compilation Process

The Q&As included in this document have been compiled from publicly available TRG memos and other educational resources that had previously been made available during the implementation of Topic 606. The staff's full analyses for the issues described in this document, along with educational resources discussed by the Private Company Council (PCC) and for the franchising industry, can be found on the FASB [website](#). However, for ease of use and as part of the Board's continuing commitment to educate stakeholders, the staff has developed this Q&A document that compiles questions and responses into a single format and location.

The staff's objective in compiling this Q&A is to improve the ease of navigating the educational resources and is not intended to issue any new implementation guidance. Accordingly, the staff compiled this Q&A using excerpts from memos previously issued. In cases in which the same issue was discussed in multiple previously issued memos, the staff consolidated those discussions into a single Q&A. Additionally, the Q&As herein reflect a compilation of both the staff previously issued memos on the issues as well as the summary of the TRG discussions. Issues for which the Board undertook standard-setting efforts are excluded from this Q&A document because the Codification contains the ultimate resolution of those issues and, accordingly, some TRG memos may not still be relevant.

For contextual purposes, this Q&A focuses only on the guidance in the Codification. It does not address other regulatory, rules, or compliance requirements that entities may need to consider when preparing and issuing financial statements.

This Q&A document includes 81 questions. Each question includes the corresponding section references within the Codification and are categorized by subject matter. While some questions may relate to multiple sections within Topic 606, they have been included only once within this document.

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SCOPE

Question 1: Are the rights and obligations of a credit card issuing bank's contract with the credit cardholder within the scope of Topic 606?

Reference(s): Sections 606-10-15 and 310-20-15

A card issuing bank can have various income streams from a cardholder. Those revenue streams related to interest income, credit card balance consolidation and balance transfer fees, late (delinquency) fees, returned check fees (on customer's credit card payment), cash advance fee, foreign currency fees, rush/expedited card fees, over-limit fee, and overdraft protection fees are all within the scope of Topic 310, Receivables, and, therefore, are not included in the scope of Topic 606, Revenue from Contracts with Customers, (per the scope exception in paragraph 606-10-15-2). Those income streams have specific guidance in Topic 310, for example, interest income is addressed in paragraph 310-10-25-9 and delinquency fees (which includes late fees and returned check fees) are addressed in paragraph 310-10-25-13. Many of the other fees are considered to be loan origination fees as addressed in Section 310-20-20.

However, questions have arisen as to whether other credit card fees (such as periodic or annual fees) are within the scope of Topic 310 or within the scope of Topic 606. The question arises because some services might be provided in conjunction with the lending arrangement and the receipt of the credit card fee. For example, the card issuing bank may provide certain ancillary services, such as concierge services or airport lounge access. This had led some stakeholders to question whether those services should be included within the scope of Topic 606.

In order to answer this question, one must first assess whether the fees are within the scope of Topic 310. If the fees are within the scope of Topic 310, then the guidance in that Topic would apply. Subtopic 310-20, Nonrefundable Fees and Other Costs, includes guidance on the recognition and the balance sheet classification of nonrefundable fees and costs associated with lending activities. If the fees are not within the scope of Topic 310, then an entity would need to assess the contract under Topic 606. The staff is aware that some stakeholders are referring to paragraph 606-10-15-4 in trying to determine the answer to this question. However, the staff notes that the guidance in that paragraph would apply at the point an entity determines that a contract includes goods or services within the scope of both Topic 606 and another Topic. That is, once that determination is made, the guidance in paragraph 606-10-15-4 provides a hierarchy on how to apply separation and allocation guidance. Therefore, if a determination is made that all goods or services in a contract are outside of the scope of Topic 606 then the guidance in that paragraph would not be applicable.

Additionally, the basis for conclusions of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, describes that the Board concluded that a loan commitment might be either integral to

lending or a separate customer service depending on the nature of the commitment. The Board concluded that to the extent a fee is to compensate the entity for a service provided during the commitment period, the separate components of a commitment fee cannot be identified and measured reliably enough to allow for separate accounting recognition for each component part. The staff notes that the basis for conclusions is non-authoritative; however, this description in the basis provides context around the language in paragraph 310-20-25-15 that “credit card fees generally cover many services to cardholders.”

The staff thinks that this question arises, in part, because the scope guidance in Topic 310 relates to a “fee” while the scope guidance in Topic 606 relates to “goods and services.” However, if the fee is within the scope of Topic 310, then the staff thinks that the services being performed in exchange for that fee also would be within the scope of Topic 310.

In the staff’s view, credit card fees are within the scope of Topic 310 based upon the guidance in Topic 310 and the basis for conclusions of Statement 91 explains what the Board considered to be “credit card fees.” Consequently, credit card fees are not within the scope of Topic 606.

As part of the staff’s research on this implementation question, the staff discussed the accounting for credit card fees under current GAAP with stakeholders. The staff’s outreach included many credit cards issuing banks and some of the large accounting firms that have significant experience auditing those institutions. All the stakeholders included in the staff’s outreach stated that all credit card fees are presently accounted for within the scope of Topic 310 (specifically Subtopic 310-20), rather than the guidance in Topic 605, Revenue Recognition. The staff notes that the Update for Topic 606 did not include consequential amendments to Topic 310 to change the scope of that topic related to credit card fees. Consequently, in the staff’s view, the conclusion under existing and new revenue recognition guidance should be the same.

The staff thinks it is important to note that a credit card issuing bank should not assume that all of its types of arrangements are excluded from the scope of Topic 606 solely because credit card fees are excluded from the scope of Topic 606. The entity should evaluate its other types of arrangements and reach a conclusion about the applicable GAAP for those other types of arrangements. For example, an entity that issues credit cards might also offer asset management services to clients for a fee. Those asset management services likely would be within the scope of Topic 606. Paragraph 606-10-15-1 states that the guidance in Topic 606 applies to **all entities**. That is, there are no entities or industries that are excluded from Topic 606. Rather, paragraph 606-10-15-2 provides a list of contracts/transactions that are within the scope of other Topics. Therefore, it would not be appropriate for an entity to conclude that it is excluded from the scope of Topic 606 solely because of its industry (such as, a financial institution or an insurance company).

The staff also thinks it is important to note that if any entity (bank or otherwise) enters into an arrangement that is labelled a credit card lending arrangement, but the overall nature of the arrangement is not a credit card lending arrangement, then the entity should not presume that the arrangement is entirely within the scope of Topic 310 and outside the scope of Topic 606.

As an example, to illustrate the staff's point, assume an entity enters into an arrangement that is labelled a credit card lending arrangement and that involves the entity providing a credit card to the customer and the entity also transferring control of an automobile to the customer. In exchange, the customer pays a fee to the entity. Although the arrangement includes a credit card lending component, the overall nature of the arrangement is not simply a credit card lending arrangement. The transfer of control of an automobile is a key element of the arrangement. Consequently, the entity cannot assume that the entire arrangement is within the scope of Topic 310.

Question 2: Are cardholder rewards programs subject to Topic 606?

Reference(s): Section 606-10-15

The 2011 Exposure Draft (ED), *Revenue Recognition (Topic 605): Revenue from Contracts with Customers*, included an example of a customer loyalty program that was within the scope of Topic 606 and provided a material right to the customer resulting in a separate performance obligation for the loyalty points (Example 22 in 2011 ED). In response to the 2011 ED, some preparers in the financial services industry requested clarification about the application of the proposal to credit card rewards programs. Specifically, those respondents were uncertain whether the Board intended the revenue model to be applied to credit card rewards models.

The Board deliberated whether to provide explicit guidance on this issue (in situations in which the rewards program is deemed not to be within the scope of another topic, such as Topic 310). The Board decided that entities should follow the guidance in the model to determine instances when customer loyalty rewards programs are or are not performance obligations and did not specify whether credit card rewards programs are in or out of the scope of Topic 606. This decision is outlined in the basis for conclusions of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, specifically, paragraph BC388.

It is important to note that Example 52 in Topic 606 (paragraph 606-10-55-353) does not address the scope question being asked. Rather, it addresses the accounting for a contract already deemed to be within the scope of Topic 606. The staff notes that there are differences between the credit card arrangements and the fact pattern included in Example 52. Additionally, the example is addressing a specific fact pattern rather than illustrating the general accounting for all reward programs.

The staff highlights that there are several items to consider in answering this question. Because the outcomes would be facts and circumstances specific, there is no single answer as to whether credit card rewards programs broadly are included in or excluded from the scope of Topic 606. Rather, the staff has outlined parts of Topic 606 that entities should consider when concluding in their specific scenarios.

The scope section of Topic 606 provides guidance on how to account for contracts when the contract includes both a financial instrument component and another component included

within the scope of Topic 606. For example, if an entity concludes that the entire arrangement consideration is within the scope of Topic 310 (that is, because the recognition of the credit card fees related to the rewards program are within the scope of that Topic) then the rewards program would not be within the scope of Topic 606. However, if the entity were to conclude the contract included a component within the scope of Topic 606, the following are some items an entity should consider when determining the appropriate accounting for the reward program.

- (a) Step 1 of the revenue model requires an entity to identify the customer in the contract. The entity would need to determine who its customer(s) is (are) in the arrangement (for example, the entity's customer may be the merchant paying interchange fees, rather than the cardholder, or both).
- (b) Step 1 of the revenue model provides guidance about when to combine two or more contracts with the same customer and account for them as a single contract. If the contracts are not with the same customer (for example, where there is a contract with the cardholder and a separate contract with the merchant, which are not related parties), the entity would not need to combine the contracts.
- (c) Step 2 of the revenue model provides guidance for identifying performance obligations (including material rights). If an entity concluded that a contract is within the scope of Topic 606 and that the cardholder is a customer, then the entity would assess whether goods and services provided under the rewards program are distinct goods or services. It is important to note that just because the cardholder is determined to be a customer, does not mean it is the card issuer's only customer (that is, the card issuer may conclude that its customers are the cardholders and the merchants).

Question 3: Are incentive-based capital allocations, such as carried interest, within the scope of Topic 606?

Reference(s): Section 606-10-15

Some entities, particularly asset managers, receive incentive-based performance fees via an allocation of capital from an investment fund under management (that is, through a "carried interest"). The fees are provided to compensate the asset manager for its services and performance in managing the fund. Many stakeholders think there are two aspects to those incentive-based fee arrangements: (a) compensation for asset management services and (b) financial exposure to the fund's performance. Stakeholders have raised questions about whether those arrangements are within the scope of Topic 606 or, instead, are within the scope of other GAAP, such as Topic 323, Investments—Equity Method and Joint Ventures, which is listed as a scope exception in paragraph 606-10-15-2(c)(3).

The staff's view is that incentive-based capital allocations are within the scope of Topic 606. The staff's view primarily is based on the following considerations:

- (a) Example 25 in Topic 606 illustrates the Board's intention about how the new revenue model would be applied to an asset manager services contract that includes a performance-based incentive fee. While the example does not state that the form of the incentive fee is a capital allocation or cash (or some other asset), the staff does not think that the arrangement is within or outside of the scope of Topic 606 depending on whether the fee is payable by cash or via carried interest.
- (b) Carried interest is designed to compensate an asset manager for the services it performs in managing and investing in the fund. The view that incentive-based capital allocations are within the scope of Topic 606 is consistent with previous Board decisions about these arrangements and results in a consistent treatment within the asset management industry and relative to service contracts in other industries.
- (c) In Accounting Standards Update No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*, the Board excluded performance-based fees from the analysis in determining the primary beneficiary of a VIE if (i) the compensation was commensurate with the services provided and (ii) the service agreement included only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length. The basis for that decision was that service arrangements that meet these two previously mentioned criteria are inherently different from other types of variable interests because that type of compensation does not subject the reporting entity to risk of loss. The risks associated with performance-based fees are only the opportunity costs of the nonreceipt of fees and not the actual exposure to losses. The staff's understanding is that during the deliberations of Update No. 2015-02, the Board's intent was that carried interest arrangements represent decision-maker fees for services and not an ownership interest.

In the staff's view, the services provided for incentive-based capital allocations, such as carried interest, are similar to services provided for separately managed accounts or non-U.S. corporations in which incentive-based performance fees are received in cash. The staff's understanding is that the legal form of asset management contracts can vary significantly. Some stakeholders have informed the staff that there is a risk that if incentive-based capital allocations are outside of the scope of Topic 606 (because they are ownership interests and should be accounted for under other GAAP), it could result in an entity structuring its investment management arrangements (that is, by having compensation be paid via an equity interest) to circumvent the revenue model in Topic 606. Consequently, some stakeholders assert that some management contracts that are economically similar would be accounted for differently.

Many TRG members agreed that the arrangements are within the scope of Topic 606. A few TRG members stated that they can understand a view that carried interest could be considered an equity arrangement, because it is, in form, an interest in the entity. Some TRG members stated that if the arrangements are considered equity interests outside the scope of Topic 606, then questions could arise in practice about the effect of such a conclusion on the analysis of whether the asset managers should consolidate the funds. In addition, each of the seven FASB

Board members stated during the meeting that they believe that carried interests are within the scope of Topic 606.

The SEC staff observer at the TRG meeting indicated that he anticipates the SEC staff would accept an application of Topic 606 for those arrangements. However, the observer noted that there may be a basis for following an ownership model. If an entity were to apply an ownership model, then the SEC staff would expect the full application of the ownership model, including an analysis of the consolidation model under Topic 810, the equity method of accounting under Topic 323, or other relevant guidance.

Question 4: Is servicing and sub-servicing income within the scope of Topic 606?

Reference(s): Sections 606-10-15, 860-50-15, 606-10-32, and 606-10-25

Some financial institutions originate loans (primarily mortgage loans) and subsequently sell them to third parties (for example, government-sponsored entities that securitize large quantities of similar loan assets). When a financial institution sells the loan to a third party, it sometimes retains the right to service the financial asset. Additionally, entities may acquire or assume the rights to service financial assets.

The entity that services a loan (servicer) performs various services, such as communication with the borrower and collection of interest, principal, and escrow payments. The level of service provided by the servicer depends on the type of loan and contractually specified terms. In exchange for servicing the loan, the servicer receives a contractually specified servicing fee. The servicer also could be compensated for their servicing activities through late fees as well as interest income earned on cash received and held before being remitted to another party (sometimes referred to as float).

In addition, a servicer might engage another entity (sub-servicer) to perform certain servicing tasks based on a contractual agreement. Unless otherwise noted, references to servicing income contemplate both servicing and sub-servicing income.

Paragraph 606-10-15-2(c) contains a scope exception for financial instruments and other contractual rights or obligations within the scope of Topic 860, Transfers and Servicing. Subtopic 860-50 requires that an intangible asset or liability be initially recognized, at fair value, when the expected future servicing cash flows (that is, the benefits of servicing) are in excess of the going market rate for those services (defined as adequate compensation in Topic 860). If the servicing fees over the life of the servicing contract are expected to provide the servicer with more than adequate compensation, then the servicer recognizes an asset; if it is expected to be less than adequate compensation, then the servicer recognizes a liability. These assets or liabilities must be either remeasured at fair value each period or amortized over the course of the servicing contract. If an entity uses the amortization method, it must assess servicing assets or servicing liabilities for impairment or increased obligation at each reporting date. Total expected cash

flows (which reflect expectations of collectibility) from the servicing fee are a key input into the measurement of the asset or liability.

Regardless of whether a servicing asset or liability exists (or is measured at zero because the servicing income is equal to adequate compensation), the servicer is entitled to the contractually specified servicing fee each period. The staff's understanding is that under current practice, servicers generally record servicing income as it is received. In some situations, servicers consider the principles for revenue recognition in SEC Staff Accounting Bulletin (SAB) Topic 13, Revenue Recognition. For example, an entity may consider whether amounts are fixed or determinable and collectibility is reasonably assured before recognizing revenue.

While Topic 860 includes detailed guidance on the initial recognition and subsequent measurement of servicing assets and liabilities, it does not include explicit guidance describing the revenue recognition of contractually specified servicing fees. However, based on the guidance in Topic 860 that requires a fair value estimate (or evaluation of impairment) at each reporting date, some stakeholders noted that the subsequent measurement guidance in Topic 860 provides implicit guidance on how to account for the servicing cash flows; that is, they view the remeasurement of the asset/liability and the collection of servicing fees (which gives rise to recording of the servicing income) as being closely linked. In a typical servicing arrangement, the servicer generally receives and records servicing fees as income each period. During each period, an amortization or remeasurement entry is made for the mortgage servicing right (MSR) asset/liability, which contemplates the receipt (or nonreceipt) of the servicing income for that period. The servicing income, including expectations of future servicing cash flows, are inputs for the measurement of the MSR asset/liability. The net result on the income statement is that the servicer records the contractual cash received in each period as income, offset by the amortization or remeasurement of the MSR asset/liability. Topic 860 describes the subsequent measurement of the MSR asset/liability.

In the staff's view, servicing arrangements that are within the scope of Topic 860 (which should not change as a result of Topic 606) are not within the scope of Topic 606. The staff acknowledges the different views about what those servicing cash flows represent (revenue versus realization of an intangible asset/liability) and thinks there is merit to the assertion that Topic 860 provides guidance on how to reflect the servicing cash flows via subsequent measurement of the MSR asset/liability. In reaching its view, the staff placed weight on the following factors:

- (a) Topic 860 is included within the scope exceptions of Topic 606 in paragraph 606-10-15-2. The guidance in Topic 860 is an accounting model (including disclosure requirements) that evolved over the course of previous standard setting that requires servicing arrangements to be recognized on the balance sheet akin to a financial asset and allows for an entity to measure the MSR asset/liability at fair value each reporting period.
- (b) Topic 860 includes disclosure requirements for servicing arrangements, including the total servicing fees received and a disaggregation of the different components. Topic 860 also includes disclosures relating to assumptions used to calculate fair value, which

would incorporate all servicing cash flows, including the inputs related to adequate compensation.

- (c) Recognition outcomes under Topic 606 (if the services are considered a series in accordance with paragraph 606-10-25-15 and the variable consideration meets the criteria in paragraph 606-10-32-40 to be allocated to each increment of service (for example, a month)) likely would be similar to the way in which practice applies Topic 860.
- (d) Applying Topic 606 to servicing arrangements could lead to practice questions (and potentially amendments to Topic 860), specifically with regards to the notion that expected cash flows currently factor into the measurement of the MSR asset/liability rather than the recognized revenue amounts. Those would be two different bases (actual cash flows and revenue per Topic 606) upon which the same cash flow stream in the same contract is recognized/measured.

However, in the staff's view, it would not be concerning if an entity that applies Topic 860 refers to the accounting framework described in Topic 606 to assist with recognition conclusions for servicing income or to provide the disclosures required by Topic 606 to the extent they are applicable and incremental to the disclosure requirements of Topic 860.

The staff also considered other fact patterns raised by stakeholders in the context of this scoping question:

- (a) Residual fees or income related to servicing (for example, nonsufficient funds charges and modification fees). The staff believes that the scoping framework described above also would apply to those fees because they are all considered benefits of servicing and, therefore, are incorporated into the measurement of the MSR asset/liability.
- (b) Income earned in situations in which a servicing asset is not obtained, or a service liability is not incurred under Topic 860. The scope of Topic 860 includes transactions in which servicing assets are obtained and servicing liabilities are incurred, including transactions in which loans are transferred with servicing retained by the transferor. If a servicing arrangement is not within the scope of Topic 860, the staff thinks it is clear on the basis of the scoping guidance in paragraph 606-10-15-2 that all servicing (or sub-servicing) income would be within the scope of Topic 606. The staff thinks that even if the amounts of servicing income are determined at the reporting date to be at adequate compensation (and, therefore, no servicing asset or servicing liability is recorded), an entity would need to still consider the various requirements in Topic 860; therefore, these arrangements would be outside the scope of Topic 606.
- (c) Servicing asset/liability subsequent measurement at fair value versus amortized cost. Under either method, the periodic reductions in the MSR asset/liability in accordance with the subsequent measurement guidance in Topic 860 reflect only the difference between the actual fees and adequate compensation; therefore, the staff thinks that the servicer's election regarding how to remeasure the MSR asset/liability does not affect the scoping considerations described above.

- (d) Hedging. The staff notes that some entities utilize hedging strategies to offset the income statement volatility of the MSR asset/liability remeasurement, but the staff thinks this is irrelevant to the scoping analysis for the servicing income.
- (e) Borrower non-payment and servicing advances. When borrowers do not make payments on a loan, stakeholders have expressed that servicing income may not be recorded yet in relation to that particular loan, and the lack of payment is reflected in the measurement of the MSR asset/liability. Meanwhile, servicing agreements may require the servicer to make payments (advances) to the loan owner or investors, during any period when the borrower does not make payments. Servicers often are entitled to recover those advances either from the borrower, loan owner or investor, or other third parties. The staff thinks that the existence of these arrangements does not affect the scoping analysis described above; however, entities may need to use judgment to consider whether revenue recognition of the servicing income is appropriate when the promised servicing inflows are not received from the borrower.

Question 5: Are deposit-related fees within the scope of Topic 606?

Reference(s): Section 606-10-15

When a customer deposits money with a depository institution (bank), the bank recognizes a liability that typically would be accounted for under Topic 405, Liabilities, because the bank generally has an obligation to deliver cash to the customer upon demand.

As part of the depository agreement, the financial institution generally is obligated to provide the customer with access to the deposited funds, serve as a custodian of the funds, and when applicable, pay interest on the deposits. Customers can access deposited funds through a variety of mechanisms and customers sometimes have to pay a fee (for example, customers might pay fees for use of an ATM or a cashier's check). Financial institutions sometimes charge customers fees that are not specifically related to the customer accessing its funds, such as account maintenance or dormancy fees.

The amount of deposit fees assessed varies based on many factors, such as the type of customer and account, the quantity of transactions, and the size of the deposit balance. Financial institutions charge, and in some circumstances do not charge, fees to earn additional revenue and influence certain customer behavior. An example is a bank that does not charge a monthly service fee, or does not charge for certain transactions, for customers that have a high deposit balance. Deposit fees can be considered either transactional in nature (such as ATM fees, wire transfers, foreign exchange, and stop payment orders) or non-transactional (such as account maintenance and dormancy fees).

Questions have arisen about whether services arising from depository arrangements and the related fees are within the scope of Topic 606 or if they are excluded from the scope of Topic 606 and are, instead, within the scope of another Topic, such as Topic 405.

The staff's view is that deposit fees are within the scope of Topic 606. The scope exception in paragraph 606-10-15-2 only relates to the deposit liability (that is, Topic 405 only addresses the accounting for the deposits that the customer gives to the financial institution, not the related fees). In the staff's view, the lack of guidance for deposit fees in Topic 405 (or other areas of GAAP) means that Topic 606 is the only applicable guidance to apply. This view aligns with the Board's intent described in paragraph BC61 in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, that contractual rights or obligations that fall under other Topics, where specific guidance exists in those topics, would not be within the scope of Topic 606. The staff understands that under current GAAP, in the absence of specific detailed application guidance in Topic 405, some financial institutions apply the principles within the SEC's SAB Topic 13, Revenue Recognition, codified as paragraph 605-10-S99-1, for guidance on how to account for the deposit-related fees. In addition, the staff understands that those fees commonly are presented as revenue (that is, non-interest income).

Implementation Considerations

Some stakeholders asserted that application of Topic 606 for deposit-related fees likely would not lead to significantly different recognition and measurement outcomes when compared with current practice. Considering the straightforward nature of the arrangements, this assertion intuitively seems reasonable to the staff (although the staff, of course, is not familiar with how every entity accounts for the fees today).

However, some stakeholders have raised concerns that some in practice might think that (a) significant changes could result from applying Topic 606 and/or (b) financial institutions might need to engage in significant implementation efforts to adopt Topic 606 for deposit fees.

To try to be helpful to stakeholders and potentially reduce the implementation effort, the staff has included below some considerations related to applying Topic 606 to deposit fees.

Contract term and optional purchases

An entity applies Topic 606 to the contract term. The contract term can have a significant effect on the application of Topic 606 because it affects the identification of promised goods or services, the transaction price, and the allocation of the transaction price (among other things).

The staff understands that customers generally have the right to cancel their depository arrangements (and retrieve their deposited funds) at any time without penalties compensating the other party. As a result, the contract term would be a day-to-day (or minute-to-minute) contract in which the termination clause is akin to a renewal right, and each day (or minute) represents a renewal of the contract. The staff understands that some arrangements provide both parties with a unilateral right to terminate without compensating the other party. If the contract term is determined to be daily, then the recognition outcomes likely would be similar regardless of the number of performance obligations identified.

Consider the following examples:

Example 1

An entity enters into a depository contract with a customer under which the entity continues to provide services until the contract is terminated. Each party can immediately terminate the contract without compensating the other party for the termination (that is, there is no termination penalty). In month 1, the customer executes an outgoing wire transfer and the entity charges a fee of \$10. In month 2, the customer uses an ATM of another financial institution and the entity charges the customer \$3.

The duration of the depository contract does not extend beyond the services already provided. This is because either party can cancel the contract without compensating the other party. The relationship is, in effect, a day-to-day contract.

Because the contract does not extend beyond the services performed, the entity would recognize revenue for the wire transfer fees in month 1 (for example, at the end of month 1 there is no future contract under which to allocate consideration) and the ATM fees in month 2.

Example 2

Assume the same facts as Example 1 and the following additional facts. The entity charges the customer a monthly account maintenance fee of \$5 unless the customer meets one of the agreed upon criteria (for example, the customer receives a direct deposit at least once a month or the customer maintains a minimum average daily balance). On occasion, a customer will raise a customer service issue, and the entity has a past practice of agreeing to rebate some or all of the \$5 fee. Based on the entity's historical experience, about 3% of maintenance fees are refunded to customers.

The staff thinks the following is a reasonable application of Topic 606 to this fact pattern:

With respect to the monthly fee, the entity would recognize revenue of \$5 each month if it is entitled to the fee because the customer did not meet one of the agreed-upon criteria. Because the contract term does not extend beyond the services already provided (either party can immediately terminate the contract without compensating the other party), the entity would not need to make estimates about future monthly fees from a customer (that is, project whether the customer will meet one of the criteria). Instead, the entity would recognize revenue for the maintenance fee if the customer does not meet one of the criteria and it would not recognize revenue for the maintenance fee if the customer meets one of the criteria. The entity would consider whether it should reduce the transaction price for refunds given to customers who raise a customer service issue. Based on the entity's historical experience, it reduces the total maintenance fee revenue (transaction price) by 3% per month (if the item is material).

With respect to the fee of \$10 for executing an outgoing wire transfer and \$3 for using the ATM of another financial institution, the entity would account for those fees the same as Example 1. The entity would recognize revenue for the wire transfer fees and ATM fees when the services are performed.

The staff thinks limiting the amounts recognized as revenue to the amounts under the current contract is consistent with paragraph BC186 in Update No. 2014-09.

Transaction price

Some stakeholders asked the staff about applying Topic 606 to deposit account fee structures whereby some customers pay fees and other customers pay no fees (or pay reduced fees). In those situations, some stakeholders questioned how to determine the transaction price when the amount of expected cash consideration (zero) is not equal to the price an entity charges other customers. Some stakeholders questioned whether the application of Topic 606 would lead to a financial statement gross up by recognizing revenue with an equal offset to interest expense.

For “premier” customers for which no fees are charged, the staff thinks an entity should consider the guidance for determining the transaction price (Step 3 of the new revenue guidance), which is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. In these situations, the only consideration received by the entity is the customer’s deposit, which can be used for lending or other purposes; however, the deposit itself is outside the scope of Topic 606.

The staff’s understanding is that these arrangements do not include an enforceable right whereby an entity is entitled to fees from premier customers. While some might view the customer providing the bank with a deposit as similar to a loan that might require an adjustment to the transaction price as a significant financing component under Topic 606, the staff thinks those stakeholders should consider the short-term nature of the contract, which likely would indicate that the financing component is not significant because there is not a long period of time between payment and transfer of the services. Furthermore, entities could avail themselves of the practical expedient for contracts under one year.

Consistent with current practice, the staff thinks there are no fees within the scope of Topic 606 if no fees are charged because the entity is not entitled to fees (in the form of cash or noncash consideration). Consider the following example. During the first day of the month, the premier customer could access its funds many times and pay no fees (despite other customers paying fees to access funds in a similar manner). Immediately thereafter the premier customer could terminate the contract and the entity is entitled to no consideration from the premier customer for all of the access that occurs on the first day of the month.

In addition, the staff understand this gross-up approach is not applied in practice today, and Topic 606 did not change the accounting for interest on deposit liabilities.

Disclosures

The staff also considered the implications related to the disclosure requirements in Topic 606. Some of the staff's thoughts about the application of some of the disclosure requirements in Topic 606 are below. However, an entity will need to evaluate the applicability of all of the disclosure requirements in Topic 606 to its specific contracts and facts and circumstances (for example, consider whether deposit fee revenue is material in considering the appropriate level of disclosure).

If a depository arrangement is considered a day-to-day contract with ongoing renewals and optional purchases, then the duration of the contract does not extend beyond the services performed. Because of the short duration, several of the disclosures in Topic 606 would not apply. For example, contract balances and remaining performance obligations related to the depository arrangements might not exist, so the disclosures in paragraphs 606-10-50-8 through 50-11, and paragraphs 606-10-50-13 through 50-16 might not apply. Additionally, because an entity generally would not need to make many judgments that would significantly affect the amount and timing of deposit fee revenue, there might not be much to disclose about judgments (paragraphs 606-10-50-17 through 50-20).

However, it is possible that other disclosure requirements might be more likely to be applicable on the basis of the specific contracts and the facts and circumstances (for example, whether deposit fee revenue is material in considering the appropriate level of disclosure). Two examples include, but are not limited to, the following:

- (a) Disaggregation of revenue (paragraphs 606-10-50-5 through 50-7) into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors, as well as sufficient information to enable users to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment, if an entity applies Topic 280 on segment reporting
- (b) Information about an entity's performance obligations (paragraph 606-10-50-12), including the nature of services and when the entity typically satisfies its performance obligations (for example, as services are rendered or upon completion of service).

This brief discussion on disclosure was meant to highlight that because of the straightforward nature of revenue recognition for deposit fees, the staff thinks that some of the disclosure requirements in Topic 606 would not be applicable. However, each entity will need to make an assessment for itself based on its specific contracts and facts and circumstances.

Question 6: Are contributions included within the scope of Topic 606?

Reference(s): Section 606-10-15

Topic 606 applies to contracts with customers. The term customer is defined as a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. A contribution is, by definition, a nonreciprocal transfer. A contribution is not given in exchange for goods or services that are an output of the entity's ordinary activities. Therefore, the FASB staff interpretation is that a contribution is not within the scope of Topic 606.

Furthermore, paragraph BC28 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, explains that revenue from transactions or events that do not arise from a contract with a customer is not within the scope of Topic 606, and, therefore, those transactions or events will continue to be recognized in accordance with other Topics. The paragraph lists donations and contributions as examples of nonexchange transactions not within the scope of Topic 606.

In conjunction with the issuance of Topic 606, many conforming amendments were made to the Codification, including amendments to Subtopic 958-605, Not-for-Profit-Entities—Revenue Recognition (renamed Not-for-Profit-Entities—Revenue Recognition—Contributions). Paragraph 497 of the conforming amendments (which describes amendments to Subtopic 958-605) states:

The following amendments reflect the removal of industry-specific guidance on revenue recognition. However, a portion of Subtopic 958-605 has been retained to provide guidance for revenue not within the scope of Topic 606, that is, guidance on contributions.

It is important to note that a not-for-profit entity might enter into transactions other than contributions, such as exchange transactions. A not-for-profit entity should evaluate whether transactions that are not contributions are within the scope of Topic 606. Some staff highlighted that a not-for-profit organization may have arrangements in which amounts received could relate to both a contribution and a good or a service. In those cases, an entity would need to evaluate the facts and circumstances to determine the nature of the arrangement.

In determining whether a transaction is within the scope of the revenue model, the FASB staff thinks it might be helpful for entities to evaluate whether the 5-step model practically could be applied to the transaction. For example, if an entity cannot identify promised goods or services to the customer in Step 2 of the model or cannot determine if (or when) control of those promised goods or services transfers in Step 5 of the model, then those facts might be indications that the transaction is not an exchange transaction with a customer.

STEP 1—IDENTIFY THE CONTRACT

Question 7: How should termination clauses be evaluated in determining the duration of a contract (that is, the contractual period)?

Reference(s): Sections 606-10-25 and 606-10-32

Some stakeholders have asked whether the contractual period should be restricted to reflect the expected termination date if each party to the contract has a unilateral enforceable right to terminate the contract. Below are some considerations about how stakeholders think that termination clauses should be considered.

In determining the contractual period in which the parties have present enforceable rights and obligations, paragraph 606-10-25-3 does not explicitly explain how termination penalties should be considered. However, some stakeholders have asserted that the guidance in paragraphs 606-10-25-3 through 25-4, together with the explanation in BC50 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, suggests that a contract exists if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract only by compensating the other party. Accordingly, those stakeholders think that a contract continues to exist during the specified contractual period even if each party to the contract has the unilateral enforceable right to terminate the contract at any time during the specified contractual period by compensating the other party. This is because enforceable rights and obligations exist throughout the contractual period, evidenced by the fact that compensation would be required to terminate the contract. In other words, on termination, parties to the contract waive those enforceable rights and avoid their obligations by paying compensation.

Some stakeholders also point to paragraph 606-10-32-4 that, in the context of determining the transaction price, states that the entity should assume the contract will not be cancelled. However, paragraph BC186 of Update 2014-09 clarifies that paragraph 606-10-32-4 applies in the context of having already identified the contract with the customer.

It should be noted that the guidance in paragraphs 606-10-25-3 through 25-4 refers to whether the termination requires compensating the other party. Some stakeholders have shared a narrow interpretation of this guidance, asserting that the guidance refers only to termination penalties. Other stakeholders take a broader view that compensating the other party is any amount related to something other than payments due as a result of goods delivered or services transferred up to the termination date and, therefore, that it is not restricted only to payments explicitly characterized as termination penalties.

Considering the guidance outlined above, some stakeholders think that an entity could reach the following conclusions:

- (a) If a contract can be terminated by each party at any time without compensating the other party for the termination (that is, other than paying amounts due as a result of goods or services transferred up to the termination date), the duration of the contract does not extend beyond the goods or services already transferred. This is the case whether the contract has a specified contract period or not. Some stakeholders think this scenario is the intent behind the discussion in paragraph BC391 of Update 2014-09 because the right to cancel the contract is no different than a right to renew the contract. Whether it is a right to cancel the contract or a right to renew the contract, a party to the contract must elect to do, or not do, something (to renew the contract or not to cancel the contract).

Example 1

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

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

- (b) If each party can terminate the contract without compensating the other party and the termination right can be exercised only after a specified minimum period, the duration of the contract is up to the point at which the contract can be terminated.

Example 2

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

The duration of the contract is fifteen months.

- (c) In Examples 1 and 2, any right to consideration at the point at which the contract is terminated would be unconditional (that is, a receivable). In other words, the right to consideration would not be conditional upon any future performance. If a contract can be terminated by either party by compensating the other party, the duration of the contract is either the specified contractual period or the period up to the point at which the contract can be terminated without compensating the other party.

Example 3

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

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

Example 4

An entity enters into a contract with a customer to supply services for five years. The entity earns a fixed fee each quarter and, if specified performance metrics are met, the entity will be entitled to a performance bonus at the end of the five-year service period (which will be paid at that time). Either party can terminate the contract at any time after two years; however, if the contract is terminated, the customer must pay a fee equivalent to the performance bonus it would otherwise only pay at the end of the contract.

The duration of the contract is five years. If the contract is terminated, the customer must make a payment that it would otherwise not have to make until the end of the contract term and the payment is based on conditions that might have changed over the full term of the contract. This indicates that at contract inception enforceable rights and obligations exist beyond the first two years.

- (d) If the entity has a past practice of not enforcing the collection of a termination penalty to which it is contractually entitled, some stakeholders have asked whether the past practice affects the assessment of the contract term.

Example 5

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

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

Stakeholders note that when an entity concludes that the contractual term is less than the stated term because of a termination clause, the following are some of the possible consequences:

- (a) In contracts containing multiple performance obligations, allocation of the transaction price may be significantly affected for a contract with a specified term of two years that is determined to be of one-year duration (because of a termination clause) compared with the two-year duration (if the termination clause were not considered).
- (b) The termination penalty, if any, would be considered part of the transaction price. The termination penalty may be variable, in which case the guidance on variable consideration, including the constraint, would be applied.

- (c) The periods covered by the termination provisions would be assessed in the same manner as renewal options (that is, whether the renewal options provide the customer a material right).

Most TRG members agreed that the conclusions reached above were consistent with the standard and agreed with the respective views for each of those examples regarding the determination of contract duration. Some TRG members highlighted the need to consider additional factors in the assessment, such as whether the termination payment is substantive.

Question 8: How do customer termination rights and penalties affect the identification of a contract duration?

Reference(s): Section 606-10-25

This question relates to how to evaluate the contract term when only the customer has the right to cancel without cause the contract and how termination penalties effect that analysis. See Question 7 about when both parties have a right to terminate.

The staff does not view a customer only right to terminate differently from a contract where both the customer and entity could terminate the contract. Furthermore, the staff does not think that an entity should have different results (even if many times the results would be similar) by calling the penalty (or forgoing a discount) a material right versus concluding there is a longer contractual term. The staff thinks that paragraph BC391 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, clarifies that customer cancellation rights can be similar to a renewal option. The staff thinks that this would typically be the case when there are no contractual penalties that compensate the other party upon cancellation and when the customer has the unilateral right to terminate the contract for other than cause or contingent events outside the customer's control.

TRG members highlighted that when performing an evaluation of the contract term and the effect of termination penalties, an entity should consider whether those penalties are substantive. Determining whether a penalty is substantive will require judgment and the examples provided above do not create a bright line for what is substantive. If the penalty is not substantive, an entity would still evaluate whether the termination right (which is akin to an option for additional goods or services) gives rise to a material right. That is, if the existence of a contractual penalty does not create a longer contract term, it still could affect whether a material right is present for the optional periods (that is, the period not included in the duration of the contract).

Consider the following examples:

Contract 1:

Entity A enters into a four-year service contract with Customer X with a right to cancel the contract at the end of each year. Contract 1 requires Customer X to pay an annual fee of CU 100, which is the standalone selling price for renewals after Year 3. Customer X can terminate the contract before Year 4 without cause but would incur a termination penalty. The penalty decreases annually throughout the contract term. Assume the penalty is substantive in each period. The following table illustrates the payments under the contract.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
Annual Fee	\$ 100	\$ 100	\$ 100	\$ 100
Termination Penalty	30	20	10	-
Cumulative Fee if Customer Cancels in this Year	\$ 130	\$ 220	\$ 310	\$ 400

In this example, Contract 1 is a four-year contract. That is, the purchases in Years 2–4 are not options for the customer to purchase additional goods or services. The substantive termination penalty is evidence of enforceable rights and obligations throughout the contract term. The termination penalty is ignored until the contract is terminated at which point it will be accounted for as a modification.

Contract 2:

An entity sells equipment and consumable parts for the equipment (both the equipment and parts are distinct goods that do not meet the overtime criteria). The standalone selling price of the equipment and parts is CU10,000 and CU100, respectively. The entity sells the equipment for CU6,000 (a 40% discount from standalone selling price) and provides an option to purchase each part for CU100. If the customer does not purchase at least 200 parts, it is required to pay a penalty to repay some or all of the CU4,000 discount provided on the equipment. The penalty decreases as each part is purchased at a rate of CU20 per part. A discount of CU10 would be viewed as a material right to the customer.

In this example, the penalty (or forgoing the upfront discount) is substantive and in effect creates a minimum purchase obligation such that the entity would conclude that the minimum number of parts required to avoid the penalty would be evidence of enforceable rights and obligations. As a result, the contract includes both the equipment and the minimum parts (200) required to not incur the penalty. Therefore, the transaction price is CU26,000 [(200 x 100) + 6,000], which should be allocated to the multiple performance obligations (CU8,667 [26,000 * (10,000/30,000)]) to the equipment and

CU17,333 [$26,000 * (20,000/30,000)$] to the parts [86.67 per part]). The entity would account for the failure to purchase additional parts and the resulting penalty as a contract modification.

Question 9: How should an entity assess collectibility for a portfolio of contracts?

Reference(s): Section 606-10-25

The question relates to how an entity should apply Step 1 (Identify the Contract) to contracts in which the entity has historical experience that it will not collect consideration from some customers in a portfolio of contracts.

Consider the following example:

An entity has a large volume of homogenous revenue generating customer contracts for which billings are done in arrears on a monthly basis. Before accepting a customer, the entity performs procedures designed to ensure that it is probable that the customer will pay the amounts owed. If these procedures result in the entity concluding that it is not probable that the customer will pay the amounts owed, the entity does not accept them as a customer. Because these procedures are only designed to determine whether collection is probable (and thus not a certainty), the entity anticipates that it will have some customers that will not pay all amounts owed. While the entity collects the entire amount due from the vast majority of its customers, on average, the entity's historical evidence (which is representative of its expectations for the future) indicates that the entity will only collect 98% of the amounts billed.

If the entity in the example above bills CU100 to its customers in a particular month and there are no other issues that would preclude recognition of revenue for that amount in the month it is billed, how much revenue should the entity recognize given that historical evidence indicates that it will collect only 98% of amounts billed? For purposes of this example assume that the entity has satisfied its performance obligations as of the billing date. The question is whether the entity should recognize revenue of CU100 or CU98 in this example.

Paragraph 606-10-25-1 provides criteria that a customer contract must meet in Step 1 of Topic 606, including an assessment of the probability of collection, before the remaining steps of Topic 606 can be applied. Specifically, paragraph 606-10-25-1(e) includes the criterion on collectibility. If any of the criteria in paragraph 606-10-25-1 are not met, revenue is not recognized until specified events have occurred, as described in paragraph 606-10-25-7.

In the example above, because the entity concluded as a result of its procedures (around the acceptance of new customers) that it is probable the customers will pay the amounts owed, the contracts meet the collectibility threshold in Step 1 of Topic 606. When the entity satisfies the performance obligations in the contracts, it would recognize revenue of CU100

and a corresponding receivable representing its right to consideration that is unconditional. The guidance in Topic 606 would not support the view that revenue of only CU98 should be recognized in this example because the entity concluded that it is probable that the customer will pay the amount to which the entity will be entitled of CU100.

The entity would evaluate the receivable for impairment as described in paragraph 606-10-45-4.

Question 10: When should an entity reassess collectibility?

Reference(s): Sections 606-10-25 and 606-10-55 (Example 4)

Under Topic 606, if a contract with a customer meets the criteria in paragraph 606-10-25-1 at contract inception, an entity does not reassess those criteria unless there is an indication of a significant change in facts and circumstances. Some stakeholders have questioned how to perform this evaluation as it relates to the collectibility criterion. Paragraph 606-10-25-5 includes a related example.

When an entity determines that a previously identified contract no longer meets the criteria in Step 1 (identify the contract) of the revenue model, paragraph 606-10-25-7 provides guidance on when to recognize consideration received from the customer as revenue.

Example 4 in paragraphs 606-10-55-106 through 109 illustrates the application of this guidance. In this example, the customer meets the criteria in paragraph 606-10-25-1 at the inception of a multi-year contract. However, in the second year of the contract the customer's "financial condition declines" and its "access to credit and available cash on hand are limited." In the example, the entity continues to recognize revenue in the second year and evaluates any receivables recognized for impairment as a result. In the third year of the contract, paragraph 606-10-55-109 indicates that "the customer has lost access to credit and its major customers and thus the customer's ability to pay significantly deteriorates." As a result, the entity re-evaluates the criteria in paragraph 606-10-25-1 and concludes that collectibility is no longer probable. Based on that conclusion, the entity does not recognize revenue for that customer in the third year.

Topic 606 emphasizes that the determination of whether there is a significant change in facts or circumstances will be situation-specific and will often be a matter of judgment. Additionally, Example 4 in Topic 606 illustrates that the change in the customer's financial condition is so significant that it is an indication that the contract is no longer valid, and it fails Step 1 of Topic 606. Example 4 demonstrates that it was not the Board's intent to capture changes of a more minor nature (that is, those that do not call into question the validity of the contract) that might reasonably fluctuate during a contract term, especially a long-term contract.

Question 11: How should an entity evaluate enforceable rights and obligations and when or if legal consultation should be considered when identifying a contract in Topic 606?

Reference(s): Section 606-10-25

Step 1 of the revenue standard requires an entity to identify the contract with the customer. Guidance in paragraph 606-10-25-1 provides five criteria to consider. Paragraph 606-10-25-2 provides additional guidance on identifying the contract. Because the guidance refers to enforceability of rights and obligations and refers to those notions as a matter of law, private company stakeholders have raised questions about whether legal consultation is a requirement in all cases. The staff observes that this question is in part arising because of some interpretations published by third parties on this topic. The staff would like to clarify that there is no requirement in Topic 606 that states that companies are required to consult with legal counsel for all revenue transactions.

Because it is not a GAAP requirement to consult with legal counsel, questions arise about specifically when private companies may want to consider consultation. The staff observes that, in some cases, it might not be clear whether a contract exists and, thus, additional work would be required (which may or may not require legal assistance, depending on the facts and circumstances); however, the staff thinks that this would be a minority population of contracts and not dissimilar from today's requirements.

Although the guidance notes that enforceability is a "matter of law," it is the staff's view that, in most cases, it will be obvious if the contract meets Step 1 of the five-step model. Also, the staff notes that the guidance only requires that a contract with a customer be identified and does not require a contract to be written. That is, oral arrangements may also meet the definition of a contract (oral contracts are explicitly mentioned in paragraph 606-10-25-2). The staff notes that in cases in which a written contract does not exist, a company may need to perform additional due diligence to assert that Step 1 has been met considering the company's customary business practices. However, the staff does not think that this is a change from current practice. In the absence of a written contract today, companies have a higher hurdle to demonstrate that the revenue is realizable as compared with those arrangements with a written contract.

Some stakeholders have had concerns that the guidance would require companies to wait for cash collection to recognize revenue when the definition of a contract is not met at inception. The staff thinks it's important to keep in mind that if an entity determines it does not meet the definition of a contract at inception, the guidance requires that the entity continue to reassess the contract to determine if the definition is subsequently met (606-10-25-6). Therefore, failure of Step 1, identifying the contract, at inception does not necessarily mean that revenue would be deferred until receipt of payment because it could meet Step 1 at a date after inception but before payment.

STEP 2—IDENTIFY THE PERFORMANCE OBLIGATION

Question 12: Should the evaluation of whether an option provides a material right be performed in the context of only the current transaction with a customer or should the evaluation also consider past and expected future transactions with the customer?

Reference(s): Section 606-10-25 and Paragraph 606-10-55-42

Because paragraph 606-10-10-4 (among others) indicates that Topic 606 applies to individual contracts with a customer, some have questioned the accounting for certain types of transactions that provide customers with rights in a current transaction that may only become material when combined with rights that have been accumulated in past transactions and/or will be accumulated in future transactions.

The staff thinks that the evaluation of whether an option provides a material right should consider all relevant transactions with the customer (that is, current, past, and future transactions).

All facts and circumstances, including those that exist outside of the current transaction with a customer, should be considered when evaluating whether a customer option gives rise to a material right. That is, forward-looking factors, such as how a right accumulates over time, should be considered when evaluating whether an existing option gives rise to a material right. Paragraph 606-10-55-42 indicates that when evaluating a discount in a contract, consideration should be given to “discounts typically given for those goods or services to that class of customer in that geographical area or market,” which they state further supports considering facts and circumstances beyond the current transaction with the customer.

To illustrate, consider the examples below. The estimated standalone selling prices used in all examples in this Q&A have been created for illustrative purposes only and are not meant to demonstrate actual standalone selling prices. However, it should be assumed that the standalone selling prices were calculated consistent with the methodologies in Topic 606.

Example 1—Loyalty Program

Entity A has a loyalty program in which its customers accumulate one point for every dollar spent. Points may be exchanged for free products when the customer accumulates enough points. Based on its historical data, Entity A determines that it is likely that its customers will accumulate enough loyalty points to receive a free product.

In the current transaction, Customer Y purchases a product from Entity A for \$50 and receives 50 loyalty points. Entity A concludes that each loyalty point has a standalone selling price of \$0.01.

Entity A would consider whether the loyalty points earned from the current transaction are expected to contribute to a material right that the customer has (or will accumulate). The evaluation would consider that an element of the right granted to Customer Y in the current transaction is the customer's ability to accumulate loyalty points that will entitle the customer to a free product.

Example 2—"Buy three and get one free" program

Entity A offers a program in which customers who have purchased three products over a given period of time may receive a fourth product free. Based on its historical data, Entity A determines that it is likely that its customers will receive a free product.

After a customer purchases the first of the three products, the customer has obtained an option (that is, an escalating right) that allows the customer to receive a free product if the customer chooses to purchase two additional products. Similarly, after the customer purchases the second of the three products, it receives an option that allows the customer to receive a free product if the customer chooses to purchase one additional product. After completion of the third product purchase, the customer has an option to obtain a free product. As a result, the standalone selling price of each option may be different.

Assume that in the current transaction, which is the customer's first of the three required purchases, Customer Y purchases a product from Entity A at its observable standalone selling price of \$6. Entity A concludes that the standalone selling price of the customer option in this transaction is \$0.30.

Entity A would consider that Customer Y has in-substance earned one-third of a free product in the current transaction (or in other words, has earned the right to receive one free product if the customer purchases two additional products). Entity A also would consider whether Customer Y is likely to purchase two additional products that will entitle it to a free product.

Question 13: Is the evaluation of whether an option provides a material right solely a quantitative evaluation or should the evaluation also consider qualitative factors?

Reference(s): Section 606-10-25 and Paragraph 606-10-55-45

The staff thinks that the evaluation of whether an option provides a material right should consider both quantitative and qualitative factors.

Considering qualitative factors is consistent with the notion that identifying promised goods or services should consider valid expectations of the customer (BC87 from the basis for conclusions of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*). A customer's perspective on what constitutes a "material right" may consider any number of qualitative factors (for example, whether the right accumulates) that would be known to the entity.

Example 1—Discount voucher

Entity A provides its customers who purchase goods on a particular day with a voucher for 25 percent off their next purchase (of any size). The voucher may be applied against the purchase of any product and expires after 60 days. Based on its historical data for similar offerings, Entity A determines that customers typically use the voucher to make an additional purchase that is, on average, more expensive than what a customer would typically purchase without a voucher. Entity A does not offer its customers any other discounts throughout the year.

On the day that Entity A offers its customers vouchers, Customer Y purchases a product for \$200 and Customer Z purchases a product for \$10.

Entity A would consider the quantitative nature of the rights received by each customer based on the standalone selling price of the voucher in relation to the transaction with the customer. Entity A also would consider that the voucher has given both Customers Y and Z the qualitative nature of the rights in that both customers have the opportunity to receive a 25 percent discount on a future purchase, including purchases for products that may have an observable standalone selling price that is significantly higher than the selling prices of the products purchased by Customers Y and Z in the current transactions.

Example 2—Nonrefundable upfront fee

Entity A and Customer Y enter into a 12-month service contract for \$60 per month. All customers are required to agree to a 12-month contract. In addition to the monthly fee, Customer Y also must pay a \$120 nonrefundable fee at contract inception. The upfront fee is not considered to transfer a promised good or service. Customer Y will only pay the \$120 fee once as long as it continuously remains a customer of Entity A. Entity A's customers have multiple service providers available to them in their geographic area. While monthly service fees are similar throughout the geographic area, some of those service providers do not charge customers upfront fees to initiate services for customers who are existing customers of a competitor.

The contract also contains a renewal option that allows Customer Y to renew the contract on a month-to-month basis. The contract does not stipulate the renewal price, but Entity A does not operate in a volatile industry and service rates have historically remained relatively stable (that is, the monthly fee is not expected to significantly increase or decrease). As a practical alternative to estimating the standalone selling

price of the renewal option, Entity A evaluates the renewal option by reference to the services provided (in accordance with paragraph 606-10-55-45).

Entity A would evaluate the quantitative factors based on an evaluation of whether its customers receive a material right with respect to renewal of the services because they do not have to pay an additional \$120 upfront fee at the beginning of the renewal period. In this case, Entity A would consider whether the renewal price that Customer Y will pay (that is, \$60/month) compared with the allocated price that a new customer would pay for the same services ($\$120/12 = \$10 + \$60/\text{month fee} = \70) provides the customer with a material right. Entity A would also consider qualitative factors such as the availability and pricing of service alternatives. For example, Entity A might consider the fact that after the one-year fixed term, Customer Y could get substantially similar services from one of Entity A's competitors at the same price as it would receive those services from Entity A (that is, \$60/month). This might call into question whether the option to renew Entity A's services at \$60/month provides Customer Y with a material right that it would not have received without entering into the initial services contract with Entity A.

Question 14: How is the class of customer considered when evaluating whether a customer option gives rise to a material right?

Reference(s): Section 606-10-25 and Paragraphs 606-10-55-42 through 55-43

Paragraph 606-10-55-42 explains that a customer option to acquire additional goods or services gives rise to a performance obligation only if the option provides a material right to the customer that it would not receive without entering into the 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). Paragraph 606-10-55-42 further explains that a customer option that provides a material right to a customer, in effect, represents an advanced payment by the customer for future goods or services.

Paragraph 606-10-55-43 states that if a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. Rather, the entity has made a marketing offer that it should account for when the customer exercises the option to purchase the additional goods or services. Stated differently, paragraph 606-10-55-43 is intended to make clear that a customer option to acquire additional goods or services would not give rise to a material right if a customer could execute a separate contract to obtain the same goods or services at the same price.

Paragraph 606-10-32-33 states that when estimating a standalone selling price, an entity should consider all available information, including information about the customer or class of customer.

Paragraph BC386 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, explains that the purpose of the guidance in paragraphs 606-10-55-42 through 55-43 is to distinguish between:

- (a) An option that the customer pays for as part of an existing contract [that is, a customer pays in advance for future goods or services]
- (b) A marketing or promotional offer that the customer did not pay for and, although made at the time of entering into a contract, is not part of the contract [that is, an effort by an entity to obtain future contracts with a customer].

Stated differently, the guidance in paragraphs 606-10-55-42 through 55-43 is intended to make clear that customer options that would exist independently of an existing contract with a customer do not constitute performance obligations in that existing contract.

For some contracts, determining whether a contract includes an option that provides a material right will be clear. However, in other cases the determination will require significant judgment. Similar judgment is required under current GAAP. For example, under current GAAP some entities might need to apply significant judgment to determine whether a discount offered on future goods or services is significant and incremental to the range of discounts reflected in the pricing of other elements in a contract and to the range of discounts typically given in comparable transactions.

An entity also will need to consider any disclosures required under Topic 606 related to its determination of whether a customer option gives rise to a material right. For example, Topic 606 requires an entity to disclose certain information about significant judgments made in applying the guidance in Topic 606. It also requires an entity to disclose certain information about its performance obligations and how the transaction price has been allocated to those performance obligations, including disclosures related to how an entity estimated the standalone selling prices of its performance obligations.

The following examples illustrate the staff's views on how the class of customer is considered when evaluating whether a customer option gives rise to a material right.

Example 1—Preferred customer pricing

Professional Consultants LLP (PCon) is one of the largest consulting firms in the world. PCon hires only the best and brightest professionals in the industry and typically charges its customers \$1,000 per hour for consulting services. Goody Corporation (Goody) owns and operates a chain of bakeries across the United States. Goody currently has a long-term master services agreement with a consulting firm that will expire in the next year. Goody has requested that its current consulting firm and several other firms, including PCon, submit proposals for a new long-term master services agreement.

PCon knows that Goody and its current consulting firm entered into several contracts under the existing master services agreement for projects that required a significant

number of consulting hours. PCon submits a proposal to provide Goody with an unspecified amount of consulting services under a master services agreement for \$800 per hour even though PCon has provided consulting services to Goody in the past at a rate of \$1,000 per hour. None of PCon's prior contracts with Goody included a material right (that is, there are no prior contracts between PCon and Goody that would have created an expectation for Goody to receive favorable pricing in the future or that would have created an expectation for PCon to provide favorable pricing in the future).

After considering all proposals, Goody decides to enter into a long-term master services agreement with PCon. The agreement does not specify the scope of service to be provided by PCon, but specifies that the price per hour for any consulting services provided under the master services agreement will remain at \$800 throughout the duration of the agreement (that is, each time Goody enters into a contract with PCon for a consulting project, the scope of services are separately negotiated, but the agreed upon hourly rate of \$800 is used to determine the price). Goody subsequently enters into a contract with PCon to perform consulting services for a specific project over the next 6 months under the terms in the master services agreement (that is, PCon will provide consulting services for \$800 per hour).

Although PCon agrees to charge Goody a rate that is less than what it typically would charge a customer (or had charged Goody in the past), the staff's view is that the contract between PCon and Goody does not include a material right. This is because the hourly rate that is offered to Goody in each contract exists independently (for example, the hourly rate that Goody would be charged if it enters into a contract for a second specific project would be the same even if it had not entered into the first contract). Rather, the pricing offered by PCon in this example is a marketing offer made in an effort to obtain future contracts with Goody.

In this example, PCon does not need to consider Goody's class of customer because the price at which PCon will provide consulting services to Goody (that is, \$800 per hour) is not dependent on any existing or prior contracts with Goody. The staff included this example to illustrate a fact pattern in which future services are offered at a "discount," but in which it is clear that the "discount" does not give rise to a material right.

Example 2—Significant discount on future purchase

Ziggy's Electronics (Ziggy) owns and operates several retail electronics stores in New York City. Ziggy currently provides customers who purchase a 50-inch television with a coupon for 50% off the purchase of one new Supersonic stereo system. Ziggy typically sells a 50-inch television and the stereo system for \$1,000 each. The coupon is redeemable only at one of Ziggy's stores and must be redeemed within 1 year of purchasing the television. Ziggy has never offered a discount of this magnitude to a customer that does not purchase a television (or an item of similar value).

Janet recently graduated from college and moved to New York City. Janet needs a television for her new apartment and decides to purchase a 50-inch television from Ziggy. At the time Janet purchases the television, she receives a coupon for a 50%

discount on the Supersonic stereo system but chooses not to redeem the coupon at the same time she purchases the television.

When evaluating whether the contract between Ziggy and Janet includes a material right, Ziggy evaluates whether Janet's option to purchase a Supersonic stereo system at a 50% discount exists independently of the existing contract with Janet (that is, the contract to purchase a television).

Assume Martha is Janet's next-door neighbor. Martha is not in the market for a new television because she recently purchased a television online from one of Ziggy's competitors. However, Martha visits the local Ziggy store where Janet purchased her television. The sales associate standing at the front of the store handed every person that walked through the door a coupon for 5% off the purchase of a Supersonic stereo system (which cannot be combined with any other offer).

In evaluating whether the discount offered to Janet exists independently of Janet's existing contract to purchase a television, Ziggy should compare the discount offered to Janet (that is, 50%) with the discount typically offered to customers similar to Martha (that is, Ziggy should compare the discount offered to Janet with the discount typically offered to a similar customer that receives the discount independent of a prior contract with Ziggy).

Because the objective of the guidance in paragraphs 606-10-55-42 through 55-43 is to determine whether a customer option exists independently of an existing contract with a customer, it would not be appropriate for Ziggy to compare the discount offered to Janet with a discount offered to another customer that purchased a television and received a 50% off coupon for the stereo. Doing so would not help Ziggy determine whether Janet would have received the discount on the stereo system without entering into the contract to purchase the television.

The discounts offered to Janet and typically offered to customers like Martha (that is, customers who are offered a discount independent of a prior contract with Ziggy) are not comparable. Rather, Janet is receiving an incremental discount that she would not have received had she not entered into a contract to purchase a television. In the staff's view, the incremental discount offered to Janet in connection with her purchase of a television is a material right.

Example 3—Volume discounts

Sprocket Corporation (Sprocket) manufactures component parts that have various uses to multiple customers. Assume for purposes of this fact pattern that the parts are interchangeable and not customized for any particular customer. Sprocket enters into a long-term master services agreement to provide unspecified volumes of parts to Jetson Corporation (Jetson). The price of the parts in a subsequent year is dependent on the volume of purchases Jetson makes in the current year. Sprocket charges Jetson \$1.00 per part in Year 1 and the contract stipulates that if Jetson's purchase volume in Year 1 exceeds 100,000 parts, the price per part will decrease to \$0.90 in Year 2. The terms of Sprocket's contract with Jetson, including the reduced price in Year 2 if the purchasing threshold in Year 1 is met, are similar to the terms offered to many of

its customers. Early in Year 1, Jetson enters into a contract with Sprocket to purchase 8,000 parts. Jetson is required to pay \$1.00 for each of those 8,000 parts.

When evaluating whether the contract between Sprocket and Jetson includes a material right, Sprocket first evaluates whether Jetson's option to receive a \$0.10 per part discount in Year 2 exists independently of the existing contract.

Assume Astro Corporation (Astro) is an existing customer that places a single order with Sprocket for 105,000 parts. Astro has purchased parts from Sprocket in the past, but none of its prior contracts with Sprocket created an expectation to purchase parts in the future at a specified price (and did not create an expectation for Sprocket to sell parts in the future at a specified price).

In evaluating whether the discount offered to Jetson exists independently of the existing contract, Sprocket should compare the price per part offered to Jetson in Year 2 (that is, \$0.90) with the price charged to customers similar to Astro (that is, Sprocket should compare the price offered to Jetson in Year 2 with the price typically offered to a similar high-volume customer that is offered a price independent of a prior contract with Sprocket).

Because the objective of the guidance in paragraphs 606-10-55-42 through 55-43 is to determine whether a customer option exists independently of an existing contract with a customer, it would not be appropriate for Sprocket to compare the price offered to Jetson in Year 2 with offers to other customers that receive pricing that is contingent on the volume of purchases in a prior year. Doing so would not help Sprocket determine whether Jetson would have been offered the price in Year 2 had it not entered into the contract(s) to purchase parts with Sprocket in Year 1.

If the price that Sprocket offered to Jetson in Year 2 and the price typically offered to customers like Astro (that is, a similar high-volume customer that is offered a price independent of a prior contract with Sprocket) are comparable, this might indicate that the price offered to Jetson exists independently of the existing contract (that is, the price offered to Jetson does not include a discount that is incremental to the discount typically offered to a similar high-volume customer). If the price Sprocket charged Jetson and Astro are not comparable, this might indicate that a portion of the price Jetson pays for parts in Year 1 is a prepayment for the parts purchased in Year 2.

In the staff's view, significant judgment will be required to determine whether the prices charged to Jetson and customers such as Astro are comparable, whether Jetson and Astro are comparable customers, and whether any difference in price is significant. The staff is not in a position to reach broad conclusions about these types of fact patterns because there are many variations of contracts and variations in facts and circumstances that can affect the conclusion in each fact pattern.

If Sprocket concludes that the contract with Jetson includes a material right, it would need to use significant judgment to account for that material right (for example, to estimate the amount of the

transaction price that should be allocated to the material right and the period in (or over) which the performance obligation associated with material right should be recognized as revenue).

The staff reminds stakeholders that Topic 606 includes a practical expedient in paragraph 606-10-10-4 that permits an entity to apply the guidance to a portfolio of contracts or performance obligations in certain circumstances. This practical expedient might simplify the accounting for contracts that include material rights.

The staff also reminds stakeholders that Topic 606 includes disclosure requirements about the judgments, and changes in the judgments, made in applying the guidance that significantly affect the determination of the amount and timing of revenue from contracts with customers.

Question 15: How should an entity account for a customer’s exercise of a material right?

Reference(s): Sections 606-10-25 and 606-10-32

Stakeholders have raised questions about whether the exercise of a material right should be accounted for as a contract modification or as continuation of the current contract. Consider the following example:

Entity enters into a contract with Customer to provide two years of Service A for \$100. The arrangement also includes an option for Customer to purchase two years of Service B for \$300. The standalone selling prices of Services A and B are \$100 and \$400, respectively. Entity concludes that the option to purchase Service B at a discount provides Customer with a material right. Entity’s estimate of the standalone selling price of the option is \$33.

Entity allocates the \$100 transaction price to each performance obligation as follows:

	<u>TP</u>	<u>SSP</u>	<u>Percent</u>	<u>Allocation</u>
Service A		\$ 100	75%	\$ 75
Option to purchase Service B		33	25	25
	<u>\$ 100</u>	<u>\$ 133</u>	<u>100%</u>	<u>\$ 100</u>

Upon executing the contract, Customer pays \$100 and Entity begins transferring Service A to Customer. The \$75 allocated to Service A will be recognized over the two-year service period. The \$25 allocated to the option to purchase Service B is deferred until Service B is transferred to Customer or the option expires.

Six months after executing the contract, Customer exercises its option to purchase two years of Service B for \$300.

The staff thinks that the guidance in the standard could be read to support the following two views as reasonable interpretations of the guidance:

- (a) The exercise of a material right should be accounted for as a continuation of the contract because the current contract contemplates the additional goods or services subject to the material right. That is, an entity should account for the exercise as a change in the transaction price of a contract in accordance with paragraphs 606-10-32-42 through 32-45. At the time a customer exercises a material right, an entity should update the transaction price of the contract to include any consideration to which the entity expects to be entitled as a result of the exercise. The additional consideration should be allocated to the performance obligation underlying the material right and should be recognized as the performance obligation underlying the material right is satisfied.
- (b) The exercise of a material right should be accounted for as a contract modification. That is, the additional consideration received and/or the additional goods or services provided when a customer exercises a material right represent a change in the scope and/or price of a contract. An entity should apply the modification guidance in paragraphs 606-10-25-10 through 25-13.

Only in cases in which the optional goods or services are determined to be not distinct from the original promised goods or services, would the accounting results appear to differ. The staff thinks that an entity typically would conclude that an optional good or service is distinct. The method used to account for the exercise of a material right will depend on the facts and circumstances of the arrangement. The staff thinks that the method used should be applied consistently by an entity to similar types of material rights with similar facts and circumstances.

The following is the application of the two views to the example above.

Entity accounts for Customer's exercise of its option to purchase Service B as a continuation of the contract. The transaction price is updated to reflect the consideration received in exchange for Service B. The amount allocated to Service A, less any amounts previously recognized as revenue (for example, Entity would have recognized revenue of \$18.75 for Service A when the option was exercised six months into the two-year contractual term), is recognized as revenue over the remainder of the two-year period over which Service A is transferred. The \$300 of consideration related to service B is added to the amount previously allocated to the option to purchase Service B (that is, a total of \$325) and is recognized as revenue over the two-year period over which Service B is transferred. In this example, none of the transaction price allocated to the material right had been recognized as revenue at the date the option was exercised by Customer.

According to this view, the exercise of a customer option is not a contract modification because it is not a change in the scope or price of a contract. Rather, the exercise of a customer option is an exercise of an existing provision in the contract. Any additional consideration received, or additional goods or services provided upon the exercise of a customer option were contemplated as part of the original contract, as evidenced by a portion of the transaction price being allocated to the customer option as a separate performance obligation.

Alternatively, the entity may account for Customer's exercise of its option to purchase Service B as a contract modification. Entity evaluates the contract modification guidance in paragraph 606-10-25-12 and determines that the contract modification should not be accounted for as a separate contract because the price of the contract did not increase by an amount of consideration that reflects Entity's standalone selling price of Service B.

Entity must then evaluate the guidance in paragraph 606-10-25-13 to determine how it should account for the modification. Depending on its evaluation of the guidance in paragraph 606-10-25-13, Entity may be required to recognize a cumulative catch-up adjustment to revenue on the date of the modification. A cumulative catch-up adjustment would not be recognized under View A or, under paragraph 606-10-25-13(a) if the entity concludes that the remaining goods or services to be provided after the modification are distinct from those transferred to the customer before the modification. However, a cumulative catchup adjustment would be required if Entity accounts for the modification in accordance with paragraphs 606-10-25-13(b) or (c).

According to this view, any additional consideration or additional goods or services provided upon the exercise of a customer option represent a change in the price and scope of a contract and should be accounted for as a modification of the contract. The original goods or services are those promised in the contract, including any material right(s). The option, when exercised, is viewed as a change in the scope of the contract because the good or service was not contracted for in the original contract. Per this view, the exercise of an option that did not provide the customer with a material right could in some cases be considered a contract modification (for example, adding a new service to an existing services contract) and do not think that conclusion should differ just because the option does, or does not, provide the customer with a material right.

The staff observes that the nature of material rights can vary significantly from one entity to next. The staff thinks an entity will need to apply judgment to determine a practical approach to accounting for material rights, including deferring revenue when the right is granted and recognizing revenue as the future goods or services are transferred to the customer. An entity might also consider the practical expedient in paragraph 606-10-10-4 that permits an entity to apply the standard to a portfolio of similar contracts, rather than on an individual contract basis.

Question 16: How should an entity assess whether pre-production activities are a promised good or service (or included in the measure of progress toward complete satisfaction of a performance obligation that is satisfied over time)?

Reference(s): Section 606-10-25 and Paragraph 606-10-55-6

Some stakeholders have raised questions on how to account for pre-production activities. Some long-term supply arrangements require an entity to undertake efforts in upfront engineering and

design to create new technology or adapt existing technology to the needs of the customer. The pre-production activity is often a prerequisite to delivering any units under a production contract.

If a pre-production activity is a promised good or service (a performance obligation or a part of a performance obligation) in a contract with a customer, then the activity will have implications for the timing of revenue recognition. An entity would allocate a portion of the transaction price to that good or service if it is a single performance obligation or allocate a portion of the transaction price to a combined performance obligation that includes the pre-production activities along with other goods and services. If the pre-production activities transfer to a customer and are included in a single performance obligation satisfied over time, then those activities are considered when measuring progress towards complete satisfaction of the performance obligation.

The entity first would evaluate the nature of its promise with the customer. Topic 606 specifies that not every activity that is performed to fulfill a contract is necessarily a promise to the customer for purposes of identifying performance obligations. Therefore, an entity should consider whether pre-production activities are a promised good or service or activities that do not transfer a good or service to the customer.

Topic 606 acknowledges (paragraph 606-10-25-17) that an entity is often required to undertake numerous activities to ultimately fulfill its promise to a customer, and that not every activity will result in the transfer of a promised good or service. For example, the profit-directed activities of an entity that includes the process by which revenue is generated, encompassing activities such as purchasing raw materials, manufacturing goods, transporting goods to market, and selling generally would not be additional promises to the customer to undertake those activities. Fulfillment costs that an entity incurs when performing some activities, although required to ultimately transfer the good or service to the customer, are not necessarily a promise to transfer an additional good or service to the customer. In paragraph BC93 of Update 2014-09, the Boards reiterated their intent that an entity should not account for activities that do not transfer a good or a service to a customer, including fulfillment activities “even though those activities are required to successfully transfer the goods or services for which the customer has contracted.”

The determination of whether pre-production activities are a promised good or service in a contract sometimes will require judgment. Entities may find it helpful to consider that the core principle of Topic 606 “is that an entity shall recognize revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.” Furthermore, Topic 606 specifies that the good or service is transferred when (or as) the customer obtains control.

Accordingly, if an entity is having difficulty determining whether pre-production activities are a promised good or service, the staff think it would be helpful for the entity to consider as part of this assessment whether control of that good or service is ever transferred to the customer. For example, if the entity is performing engineering and development as part of developing a new product for a customer and the customer will own the intellectual property (for example, patents) that results from those activities, then the entity likely would conclude that it is transferring

control of that intellectual property to the customer. Consequently, the entity likely would conclude that the activities are a promised good or service in the contract.

The staff have used the straightforward example above to illustrate a case in which it would be clear that control has transferred. However, sometimes an entity will need to apply judgment to determine whether control of a good or service is ever transferred to the customer. Topic 606 includes criteria in paragraph 606-10-25-27 for determining whether an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation over time. The staff think one of those criteria that may be applicable to pre-production activities is whether the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. Paragraph 606-10-55-6 notes that sometimes an entity may not be able to readily identify whether this criterion is met. In those circumstances, an entity would consider whether another entity would need to reperform the work that the entity has completed to date if that other entity were to fulfill the remaining performance obligation. For example, consider a scenario in which an entity is performing engineering and development as part of developing a new product for a customer. If the entity provides the customer with periodic progress reports (in a level of detail that would not require the customer to contract with another entity to reperform the work) or if the entity is required to provide the customer with the design information completed to date in the case of a termination, then the entity likely would conclude that control of that service has transferred to the customer.

The notion of control and considering when goods or services do not transfer to a customer also can be found in the guidance on measuring complete satisfaction of a performance obligation.

As an example, when a piece of equipment is transferred over time, an entity has determined that the customer has control over the asset because, for example, the entity has a right to payment for an asset with no alternative use. The entity might include labor costs in a cost-to-cost input method measure of progress for constructing the piece of equipment. The labor itself is not a separate promised good or service to the customer in the contract. However, each time the worker turns a wrench, the asset (the equipment) is changed and the customer obtains control of that changed asset. Similarly, an entity might determine the pre-production cost should be included in the measure of progress, depending on the circumstances of the arrangement. However, if the arrangement involves a significant amount of costs for the entity near the start of the arrangement and the activities giving rise to those costs do not transfer a good or a service to the customer, then the entity should consider the guidance on adjustments to measure of progress when using a cost based input method in paragraph 606-10-55-21. Application of that guidance would require an entity to consider whether the costs for certain activities should be excluded from the measure of progress or whether the input method should be adjusted to recognize revenue only to the extent of that cost incurred.

Question 17: How should an entity evaluate whether a product warranty is a performance obligation in a contract with a customer when the warranty is not separately priced?

Reference(s): Section 606-10-25 and Paragraph 606-10-55-33

Topic 606 requires a warranty that provides a service in addition to the assurance that the product complies with agreed-upon specifications to be accounted for as a separate performance obligation. However, it does not include a bright line on how to make the distinction of when a warranty provides a service if the customer has the option to purchase a warranty, such as when it is separately priced or negotiated. Instead, Topic 606 provides three factors in paragraph 606-10-55-33 to consider in assessing whether a warranty provides a service. Because the assessment is based on an evaluation of factors, rather than determinative criteria, judgment based on the facts and circumstances will be necessary.

The staff concluded that, under Topic 606:

- (a) An entity would account for a warranty as a performance obligation if it has an option to purchase the warranty, such as when it is separately priced or negotiated.
- (b) Warranties also would be accounted for as performance obligations if the warranty provides the customer with a service in addition to the assurance that the product complies with agreed upon specifications. Therefore, the accounting for warranties under Topic 606 is different from existing GAAP. Entities might account for some warranties as performance obligations under Topic 606 that are not separate deliverables (or elements) under existing revenue guidance.

The evaluation of whether a warranty provides a service in addition to the assurance that the product complies with agreed-upon specifications will require judgment.

Consider the following example:

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

Paragraph 606-10-55-33 provides factors for evaluating whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, using judgment of facts and circumstances. The following is a summary of those factors and analysis of each factor in the example above:

- (a) If the warranty is required by law—The indicator states that if the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation. In this example, because there is no law that requires the entity to make a promise for the lifetime of the product, this indicator suggests the warranty is a performance obligation.

- (b) The length of the warranty coverage—The indicator states that a longer warranty coverage period increases the likelihood that the warranty is a performance obligation. Because the length of the warranty is for the life of the baggage, this indicator suggests the warranty is a performance obligation.
- (c) The nature of the tasks that the entity promises to perform—In the above example, the nature of the tasks not only includes repairing baggage that does not meet the promised specifications, but also includes replacing broken or damaged baggage for free. Because the baggage warranty goes beyond the promise that the baggage complies with agreed-upon specifications, this indicator suggests the warranty is a performance obligation.

For the example above, on the basis of the promise provided and an analysis of the factors included in paragraph 606-10-55-33, the staff thinks the warranty provided by the baggage company is a service in addition to the assurance that the product complies with agreed-upon specifications. Consequently, the staff thinks the service should be accounted for as a performance obligation.

The staff thinks that the guidance in paragraphs 606-10-55-33(a) and 606-10-55-35 should not be applied by analogy for warranties that are not required by law and that such an analogy disregards the nature of the promise given to the customer, the factors in paragraph 606-10-55-33 for determining whether a warranty is a performance obligation, and the overall facts and circumstances of the arrangement.

The staff thinks that while the length of the warranty alone is not determinative, the length of the warranty is an important consideration under Topic 606. The indicator included in paragraph 606-10-55-33(b) states that the longer the warranty coverage, the more likely the warranty is a performance obligation.

Overall, an entity should not focus its assessment on when the fault in the product arises. Rather, entities should evaluate if the substance of the warranty reflects an additional service, considering the promise made, and using the factors in paragraph 606-10-55-33 for assessing if warranties are performance obligations in Topic 606.

In conclusion, the evaluation of whether a warranty provides a service in addition to the assurance that the product complies with agreed-upon specifications will require judgment of facts and circumstances. While the example above illustrates a relatively straight forward set of facts and circumstances that demonstrate an instance of when a warranty provides a service, the staff would expect that there are other instances for which more judgment will be required. In those cases, the staff thinks an entity should consider all relevant facts and circumstances in applying the guidance in Topic 606, including the factors in paragraph 606-10-55-33.

Question 18: In order to apply the series provision, how should an entity consider whether the performance obligation consists of distinct goods or services that are substantially the same?

Reference(s): Section 606-10-25

In order to be considered a series, there must be two or more goods or services that are distinct, and each distinct good or service must also be considered substantially the same.

The staff thinks the first step is to determine the nature of the entity's promise in providing the services to the customer. In some cases, an entity would need to determine if the nature of the promise is the actual delivery of a specified quantity of service or the act of standing ready to perform. If the nature of the promise is the delivery of a specified quantity of a service, then the evaluation should consider whether each service is distinct and substantially the same. If the nature of the entity's promise is the act of standing ready or providing a single service for a period of time (that is, because there is an unspecified quantity to be delivered), the evaluation would likely focus on whether each time increment, rather than the underlying activities, are distinct and substantially the same. This evaluation will require judgment.

The staff thinks that making this evaluation based on the nature of the promise is consistent with the examples throughout Topic 606. That is, the Board intended that a series could consist of distinct time increments (an hour of cleaning) or the good or service delivered (each unit of electricity), depending on the nature of the promise. For example, paragraph BC285, of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, discusses a hotel management performance obligation that is a series of distinct days of service. In that example, the nature of the promise is to provide a daily management service, and not a specified amount of services, which could include management of the hotel employees, accounting services, training, procurement, etc. The staff notes that the underlying activities could significantly vary within a day and from day to day; however, that would not be relevant to the evaluation of the nature of the promise. In contrast, Example 13 (paragraph 606-10-55-160) describes an annual contract to provide monthly payroll processing services that is considered a series. In this contract, the nature of the promise is to deliver twelve distinct instances of the service, rather than a promise to stand ready to perform an undefined number of tasks.

When considering the nature of the entity's promise and the applicability of the series guidance, the staff also thinks it could be helpful to consider the reason why the entity concluded that a performance obligation is satisfied over time. If a performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits provided by its services as it performs (paragraph 606-10-25-27(a)), that might indicate that each increment of service being performed is capable of being distinct (paragraph 606-10-25-19(a)). That is because the customer can benefit on its own from each increment of service. The entity would then need to evaluate whether each increment was separately identifiable (paragraph 606-10-25-19(b)) and substantially the same, as described above.

If a promise is satisfied over time based on the other criteria in paragraph 606-10-25-27, the nature of that promise might be the delivery of a single specified good or service. For example, a contract to construct a single piece of equipment might meet the criteria to be recognized over time in paragraph 606-10-25-27(b). The nature of the promise is to provide the piece of equipment and not a daily construction or manufacturing service. As such, the staff does not think this performance obligation is a series because the individual goods or services within that performance obligation are not distinct, and the evaluation of a time increment is not relevant due to the nature of the promise. However, a contract for two pieces of equipment that each meet the criteria to be recognized over time could be a series comprised of two pieces of equipment if they are substantially the same.

A contract to provide professional services that results in a professional opinion might be recognized over time if it meets the criteria in paragraph 606-10-25-27(c). In this arrangement, the nature of the promise is providing the professional opinion and not a daily service. As such, the staff does not think this service would be a series. That is because there is no increment of the service that could be a separate performance obligation because each of the activities are inputs to provide the combined output of the professional opinion and, therefore, are not distinct within the context of the contract. Similarly, due to the nature of the promise, a time-based increment of the service would not be relevant.

Consider the following examples:

Example A:

Information technology (IT) Seller and IT Buyer execute a 10-year IT Outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term. For example, the vendor will provide server capacity, manage the customer's software portfolio, and run an IT help desk. The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power (MIPs), number of software applications used, or number of employees supported, and the price per unit differs for each type of activity. Before the delivery of the service, IT Seller performs certain initial set-up activities to be in a position to provide the other services in the contract. IT Seller charges the IT Buyer a nonrefundable upfront fee related to the transition activities. IT Seller concludes that the set-up activities do not transfer services to the customer.

The per unit price charged by IT Seller declines over the life of the contract. The agreed upon pricing at the onset of the contract is considered to reflect market pricing. The pricing decreases to reflect the associated costs decreasing over the term of the contract as the level of effort to complete the tasks decreases. Initially, the tasks are performed by more expensive personnel for activities that require more effort. Later in the contract, the level of effort for the activities decreases, and the tasks are performed by less expensive personnel. The contract includes a price benchmarking clause whereby the IT Buyer engages a third-party benchmarking firm to compare the contract pricing to current market rates at certain points in the contract term. There is an automatic prospective price adjustment if the benchmark is significantly below IT

Seller's price. Assume IT Seller concludes that there is a single performance obligation that is satisfied over time because the customer simultaneously receives and consumes the benefits provided by its services as it performs.

The entity first considers the nature of its promise to the customer in this contract (that is, whether the entity's promise is to provide an integrated outsourcing service or, instead, to provide defined items or activities that are distinct from each other). Because IT Seller has promised to provide an unspecified quantity of activities, rather than a defined number of services, the staff thinks it would be reasonable to conclude that the nature of the promise is an obligation to stand ready to provide the integrated outsourcing service each day.

If the nature of the entity's promise is the overall IT outsourcing service, the staff thinks that each day of service could be considered distinct because the customer can benefit from each day of service on its own and each day of service is separately identifiable. Put another way, each day could be separately identifiable because the entity does not provide an integration service between the days (that is, while the activities are generally coordinated and inputs to the combined service, each day those combined activities are provided is not an input to a combined output), each day does not modify or customize another day, and the days of service are generally not highly interdependent or interrelated because the entity can fulfil its obligations each day independent of fulfilling its obligations for the other days.

If IT Seller concluded that the nature of its promise is one overall service, the staff also thinks it would be reasonable to conclude each day of service is substantially the same. That is, even if the individual activities that comprise the performance obligation vary from day to day, the nature of the overall promise is the same from day to day. Therefore, the entity has promised the daily IT outsourcing service.

The staff would not consider the set-up activities in the assessment of whether or not the distinct services are the same. That is because those activities do not transfer goods or services to the customer and would not be considered part of the performance obligation, as stated in paragraph 606-10-25-17.

Example B:

Transaction Processor (TP) enters into a 10-year agreement with a customer. Over the 10-year period, TP will provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use TP's system to process all of its transactions; however, the ultimate quantity of transactions is not known. TP concludes that the customer simultaneously receives and consumes the benefits as it performs. TP charges the customer on a per transaction basis. For each transaction, the customer is charged a contractual rate per transaction and a percentage of the total dollars processed. TP also charges the customer a fixed upfront fee at the beginning of the contract.

If TP concludes that the nature of its promise to the customer is one of providing continuous access to its system, rather than one of processing a particular quantity of transactions, then TP might conclude that there is a single performance obligation to stand ready to process as many transactions as the customer requires. If that is the case, the staff thinks it would be reasonable to determine if there are multiple distinct time increments of that service. The staff thinks that each day of service could be considered distinct because the customer benefits each day from the access to its system (capable of being distinct) and each day is separately identifiable. That is, each day of service could be separately identifiable because there is no significant integration service, each day does not modify or customize another day, and each day is not highly interdependent or interrelated.

The staff thinks that each day of access (the distinct service) provided to the customer could be considered substantially the same because the customer is deriving a consistent benefit from the access over each day of the service period even if the number of transactions processed in a given day differs from the next. That is, if the nature of what could be considered daily performance obligations is the stand-ready service to provide access, the nature of each day would be similar.

If TP concludes that the nature of the promise is the processing of each transaction, then TP would need to evaluate whether a series of distinct transactions was present. The staff notes that this view of the performance obligation raises additional questions when there is an undefined quantity of transactions and if each transaction should be considered an optional purchase that is accounted for separately. Regardless, the staff thinks each transaction processed could be considered substantially the same even if there are multiple types of transactions that generate different payments. Furthermore, the staff thinks that each transaction could be a distinct service because the customer benefits from each transaction and each transaction could be distinct in the context of the contract.

Example C:

Hotel manager (HM) enters into a 20-year agreement to manage properties on the behalf of the customer. HM receives monthly consideration based on 1 percent of monthly rental revenue, reimbursement of labor costs incurred to perform the service, and an annual incentive payment based upon 8 percent of gross operating profit. HM concludes that the customer simultaneously receives and consumes the benefits provided by its services as it performs.

HM must first consider the nature of its promise to the customer in this contract (that is, whether the entity's promise is to provide a single integrated management service or, instead, to provide defined items or activities that are distinct from each other). If the nature of HM's promise is the overall management service because the underlying activities are not distinct from each other, the staff thinks that each day of service could be considered distinct because the customer can benefit from each day of service on its own and each day of service is separately identifiable.

Example C is similar to the hotel management example in paragraph BC285 of Update 2014-09 where the Board concluded that each time increment of service is distinct and substantially the same. Therefore, assuming the nature of the promise is the overall management service, the staff thinks the service performed each day could be considered distinct and substantially the same.

Example D:

Franchisor grants franchisee a license that provides franchisee with the right to use franchisor's trade name and sell its products for 10 years. Franchisor will receive a sales-based royalty of 5 percent of the franchisee's sales for the term of the license as well as a fixed fee. Franchisor concludes that the nature of its promise is to provide a right to access the intellectual property throughout the license period, and the performance obligation is satisfied over time because franchisee simultaneously will receive and consume the benefit from franchisor's performance of providing access to its intellectual property.

The staff thinks that the single performance obligation (the right to access the entity's intellectual property for a period of time) could be considered to have multiple distinct services of providing access each day, week, month, etc. However, this would only be the case because the entity had first concluded that the nature of the license is the right to access over time (**note:** if the nature of the license is a right to use the intellectual property, the entity's performance (its singular act) is complete when it makes the intellectual property available for the customer's use). The staff thinks the customer benefits from the right of access (capable of being distinct) each day on its own, and each day could be separately identifiable because there is no integration service provided between the days of access provided, no day modifies or customizes another, and the days of access are not highly interdependent or highly interrelated. Similar to the other examples, the staff thinks that the nature of each distinct daily service is the same because the customer consumes and receives a consistent benefit each day (that is, the right to access the intellectual property).

Question 19: In order to apply the series provision, must the goods be delivered, or services performed consecutively?

Reference(s): Section 606-10-25

Some stakeholders have questioned whether goods or services must be delivered or performed consecutively in order to apply the series provision. That is, they question whether the series provision applies when there is a gap or an overlap in the entity's delivery of goods or performance of services. Consider the following examples:

Example A:

An entity has contracted with a customer to provide a manufacturing service in which it will produce 1,000 units of a product per month for a 2-year period. The service will be performed evenly over the 2-year period with no breaks in production. The units produced under this service arrangement are substantially the same and are manufactured to the specifications of the customer. The entity does not incur significant upfront costs to develop the production process. Assume that its service of producing each unit is a distinct service in accordance with the criteria in paragraph 606-10-25-19. Additionally, the service is accounted for as a performance obligation satisfied over time in accordance with paragraph 606-10-25-27 because the units are manufactured specific to the customer (such that the entity's performance does not create an asset with alternative use to the entity), and if the contract were to be cancelled, the entity has an enforceable right to payment (cost plus a reasonable profit margin). Therefore, the criteria in paragraph 606-10-25-15 have both been met.

Example B:

Assume the same facts as the example above, except that different from Example A, the entity does not plan to perform evenly over the 2-year service period. That is, the entity does not produce 1,000 units a month, continuously. Instead, the entity plans to perform the manufacturing service over the 2-year period, but in achieving the production targets, the entity produces 2,000 units in some months and zero units in other months.

Although the term “consecutively” is not used in Topic 606, this term is included in the basis for conclusions of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, in various paragraphs including paragraphs BC113 and BC116. This has led some stakeholders to question whether they must assess whether the goods and services are delivered or performed consecutively.

The term “consecutively” was used in previous drafts of the standard but was removed from the guidance before issuance of the final standard. This term also appeared in staff papers prepared during the redeliberations process for the 2011 Exposure Draft that were available to the public. Some stakeholders assert that the removal of that term in the final standard indicates that the Board did not intend to require delivery or performance to be consecutive. That is, those stakeholders assert that the series provision still applies despite gaps in performance or overlapping performance (as long as the criteria in paragraph 606-10-25-15 are met).

In reviewing fact patterns with stakeholders, it seems that some may be over analyzing the use (or lack of use) of the term “consecutively” in the standard. That is, those stakeholders are viewing whether the goods or services are delivered or performed consecutively as a determinative factor in assessing whether the series provision should be applied. In the examples above, those stakeholders appear to think that Example A would result in a single performance obligation (because they would view the entity as transferring the series of distinct manufacturing services consecutively because it is performing the services evenly in producing

1,000 units each month of the 2-year contract period), while Example B would not be a single performance obligation because the entity is not consecutively performing the services (that is, because of the gaps in performance during the 2-year contract period).

The staff notes that the Board provided two criteria to determine if the series provision should be applied in paragraph 606-10-25-15. Those criteria focus on whether each distinct good or service meets the criteria to be satisfied over time and whether the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation. While an entity may consider the pattern of performance in determining the measure of progress towards satisfying a performance obligation, the consideration of whether the pattern of performance is consecutive or not is not explicit in the criteria. The staff, therefore, does not think whether the pattern of performance is consecutive is determinative to whether the series provision applies.

The staff further notes, in response to references of some stakeholders to the basis for conclusions of Update 2014-09, that paragraph BC113 does not state the series provision was intended to apply only to "circumstances in which the entity provides the same good or service consecutively over a period of time (for example, a repetitive service arrangement)." Other stakeholders note the term "consecutively" is used in paragraph BC116. The context of the statement in paragraph BC116 is in relation to comments received on paragraph 30 in the 2011 ED. In response to that proposed guidance in the 2011 ED, some stakeholders questioned whether that proposed guidance applied only to delivered goods or services or both concurrently and consecutively delivered goods or services. Paragraph BC116 is intended to communicate that it was the Board's intent, even in the 2011 ED, for the series provision to apply to consecutively transferred goods or services, largely because the Board did not think any explicit guidance is necessary for concurrently delivered goods or services that have the same pattern of transfer. Paragraph BC116 was not, in the staff's view, intended to suggest that the series provision only applied to consecutively delivered or performed goods or services.

The staff observes that if the consecutively notion were determinative then stakeholders might reach different judgments about what constitutes a consecutively delivered series of goods or services. For example, assume an entity agrees to perform a manufacturing service which results in the production of 100 widgets each month for 2 years, similar to Example A earlier in this section. Some might say that, in this scenario, the entity will consecutively perform the manufacturing service each month during the contract period. However, if 100 widgets are well below the entity's manufacturing capacity, such that it produces the 100 widgets in Month 1 on the first day of the month, another entity might conclude that there is no consecutive performance because the entity does not perform any manufacturing service during the rest of Month 1. Requiring that a series apply only to consecutively delivered goods or performed services might result in inconsistent application between entities with similar arrangements based solely on how each entity applies the consecutive notion.

In conclusion, the staff does not think a series of distinct goods or services that meets the requirements in paragraph 606-10-25-15 must be transferred consecutively for the series provision to apply. Therefore, the staff thinks that the fact patterns outlined in both Example A

and Example B introduced earlier in this section would be accounted for as single performance obligations in accordance with the series provision (provided the two criteria in paragraph 606-10-25-15 are met).

Question 20: In order to apply the series provision (that is, account for the arrangement as single performance obligation), does the accounting result need to be the same as if the underlying distinct goods or services each were accounted for as separate performance obligations?

Reference(s): Section 606-10-25

Some stakeholders do not think that it would be appropriate to apply the series provision when it would result in a different pattern of revenue recognition for the single performance obligation than would result as compared to the pattern of revenue recognition that would result for the goods or services if they were each accounted for as separate performance obligations. Other stakeholders point out that the standard does not require the accounting result to be the same regardless of whether the arrangement was treated as a single performance obligation or as multiple performance obligations.

Consider the following example:

An entity contracts with a customer to perform a manufacturing service that results in the production of 10 widgets. The manufacturing service will be performed over a 3-year period. The contract price is CU100 million and the standalone selling price for each widget is CU10 million.

Total expected costs are anticipated to be CU80 million. The service the entity will provide to the customer in producing each widget is substantially the same, but the design is new, so the entity expects a decline in production costs over time. Production of the first five units is expected to cost CU9 million/widget. The costs to produce the other five widgets are expected to be CU7 million/widget.

For the purposes of this example, assume the entity determines that each service the entity will provide in producing 1 of the 10 widgets is distinct, meets the criteria to be satisfied over time, and that the same cost-based measure of progress would be used for each service the entity provides to produce 1 unit (thus, both of the series provision criteria in paragraph 606-10-25-15 are met). The following demonstrates the difference in accounting that results from concluding the series provision applies as compared to the accounting that would result if it was determined that the contract is for 10 separate performance obligations.

	Total Contract	Series Provision (1PO)		10 Separate POs	
		Units 1–5	Units 6–10	Units 1–5	Units 6–10
Revenue	100	56	44	50	50
Costs	80	45	35	45	35
Margin	20	11	9	5	15

Although CU20 million in margin is recognized for the contract under both scenarios, there is a timing difference in terms of revenue recognition (and margin) because more revenue is recognized in relation to the service to produce the first 5 widgets (and less in relation to its service to produce the final 5 widgets) when the series is accounted for as a single performance obligation using a single measure of progress towards complete satisfaction.

The Board included two criteria in paragraph 606-10-25-15 to determine whether the series provision should be applied. Those criteria do not include a requirement to assess if applying the series provision would result in a different amount of revenue in a period than the amount of revenue in a period that would result from accounting for each unit as a separate performance obligation. Requiring an entity to compare recognition patterns in a “with and without” type manner would seem to be onerous and negate much of what the Board’s intent appears to have been in establishing the series provision. The basis for conclusions of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* (paragraphs BC113 and BC114), explains that the purpose for including the series provision was, largely, to simplify an entity’s accounting and make it more operational. A requirement to have to prove whether application of the series provision results in a difference in the revenue recognition result would be counter to that objective.

Accordingly, the staff does not think application of the series provision requires an entity’s revenue recognition to be substantially the same with or without the series provision. Such a requirement would almost certainly make it more difficult for entities to meet the requirement, and because the series provision is not optional, it likely would require entities to undertake a “with and without” type analysis in a large number of circumstances to prove whether the series provision applies or not. Therefore, in the staff’s view, the series provision would apply to Example A because the fact pattern meets the criteria in paragraph 606-10-25-15, despite the difference in the timing of revenue recognition between the two conclusions (single performance obligation versus 10 separate performance obligations).

Question 21: When should an optional purchase be considered a separate performance obligation?

Reference(s): Sections 606-10-25 and 606-10-55

This question relates to when, if ever, the goods or services underlying the option to purchase additional goods or services should be a performance obligation when there are no contractual

penalties that compensate the other party. There are various reasons why an entity might think it is virtually certain (or highly probable/probable) that the customer will exercise its option for additional goods or services. This might be the case, for example, in cases in which the entity is the sole provider of the goods or services and/or the contract includes an exclusivity clause that requires the customer to acquire those goods and services only from the entity.

The staff view is that goods or services must be legally enforceable in order to be considered a performance obligation. Items that as a “matter of law” (paragraph 606-10-25-2) are optional from the customer’s perspective should not be identified as goods or services promised in the contract and, therefore, not identified as performance obligations. The options should instead be assessed to determine whether the customer has a material right. As a result, consideration that would be received for optional goods or services if the customer exercises its right should not be included when determining the transaction price for the existing contract.

This is because the option for the customer to purchase additional goods or services represents a right that should be evaluated in accordance with paragraphs 606-10-55-41 through 55-45 to determine whether it represents a material right (and if so, a portion of the consideration would be allocated to the right). Paragraph 606-10-55-42 states that an option to acquire additional goods or services “gives rise to a performance obligation in the contract only if the option provides a material right to the customer.” This view is consistent with paragraph BC186 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, that the transaction price should only include amounts to which the entity has rights under the present contract and should “not include estimates of consideration from the future exercise of options for additional goods or services.”

Consider the following examples:

Example 1:

An entity sells equipment and a consumable part for the equipment (both the equipment and the part are distinct goods based on the guidance in paragraphs 606-10-25-19 through 25-22 that do not meet the over time recognition criteria in paragraph 606-10-25-27). The equipment does not function without the consumable part, but the customer could resell the equipment. The standalone selling price of the equipment is CU10,000 and the standalone selling price of each part is CU100. The costs of the equipment and each part are CU8,000 and CU60, respectively.

Scenario A: The entity sells the equipment for CU6,000 (40% discount from standalone selling price) with a contractual option to purchase each part for CU100. There are no contractual minimums; however, the entity estimates the customer will purchase 200 parts over the 2 years. Assume, that the seller and customer have an exclusive contract where the customer cannot purchase the goods from other vendors during the contract term.

The parts underlying each option would not be considered a part of the contract and there is no material right. The transaction price is CU6,000, which is entirely attributable to the equipment,

and the entity would have a loss of CU2,000 when it transfers control of the equipment to the customer.

Scenario B: The entity sells the equipment for CU10,000 and each part for CU80 (the entity concludes the 20% discount on parts is material). The customer is not required to purchase any parts; however, the option to purchase parts represents a material right. Assume the entity estimates 200 parts would be purchased and the standalone selling price of the material right is CU4,000.

The discount on the option to purchase each part would give rise to a material right and the contract would have two performance obligations, the equipment and the material right. The transaction price (CU10,000) would be allocated to the performance obligations based on the standalone selling price (4,000 [200 estimated purchases * 20 discount] for the material right and 10,000 for the equipment) of each performance obligation (CU7,143 [10,000/14,000 * 10,000] allocated to the equipment and CU2,857 [4,000/14,000 * 10,000] to the material right). The allocated transaction price would be recognized as each performance obligation is satisfied. The entity would recognize a loss on the sale of the equipment and some of the transaction price is deferred until parts are transferred.

Example 2:

A vendor enters into a five-year contract to provide a service to a customer with payments due monthly (assume collection is probable and pricing reflects standalone selling price throughout the contract term). To secure the contract, the vendor makes an upfront payment to the customer. Contractually, the customer has the right to terminate the contract at any time with 30 days of notice without penalty. The vendor does not have the right to terminate the contract. Most customers do not terminate the contract, in part because of the time and effort required for set-up on the vendor's system and the cost that would be incurred to change vendors.

The contract is a month to month contract because the termination clause is akin to a renewal right. Because the prices charged for each month are at the standalone selling price there is no material right. The upfront payment made to the customer by the vendor does not affect the analysis of the material right because the failure to renew does not affect the customer's ability to retain the payment from the vendor and, therefore, would not be considered a penalty. As such, only the future options are considered and paragraph 606-10-55-43 clarifies that even if the contract provides a right to exercise an option because of a present contract, that option is considered a marketing offer if there is not a material right.

In summary, the staff does not think Topic 606 requires estimating future contracts the customer will enter into with the vendor. The staff thinks that options are only a performance obligation if the option provides the customer with a material right (that is, the underlying goods or services are not the performance obligation). Furthermore, the staff thinks paragraph 606-10-55-43 clarifies that even if the contract provides a right to exercise an option because of a present contract, that option is considered a marketing offer if it does not represent a material right. Finally, if the upfront deliverable in the arrangement is considered a distinct good or service, the

staff thinks it is counterintuitive to conclude that the entity is economically compelled to purchase additional items solely because they are utilized with the upfront good. That is because if the good or service is distinct, then the customer can benefit from that good or service on its own without any additional goods or services and the promise is separately identifiable from the other promises in the contract.

The staff also does not view optional purchases of additional goods or services to be similar to implied promises in a contract. The staff thinks the guidance in paragraph 606-10-25-16 is specific to promises made by the vendor that creates an expectation of the customer. In other words, the consideration in the current contract relates to those promises implied by the vendor rather than pulling forward consideration from future contracts.

The staff notes that there is often judgment required to determine the extent of the contract and entities also should consider the guidance in paragraph 606-10-25-9 on contract combination. The staff's view on options to purchase additional goods or services does not preclude an entity from making judgments about the extent of the legal contracts (which is a determination that requires consideration of the terms and conditions of the contract together with the legal framework in the relevant jurisdiction) and when those contracts should be combined with other contracts.

Question 22: What is the nature of the promise to the customer in arrangements described as stand-ready obligations?

Reference(s): Section 606-10-25

Determining the nature of the good or service an entity is promising to transfer to the customer is fundamental to properly accounting for a performance obligation. Paragraph 606-10-25-33 states that doing so is necessary in order to determine the appropriate measure of progress for a performance obligation. However, some stakeholders are raising questions about determining the nature of the good or service that is being provided to the customer in arrangements. Those stakeholders question whether the nature of the good or service underlying promises such as Types A through D is the act of “standing ready” or whether it is the actual delivery of the underlying goods or services that the entity stands ready to provide to the customer.

- (a) Type A—Obligations in which the delivery of the good(s), service(s), or intellectual property underlying the obligation is within the control of the entity, but for which the entity must still further develop its good(s), service(s), or intellectual property. For example, a software vendor might promise to transfer unspecified software upgrades at the vendor's discretion, or a pharmaceutical company might promise to provide when and-if-available updates to previously licensed intellectual property based on advances in research and development;

- (b) Type B—Obligations in which the delivery of the underlying good(s) or service(s) is outside the control of the entity and the customer. For example, an entity promises to remove snow from an airport’s runways in exchange for a fixed fee for the year;
- (c) Type C—Obligations in which the delivery of the underlying good(s) or service(s) is within the control of the customer. For example, an entity might agree to provide periodic maintenance, when-and-if needed, on a customer’s equipment after a pre-established amount of usage by the customer; and
- (d) Type D—Making a good or service available to the customer continuously, such as in the health club example set forth in Example 18 (paragraphs 606-10-55-184 through 55-186) of Topic 606.

The staff thinks that whether the obligation is to provide a defined good or service (or goods or services), or instead, to provide an unknown type or quantity of goods or services might be a strong indicator as to the nature of the entity’s promise in the contract. The staff notes, however, that in either case the entity might be required to “stand ready” to deliver the good(s) or service(s) whenever the customer calls for them or upon the occurrence of a contingent event (for example, snowfall).

In general, in a contract to provide, for example, 100 specified goods or services, the nature of the entity’s promise is to provide those goods or services, and that this would be the case regardless of whether the customer was able to specify the timing for the transfer of those goods or services.

In contrast, in arrangements such as Type B, C, or D (that is, where the entity will provide uncertain goods or services—for example, the entity knows it will provide maintenance services, but does not know how many service calls it will make or what it will be required to fix), the entity provides a service to the customer in “standing ready” to perform. Paragraph BC160 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, supports the view that the Board intended that, in some cases, the nature of the “entity’s promise is to stand ready for a period of time, rather than providing a service only when the customer requires it.” The customer obtains (that is, receives and consumes) a benefit from the assurance that a “scarce” resource is available to it (“standing ready”), when-and-if needed or desired. Some additional examples that might further illustrate the benefit a customer obtains from the entity “standing ready” include:

- (a) A customer paying an attorney a fixed fee (a retainer) for a period of time so that he/she is available to the customer when needed (for example, if the customer is served with litigation) or desired (the customer wishes to file a legal complaint against another entity).
- (b) A customer that purchases an extended product warranty for a piece of equipment that requires the entity to remediate any issues with the product when-and-if problems arise.

Some stakeholders have suggested that promises of the nature described as Type A above (for example, to provide when-and-if available updates or upgrades in software or biotechnology

licensing arrangements) require additional analysis to determine the nature of the promise because the entity, rather than the customer or external events, might unilaterally control when updates or upgrades become available for transfer to the customer. However, given that an entity often will not be able to predetermine when a major intellectual property improvement will be completed and available for transfer to a customer, how many will be completed and available for transfer during the contract period, or what features or functionality will be included as part of those upgrades, the nature of the entity's promise in "Type A" arrangements might have considerable similarity to those described as Types B through D above. For example, a biotechnology company likely cannot unilaterally determine when its scientists will make a research and development advancement for a drug or compound. As another example, a software company might have no major update or upgrade available for release during a contract period, particularly if the contract period is relatively short (for example, a one-year software post-contract customer support—or PCS—renewal period). In those examples, the entity's performance with respect to a Type A, when-and-if available upgrade right might, similar to those other types of obligations, be dependent upon events or circumstances that are largely outside the entity's control.

Similar to obligation Types B through D, a Type A promise to when-and-if available (that is, unspecified) upgrades is also often about the customer obtaining assurance that it will have access to future improvements to the product it has obtained or the intellectual property it has licensed. Using a software license as an example, if the promise is truly to unspecified upgrades (that is, the upgrades are not merely implicitly specified and promised to the customer in accordance with paragraph 606-10-25-16—see next paragraph), then the nature of (and benefit from) that promise is the entity providing the customer with a guarantee against obsolescence or defects in the software. This guarantee provides benefit to the customer by protecting the customer's investment in the software (which may include, for example, an expensive implementation that would not be recovered economically if the customer had to implement a new software solution in the nearer medium-term) and/or the customer's related business interests (for example, a customer that embeds the entity's software in its own products might want assurance that it will have access to upgrades of the software so that its products remain competitive in the marketplace). Absent the unspecified upgrade right, the entity might charge the customer exorbitant fees in a separate negotiation for the next version of the software or might enter into an exclusive arrangement with another customer that restricts the customer's ability to obtain the upgrades.

In determining the nature of its promise to a customer in a Type A arrangement, an entity should carefully consider whether it has promised one or more specified upgrades to a customer even if the contract refers only to unspecified upgrades that will be transferred to the customer only when-and-if they become available. Paragraph 606-10-25-16, as well as the discussion in paragraph BC87 of Update 2014-09, clearly stipulate that if the customer has a valid expectation (for example, that a specific upgrade will be transferred to the customer), then the customer would view those promises as part of the negotiated exchange. In that case, the entity's promises to the customer might include both an unspecified upgrade right (that is, the right to any updates or upgrades that may become available, but are not explicitly or implicitly promised

to the customer) and a specified upgrade right (for example, a specific version upgrade, with specifically anticipated additional or changed functionality, or an enhancement that has been implicitly promised to the customer by the entity's customary business practices, specific statements, or other communications), or might just include a specified upgrade right. A promise to deliver a specified upgrade should be accounted for in the same manner as any other specifically promised good or service (for example, a promise to deliver a specified intellectual property upgrade should be evaluated in the same manner as any other license of intellectual property).

Question 23: How can an entity distinguish optional purchases from variable consideration?

Reference(s): Sections 606-10-25 and 606-10-32

Some stakeholders have questions about how to distinguish between a contract that contains an option to purchase additional goods and services and a contract that includes variable consideration based on a variable quantity (such as a usage-based fee) because variable quantities can give rise to variable consideration in some contracts.

Contracts that contain options to purchase additional goods or services could result in variable quantities of goods or services being purchased by the customer. That variability is caused by the customer's ability to exercise its option. Paragraph 606-10-55-42 notes that a customer option is accounted for only if it provides a material right to the customer. In that case, the option (material right), but not the underlying goods or services, is the performance obligation.

Some stakeholders think there is an inconsistency between paragraphs BC50 and BC391 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. Those stakeholders think that paragraph BC50 indicates that any time a vendor has a stand-ready obligation, any future purchases under that contract (optional or not) should be considered a part of the initial contract and should be estimated to determine the transaction price. That is because the vendor is obligated to stand ready and that contract has created enforceable rights and obligations between the parties. However, other stakeholders think that paragraphs BC50 and BC391 should be considered together. That is, if the customer has the option to terminate a contract, the customer's right is in effect an option to purchase additional goods or services that would be a performance obligation only if it provides the customer with a material right.

Accounting for a contract that contains an option to purchase additional goods and services and a contract that includes variable consideration sometimes would result in minimal differences in the timing and measurement of revenue recognized in a reporting period. For example, the accounting for a contract that requires an entity to process transactions for a constant amount of consideration per transaction over a specified period would likely result in revenue recognized as each transaction is processed. This would be the case regardless of whether each

transaction processed was considered an optional purchase or, instead, variable consideration for the entity's service of processing transactions over the specified period.

However, there could be a difference in required disclosures. If each transaction was considered an optional purchase, an entity would not be required to disclose an estimate of the consideration received from the exercise of future options. In contrast, if each transaction processed was considered variable consideration, the entity would be required to estimate the remaining transactions to be processed in order to disclose the transaction price allocated to the remaining performance obligations in paragraphs 606-10-50-13 through 50-16 unless it qualifies for one of the practical expedients in paragraph 606-10-50-14.

In addition to disclosure differences, the distinction between optional purchases and variable consideration can have a significant effect on contracts with multiple performance obligations.

Consider the following example:

Example 1

Company X agrees to sell Customer Y equipment and a service of processing transactions. The equipment and service are both distinct. The equipment is transferred to the customer at the beginning of the service period and the service is performed over the following year. The only consideration in the contract is based on the number of transactions processed. The number of transactions to be processed are unknown and there are no contractual minimums.

If each transaction was considered to be an optional purchase and there is no material right, then the entity would not allocate any of the contingent-based consideration to the transferred equipment because each transaction would be the performance obligation in an independent contract accounted for separately.

In contrast, if the transaction processing is considered to give rise to variable consideration, then the transaction price would include an estimate of the variable consideration (subject to the constraint) and the transaction price would be allocated to the equipment and service (unless the variable consideration were allocated to only the equipment or the service in accordance with paragraph 606-10-32-40).

The staff thinks sometimes judgment will be needed to distinguish between contracts with an option to purchase additional goods or services and contracts that have variable consideration (in particular, distinguishing between optional purchases and usage-based fees). The staff thinks the first step (which is a critical step) is to appropriately identify the nature of the promises in the contract as well as the rights and obligations of the parties. In the staff's view, the following are some differences between optional purchases and variable consideration that may be helpful when evaluating a contract under Topic 606:

- (a) Options for additional goods or services: The customer has a present contractual right that allows it to choose the amount of additional distinct goods or services (or change

the goods or services to be delivered) that are purchased (that is, a separate purchasing decision). Before the customer's exercise of that right, the vendor is not presently obligated to provide (and does not have a right to consideration for delivering) those goods or services.

- (b) Variable consideration: The customer previously has entered into a contract that obligates the vendor to transfer the promised goods or services. The future events (including the customer's own actions) that result in additional consideration occur after (or as) control of the goods or services have (or are) transferred. The customer's actions do not obligate the vendor to provide additional distinct goods or services (or change the goods or services to be transferred).

What Are Optional Purchases?

Topic 606 does not define the term customer option. However, Topic 606 discusses customer options to acquire additional goods or services. Paragraph BC386 of Update 2014-09 states that if the option is deemed to be a marketing offer, then it is not part of the contract and paragraph 606-10-55-42 states that in those cases the marketing offer is only accounted for when the customer exercises its option. Because an option that is a marketing offer is considered a new contract if it is exercised, the staff thinks that an analogy to the contract modification guidance in paragraphs 606-10-25-12 through 25-13 could be helpful when an entity is distinguishing between optional purchases and variable consideration. This is because the modification guidance provides an example of the customer changing the amount of goods or services provided. For a modification to be considered a separate contract, one of the criteria is that the modification results in the addition of promised goods or services that are distinct. Similarly, the staff thinks the exercise of a customer option for additional goods and services would typically result in the addition of promised goods or services that are distinct.

The staff does not think paragraph BC50 implies that any time a vendor is obligated to stand ready to perform that the contract always contains a single performance obligation of standing ready to provide goods or services (and, therefore, that the entity must include an estimate of expected purchases in the transaction price). The staff thinks that paragraphs BC50 and BC391 should be considered together and that an entity should consider the present legally enforceable rights in the contract when identifying the performance obligation(s). In some contracts, the present legally enforceable rights merely give the customer a right to purchase additional goods or services.

The staff also considered the guidance in paragraphs 606-10-55-340 through 342 (Example 50). In this example, the contract includes a present right (the option) for the customer to purchase additional minutes or text messages, which when purchased are distinct. Furthermore, the customer controls the ability to purchase the minutes or texts.

Based on the guidance above, the staff views an optional purchase as providing the customer with a present right to choose the amount of additional distinct goods or services (or change

the current goods or services) it will purchase. In other words, before the exercise of that right, the vendor is not presently obligated to provide the additional distinct goods or services. In the staff's view, the following is an example of optional purchases:

Example 2—Optional Purchases

Entity B enters into a contract to provide 100 widgets to Customer Y at CU10 per widget. Each widget is a distinct good transferred at a point in time. The contract also provides Customer Y the right to purchase additional widgets at the standalone selling price of CU10 per widget. Therefore, the quantity that may be purchased by Customer Y is variable.

Although the quantity that may be purchased is variable, the transaction price for the existing contract is fixed at CU1,000. That is, the transaction price includes only the consideration for the 100 widgets specified in the contract and any exercise of an option is accounted for as an independent contract (because there is no material right given the pricing of the option to acquire additional widgets in this contract). The contract provides a right that allows the customer to choose the number of additional widgets which are distinct goods. In addition, while Entity B may have an obligation to stand ready to deliver additional widgets, Entity B is not legally obligated to provide the widgets until Customer Y exercises the option.

Why Are Optional Purchases Different from Variable Consideration?

As discussed above, when contracts contain an optional purchase, the customer's actions (of exercising the option) result in the vendor's obligation to provide additional distinct goods or services. However, paragraph BC417 clarifies that a customer's future actions can also result in variable consideration. As such, to distinguish between an optional purchase and variable consideration based on the customer's actions, the staff thinks it is important to determine the vendor's rights and obligations that arise from the customer's actions.

Some stakeholders question whether a customer's action that obligates it to pay the vendor would be indicative of an optional purchase. Those stakeholders also might consider the customer's ability to avoid payment similar to a right to exercise an option. Paragraph BC148(c) discusses how the Board considered the right to payment in Topic 606 and states "In cases in which the customer clearly receives benefits as the entity performs, as in many service contracts, the possibility that the entity ultimately will not retain the payment for its performance is addressed in the measurement of revenue."

The staff thinks paragraph BC148(c) makes it clear that when an entity transfers goods or services, the possibility it will not be entitled to consideration for its services is addressed in measurement of revenue (that is, Step 3). As such, when paragraph BC148 is taken together with paragraphs BC417 through BC418, the staff thinks that customer actions or events that result in additional payment after (or as) control of the goods or services has transferred would

be indicative of variable consideration. In contrast, the customer's action in an optional purchase results in a new obligation for the vendor to transfer additional distinct goods or services.

Consider the example of a franchise license with a sales-based royalty. The customer's actions (the use of the license) result in a payment for the service that is already being provided (the right to access the license transferred over time) and the customer actions (use of the license) do not result in additional goods or services to be provided. In the staff's view, the following are examples of variable consideration:

Example 3—Goods

Entity A enters into a contract to provide equipment to Customer X. The equipment is a single performance obligation transferred at a point in time. Entity A charges the customer based upon usage of the equipment at a fixed rate per unit of consumption. The contract has no minimum payment guarantees. The customer is not contractually obligated to use the equipment; however, Entity A is contractually obligated to transfer the equipment to Customer X. The usage of the equipment by the customer is a variable quantity that affects the amount of consideration owed to the entity. It does not affect the entity's performance obligation, which is to transfer the piece of equipment. In other words, the vendor has previously performed by transferring the distinct good, and the customer's actions that result in additional payment occur after the goods have been transferred and do not require the vendor to provide additional goods or services.

Example 4—Services

D, a nightclub, hires Company S to provide security services, which includes checking identification of each customer at the door and collecting the entrance fee on the behalf of D. S receives CU1 for each customer that comes through the door. That is, S will get paid CU1 each time it checks identification and collects the cover charge. If no customers come into D, then S will not get paid, but it is still obligated to perform each night. The performance obligation in the contract is the security service for a night. The variability in the contract that affects the amount S is paid does not affect the amount of services to be provided. That is, S is required to perform by watching the door regardless of the number of customers. The events that result in payment occur as S performs the service and are not a result of a choice made by the customer. The amount S ultimately is paid is factored into the measurement of the transaction price.

Examples of Optional Purchases versus Variable Consideration

Consider the following examples:

Example 5—IT Outsourcing

IT Seller and IT Buyer execute a 10-year IT outsourcing arrangement in which IT Seller provides continuous delivery of different outsourced activities over the contract term. For example, the vendor will provide server capacity and manage the customer's software portfolio, along with other activities. The total monthly invoice is calculated based on different units consumed. For example, the billings might be based on millions of instructions per second of computing power (MIPs), number of software applications used, or number of employees supported. Price per unit differs for each type of activity provided. IT Seller charges the IT Buyer a nonrefundable upfront fee related to the transition activities.

Example 6—Transaction Processing

Transaction Processor (TP) enters into a 10-year agreement with a customer. Over the 10-year period, TP will provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use TP's system to process all of its transactions; however, the ultimate quantity of transactions is not known and is outside the control of the TP and its customer. TP concludes that the customer simultaneously receives and consumes the benefit of providing the network as it performs. TP charges the customer on a per transaction basis. TP also charges the customer a fixed upfront fee at contract inception.

Example 7—Supply Agreement

Supplier enters into a 5-year exclusive master supply agreement with a customer which obligates the supplier to produce and sell parts for a particular product the customer manufactures to the customer as requested. The customer is not obligated to purchase any parts; however, it is highly likely it will purchase parts because the part is required to manufacture the product and it is not practical to get parts from multiple suppliers. Each part is a distinct good that transfers to the customer at a point in time.

IT Outsourcing

The staff (and many stakeholders in this industry) views the type of arrangement above as being a single performance obligation (each of the underlying activities are not distinct) for the entire contract term. The staff and those stakeholders think that the nature of the promise is to provide a single continuous integrated service for the contract term.

In the IT outsourcing fact pattern contemplated above, the customer's actions do not obligate the vendor to transfer additional distinct goods or services. The customer previously made the choice (by entering into the contract) that obligated the vendor to provide services and the customer to only use that vendor's services for that population of the customer's IT needs. The customer's subsequent actions utilize the service to which IT Seller is already committed and performing.

The staff views the nature of the promise (and the rights and obligations) in the IT contracts contemplated above as being different from Example 50 in Topic 606 (the optional purchases of additional calls or text messages). This is because in the telecom example (Example 50) the customer has the choice to acquire additional distinct services (the minute or the message) that obligates the provider to deliver the additional services. In contrast, in the IT outsourcing scenario, the customer's subsequent action (the usage of the service) does not obligate the vendor to provide additional distinct goods or services because the nature of the promise is the overall service and not the individual activities. That is, the staff (and many stakeholders in this industry) views the quantity of units used to determine the payments as a measure of usage (that is, computing power consumed) of the service being performed (that is, the overall outsourcing service) rather than distinct services purchased by the customer. Finally, the staff views a typical customer option in the outsourcing scenario to be a right to extend the contract term (because the overall daily services are the additional distinct services).

Finally, the type of arrangements the staff is considering would have enforceable rights and obligations in the contract. Under the contract, the vendor is presently obligated to make the IT outsourcing service continuously available to the customer throughout the non-cancellable contract term. The vendor's performance creates a right to payment, the variability of which is reflected in the measurement of revenue.

Transaction Processing

The staff views this type of transaction processing service as a single performance obligation (that may be a series of distinct services) that spans the contract period. The staff thinks the nature of the promise is to provide the customer with continuous access to the processing platform so that when the customer's customer submits a transaction it is processed for the customer.

In the fact patterns contemplated above, the customer does not control the number of transactions processed and is contracting for access to the processing platform. Because the customer does not control the number of transactions processed, entering into the initial contract is the purchasing decision after which the customer does not have the ability to choose quantities processed. As such, because the vendor is already obligated to provide continuous access to the platform (and receive consideration for that service), the events that result in payment occur after (or as) the vendor transfers the service and do not result in an obligation for the vendor to transfer additional goods or services.

Finally, the type of arrangements the staff is considering would have enforceable rights and obligations in the contract. Under the contract, the vendor is presently obligated to make the service continuously available throughout the contract term on the customer's behalf and the customer has the right to those services. The vendor's performance creates a right to payment, the variability of which is reflected in the measurement of revenue.

Supply Agreement

Some stakeholders think that the nature of the promise in this example is a service of standing ready to perform with a single performance obligation. Under that view, the entity would estimate the number of purchases to be made throughout the contract term and continually adjust the transaction price and reallocate the consideration among the transferred goods or services. Stakeholders that view this arrangement as a single performance obligation do not see a difference between this example and the outsourcing or transaction processing examples. They would view the nature of any contract (or most contracts) with a stand-ready obligation and an undefined quantity of items that will be provided, or activities performed as a single service rather than the delivery of the underlying goods or services.

The staff views the nature of the promise in this example as the delivery of the parts, rather than (or in addition to) a service of standing ready. The staff thinks an important distinction between this fact pattern and transaction processing, or outsourcing arrangements is that the contract provides a right to choose the quantity of additional distinct goods versus a right to use the services for which control to the customer has (or is currently being) transferred. Similarly, the supplier is not obligated to transfer any parts until the customer submits the purchase order, while in the other fact patterns the vendor is obligated to make the promised services available to the customer without any additional decisions made by the customer.

In some contracts, the nature of the entity's promise is primarily that of "standing ready," or making available a scarce resource to the customer when-and-as it is needed (for example, the service of making the entity's health club available for the customer's use when the customer decides to use it). In contrast, in other cases, the nature of the promise is to transfer specified goods or services. For example, a contract to deliver 100 widgets over the next five years when the customer requests the widgets generally would not be a "stand-ready obligation," nor would a contract that simply sets out terms and conditions for future orders, but requires purchase orders of a specified quantity at a later date to obligate the vendor to perform (and customer to pay). Paragraph 606-10-55-185, which describes a stand-ready obligation, may also help distinguish the differences.

The staff does not view customer purchases under a master supply agreement to be similar to a customer's use of a health club. When the customer submits a purchase order, it is contracting for a specific number of distinct goods and creates new performance obligations for the supplier. In contrast, in the health club example, the customer is using services that the health club has made available and no new obligations arise from the usage of the service.

Summary

The staff thinks the determination of whether a contract has variable consideration, or an optional purchase, is highly dependent upon the evaluation of the nature of the promise in the contract. Consequently, not all outsourcing, transaction processing, and supply agreements automatically would be accounted for consistently with the staff views of the examples in this Q&A. An entity will need to evaluate the facts and circumstances of its contracts to determine the nature of its promise to the customer. Similar to previous GAAP, this sometimes will require the use of judgment.

The staff suggests that when an entity is evaluating the nature of its promises, the entity also should be mindful of the disclosure requirements in Topic 606. Those disclosure requirements include, but are not limited to, a description of the nature of the goods and services that the entity has promised to transfer and significant judgments, and changes in the judgments, made in applying Topic 606 that significantly affect the determination of the amount and timing of revenue. For many entities, the disclosure requirements in Topic 606 are incremental to those required under previous GAAP.

Question 24: How does the guidance on identifying performance obligations apply to the franchisor industry?

Reference(s): Sections 606-10-25 and 606-10-32

Before the adoption of Topic 606, under Topic 952, Franchisors, the initial franchise fee typically is recognized when the location opens. Because of the existence of industry-specific GAAP, franchisors historically have not had to assess whether pre-opening services are a separate deliverable.

Under the new guidance, the franchisor determines if the pre-opening activities contain any distinct goods or services. The guidance on identifying performance obligations is included in paragraphs 606-10-25-14 through 25-22. Paragraph 606-10-25-19 provides guidance on determining whether goods or services are distinct.

The transaction price is then allocated to distinct performance obligations based on standalone selling prices (paragraph 606-10-32-28). The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. Typically, the best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. However, if a standalone selling price is not directly observable, an entity estimates the standalone selling price. The guidance does not prescribe any particular method for estimation but provides the following examples of estimation methods:

- (a) Adjusted market assessment approach—An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be

willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

- (b) Expected cost plus a margin approach—An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
- (c) Residual approach—An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract.

A sales-based royalty stream is recognized over time under Topic 606, which is consistent with how entities account for sales-based or usage-based royalties today (paragraph 606-10-55-65).

Consider the following example:

A franchisee enters into a 10-year arrangement with a franchisor to open a restaurant location. The consideration comprises a \$25,000 upfront fee and a royalty of 4 percent of future sales. The franchise agreement grants the franchisee the right to use the franchisor's intellectual property. Before opening the restaurant, the franchisor will provide various services related to the opening, such as site selection and training.

Sales-Based Royalty

On the basis of the guidance in paragraph 606-10-55-65, the entity in the example does not estimate the royalties for the entire franchise period. The 4 percent royalty is allocated entirely to the license because the variable payment relates specifically to an outcome from the performance obligation to transfer the license. As such, the entity records revenue related to the 4 percent royalty as the customer's subsequent sales occur.

Identifying Performance Obligations

When implementing Topic 606, the common question in the fact pattern above has been whether the \$25,000 fee relates to a single performance obligation for the license of intellectual property, which must be spread over the 10-year term of the arrangement, or whether the entire \$25,000 fee may be allocated to separate performance obligations associated with the activities of the location opening, which would be recognized upfront consistent with current GAAP. Because the allocation of revenue depends on determining whether the goods or services are distinct (which some, all, or none may be), as well as determining the standalone selling price for each distinct good or service, the answer may differ from franchisor to franchisor.

If the franchisor determines that some or all of the pre-opening services are distinct, then it would recognize revenue when (or as) those services are performed (that is, typically upfront).

In this example, the entity determines that the training services are distinct because they are not highly interrelated with the franchise license. In this case, the entity determines that the training is not highly brand specific and consists principally of training that could be relevant to the operations of a similar business or businesses in general. In this example, the entity also determines that the site selection services are distinct from the license because they are not specific to the brand and could be provided by a third party. Next, the entity would need to determine the standalone selling price of the services that are separate performance obligations and allocate the transaction price to them based on the standalone selling prices.

Allocation/Standalone Selling Prices (Scenario 1)

The guidance does not prescribe a single method to determine standalone selling price. In applying the guidance on standalone selling price, the staff has considered how that analysis might be performed for training if it is considered a distinct performance obligation. The first step is to determine if the standalone selling price is observable (that is, the price charged if the entity provides any training services apart from the franchise license). For example, after the agreement for the franchise license, what would the franchisor charge to train new employees of the franchisee? Does the contract include a component of training for free for a minimal number of employees and then charge for additional employees (for example, free training for the first five employees but \$X per additional employee)? If the entity does not have an observable standalone selling price for training, it might consider (a) the price that a third party typically charges for comparable education or (b) the cost of training plus an expected margin.

Consider that in this example a portion of the initial franchise fee, rather than the entire fee, is allocated to the pre-opening services (for example, \$20,000). In this case, the entity determines that allocating the fixed consideration related to the standalone selling price of the pre-opening services and allocating a portion of the initial franchise fee and sales-based royalty to the license is consistent with the allocation objective.

Allocation/Standalone Selling Prices (Scenario 2)

Assume that the example above is modified so that the standalone selling prices of the pre-opening services is \$30,000. Therefore, the standalone selling price of the pre-opening services (\$30,000) is greater than the amount of the initial franchise fee (\$25,000). In this case, the entity would recognize the entire fee (\$25,000) as the pre-opening services are performed because the guidance does not allow pulling forward a portion of the future sales-based royalty (because of the guidance in paragraph 606-10-55-65).

Summary

The example above illustrates the following key takeaways in this inquiry when implementing the revenue standard:

- (a) Topic 606 does not include presumptions about the number of performance obligations in an arrangement. For example, an entity may not presume that the initial franchise fee would always be recognized over the license term. The staff observes that this presumption is not included in the guidance.
- (b) When assessing the standard, entities should consider the facts and circumstances of their specific arrangements and not over-generalize. Franchise arrangements vary considerably. Whether pre-opening services are distinct will depend on “what” the franchisor is doing. That is, the franchisor should understand the nature of the services it is performing and whether some, none, or all of those service are distinct in order to come to an appropriate accounting conclusion.

STEP 3—DETERMINE THE TRANSACTION PRICE

Question 25: Which payments to a customer are within the scope of the guidance on consideration payable to a customer?

Reference(s): Section 606-10-32

Topic 606 does not explicitly state whether the requirement to determine if an amount payable to a customer relates to a distinct good or service acquired at an amount that does not exceed fair value applies to all payments to a customer. Topic 606 also does not state that some payments are excluded from the assessment. Stakeholders have identified different interpretations on the scope of the consideration payable to a customer guidance:

- (a) Interpretation A: Entities should assess all consideration payable to a customer
- (b) Interpretation B: Entities should only assess consideration payable to a customer within a contract with a customer (or combined contracts).

Interpretation A

Some stakeholders think that entities must apply the guidance on consideration payable broadly to all customer payments. Supporters of this interpretation believe the intent of the guidance is similar to existing GAAP; therefore, the accounting results should be similar.

Supporters of Interpretation A note paragraphs BC256 and BC257 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, that discuss the basis for the assessment that an entity performs to determine if the consideration is a discount or refund for goods or services provided to a customer or a payment for goods and services received from the customer.

Stakeholders that support Interpretation A note that the Board acknowledged that consideration received from a customer and consideration paid to a customer could be linked even if they are separate events. The only way to determine if consideration paid to the customer is linked to a revenue contract with a customer is to assess whether the consideration paid to the customer was for distinct goods or services acquired at an amount that does not exceed fair value. Said another way, because any payment to a customer “could be linked,” an entity would need to assess whether each payment relates to a distinct good or service acquired at an amount that does not exceed fair value.

Supporters acknowledge that Topic 606 does not explicitly state which payments should be considered. However, those stakeholders point out that Topic 606 also does not explicitly state that some payments to a customer should be considered while others are not considered in context of the consideration payable to a customer guidance. Those stakeholders reason that the lack of explicit guidance is consistent with the basis for conclusions of Update 2014-09 that all consideration payable to a customer should be assessed. They also think that conclusion is consistent with existing GAAP, which seems reasonable because the concepts related to consideration payable to a customer in Topic 606 are similar to existing GAAP.

Interpretation B

Supporters of Interpretation B think the guidance on consideration payable to a customer is only applicable to amounts paid within the same contract or contracts that must be combined pursuant to paragraph 606-10-25-9. That view is consistent with paragraph 606-10-10-4 which states that Topic 606 “specifies the accounting for an individual contract with a customer.” These supporters also note that when consideration payable to a customer is not for distinct goods and services acquired at an amount that does not exceed fair value, the standard requires an entity to reduce the “transaction price” for the amount in excess of fair value. The transaction price notion is about the total consideration at the contract level and, therefore, the consideration payable to a customer needs to be within a contract (or combined contracts) with a customer.

Supporters of Interpretation B acknowledge that a payment to a customer could be related to a contract with a customer but might not always be identified through the contract combination guidance because the two contracts may not be “entered into at or near the same time.” However, supporters of Interpretation B assert that if an entity considers the contract modification guidance in context to the overall objective of Topic 606, it should identify consideration payable to a customer that relates to a revenue contract. With a focus on the overall objective of the revenue standard, those stakeholders think an entity would not only assess if the contract with the customer was legally modified, but also assess whether the contract has been economically modified.

To illustrate, assume that a truck manufacturer sells to a dealer 100 trucks. After delivery of the trucks, the dealer has difficulty selling the trucks to end customers. Six months after the delivery of the trucks to the dealer, the truck manufacturer communicates externally that it will provide \$5,000 to each customer that purchases a truck from the dealer within 30 days. The contract for the sale of the 100 trucks and the contract for the rebate to the end customer might not be combined because the contracts were not entered into at or near the same time. The entity could conclude that the rebate to the end customer is not a contract modification, because the rebate does not change the scope or price of the contract with the dealer that is approved by both parties in accordance with paragraph 606-10-25-10. However, those stakeholders think economically the rebate is a modification of the sales price of the contract with the dealer. The manufacturer would be indifferent if the \$5,000 is provided to the dealer or the end customer as long as the incentive generates more truck sales. The mechanics of whether the \$5,000 goes to

the dealer or to the end customer does not change the economics that led the manufacturer to offer the incentive.

Supporters of Interpretation B also think that, with Interpretation A, an entity might not meet the “core principle” of the revenue standard in paragraph 606-10-10-2 that “an entity shall recognize revenue to depict the transfer of promised goods or services to customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services.” They assert that, with Interpretation A, an entity could be required to recognize a payment to a supplier (that is also a customer) as a reduction of revenue because of an unrelated transaction in a different line of business with that same supplier. This could occur because the entity is unable to demonstrate that the payment represents the fair value of the distinct goods or services it receives from the vendor. In that circumstance, those stakeholders assert that an entity’s revenue does not faithfully represent the consideration to which the entity *expects* to be entitled for providing goods and services.

TRG members agreed that a reasonable application of either View A or View B should result in similar financial reporting outcomes and that reasonable application of either view could be accomplished with processes and internal controls to identify payments to customers that could be related to a revenue contract.

Question 26: Who are considered an entity’s customers when applying the guidance on consideration payable to a customer? Is this guidance meant to apply only to customers in the distribution chain or more broadly to any customer of an entity’s customer?

Reference(s): Section 606-10-32

The guidance on consideration payable to a customer refers to payments made “to other parties that purchase the entity’s goods or services from the customer.” Paragraph BC255 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, refers to payments an entity makes to “its customers or to its customer’s customer (for example, an entity may sell a product to a dealer or distributor and subsequently pay amounts to or provide a cash incentive to a customer of that dealer or distributor).” Questions have arisen as to whether the scope of the guidance applies only to payments to customers in the distribution chain or whether “customer’s customer” should be interpreted more broadly.

For example, an entity that is acting as an agent typically views the principal in the arrangement as its customer. The agent may make incentive payments to parties that purchase the principal’s good or service. In many cases, these incentives are not part of the contract with the principal, or a promise made explicitly or implicitly to the principal; although, the principal may be aware of the incentive program. The agent makes incentive payments to the principal’s customer, such as providing coupons or cash rebates, to increase the volume of transactions on which it earns

its agency fee. These parties are not purchasing the agent's goods or services (that is, the principal's customer is not in the distribution chain).

Most TRG members supported the view that an entity's customers include those in the distribution chain and might include a customer's customer outside of the distribution chain. An entity must identify its customer in each revenue transaction and entities within the distribution chain. In addition, an entity that is acting as an agent (that is, arranging for another party to provide goods or services), might identify multiple customers depending on the facts and circumstances of the arrangement. That is, the entity might view both the principal and the end customer as customers in the arrangement. TRG members noted that under existing GAAP an entity might view the principal's end customer as its customer, while others might not, and as a result there is some diversity in practice today about whether an entity that is an agent thinks its customer is only the principal. Regardless of whether an entity concludes that the principal's end customer is also a customer of the entity, a payment to a principal's end customer that was contractually required based on an agreement between the entity and the principal would represent consideration payable to a customer.

Question 27: How should an entity determine the presentation of amounts billed to customers (gross or net) under Topic 606?

Reference(s): Section 606-10-32

The guidance on transaction price in paragraph 606-10-32-2 states that the transaction price should exclude "amounts collected on behalf of third parties."

Conversely, if an entity is not collecting an amount on behalf of a third party (for example, on behalf of a government or another service provider), that amount should be included in the transaction price. Sometimes it may not be entirely clear whether the amounts are collected on behalf of third parties. In those cases, some stakeholders have expressed the view that an entity should apply the principal-agent framework in Topic 606 to determine whether it is merely a conduit for the amounts collected or whether it is the principal with respect to the obligation. An entity could use the principal-agent framework to help it to determine whether the customer is compensating the entity for a cost it incurred to provide a good or service (that is, as a principal) or, instead, whether the entity is arranging for the customer to pay its (the customer's) obligation to another party (that is, acting as an agent).

The principal versus agent implementation guidance assists an entity in determining whether the nature of its promise is a performance obligation to provide the specified goods or services itself or to arrange for another party to provide services. For items such as shipping and handling fees and other out-of-pocket expenses, this guidance is applicable because those costs are incurred by the entity as part of satisfying a performance obligation. Because taxes and other assessments are generally an obligation to a governmental authority, rather than to a customer, the principal versus agent guidance is applied by analogy.

Below are some considerations about how stakeholders note that the principal versus agent guidance could be applied in determining how to present some common amounts billed to customers.

- (a) Shipping and handling fees—In determining whether it is a principal or an agent for shipping and handling, an entity might consider whether:
 - (i) The entity is responsible for directly providing or for procuring the service (including supplier selection).
 - (ii) The entity has discretion in setting the price charged for the shipping and handling to the customer (for example, entities often charge customers more or less than the costs incurred).
 - (iii) The entity's profit or loss on the shipping and handling is not fixed (if the entity has pricing discretion, the margin the entity earns, or incurs in the case of providing free or significantly discounted shipping and handling, is variable).
 - (iv) The entity bears the credit risk with respect to those fees. For example, if the entity is providing the shipping and handling services itself or if it is responsible for payment to the shipping provider regardless of its ability to collect the shipping and handling fees billed to the customer.
- (b) Other out-of-pocket expenses—Shipping and handling fees are often a type of out-of-pocket expense. Therefore, the considerations summarized above for shipping and handling fees often would be similar to the considerations for other out-of-pocket expenses, except that in many arrangements, the entity is required to bill the customer for the amount incurred.
- (c) Taxes and other assessments remitted to governmental authorities—In determining whether the entity is a principal or an agent with respect to taxes and other assessments, one or more of the following might indicate that the entity is the principal (and, therefore, that the entity would present the billings as revenue and the remittances as a cost).
 - (i) The entity is primarily responsible for fulfilling the obligation (that is, the entity is primarily responsible for the tax or other assessment). For example, U.S. telecommunications companies historically have been required to pay Universal Service Fund (USF) fees to the U.S. Federal Communications Commission based on their revenues. They are responsible for that assessment regardless of whether they choose to seek full or partial reimbursement of that assessment through billings to their customers. In contrast, in some jurisdictions, the customer may be responsible for payment of sales (or use) taxes even though the jurisdiction may require the entity to collect the tax from the customer and remit the entire amount to the jurisdiction. If the entity (for example, an internet vendor) does not collect the tax, the customer may be responsible for remitting the applicable sales or use tax to the appropriate jurisdiction.

- (ii) The entity has latitude with respect to the amount charged to the customer. Continuing with the examples above, entities that are required to collect sales tax from customers are required to do so at the amount owed to the jurisdiction and remit that amount to the jurisdiction, while U.S. telecommunications companies make their own decision about whether and how they recover the costs of their USF assessment from their customers.
- (iii) The amount retained by the entity is not fixed. In the case of many sales taxes, the entity is required to remit what it collects and, therefore, its retention is fixed (at zero). Conversely, if the entity has discretion as to whether or how much it collects from the customer, then its margins on the tax or other assessment are not fixed and the price represents a business decision about the price customers will be willing to pay for its goods or services.
- (iv) The entity has credit risk. If the entity is solely responsible for payment of the full tax or other assessment amount, regardless of whether it collects any amounts it has billed to its customers, it would have credit risk.

Other stakeholders have raised questions with respect to the guidance in paragraph 606-10-32-2 that states that the transaction price should include only “the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.” Those stakeholders question whether there is, as a result of the definition of transaction price, a possible distinction between items such as reimbursements of out-of-pocket expenses or shipping and handling fees charged as part of fulfilling a promised good or service and collections for taxes or other assessments by governmental authorities.

Some assert that out-of-pocket expenses, including shipping and handling fees, are generally incurred by the entity in fulfilling its performance obligation(s) to the customer, and, therefore, the amounts billed to the customer represent consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. They assert that the fees are no different than the transaction price of a good representing “reimbursement” for the costs to produce that product (for example, the cost of each item of raw material, labor, depreciation on manufacturing equipment).

With respect to collections of taxes or other assessments, some stakeholders note that it is not clear whether those amounts represent consideration to which the entity expects to be entitled in exchange for transferring promised goods or services to a customer. In addition, they note that it can vary depending on the nature of the sales tax or other assessment from a governmental entity. Those billings may not relate to the entity’s fulfillment of a promised good or service. This may be evident in circumstances when the price of the good or service varies among jurisdictions by the statutorily mandated tax or assessment amount. For example, when a good is sold over the internet, a sales tax amount is added (or not added) at time of checkout based on where the customer resides. In addition, in some jurisdictions, certain types of entities might not be required to pay sales tax for certain products, while other types of entities are required to pay sales tax for the same products. In those examples, because the price variation

is entirely attributable to the tax (and not attributable to any incremental performance), some assert that the tax amount should not be considered to be part of the consideration to which the entity is entitled in exchange for transferring the promised good or service to the customer. Those amounts would, therefore, be excluded from revenue.

Other stakeholders assert that a principal-agent analysis of the nature described above is appropriate to determine whether those amounts should be considered part of the transaction price because an obligation of the entity to a governmental authority that is required in order for the entity to conduct business is no different than other costs of the entity that are paid with the proceeds from the entity's sales. For example, assume an entity sells a product to a customer for CU100 and, as a direct result of that sale, owes a third party a sales commission of CU10 and owes a governmental authority a tax on the transaction of CU8. There appears to be no substantive difference between the third-party commission and the tax. The two costs were incurred as a direct result of the specific sale transaction, and neither the commission nor the tax provide any additional good or service to the customer beyond the product purchased.

The staff agrees with the view of most TRG members that Topic 606 provides sufficient guidance to determine the gross or net presentation of amounts billed to customers, including shipping and handling fees and reimbursements of other out-of-pocket expenses, and various taxes collected from customers and remitted to governmental authorities. See paragraph 606-10-32-2A for an accounting policy election about exclusion of taxes from the transaction price.

Question 28: How should an entity assess whether a contract includes a price concession?

Reference(s): Section 606-10-32, Example 3

An area of judgment in Topic 606 is determining whether a situation in which an entity determines that it will collect less than the stated contract price is the result of a collectibility issue or a price concession. If an entity determines that it will collect less than the stated contract price due to a price concession (regardless of whether the price concession is implicit or explicit), then that amount is accounted for as a reduction of the transaction price. That is, the amount is considered to be variable consideration that is subject to the constraint on variable consideration in determining the transaction price (Step 3 of Topic 606) rather than an input into the collectibility assessment in Step 1. Therefore, the determination about whether something is a price concession or a collectibility adjustment may have a significant effect on an entity's revenue recognition.

If an entity concludes that it is offering a price concession, then the entity would estimate the transaction price in accordance with paragraph 606-10-32-8 and constrain some or all of the amount of variable consideration, as applicable, in accordance with paragraphs 606-10-32-11 through 32-12.

Paragraph 606-10-32-7 provides guidance on what factors to consider in determining whether an entity has offered a price concession. This suggests that an entity's past experience provides evidence in assessing whether a price concession has been offered to a customer.

Example 3, Implicit Price Concession, in the Illustrations to Topic 606 provides further guidance on evaluating whether an entity has offered an implicit price concession. In the first paragraph of Example 3, the entity provides services before the entity has assessed whether the customer is committed to the contract; and therefore, before the criteria in Step 1 have been met.

After providing the services, the entity assesses if the criteria in Step 1 have been met and determines that it does have a contract with the customer. The entity assesses the amount of consideration to which it will be entitled to and whether the reduction from the standard billing rate is due to collectibility issues or due to an implicit price concession. The remaining paragraphs in Example 3 discuss the factors that lead the entity to conclude that a price concession has been offered to the customer. Those factors include additional information about the patient's intention and ability to pay, and the entity's intentions with regards to the services provided and acceptance of consideration, which are highlighted in paragraphs 606-10-55-103 through 55-105 of Example 3.

The basis for conclusions of Topic 606 (Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*) also discusses how an entity should consider its intentions and not only refer to past experience in assessing if a price concession has been granted to a customer (paragraph BC193).

While Topic 606 provides examples of factors to consider in the illustrations and basis for conclusions, the Board also acknowledged that it may be difficult in some cases to distinguish between a price concession and customer credit risk. Consistent with current GAAP, entities might need to apply judgment (paragraph BC194).

Topic 606 indicates that an entity should look to past practice as well as the entity's intentions when entering into the contract with a customer. The determination of whether a reduction in consideration is due to concerns about collectibility or as a result of a price concession will require an assessment of the specific facts and circumstances and require significant judgment, which is consistent with current GAAP.

Question 29: When should an entity recognize consideration payable to a customer? How does the guidance on timing and recognition of consideration payable reconcile with the variable consideration guidance?

Reference(s): Section 606-10-32

Some stakeholders have questioned when an entity should recognize consideration payable to a customer, which occurs in Step 3 (Determine the Transaction Price) of Topic 606. The

question arises due to the interaction of the guidance on constraining variable consideration and the guidance on consideration payable to the customer.

Paragraph 606-10-32-27 provides guidance on the timing of recognizing consideration payable to a customer. Paragraph 606-10-32-25 provides guidance on recognizing consideration payable to a customer that is variable. Paragraph 606-10-32-6 provides guidance on what constitutes variable consideration.

The question on consideration payable to a customer in Topic 606 is related to situations in which an entity promises to pay consideration to a customer after it recognizes revenue for the transfer of goods or services to the customer. This is because some stakeholders assert that the variable consideration guidance would require recognition of the consideration payable to a customer (that is, a reduction of revenue) when revenue is recognized; whereas, the guidance on consideration payable to the customer might indicate that a later date is acceptable.

Consider the following example:

An entity that manufactures consumer goods enters into a contract to sell a new product to a customer (a retail store chain) on December 15th. Before delivering any of the new products to the retail store chain, the entity's marketing department assesses whether the entity should offer CU1-off coupons in newspapers to encourage consumers to buy the new product. The entity will reimburse the retail store chain for any coupons that are redeemed. The entity has not historically entered into similar coupon offerings in the past. The entity delivers the new consumer goods (1,000 units at CU10/unit) to the retail store chain on December 28th. Assume for this example, that the customer has no right to return the products. On December 31st, the entity decides to make the coupon offering. On January 2nd, the entity communicates to its customer that it will reimburse the retail store chain on March 30th for any coupons redeemed by the retail store's customers. Assume the entity prepares its financial statements based on a calendar year end.

The specific facts and circumstances of the arrangement will affect the entity's conclusion about whether the CU1,000 of consideration payable to a customer (1,000 units x CU1/unit rebate, for simplicity, ignore the effects of potential breakage) should be recognized on December 28th (the date revenue is recognized), January 2nd (the date the entity promises to pay the consideration to its customer), or some date in between. In this example, the staff does not think March 30th would be an acceptable date to recognize the consideration payable to the customer. If the entity waited until March 30th to recognize the reduction in revenue, the CU1,000 reduction in revenue would not be recognized until after it recognizes revenue and after it makes a promise to pay the customer.

Paragraph 606-10-32-43 states that changes in the transaction price for satisfied performance obligations (such as, in the example above, the transferred products) shall be recognized as revenue, or as a reduction in revenue, in the period in which the transaction price changes. Therefore, beginning on the date the entity considers offering the coupons, the entity should consider whether there is a change in the transaction price (that is, has the amount of consideration to which the entity expects to be entitled for transferring the products changed).

Simply having the thought of, or having some initial preliminary discussions about, a potential coupon offering does not necessarily result in a change to the transaction price. However, the entity might no longer reasonably expect to be entitled to CU10,000 for the 1,000 products even before the January 2nd date upon which it promises the consideration to the customer (for example, on December 31st the entity committed to the coupon program). Therefore, the date at which the transaction price changes will be a matter of judgment.

If the products are delivered on December 28th and the entity recognized CU10,000 as revenue, and the entity subsequently concludes there is a change in the transaction price downward to CU9,000, then that CU1,000 should be recognized as a reduction to revenue in the period in which it determines that the transaction price has changed.

In the example above, the entity provides the customer with a CU1-off coupon, which is a form of variable consideration. Paragraph 606-10-32-6 describes consideration payable to a customer as a type of variable consideration. The entity would consider the guidance on variable consideration and the guidance on consideration payable to customer. That is, the two concepts are related, and an entity does not only look to one or the other.

The guidance indicates an entity would estimate the consideration it expects to pay the retail store chain and include that amount in the transaction price (Step 3). Because the transaction price includes variable consideration, the entity would follow the guidance in Step 3 on constraining estimates of variable consideration.

The entity also would consider whether an implicit promise for the coupon has been made before making the formal promise. The guidance in paragraph 606-10-32-25(b) states that a promise of consideration to a customer might be implied by an entity's customary business practices. Therefore, in many cases the promise to pay consideration may occur at a point before the formal offer is made.

Regardless of whether an entity was following the guidance on variable consideration or consideration payable to the customer (including consideration of the guidance on changes in transaction price), the recognition of the sales incentive (the coupon) would result in a reversal of revenue. That reversal of revenue should be made at the earlier of the date that there is a change in the transaction price in accordance with paragraph 606-10-32-25 or the date at which the consideration payable to a customer is promised in accordance with paragraph 606-10-32-27.

As described in paragraph 606-10-05-3, the core principle of the standard is to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. If the entity never expects to be entitled to that consideration, it would not be appropriate to recognize the reduction of revenue at a later date. Furthermore, the notion of the constraint on variable consideration is that revenue should not be recognized if it is probable [highly probable] of significant reversal. In this example, a delay in recognizing the effect of the coupon might result in a significant reversal of revenue which would be in conflict with the constraint principle.

TRG members discussed when an entity should recognize consideration payable to a customer as a reduction to revenue. The guidance on consideration payable to a customer in paragraph 606-10-32-27 states that such amounts should be recognized as a reduction of revenue at the later of when the related revenue is recognized or the entity pays or promises to pay such consideration (promises could be implied by customary business practices). This is referred to as the “later of guidance” here. Some TRG members highlighted that if an entity intends to provide its customer with a price concession when entering into the contract (regardless of the form of the price concession, for example, cash payment, rebate, account credit, or coupon), then the contract includes variable consideration and it should consider that price concession when estimating variable consideration (subject to the constraint on variable consideration). In determining whether an entity intends to provide the customer with a price concession, the entity should consider the guidance in paragraphs 606-10-32-6 through 32-7. If the contract includes variable consideration because of an expected price concession, then the entity would not wait until it has communicated the price concession to the customer to recognize a reduction in revenue under the later of guidance. Instead, the entity would account for the variable consideration in accordance with paragraph 606-10-32-14.

TRG members agreed that the later of guidance in Topic 606 would be applied in more limited circumstances than the later of guidance in existing GAAP. This is because the core principle of Topic 606 is that an entity recognizes revenue in an amount that reflects the consideration to which the entity expects to be entitled. Consistent with that core principle, Topic 606 includes estimates of variable consideration (subject to the constraint) in the transaction price, and it requires an entity to reassess the transaction price when the amount to which the entity expects to be entitled changes. Under Topic 606, in accordance with paragraphs 606-10-32-6 through 32-7, an entity would account for consideration payable to a customer as variable consideration when either the customer has a valid expectation based on customary business practices or the entity’s intention is to provide consideration to the customer when entering into the contract.

Question 30: Should the constraint on variable consideration be applied at the contract level or the performance obligation level?

Reference(s): Section 606-10-32

Some stakeholders have questioned whether the constraint on variable consideration should be applied at the performance obligation level or the contract level. This question might be particularly pertinent in scenarios in which variable consideration is not allocated proportionately to all performance obligations in a contract, or when one performance obligation is fixed and the other is variable.

Consider the following example:

An entity enters into a contract with a customer to provide it with equipment and a consulting service. The purpose of the consulting service is to improve the customer’s

manufacturing process. The equipment and the consulting service are separate performance obligations. The stated price for the equipment is fixed at CU10 million. The contract does not include stated, fixed consideration for the consulting service, but if the customer's manufacturing costs decrease by 5% over a one-year period, the entity will receive CU50,000 for the consulting service.

The standalone selling prices of the equipment and consulting service are determined to be CU10 million and CU50,000, respectively. The entity allocates the potential performance-based fee entirely to the consulting service performance obligation based on the criteria in paragraph 606-10-32-40. Because the equipment is not expected to have any positive or negative effect on the customer's manufacturing costs, the entity concludes that the variable payment terms relate specifically to the entity's consulting service and allocating the consideration in this manner is consistent with the overall transaction price allocation objective.

In the fact pattern above, the entity concludes that CU50,000 is the most likely amount of consideration to which it expects to be entitled using the most likely method. The entity also concludes it is not probable that it will earn the performance-based fee. However, despite the fact that the entity concludes that it is not probable it will earn the fee, the entity also has to evaluate whether inclusion of the amount in the transaction price may result in a significant revenue reversal. Paragraph 606-10-32-12 specifies that an entity must consider both the likelihood and the magnitude of a potential revenue reversal in determining whether the constraint on variable consideration applies. Some stakeholders have questioned whether the significance/magnitude determination is based on an assessment of the potential reversal of revenue against (a) the transaction price allocated to the related performance obligation (in this case, CU50,000) or (b) the total transaction price for the contract (CU10.05 million). Those stakeholders assert that an entity may come to a different conclusion about whether variable consideration must be constrained depending on which approach it follows. For example, some stakeholders assert that the entity would include the CU50,000 in the transaction price (that is, it would not be constrained) because it is not significant to the entire contract transaction price, including the variable consideration, of CU10.05 million. Other stakeholders assert that the CU50,000 should be constrained because any reversal would represent a 100% reversal on revenue recognized related to that performance obligation.

Topic 606 provides guidance (paragraphs 606-10-32-11 and 32-12) that is relevant to determining the magnitude of a potential revenue reversal.

In addition, the basis for conclusions of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, includes some excerpts relevant to this discussion. Based on discussions with stakeholders, it appears that the question outlined in the above paragraph has been raised principally as a result of the paragraphs BC216 through BC217. Also relevant to this issue, in paragraph BC206, the Board provided its reasoning for including the constraint in Topic 606.

While these basis for conclusions paragraphs and the absence of explicit guidance on the level at which the magnitude of a potential revenue reversal is determined in the standard explains why the question has been raised, the unit of account for determining the transaction price (Step 3 of the model) is the contract, not the performance obligation. The staff notes that while the unit of account is not explicitly stated with respect to application of the constraint, a contract unit of account is explicitly noted elsewhere within the basis for conclusions discussion about Step 3 of the model. Specifically, paragraph BC234 of Update 2014-09 relates to identifying a significant financing component in a contract.

The Board's reasoning with respect to identifying significant financing components explains why an entity should consider significance at the contract level rather than the performance obligation level. Additionally, the practical expedient on applying Topic 606 (paragraph 606-10-10-4) to a portfolio of contracts would permit an entity to evaluate application of the constraint to a portfolio of contracts with similar characteristics (for example, similar variable fee structures) so long as the effects on the financial statements would not differ materially from applying this guidance to the individual contracts. The staff thinks an entity might conclude, for example, that it does not need to evaluate each of its variable consideration arrangements such as the one included in the example above, if the potential cumulative effect of a revenue reversal in all of those contracts would not be material.

Determining the magnitude of a potential revenue reversal, and application of the overall constraint, should not be confused with the core requirement for determining the transaction price. That is, the core principle of Topic 606 is to recognize revenue to depict the transfer of promised goods or services to customers in an amount (that is, the transaction price) that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. If the entity does not expect to be entitled to CU50,000 (for example, it concludes the most likely amount to which it will be entitled is CU0, rather than CU50,000) it would not include that amount in the transaction price regardless of whether a reversal of that amount would be significant or not. That is, the CU50,000 performance-based fee would be excluded from the transaction price before the entity even assesses whether to apply the constraint on variable consideration.

TRG members generally agreed that the constraint on variable consideration should be applied at the contract level. Therefore, the assessment of whether a significant reversal of revenue will occur in the future (the constraint) should consider the estimated transaction price of the contract rather than the amount allocated to a performance obligation.

Question 31: How should the factor in paragraph 606-10-32-17(c) be applied in determining when the difference between promised consideration and cash selling price is not related to a significant financing component?

Reference(s): Section 606-10-32

The Board included a list of factors in Topic 606 to indicate when a significant financing component might not exist. Implementation questions have arisen about the factor in paragraph 606-10-32-17(c) regarding how “broadly” this factor should be applied.

The question arises, in part, due to the interaction of the guidance in paragraphs 606-10-32-15 and 606-10-32-16. Paragraph 606-10-32-15 explains the principle is to adjust the promised amount of consideration for the time value of money if the customer or entity receive a significant benefit of financing the transfer of goods or services to the customer. The objective when adjusting the promised amount of consideration for a significant financing component in paragraph 606-10-32-16 is to recognize revenue for the goods and services at an amount that reflects what the cash selling price would be without the significant financing component that the entity already concluded exists based on applying Topic 606. It is important to note that the objective of measuring a significant financing component should not be interpreted as the principle for evaluating whether a significant financing component exists. Rather, it is the objective an entity should apply when adjusting the transaction price because it has concluded there is a significant financing component under Topic 606.

When reading the totality of the guidance on significant financing components, including the basis for conclusions of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, it seems clear that the Board did not intend to include a presumption that if the cash selling price varies from promised consideration (or there is a long-time frame between transfer of the goods and payment), then a significant financing component exists. That is, the standard does not include such a presumption and requires the use of judgment in the assessment. Paragraph BC231 of Update 2014-09 discusses some of the Board’s considerations.

Paragraph BC230 provides some further guidance on this topic. This paragraph highlights that an entity should consider whether the payment terms of the contract provide the benefit of financing to the customer or entity (and which is significant at the contract level). It is noting that there may be other reasons than providing financing and reasons why the consideration is not remitted at the time the performance obligations are satisfied. An entity will need to apply judgment to determine whether the payment terms are providing finance or are for another reason. Paragraph 606-10-32-17(c) contains some language about the difference being proportional to the reason for the difference.

The staff further notes that paragraph 606-10-32-16 deemphasized “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” as compared to exposure drafts of Topic 606 as a direct response to feedback from stakeholders on those previous exposure drafts.

Furthermore, the Board included the factors in paragraph 606-10-32-17 to clarify the circumstances in which a contract does not provide the entity or the customer with a significant benefit of financing. The basis for conclusions of Update 2014-09 includes discussion of the factor included in paragraph 606-10-32-17(c).

The staff notes that the basis for conclusions specifically (paragraph BC238) discusses why the Board did not provide an exemption for advance payments. Furthermore, the standard includes two examples on advance payments. In Example 29, Advance Payment and Assessment of the Discount Rate (paragraph 606-10-55-240), the entity concludes there is a significant financing component due to the different payment options available to the customer and length of time between the advance payment from the customer and the transfer of control. In Example 30, Advance Payment (paragraph 606-10-55-244), the entity concludes that there is not a significant financing component because the timing difference relates to a reason other than financing.

Topic 606 is clear that advance payments are not excluded from the scope of the guidance on significant financing component. However, the Board readily acknowledged that there may be valid non-financing reasons for an advance payment. In those cases, an entity should establish why that feature of the arrangement is not providing a significant financing benefit but is instead there for a different and substantive business purpose. As previously noted, in addition to having a reason other than financing, paragraph 606-10-32-17(c) requires the difference between the promised consideration and cash selling price of the good or service to be proportional to the reason for the difference.

In the staff’s view, determining whether a contract with a customer includes a significant financing component is a matter of judgment, both in determining whether a financing component exists and, if so, in determining the significance of the benefit that the financing component provides to the customer or the entity. The guidance referred above seems to make clear that the Board thinks some contracts provide a significant benefit of financing, but that differences (a) between the timing of payment and the transfer to the goods or services and (b) between the stated price and the cash selling price of a good or service are not necessarily indicative of a significant financing component. It is important that entities analyze all of the facts and circumstances in the arrangement in applying the guidance on significant financing components to determine if one exists. It is clear that judgment will be required in this area of Topic 606.

The Board included a number of items for an entity to consider when making judgments about whether a significant financing component exists in a contract. Those considerations include the criteria in paragraph 606-10-32-16, the factors in paragraph 606-10-32-17, and several illustrative examples (Examples 26, 27, 28 (Case A), 28 (Case B), 29, and 30 starting at paragraph 606-10-55-227).

In addition, to reduce the cost and complexity of applying the guidance on significant financing components, the Board decided to include a practical expedient in the guidance. Paragraph

606-10-32-18 states that an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects that the period between when the entity transfers a promised good or service and when the customer pays for that promised good or service will be one year or less. The staff thinks this practical expedient should substantially reduce the population of contracts for which an entity would be required to evaluate whether a significant financing component exists (that is, because most contracts would be eligible for the practical expedient, an entity would not be required to make judgmental evaluations about whether there is an implied financing element).

The Board could have removed judgment in this area by not requiring any consideration of whether a significant financing component exists. That decision would have been a significant difference compared with existing GAAP for (a) revenue and (b) many other areas. The Board also could have removed judgment by always requiring a financing component to be accounted for whenever there is a difference between the timing of payments in comparison to performance. However, such a decision would have been inconsistent with the feedback the Board received from stakeholders about circumstances in which the difference is unrelated to financing and likely would result in more cost and complexity than permitting an entity to apply judgment in determining when a contract includes the significant benefit of financing to one of the parties.

TRG members agreed that there is no presumption in the standard that a significant financing component exists or does not exist when there is a difference in timing between when goods and services are transferred and when the promised consideration is paid. An entity will need to apply judgment to determine whether the payment terms are providing financing or are for another reason. TRG members discussed the factor in paragraph 606-10-32-17(c) relating to whether the difference in promised consideration and cash selling price is for a reason other than financing, noting that it might be more likely that an advance payment would meet that factor compared to payments in arrears. However, TRG members also agreed that there is no presumption as to whether advance payments do or do not contain significant financing components and that advance payments should be assessed under Topic 606. However, several members stressed that when entities consider whether the difference in promised consideration and cash selling price is for a reason other than financing, they also must consider whether the difference between those amounts is proportional to the reason for the difference. Many TRG members noted that it will require significant judgment in some circumstances to determine whether a transaction does, or does not, include a significant financing component, and they thought that when the Boards developed Topic 606, they understood judgment may often be required in this area.

Question 32: If the promised consideration is equal to the cash selling price, does a financing component exist?

Reference(s): Section 606-10-32

Some stakeholders have questioned whether the guidance that includes the objective for adjusting the promised amount of consideration for a significant financing component (paragraph 606-10-32-16) implies that there is never a significant financing component when there is not a difference between the amount of promised consideration and the cash selling price. In certain industries, it may be common for the promised consideration and cash selling price to be equal. Consider the following examples.

Example 1

A customer can purchase a piece of equipment for CU1,200 and then will be eligible to purchase service for the equipment for CU100 each month under a month-to-month service contract. However, the customer could choose to pay zero for the equipment on day one and have the option to sign a note to pay the CU1,200 over a 24-month period without an additional charge for interest and still pay CU100 each month for service.

Example 2

A furniture retailer offers a promotion for a CU2,000 dining set. Customers have the option to obtain 0% financing for 3 years as part of this special promotion or to pay the entire amount at the time of purchase.

In the examples above, the list price of the goods is equal to the promised consideration in the contract. However, it is important to note that the list price might not always equal the cash selling price and a contract might have an implied interest rate that is different from a stated interest rate. For example, if a customer offers to pay cash upfront when the entity is offering “free” financing, the customer might be able to pay less than the list price. That is, the true cash selling price might be (in fact, may be likely to be) less than the list price. This notion is consistent in concept with the guidance in paragraph 606-10-32-32, which states that a contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service.

In the examples above, if the list price, the cash selling price, and the promised consideration are all equal, the respective entities should not automatically assume that there is no significant financing component. The difference, if any, between the amount of promised consideration and the cash selling price is a consideration (that is, it is one of two factors in paragraph 606-10-32-16, not the only consideration), not a presumption, in determining whether a significant financing component exists. The guidance in paragraph 606-10-32-16 further specifies that an entity should consider all relevant facts and circumstances. Accordingly, this one fact, that the

cash selling price is equal to the selling price in the contract, would not be the totality of the assessment. However, if the list price, the cash selling price, and the promised consideration are all, in fact, equal (including after careful consideration of whether the list price is the cash selling price), that might indicate that the contract does not include a significant financing component.

That is not to say that if list price, cash selling price, and promised consideration are equal that a financing component cannot exist. Rather, entities should carefully evaluate whether those items are all, in fact, equal. Determining a “cash selling price” may require judgment and the fact that an entity provides “zero interest financing” does not necessarily mean that the cash selling price is the same as the price another customer will pay over time. Entities would consider the cash selling price as compared to the promised consideration in making the evaluation based on the overall facts and circumstances of the arrangement.

It also may be possible that in these type of scenarios (that is, zero implied interest) that a financing component exists but that it may not be significant. Entities will need to apply judgment in determining whether the financing component is significant or not.

Question 33: Does the standard preclude accounting for financing components that are not significant?

Reference(s): Section 606-10-32

The standard requires accounting for “significant” financing components. Some stakeholders have questioned whether it would be acceptable to account for financing components that are not significant.

The staff understands that the genesis of this question has to do with the fact that the assessment of the significance of the financing component is based on an evaluation of the contract. That is, an entity might deem the financing to not be significant at the contract level but might prefer to account for it if it is material at the entity level (although the standard does not require an entity level assessment of materiality in this area). Additionally, an entity may have a portfolio of contracts that include financing components for which some are significant, and others are insignificant. In this scenario, it would likely be less burdensome to implement the standard if the entity accounts for the financing component across all contracts in its portfolio instead of having to apply two methods of accounting (that is, apply financing component accounting to some and not to others). The Board’s rationale for placing the significance assessment at the contract level is described in paragraph BC234 of the basis for conclusions of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The rationale for assessing significance at the contract level was to reduce the burden for entities. That is, it was for practical reasons rather than conceptual reasons. The staff is not aware of any guidance in the standard that would preclude an entity from deciding to account for a financing component that is not significant.

Question 34: How should an entity determine if the practical expedient can be applied in scenarios in which there is a single payment stream for multiple performance obligations?

Reference(s): Section 606-10-32

Topic 606 permits an entity to use the practical expedient referenced in paragraph 606-10-32-18 in applying the guidance on significant financing component. That practical expedient allows an entity not to adjust promised consideration for the amount of a significant financing component when the period between when the entity transfers a promised good or service to a customer and when a customer will pay for that good or service will be one year or less.

The staff has received implementation questions about scenarios in which the cash payment may not be directly tied to a particular good or service in a contract.

Consider the following example:

An entity offers a 24-month contract to customers which include the delivery of a device at contract inception and related services over 24 months. The entity concludes that the device and services are each distinct. The promised amount of consideration (combined amount for device and services) is CU2,400 payable in 24 monthly installments of CU100. Assume the transaction price is allocated to the device (CU500) and services (CU1,900 [CU79 per month]). For purposes of this example, assume that the arrangement includes a significant financing component as the question to be answered only relates to whether the practical expedient can be applied. For purposes of the analysis, this example does not include the calculation of the amount that would be attributed to interest income.

In determining the period between when the entity transfers a promised good or service and when the customer pays for that good or service, the question arises as to whether the entity should consider the full monthly consideration received as a payment of the first good or service delivered (that is, follow a first-in-first-out approach) or whether the entity should proportionately allocate the monthly consideration promised in the contract between the equipment and the services.

Assume that the entity transfers the device first and recognizes revenue for CU500. Each month the entity transfers the services and recognizes revenue for CU79. The two alternatives for determining whether the practical expedient applies are illustrated as follows:

View A

The entity allocates consideration to the first item delivered (the device). Therefore, the device will be “paid” (that is, in relation to the allocation of the transaction price) in full after 5 months (CU100/month for 5 months) and the entity concludes that the period between delivery of the device and receipt of the consideration is less than one year.

The entity notes that any given month of service will be settled in less than 12 months under this approach. For example, services delivered in month 1 will be fully paid in month 6, services delivered in month 2 will be fully paid in month 7, and so on.

The entity, therefore, applies the practical expedient not to adjust the consideration promised in the contract for the effects of a significant financing component as the entity concludes that the period between transfer of any good or service in the contract and when the customer pays for that good or service is one year or less.

View B

The entity proportionally allocates the monthly consideration to the device and the services. Each month, CU79 of the cash is allocated to service and CU21 cash is allocated to the device.

The amount related to the service receivable is fully settled at the end of each month. The entity will, however, receive the full amount outstanding on the handset only over 24 months (CU21/month for 24 months). The entity concludes that the period between delivery of the device and receipt of the consideration relating to the device to be more than one year. Therefore, the entity would be required to consider whether there is a significant financing component in the contract.

The staff notes that the fact that the practical expedient would not apply does not mean there is necessarily a significant financing component in the contract (that is, the entity would need to consider the guidance in paragraphs 606-10-32-15 through 32-17 to make that determination).

TRG members discussed the difficulty in determining when a customer has paid for a particular good or service in a contract with a customer because of the fungible nature of cash. In some circumstances, it may not be clear whether cash collected relates to a specific performance obligation in a contract. In other instances, it may be clear that a cash payment is related to a specific performance obligation based on the terms of the contract. The overall view was that judgment will need to be applied to determine whether the practical expedient may be applied based on the facts and circumstances.

Question 35: How should an entity evaluate whether a customer option that provides a material right includes a significant financing component?

Reference(s): Section 606-10-32

The staff notes that paragraph 606-10-32-15 clarifies that an entity must consider the effects of the time value of money when determining the transaction price. This evaluation would include consideration of whether a significant financing component exists as a result of a material right (that is, the evaluation would be the same as for any other performance obligation). However,

consistent with the evaluation of whether a significant financing component exists in any other contract (that is, one that does not provide a material right to the customer), an entity would consider the guidance in paragraphs 606-10-32-17 through 32-18.

Paragraph 606-10-32-17(a) states that a contract would not have a significant financing component if a customer pays for a good or service in advance, and the timing of the transfer of those goods or services is at the discretion of the entity. Therefore, if the timing of when the customer will exercise its option is at the customer's discretion, no significant financing component would exist. Similarly, as a practical expedient, paragraph 606-10-32-18 states that an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

Absent applicability of the guidance in paragraphs 606-10-32-17(a) and 606-10-32-18, a significant financing component may exist as a result of providing a material right for which an entity, in effect, has received advanced payment. Determining whether providing a material right results in a significant financing component will require the use of judgment and will depend on the specific facts and circumstances underlying the material right.

Question 36: How should an entity calculate the adjustment of revenue in arrangements that contain a significant financing component?

Reference(s): Section 606-10-32, Example 26 (55-227), Example 29 (55-240), and Section 835-30-35

While Topic 606 requires accounting for a significant financing component apart from revenue, the standard does not include explicit guidance on how to calculate the interest income/expense. However, the standard includes guidance on estimating the discount rate and some examples (Example 26, Existence of a Significant Financing Component in the Contract, and Example 29, Advance Payment and Assessment of the Discount Rate, are included in this Q&A). Example 29 includes the calculation of interest expense in an advanced payment scenario. Some stakeholders have raised a question as to how to perform the calculations.

Paragraph 606-10-32-19 includes guidance on determining the discount rate in the standard. The standard also includes guidance on the presentation of the financing component in the income statement (paragraphs 606-10-32-20 and 606-10-32-204). Furthermore, Topic 606 includes some illustrations (Examples 26 and 29) of how to apply the guidance.

Because the standard does not provide guidance on subsequent accounting, entities should refer to respective GAAP (Subtopic 835-30) to determine the appropriate accounting.

Subtopic 835-30 provides guidance on subsequent measurement in situations in which imputation of interest is required. The guidance requires the use of the interest method. That

is, with respect to a note for which the imputation of interest is required, the difference between the present value and the face amount shall be treated as discount or premium and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. The guidance allows for other methods of amortization to be used if the results obtained are not materially different from those that would result from the interest method. Although the guidance in Subtopic 835-30 provides guidance when there are extended payment terms to the customer, a similar calculation methodology would be applied to advance payments from a customer.

Question 37: How should the significant financing guidance be applied when there are multiple performance obligations?

Reference(s): Section 606-10-32

The examples in Topic 606 about the significant financing component guidance include scenarios in which there is a single performance obligation. Stakeholders have raised questions about how to apply the guidance when there are multiple performance obligations. Specifically, the key question stakeholders have raised is whether an adjustment for a significant financing component should ever be attributed to only one or some of the performance obligations in the contract, rather than to all of the performance obligations in the contract.

Identifying and accounting for significant financing components is part of determining the transaction price (that is, it is part of Step 3 of the revenue model). The transaction price is defined in paragraph 606-10-32-2 as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services. That is, when determining the transaction price, the effect of financing would be excluded because the financing component (interest expense or interest income) is in exchange for financing, rather than for the exchange of promised goods or services and is a separate component of the contract apart from the revenue generation for goods and service.

After determining the total transaction price for the contract, the entity would allocate the transaction price to performance obligations in Step 4. For example, if the consideration in a contract is CU100 and an entity determines that the interest component (significant benefit received by the customer) is CU10, then the transaction price is CU90. The standard requires allocation of the transaction price to the performance obligations in the contract on a relative standalone selling price basis in most cases. However, the standard also requires allocation of a bundled discount and allocation of variable consideration on a basis other than relative standalone selling price when specified criteria in the paragraphs referenced above are met.

The staff thinks it would be reasonable to attribute a significant financing component to one or more, but not all, of the performance obligations, by analogy to the allocation of variable consideration or allocation of a discount guidance. That is, it might be possible to determine that a significant financing component relates specifically to one (or some) of the performance

obligations in the contract. Attribution of a financing component to one (or some) of the performance obligations will require the use of judgment. Attributing the effect of the significant financing component entirely to one (or some) performance obligations might produce an allocation result that is more consistent with the overall allocation objective in paragraph 606-10-32-28.

The standard is clear that when determining the transaction price, the effect of financing is excluded from the transaction price before the allocation of the transaction price to performance obligations. TRG members agreed with the staff views that it may be reasonable in some circumstances to attribute a significant financing component to one or more, but not all, of the performance obligations in the contract. Some TRG members agreed that, practically, this might be in a manner analogous to the guidance on allocating variable consideration or allocating a discount.

Question 38: What is the interaction between the guidance on allocating discounts and allocating variable consideration?

Reference(s): Section 606-10-32

Stakeholders have different views about whether the guidance on allocating discounts or the guidance on allocating variable consideration should be applied in certain circumstances.

The staff thinks that paragraph 606-10-32-41 establishes a hierarchy for allocating variable consideration such that when a contract includes variable consideration, an entity should first apply the guidance on allocating variable consideration before considering the guidance on allocating discounts.

The staff notes that, in accordance with paragraph 606-10-32-41, only after the entity considers whether all or a portion of the variable consideration in the contract relates to a specific part(s) of the contract should the entity consider the remaining paragraphs on allocating the transaction price to the performance obligations in the contract (that is, paragraphs 606-10-32-28 through 606-10-32-38). Those remaining paragraphs include the specific guidance on allocating a discount. The staff thinks that guidance is clear that an entity first considers the allocation of variable consideration because the guidance states that the other paragraphs “shall be applied to allocate the remaining amount of the transaction price” (paragraph 606-10-32-41). Because an entity is first required to identify variable consideration and determine whether it should allocate variable consideration to one or some, but not all, performance obligations (or distinct goods or services that comprise a single performance obligation in accordance with paragraph 606-10-25-14(b)) based on the guidance above, the entity would consider the requirements for allocating a discount only if the discount is not variable consideration or the entity does not meet the criteria to allocate variable consideration to a specific part of the contract.

The staff thinks it is important to emphasize that the guidance on allocating variable consideration in paragraphs 606-10-32-39 and 32-40 does not apply to consideration that is

not variable consideration. The mere use of the terms *discount* or *rebate* in paragraph 606-10-32-6 does not mean any contract that contains a discount, or a rebate contains variable consideration. If the amount of a discount or a rebate in a contract is fixed and not contingent (for example, a CU100 discount or rebate received solely as a consequence of entering into the contract), that discount or rebate is not variable consideration.

TRG members agreed with the above and also pointed out that not all discounts are variable and that if a discount is fixed, it does not result in variable consideration. In those cases, an entity would apply the guidance on allocating discounts and would not consider the guidance on allocating variable consideration.

Question 39: Is an entity applying the portfolio practical expedient when it considers evidence from other, similar contracts to develop an estimate using the expected value method?

Reference(s): Section 606-10-32, Example 22 (Paragraphs 606-10-55-202 through 55-207)

The staff understands that this question has been raised by stakeholders, in part, because of interpretations of Example 22, Right of Return, in Topic 606. The example states that the entity is applying the portfolio practical expedient, but it is unclear from the example how the application of the portfolio practical expedient affects the accounting.

To address the implementation question, the staff analyzed Example 22. The following stated facts from the example are relevant to this implementation issue:

- (a) The entity enters into 100 contracts with customers, and each contract is for 1 product for \$100 each (it is the same product in each contract). Unused products can be returned within 30 days for a refund and, therefore, the contracts include variable consideration.
- (b) The entity applies the portfolio practical expedient for the contracts in accordance with paragraph 606-10-10-4.
- (c) The entity estimates the variable consideration using the expected value method and determines that 97 of the 100 products will not be returned.
- (d) The entity concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, \$9,700) will not occur as the uncertainty is resolved (that is, over the return period).

(e) The entity recognizes the following journal entry (among others):

Cash	\$10,000 (\$100 × 100 products transferred)
Revenue	\$9,700 (\$100 × 97 products not expected to be returned)
Refund liability	\$300 (\$100 refund × 3 products expected to be returned)

In this example, the entity selected the expected value method to estimate variable consideration because it would better predict the amount of consideration to which it will be entitled. The staff observes that there are two potential outcomes for each contract from the variability of product returns: the product either will be returned or will not be returned. That is, the revenue for each contract ultimately either will be \$100 or will be \$0. However, the entity concluded that the expected value is the appropriate method for estimating variable consideration, because the entity has a large number of contracts with similar characteristics. In order to estimate the expected value, the entity considers evidence from historical experience for this product and customer class and concludes that \$97 is the expected value from each contract.

The example states that the entity applied the portfolio practical expedient in accordance with paragraph 606-10-10-4. The application of the portfolio practical expedient requires that the “entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio.” That is, when electing the portfolio practical expedient, the entity has concluded that there could be a difference in the accounting between the individual contract(s) and the portfolio of contracts. While the Board indicated that they did not intend for entities to “quantitatively evaluate each outcome,” in applying the portfolio practical expedient, there would be a difference that could be assessed.

The example states that the contracts relate to the sale of a single product; therefore, the products are homogenous in nature. There is nothing in the example to indicate that there could be a difference between estimating variable consideration for returns for the individual contracts using the expected value method or the portfolio of contracts. That is, there is no reason that the entity needed to elect the portfolio practical expedient.

In contrast, consider the following change to the example that could result in a difference between the accounting for the individual contracts and the portfolio of contracts: An entity enters into 100 contracts with customers. The 100 contracts are for 45 contracts for one unit of product A for \$100 per unit and 55 contracts for one unit of product B for \$100 per unit. Product A has a historical return rate of 4% and Product B has a historical return rate of 3%. However, the weighted-average return rate for Products A and B is about 3% because historically more of Product B has been sold than Product A.

Similar to the original example, the entity concludes that the expected value method best predicts the amount of consideration to which it will be entitled. In this case, the entity concludes that information about return rates for Product B are not relevant in estimating the return rate for Product A, and vice versa. To account for the individual contracts, the entity would make a

separate estimate of variable consideration for Products A and B on the basis of its historical experience with returns for each product. The entity would recognize total revenue of \$9,600, as follows (the return rate is applied to the number of products):

Product A—4% Return Rate

Cash	\$4,500 (\$100 × 45 products)
Revenue	\$4,300 (\$100 × 43 products not expected to be returned)
Refund liability	\$200 (\$100 refund × 2 products expected to be returned)

Product B—3% Return Rate

Cash	\$5,500 (\$100 × 55 products)
Revenue	\$5,300 (\$100 × 53 products not expected to be returned)
Refund liability	\$200 (\$100 refund × 2 products expected to be returned)

Alternatively, the entity could apply the portfolio practical expedient in paragraph 606-10-10-4 if it reasonably expects that the difference between accounting for each individual contract (\$9,600 of total revenue) would not vary materially from accounting for the portfolio of contracts (\$9,700 of total revenue, which is based on applying an overall 3% return rate). The quantification of the difference is provided to illustrate application of the portfolio practical expedient. Topic 606 does not require quantification; an entity is only required to conclude that there is a reasonable expectation that the effects on the financial statements from applying the guidance to a portfolio of contracts would not differ materially from applying this guidance to individual contracts within the portfolio.

The staff thinks that an entity can consider evidence from other, similar contracts to develop an estimate of variable consideration using the expected value method without applying the portfolio practical expedient. That is, the use of a portfolio of data is not the same as applying the portfolio practical expedient. In order to make an estimate of variable consideration in a contract (and other estimates to account for a contract with a customer), an entity frequently will make judgments, in part, based on its historical experience with other, similar contracts. Considering historical experience does not necessarily mean the entity is applying the portfolio practical expedient. The staff observes that this view is further made clear by the guidance on estimating the standalone selling price of a good or service. Paragraph 606-10-32-34(a) states that a suitable method for estimating the standalone selling price of a good or service would include referring to prices of similar goods or services.

Question 40: Can the estimated transaction price under the expected value method be an amount that is not a possible outcome of an individual contract?

Reference(s): Section 606-10-32

Consider the following example:

Entity A develops websites for customers. The contracts include similar terms and conditions and contain a fixed fee plus variable consideration for a performance bonus related to the timing of Entity A completing the website. Based on Entity A's historical experience, the bonus amounts and associated probabilities for achieving each bonus are as follows:

<u>Bonus Amount</u>	<u>Probability of Occurrence</u>
\$0	15%
\$50,000	40%
\$100,000	45%

To estimate the variable consideration in a new contract with a customer, Entity A considers paragraph 606-10-32-8 and concludes that the expected value method, as compared to the most likely amount method, would better predict the amount of consideration to which it will be entitled because the entity has a large number of contracts that have similar characteristics to the new contract. The expected value of the variable consideration is \$65,000 ($[\$0 * 15\%] + [\$50,000 * 40\%] + [\$100,000 * 45\%]$). When considering the constraint on variable consideration, Entity A considered the factors that could increase the likelihood of a revenue reversal in paragraph 606-10-32-12 and concluded that it has relevant historical experience with similar types of contracts and that the amount of consideration is not highly susceptible to factors outside of the entity's influence. There are two views regarding the appropriate amount of variable consideration to include in the transaction price:

- (a) View A—The transaction price should be constrained to the highest amount that is both a possible outcome of the contract and a probable outcome (variable consideration = \$50,000).
- (b) View B—The transaction price is not automatically reduced by the constraint on variable consideration (variable consideration = \$65,000).

A few TRG members thought that the transaction price must be a possible outcome in that specific contract (View A). However, most TRG members thought that the application of that view would not result in recognizing revenue in a manner that is consistent with the core principle of Topic 606. When an entity has concluded that the expected value approach is the appropriate method to estimate variable consideration, application of the constraint also

is performed based on the expected value method (View B). That is, an entity is not required to switch from an expected value method to most likely amount for purposes of applying the constraint. As a result, if an entity applies the expected value method (and uses a portfolio of data in determining the expected value) for a particular contract, the estimated transaction price might not be a possible outcome in an individual contract. An entity must still consider the constraint on variable consideration. That is, in some cases, an entity might constrain an expected value estimate when determining the transaction price.

TRG members also raised a question about when an entity is required to use the expected value method versus the most likely amount method to estimate variable consideration. Paragraph 606-10-32-8 requires that an entity select the method that the “entity expects to better predict the amount of consideration to which it will be entitled.” The expected value method may better predict the amount of consideration to which the entity will be entitled if an entity has a large number of contracts with similar characteristics. The determination of which method to use in estimating variable consideration will require judgment.

Question 41: If there is an undefined quantity of outputs but the contractual rate per unit of output is fixed, is the consideration variable?

Reference(s): Section 606-10-32

The staff is aware that some stakeholders have questioned whether a contract includes variable consideration if the contract includes an undefined quantity of outputs, but the contractual rate per unit of output is fixed. For example, a transaction processor has a contract with a customer where the price per transaction is \$0.001 per transaction, but the quantity of transactions is not fixed.

Topic 606, specifically paragraphs 606-10-32-5 through 32-8, includes guidance on variable consideration.

The staff thinks the determination of whether an arrangement includes variable consideration based on the paragraphs referenced above is dependent upon the evaluation of the entity’s promise. If the nature of the promise is to perform an unknown quantity of tasks throughout the contract period and the consideration received is contingent upon the quantity completed, the total transaction price would be variable because it is based on the occurrence or nonoccurrence of events outside the entity’s control (for example, the customer’s usage or other events) and the contract has a range of possible transaction prices. Said differently, if there is an undefined quantity of outputs in a contract but the contractual rate per unit of output is fixed, the consideration is variable. In contrast, if the nature of the promise is to perform a defined number of distinct services at a fixed price per unit, then the consideration would be fixed because the total transaction price is known. An entity would need to consider all substantive terms of the contract, which could include contractual minimums or other clauses that would make some

or all of the consideration fixed. TRG members further highlighted that quantities of a good or service that represent “optional purchases” do not create variable consideration.

In the following examples (A,B, and D), the staff thinks that if the nature of the promise is a daily integrated service or a promise to stand ready to perform, rather than to provide a defined number of transactions, then the consideration would be variable because the consideration to be paid is unknown. In Example A, the entity would have the right to bill based upon the units consumed of the various tasks that day. Because the number of units are not defined each day (or for the entire contract), the consideration would vary each day based upon the level of activity. For example, IT Seller may earn CU100 for its activities during one distinct day of service and CU200 in the next day but not earn a known fixed amount of consideration. Similarly, in Examples B and D, because there is not a defined quantity of transactions in the contract, the transaction price would be variable.

Example A

Information technology (IT) Seller and IT Buyer execute a 10-year IT outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term. For example, the vendor will provide server capacity, manage the customer’s software portfolio, and run an IT help desk. The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power (MIPs), number of software applications used, or number of employees supported, and the price per unit differs for each type of activity. Before the delivery of the service, IT Seller performs certain initial set-up activities to be in a position to provide the other services in the contract. IT Seller charges the IT Buyer a nonrefundable upfront fee related to the transition activities. IT Seller concludes that the set-up activities do not transfer services to the customer. The per unit price charged by IT Seller declines over the life of the contract. The agreed upon pricing at the onset of the contract is considered to reflect market pricing. The pricing decreases to reflect the associated costs decreasing over the term of the contract as the level of effort to complete the tasks decreases. Initially, the tasks are performed by more expensive personnel for activities that require more effort. Later in the contract, the level of effort for the activities decreases, and the tasks are performed by less expensive personnel. The contract includes a price benchmarking clause whereby the IT Buyer engages a third-party benchmarking firm to compare the contract pricing to current market rates at certain points in the contract term. There is an automatic prospective price adjustment if the benchmark is significantly below IT Seller’s price. Assume IT Seller concludes that there is a single performance obligation that is satisfied over time because the customer simultaneously receives and consumes the benefits provided by its services as it performs.

Example B

Transaction Processor (TP) enters into a 10-year agreement with a customer. Over the 10-year period, TP will provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use TP’s system

to process all of its transactions; however, the ultimate quantity of transactions is not known. TP concludes that the customer simultaneously receives and consumes the benefits as it performs. TP charges the customer on a per transaction basis. For each transaction, the customer is charged a contractual rate per transaction and a percentage of the total dollars processed. TP also charges the customer a fixed upfront fee at the beginning of the contract.

Example D

Franchisor grants franchisee a license that provides franchisee with the right to use franchisor's trade name and sell its products for 10 years. Franchisor will receive a sales-based royalty of 5 percent of the franchisee's sales for the term of the license as well as a fixed fee. Franchisor concludes that the nature of its promise is to provide a right to access the intellectual property throughout the license period, and the performance obligation is satisfied over time because franchisee simultaneously will receive and consume the benefit from franchisor's performance of providing access to its intellectual property.

In the following example, the staff thinks it is clear that the monthly fee based on a percentage of sales and the annual incentive fee are variable. If the nature of the entity's promise is to provide the daily management service and not a specified amount of labor hours at a rate per hour, the staff and other stakeholders in the hospitality industry also think that the cost reimbursements are variable because the amount is not known at the beginning of the contract and the amount that the entity will be entitled to changes based upon the requirements to fulfill the contract for each day of distinct service.

Example C

Hotel manager (HM) enters into a 20-year agreement to manage properties on the behalf of the customer. HM receives monthly consideration based on 1 percent of monthly rental revenue, reimbursement of labor costs incurred to perform the service, and an annual incentive payment based upon 8% of gross operating profit. HM concludes that the customer simultaneously receives and consumes the benefits provided by its services as it performs.

Question 42: How should an entity account for restocking fees for widgets expected to be returned?

Reference(s): Section 606-10-32

Entities sometimes charge customers a "restocking fee" when a product is returned. Restocking fees typically are charged to compensate entities for various costs associated with a product return, such as shipping costs and repacking costs. Restocking fees also may be charged to

compensate an entity for the reduced selling price that an entity may charge other customers for a returned product.

The staff thinks that the restocking fees for widgets expected to be returned should be included as part of the transaction price when control of the widgets transfers. The staff also thinks that a returned product subject to a restocking fee is no different than a partial return right and, therefore, should be accounted for similarly. That is, the staff thinks that a restocking fee should be included in the transaction price if an entity is entitled to that amount, regardless of whether that amount is explicitly stated as a restocking fee in the contract or the entity offers its customers less than a full refund for product returns in order to compensate the entity for various costs associated with a product return.

For example, Entity enters into a contract with Customer to sell 10 widgets for \$100 each. The cost of each widget is \$75. Customer has the right to return a widget but will be charged a restocking fee of 10% (that is, \$10 per widget). Entity expects to incur restocking costs of 5% (that is, \$5 per widget). Entity concludes that, due to the existence of a return right, the consideration promised in its contract with Customer includes a variable amount. Entity uses the expected value method for estimating the variable consideration and estimates that 10% of widgets will be returned and that it is probable that returns will not exceed 10%. Entity expects that the returned widgets can be resold at a profit.

In this case, Entity would recognize revenue of \$910 [(9 widgets expected not to be returned * \$100 selling price) + (1 widget expected to be returned * \$10 restocking fee)] and a refund liability of \$90 [1 widget expected to be returned * (\$100 selling price – \$10 restocking fee)] when control of the widgets transfers to Customer.

Question 43: How should an entity account for upfront payments to a customer?

Reference(s): Section 606-10-32

Payments to customers are common in many industries. Payments to customers (or potential customers) can take the form of cash or other items (for example, a coupon, a credit, or a voucher). Scenarios also include the issuance of equity. For example, an entity may make a payment to a customer to:

- (a) Reimburse the customer for costs associated with entering into a contract (such as costs for setting up a new vendor or costs to shut down operations that will be outsourced to the vendor)
- (b) Obtain a customer contract in a competitive environment (pay-to-play or exclusivity)
- (c) Provide additional incentives or discounts to customers.

The scope of the issue discussed in this Q&A is about payments to customers (and, arguably, potential customers). The analysis in this Q&A does not apply to payments that are made to third parties that are not customers (or potential customers). This is because Topic 606 applies to contracts with customers and does not provide guidance on payments to other parties (for example, a payment an entity makes to its vendor for services received), as described in paragraph 606-10-32-26.

Although this Q&A applies to payments to customers, sometimes the very challenge with this topic is determining whether the payment is to a customer. An entity will need to apply judgment in some circumstances to determine whether the counterparty to the arrangement is a customer in a revenue contract(s). The following are some examples for which judgment may be needed:

- (a) An entity might make a payment to a third party that has never been a customer of the entity, but the payment is made as part of contract negotiations to incentivize the third party to become a customer. The third party is not required to make purchases to receive the payment (for example, purchases are at the option of the third party).
- (b) An entity might have conducted business in prior transactions with the counterparty as a customer, but because of the nature of the current arrangement, there is some ambiguity about whether the counterparty is a customer in the current arrangement. For example, a counterparty might be a longstanding customer in a particular segment, but that same counterparty is a collaborator in another segment (for example, development of a new product).
- (c) An entity might determine that the counterparty is a collaborator, rather than a customer, if the counterparty has not contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities. (The FASB received an agenda request from a stakeholder about accounting for collaborative arrangements under Topic 808. See Accounting Standards Update No. 2018-18, *Collaborative Arrangements (Topic 808): Clarifying the Interaction between Topic 808 and Topic 606*).
- (d) An entity might make a payment to a third party that is expected to be a customer in a future period, but the entity receives an intangible asset in exchange for the payment (for example, the right to be the exclusive provider of a particular component of a key product of the third party).

The staff's analysis in this Q&A does not apply to scenarios in which an entity sells goods or services to a customer at a loss with a strong expectation of profit on future orders from that customer. The staff's analysis on upfront payments to customers should not be applied by analogy to scenarios in which an entity has a loss on the sale of inventory or another asset.

Consideration payable to a customer is excluded from the scope of the guidance in Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers. Therefore, the staff's analysis in this question does not relate to incremental costs of obtaining a contract or costs incurred in fulfilling a contract with a customer, which are within the scope of Subtopic 340-40.

The staff thinks that an entity will need to evaluate the facts and circumstances and make judgments about the nature of the payment. In the staff's view, an important first step in evaluating the accounting for an upfront payment is understanding the reasons for the payment, the rights and obligations resulting from the payment (if any), the nature of the promise(s) in the contract (if any), and other relevant facts and circumstances. Understanding this rationale can be instructive when determining the accounting and in particular, understanding whether and how the entity expects to obtain future benefits as a result of the payment. In addition, this rationale can be helpful in deciding what information about the arrangement should be disclosed to financial statement users.

If the counterparty is a customer, paragraph 606-10-32-25 is clear that the payment should be recorded as a reduction of revenue, unless the payment to the customer is in exchange for a distinct good or service. If that payment relates entirely to the current contract with the customer, Topic 606 is clear on how the payment would be recognized. The consideration paid to a customer is accounted for as a reduction of the transaction price. The practical effect of this accounting is that:

- (a) An entity will record an asset for the upfront payment. This asset essentially represents an advance of funds to the customer, which the entity recovers subsequently as related goods or services are performed.
- (b) The payment is recognized as a reduction of revenue as the goods or services are transferred to the customer.

The TRG discussed the following circumstances in which the accounting is less straightforward than the scenario in the above paragraph:

- (a) An entity makes an upfront payment to a customer (or a potential customer) and does not have a revenue contract (that is, there is not yet a contract to be accounted for under Topic 606). An entity might make an upfront payment in anticipation of future purchases from the customer.
- (b) An entity makes an upfront payment to a customer and there is a revenue contract. However, the upfront payment relates to the current contract as well as anticipated future revenue contracts.

There are two views about the timing of when the reduction in revenue for an upfront payment should be recorded.

- (a) View A—Payments to customers should be recognized as a reduction of revenue as the related goods or services (that is, the expected total purchases resulting from the upfront payment) are transferred to the customer. The payment might be recorded in the income statement over a period that is longer than the current legally enforceable contract. Identification of the related goods or services will require judgment on the basis of the facts and circumstances. The asset would be periodically assessed for recoverability.

- (b) View B—Payments to customers should be recognized as a reduction of revenue from the existing contract (that is, existing enforceable rights and obligations). If no revenue contract exists, then the entire payment would be immediately recognized in the income statement.

TRG members observed that View A would be appropriate in many cases. TRG members agreed with the staff view that if an asset is recorded it should meet the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*, and an entity should assess whether the asset is impaired in subsequent reporting periods. However, TRG members agreed with the staff view that View B could be appropriate in some cases. TRG members agreed with the staff view that the accounting is not a policy election and agreed that an entity should understand the reasons for the payment, the rights and obligations resulting from the payment (if any), the nature of the promise(s) in the contract (if any), and other relevant facts and circumstances for each arrangement when determining the appropriate accounting. TRG members also agreed with the staff that the assessment will require significant judgment in some cases and appropriate disclosures in the financial statements might be important.

STEP 4—ALLOCATE THE PRICE TO THE PERFORMANCE OBLIGATION

Question 44: How should the transaction price allocation guidance be applied to a transaction in which an entity is a principal for some of the deliverables and an agent for others?

Reference(s): Section 606-10-32

To illustrate this potential issue, consider the following example:

A web-based entity (the “originator”) collects data related to its users. In exchange for a fee, the originator provides third parties with access to that data. A third-party service provider may bundle the service from the originator with its own services and sell the package to another entity (the “customer”). The customer remits a combined fee for access to the originator’s service and the third party’s services to the third party. The third-party service provider remits the originator’s fee, net of the agreed upon commission, to the originator. The customer is aware of the component of the combined fee that is related to the originator’s service.

In this example, the third-party service provider is delivering a bundle of services to the end customer for a combined fee. A portion of that fee is designated for the originator’s service based on the originator’s price list. The originator grants access to the data directly to the end customer. The third-party service provider (the intermediary with respect to the data access services) may determine it is an agent for the data access services, while being the principal for all of the other elements in the transaction (that is, the other services provided to the end customer).

The staff is aware of the following two views about the interaction of the transaction price allocation guidance with the principal versus agent guidance in determining how the intermediary in the above example should allocate any overall discount in its contract with the end customer:

- (a) View A—Any discount in the overall arrangement is allocated to each element, regardless of whether the element is a “gross” or a “net” element (unless the entity meets the criteria to allocate the discount entirely to one or more, but not all performance obligations in the contract).
- (b) View B—The entity should recognize its fee (or commission) for any net elements and any discount should be allocated only to the “gross” elements.

The appropriate interpretation may not be directly related to application of the allocation guidance. If an entity (for instance the service provider in the example above) determines that it is the principal to some of those promised goods or services and an agent to the others, then it should question whether it has one customer (that is, the end customer receiving all of the goods or services) or multiple customers (that is, the end customer for those elements for which the entity is the principal and the originator for those elements for which it is an agent).

If the entity has a single customer, some think that View A would appear to be consistent with the allocation guidance. However, if the entity has more than one customer, the contract combination guidance does not allow for combining arrangements with two or more unrelated third parties. The contract combination guidance addresses combining contracts with the same customer (or related parties of the customer). Therefore, allocating a bundled discount across these contracts may not be appropriate if the entity has two customers in the arrangement.

It may further be appropriate for the entity to consider whether it is principal to only some of the promised goods or services in the contract if those goods or services are not separable from each other (for example, where the goods or services are each inputs to a combined item for which the customer contracted).

Question 45: In order to meet the requirements in paragraph 606-10-32-40(b), is the allocation to be made on a relative standalone selling price basis?

Reference(s): Sections 606-10-32 and 606-10-55

Paragraph 606-10-32-40(b) requires the allocation of variable consideration to a distinct service consistent with the allocation objective in paragraph 606-10-32-28.

The staff has become aware that some stakeholders think the allocation of variable consideration to a distinct good or service in a series is required to be based on standalone selling prices. This could limit the number of transactions that qualify under this guidance because it might imply that each distinct service that is substantially the same would need to be allocated the same amount (absolute value) of variable consideration.

Paragraph 606-10-32-29 states that to meet the allocation objective, an entity shall allocate the transaction price to each performance obligation on a standalone selling price basis. However, that paragraph specifically excludes paragraphs 606-10-32-39 through 32-41 on allocating variable consideration to a distinct service in a series from this requirement. Furthermore, paragraph 606-10-32-30 states that the guidance in paragraphs 606-10-32-31 through 32-41 on the standalone selling price allocation do not apply to the allocation of variable consideration. Paragraph BC280 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, describes that while standalone selling price is the default method for determining whether the allocation objective is met, the Board decided that other methods

could be used in certain instances and, therefore, included the guidance on allocating variable consideration.

Based on the above, the staff thinks that a relative standalone selling price allocation is not required to meet the allocation objective when it relates to the allocation of variable consideration to a distinct good or service in a series. However, as stated in Example 35, Allocation of Variable Consideration, where variable consideration is allocated to different performance obligations, standalone selling prices in some cases might be utilized (but are not required to be utilized) to determine the reasonableness of the allocation.

The Board did not describe other methods that could be used to comply with the allocation objective other than stating in paragraph 606-10-32-40(b) that an entity should consider all the payment terms and performance obligations. As such, the staff thinks that stakeholders should apply reasonable judgment to determine whether the allocation results in a reasonable outcome. Consider the following examples; however, note that the staff does not think the examples below are all inclusive, and there could be other reasons why a variable fee would or would not meet the allocation objective.

Example A

Information technology (IT) Seller and IT Buyer execute a 10-year IT Outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term. For example, the vendor will provide server capacity, manage the customer's software portfolio, and run an IT help desk. The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power (MIPs), number of software applications used, or number of employees supported, and the price per unit differs for each type of activity.

Before the delivery of the service, IT Seller performs certain initial set-up activities to be in a position to provide the other services in the contract. IT Seller charges the IT Buyer a nonrefundable upfront fee related to the transition activities. IT Seller concludes that the set-up activities do not transfer services to the customer.

The per unit price charged by IT Seller declines over the life of the contract. The agreed upon pricing at the onset of the contract is considered to reflect market pricing. The pricing decreases to reflect the associated costs decreasing over the term of the contract as the level of effort to complete the tasks decreases. Initially, the tasks are performed by more expensive personnel for activities that require more effort. Later in the contract, the level of effort for the activities decreases, and the tasks are performed by less expensive personnel. The contract includes a price benchmarking clause whereby the IT Buyer engages a third-party benchmarking firm to compare the contract pricing to current market rates at certain points in the contract term. There is an automatic prospective price adjustment if the benchmark is significantly below IT Seller's price.

Assume IT Seller concludes that there is a single performance obligation that is satisfied over time because the customer simultaneously receives and consumes the benefits provided by its services as it performs.

In this example, the events that trigger the variable consideration are the same throughout the contract, but the price per unit decreases each year. The staff thinks that even with the declining prices, the allocation objective could be met if the pricing is based on market terms or the changes in price are substantive and linked to changes in the entity's cost to fulfill the obligation or value provided to the customer. In this example, the contract contains a price benchmarking clause whereby the IT Buyer engages a third-party benchmarking firm to compare the contract pricing to current market rates, which may help support the allocation objective.

Example B

Transaction Processor (TP) enters into a 10-year agreement with a customer. Over the 10-year period, TP will provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use TP's system to process all of its transactions; however, the ultimate quantity of transactions is not known. TP concludes that the customer simultaneously receives and consumes the benefits as it performs.

TP charges the customer on a per transaction basis. For each transaction, the customer is charged a contractual rate per transaction and a percentage of the total dollars processed. TP also charges the customer a fixed upfront fee at the beginning of the contract.

If the nature of the entity's promise is a single service to process as many transactions as the customer requires, the fees based on quantity processed and the fees based on a percentage of dollars processed might be considered variable consideration. The staff thinks the fees based on quantity processed and percentage of dollars processed could meet the allocation objective for each month of service. For example, the allocation objective could be met if the fees are priced consistently throughout the contract and the rates charged are consistent with the entity's standard pricing practices with similar customers.

Example C

Hotel manager (HM) enters into a 20-year agreement to manage properties on the behalf of the customer. HM receives monthly consideration based on 1 percent of monthly rental revenue, reimbursement of labor costs incurred to perform the service, and an annual incentive payment based upon 8 percent of gross operating profit. HM concludes that the customer simultaneously receives and consumes the benefits provided by its services as it performs.

Example C is similar to the hotel management example in paragraph BC285 of Update 2014-09 where the Board noted that variable consideration based upon 2%

of daily occupancy rates could be allocated to each day. The staff thinks the base monthly fees could meet the allocation objective for each month because they are similar to the example in paragraph BC285 in that there is a consistent measure throughout the contract period that reflects the value to the customer each month (the % of monthly sales). Similarly, if the cost reimbursements are commensurate with the entity's efforts to fulfill the promise each day, then the allocation objective for those variable fees could also be met. Finally, the staff thinks that the allocation objective could also be met for the incentive fee if it reflects the value delivered to the customer for the annual period (reflected by the profits earned) and is reasonable compared to the incentive fees that could be earned in other periods.

Example D

Franchisor grants franchisee a license that provides franchisee with the right to use franchisor's trade name and sell its products for 10 years. Franchisor will receive a sales-based royalty of 5 percent of the franchisee's sales for the term of the license as well as a fixed fee. Franchisor concludes that the nature of its promise is to provide a right to access the intellectual property throughout the license period, and the performance obligation is satisfied over time because franchisee simultaneously will receive and consume the benefit from franchisor's performance of providing access to its intellectual property.

The staff thinks that allocating the royalties to the respective day in which it has the right to invoice could be consistent with the allocation objective. In this example, the formula and price are consistent throughout the license term, and the amount allocated to each day reasonably reflects the value/benefit to the customer of its access to the intellectual property for that day (reflected by the sales that access has generated for the customer).

STEP 5—RECOGNIZE REVENUE

Question 46: In order to apply the practical expedient for measuring progress toward complete satisfaction of a performance obligation, may the practical expedient be applied to contracts with rates that change during the contract term?

Reference(s): Section 606-10-25 and Paragraph 606-10-55-18, Example 42 starting Paragraph 606-10-55-298

Some stakeholders have questioned whether the practical expedient for measuring progress toward complete satisfaction of a performance obligation based on amounts to which the entity has a right to invoice may be applied to contracts with rates that change during the contract term or situations in which there are multiple rates for multiple goods or services. Examples of contracts in which the rates may change include:

- (a) Contracts in the power and utilities industry, as the rates per unit in certain contracts change and the rates are priced by reference to one or more market indicators, which might include the observable forward commodity price curve.
- (b) Contracts in the information technology (IT) services industry, as the rates per unit in certain contracts change. Outsourcing arrangements are generally large scale, multi-year contracts in which the entity agrees to provide delivery of services for an unknown quantity of units. In an IT outsourcing arrangement, rates might decrease over the term of the contract because, for example, the level of effort to provide the services to the customer declines. Those contracts might include a price benchmarking clause whereby the customer engages a third-party benchmarking firm to compare contract pricing to current market rates. The contracts might have specific procedures (at certain points over the contract term) whereby the contract price is adjusted to a market rate.

Some stakeholders think that the practical expedient for measuring progress toward complete satisfaction of a performance obligation may be applied to the types of contracts listed above because they think the amounts billed correspond directly to the value to the customer.

Consider the following more detailed examples:

Example A

Power Seller and Power Buyer execute a contract for the purchase and sale of electricity over a 6-year term. Power Buyer is obligated to purchase 10 megawatts (MW) of electricity per hour for each hour during the contract term (87,600 MWh per annual period) at prices that contemplate the forward market price of electricity at contract

inception. The contract prices are as follows: Years 1–2: \$50/MWh, Years 3–4: \$55/MWh, and Years 5–6: \$60/MWh. The transaction price, which represents the amount of consideration to which Power Seller expects to be entitled in exchange for transferring electricity to Power Buyer, is \$28,908,000 (annual contract prices per MWh multiplied by annual contract quantities). Power Seller concludes that the promise to sell electricity represents one performance obligation that will be satisfied over time.

Example B

IT Seller and IT Buyer execute a 10-year IT outsourcing arrangement in which IT Seller provides continuous delivery of outsourced activities over the contract term. For example, the vendor will provide server capacity, manage the customer’s software portfolio and run an IT help desk. The total monthly invoice is calculated based on different units consumed for the respective activities. For example, the billings might be based on millions of instructions per second of computing power (MIPs), number of software applications used, or number of employees supported, and the price per unit differs for each type of activity.

IT Seller concludes that each of the activities described will be satisfied over time. Although each activity has a contractual minimum, the IT Buyer is expected to exceed that minimum. Therefore, the IT Buyer pays the IT Seller the relevant price per unit.

The agreed upon pricing at the onset of the contract is considered to reflect market pricing. The pricing decreases to reflect the associated costs decreasing over the term of the contract as the level of effort to complete the tasks decreases. Initially, the tasks are performed by more expensive personnel for activities that require more effort. Later in the contract, the level of effort for the activities decreases, and the tasks are performed by less expensive personnel. The contract includes a price benchmarking clause whereby the IT Buyer engages a third-party benchmarking firm to compare the contract pricing to current market rates at certain points in the contract term. There is an automatic prospective price adjustment if the benchmark is significantly below IT Seller’s price.

Paragraph 606-10-55-18 explains the circumstances in which an entity may apply the practical expedient. Contract A in Example 42, Disclosure of the Transaction Price Allocated to the Remaining Performance Obligations, in Topic 606 illustrates a situation in which the practical expedient applies to a two-year cleaning services arrangement in which services are typically performed at least once per month. For services provided, the customer pays an hourly rate of \$25. Paragraph 606-10-55-300 in the example notes that “because the entity bills a fixed amount for each hour of service provided, the entity has a right to invoice the customer in the amount that corresponds directly with the value of the entity’s performance completed to date in accordance with paragraph 606-10-55-18.”

Paragraph BC167 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, states:

The Boards also decided that, in some circumstances, as a practical expedient, another appropriate output method is to recognize revenue at the amount of consideration to which an entity has a right to invoice. This method is appropriate if the amount of consideration that the entity has a right to invoice corresponds directly with the value to the customer of each incremental good or service that the entity transfers to the customer (that is, the entity's performance completed to date). This may occur, for example, in a services contract in which an entity invoices a fixed amount for each hour of service provided.

Some stakeholders, as well as the staff, think Example A above is a scenario that would qualify for the practical expedient because the amount that will be billed to Power Buyer by Power Seller corresponds directly with the value to the Power Buyer of Power Seller's performance completed to date in accordance with paragraph 606-10-55-18. The amount that will be billed is based on both (a) the units of power transferred to the customer and (b) a rate per unit of power that is priced by reference to one or more market indicators (for example, the observable forward commodity price curve). While the rate per unit of power is not the same for the duration of the contract, the rates per unit reflect the value to the customer because the rates are based on one or more market indicators. When applying paragraph 606-10-55-18, some stakeholders and the staff think that a fixed price is not always required for the duration of the contract. However, a price increase or decrease must be based on the value of those later units to the customer. Determining whether the price change is consistent with the value to the customer often will require the use of judgment.

Additionally, these stakeholders and the staff think that for purposes of applying the practical expedient, the market prices or standalone selling prices might reflect value to the customer but are not required to be assessed to demonstrate that the amount invoiced reflects value to the customer. Rather, the phrase value to the customer is intended to indicate that judgment is required to assess whether the practical expedient can be applied. Market or standalone selling prices, or another means could be used to demonstrate that the amount invoiced to the customer corresponds directly to the value to the customer for the entity's performance to date.

Some stakeholders and the staff also think that Example B above is a scenario that would qualify for the practical expedient because the amount billed to IT Buyer by IT Seller corresponds directly with the value to the IT Buyer of IT Seller's performance to date in accordance with paragraph 606-10-55-18. The fixed minimum amount is not substantive (that is, the entity expects to exceed the minimum amounts, in part, on the basis of historical experience), and the amount billed to IT Buyer reflects the rates and amounts (price and quantities) for the activities provided. Similar to Example A, although the rates change for the respective activities over the duration of the arrangement, the rates reflect the value to the customer, which is corroborated through: (1) the benchmarking (market) adjustment and (2) declining costs (and level of effort) of providing the tasks that correspond with the declining pricing of the activities. Additionally, even though there are multiple activities in Example B, the conditions to apply the practical expedient in paragraph 606-10-55-18 are met because the amounts invoiced to IT Buyer correspond with the value to the IT Buyer of each incremental activity that the IT Seller provides to the IT Buyer (that is, the IT Seller's performance completed to date).

The staff thinks that determining whether an entity can apply the practical expedient will require the use of judgment. It is important to note that the mere fact that an entity and its customer agree upon an invoice/payment schedule does not automatically mean the amount an entity has the right to invoice at a given point corresponds directly with the value to the customer for the goods or services provided to date. For example, the customer might request lower payments earlier in the duration of the contract and higher payments later in the duration to increase its operating cash flow in the short term. As another example, the entity might request a significant payment early in the duration of the contract to reduce credit risk or to have the customer demonstrate that it is committed to a long-term service arrangement.

Paragraph BC163 of Update 2014-09, standard states that “value to the customer is not intended to be assessed by reference to the market prices or standalone selling prices of the individual goods or services promised in the contract, nor is it intended to refer to the value that the customer perceives to be embodied in the goods or services.” The staff has become aware that some stakeholders think the description of the phrase value to the customer in that paragraph should be applied to the same phrase in paragraphs 606-10-55-17 through 55-18. However, the staff thinks that the language in that paragraph was not intended to be applied to paragraph 606-10-55-18 and that the phrase value to the customer is used in two different contexts. Paragraph 606-10-55-17 (and the related discussion in paragraph BC163) is in the context of measuring progress toward satisfaction of the performance obligation with a focus on the proportion of outputs delivered relative to total outputs in the performance obligation, not measurement and allocation of the transaction price and recognition.

Put another way, the discussion in paragraph BC163 (and paragraph 606-10-55-17) is about progress toward satisfying the performance obligation and, thus, has to do with how much or what proportion of the goods or services (quantities) have been delivered (but not the price). For example, for purposes of paragraph 606-10-55-17, an entity might consider the units produced to date (10) divided by the total expected units produced (100) to measure progress (10%). In contrast, paragraph 606-10-55-18 is about recognizing revenue on the basis of invoicing as it corresponds to the value transferred to the customer. This includes determining the revenue to be recognized, which involves multiplying the price assigned to the goods or services delivered by the measure of progress (that is, the quantities or units transferred). The intent of the practical expedient in paragraph 606-10-55-18 is that it is an expedient to Steps 3, 4, and 5 in Topic 606. This is corroborated by the existence of the related practical expedient for disclosure of remaining performance obligations included in paragraph 606-10-50-14, which provides relief from estimating the aggregate transaction price for remaining performance obligations.

In conclusion, the staff expects that some contracts with customers that do not have a fixed price per unit for the duration of the contract will qualify for the practical expedient. However, judgment will be required to assess whether the entity’s right to consideration from a customer corresponds directly to the value to the customer for performance completed to date. This assessment may include, but is not required to include, an assessment of market or standalone selling price.

The staff and TRG members noted that application of the practical expedient in those situations involves an analysis of the facts and circumstances of the arrangement. The objective of

the analysis is to determine whether the amount invoiced for goods or services reasonably represents the value to the customer of the entity's performance completed to date. For example, a contract to purchase electricity at prices that change each year based on the forward market price of electricity would qualify for the practical expedient if the rates per unit reflect the value of the provision of those units to the customer.

The staff, Board members, and TRG members also acknowledged that judgment will be required about whether the practical expedient can be applied in fact patterns that include upfront and back-end fees. An assessment of the significance of those upfront and back-end fees relative to the variable consideration in the arrangement likely would be important. Additionally, TRG members generally agreed that a series of distinct goods or services (in accordance with the guidance in paragraphs 606-10-25-14 through 25-15) could also be within the scope of the practical expedient in paragraph 606-10-55-18.

Question 47: Can multiple measures of progress be utilized to depict an entity's performance in completing a combined performance obligation?

Reference(s): Section 606-10-25

Step 5 requires an entity to select a method to measure progress toward completion of a performance obligation satisfied over time. Paragraph 606-10-25-32 states that an entity should apply a single measure of progress for each performance obligation, and paragraph BC161 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, explains the Board reasoned that utilizing more than one method to measure its performance would effectively bypass the guidance on identifying performance obligations. This is in contrast to existing GAAP in which there is little authoritative guidance related to the attribution in combined units of account or service arrangements and GAAP does not explicitly state that multiple attribution is unacceptable.

The staff thinks that Topic 606 is clear that using multiple methods of measuring progress for the same performance obligation would not be appropriate. For example, utilizing different measures of progress for different nondistinct goods or services in the combined performance obligation or allocating a portion of the transaction price and recognizing revenue for a non-distinct good or service (or allocating fixed consideration to a distinct good or service that forms part of a single performance obligation) would be inappropriate. More specifically, ignoring the unit of account prescribed in Topic 606 and recognizing revenue in a manner that overrides the separation and allocation guidance would not be appropriate.

Based on paragraph BC161, the staff also thinks that a single method of measuring progress should not be broadly interpreted to mean an entity may apply multiple measures of progress so long as all measures employed are either output or input methods. Utilizing different types of input or output methods for different promises in a combined performance obligation would have the result of treating each promise as a separate performance obligation.

Question 48: How should an entity determine the measure of progress when a combined performance obligation satisfied over time contains multiple goods or services?

Reference(s): Section 606-10-25

Paragraph 606-10-25-31 states that the overall objective when measuring progress toward complete satisfaction of a performance obligation satisfied over time is to depict an entity's performance in satisfying its performance obligation. As noted in paragraph BC159 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, the Board decided it would not be feasible to consider all possible methods and prescribe when an entity should use each method. Accordingly, an entity should use judgment when selecting an appropriate method of measuring progress toward complete satisfaction of a performance obligation. However, that does not mean that an entity has a "free choice."

It may require more judgment to determine the measure of progress in a combined performance obligation when there are multiple nondistinct promises that have different patterns of performance, but like other performance obligations satisfied over time, an entity must apply judgment in selecting the method that complies with the overall objective. If there is not a clear pattern that applies to all of the goods or services (for example, all services are time based over the same time period), the staff does not think that entities should default to a "final deliverable" or "predominant deliverable" methodology. Instead, an entity should consider the nature of the entity's overall promise for the combined performance obligation and performance required to completely satisfy the entire performance obligation. To make that assessment, the staff thinks it is important to consider the reasons why the entity decided that the goods or services are not distinct and have been bundled into a combined performance obligation.

If an entity thinks that the result of a single measure of progress for a combined performance obligation does not faithfully depict the economics of the arrangement, the staff thinks it could be an indicator that the entity has not identified the appropriate performance obligations (that is, there might be more than one performance obligation). That is not to say the entity definitively has identified the wrong performance obligation(s). The staff understands there will be cases under Topic 606 (similar to current practice) in which the entity has properly identified the unit of account and selecting a single measure of progress for the combined performance obligation will require significant judgment.

The staff has prepared a few scenarios to illustrate how to approach this issue. It is important for stakeholders to note when reading the scenarios and staff views that an entity will need to consider the specific facts and circumstances of a contract with a customer and sometimes apply significant judgment to identify an appropriate performance obligation and measure of progress that depicts an entity's "performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation)" (paragraph 606-10-25-31).

Scenario 1

A cloud computing company provides software as a service solution to its customers. The typical arrangement includes promises for access to hosted software for one year and upfront implementation services. The one-year hosting period begins when the implementation is complete, and the customer cannot access or utilize the service until this time.

The implementation services are typically performed over a 3-month period. The vendor's solution is proprietary, and no other vendors are capable of performing the implementation. Furthermore, the customer cannot derive benefit from the implementation or the hosting service until the implementation is complete. For the purpose of this example, it is assumed that the entity concludes the implementation services are not capable of being distinct from the hosting. Assume the entity concludes there is no material right for future renewals.

Assume that the total transaction price is CU1,100, and the direct costs that would be used in the cost to cost input method is CU80 for implementation and CU200 for the hosting service.

In the staff's view, the entity should use a measure of progress that depicts the performance of the hosting services beginning when the hosting service commences. The nature of the entity's overall promise (and, therefore, combined performance obligation) is to provide the hosting service, and no revenue would be recognized over the implementation period because that promise does not transfer a service to a customer. The entity would select a method that depicts the performance of the hosting services to measure progress toward completion. For example, a time-based method might be considered appropriate. The entity would need to consider whether it meets the criteria to capitalize the costs of implementation in accordance with paragraph 340-40-25-5.

The staff thinks that the nature of the entity's overall promise is the hosting service and the implementation service does not transfer a service to a customer. If the implementation does not transfer a service, then it would be disregarded from the performance obligation, similar to set up activities described in paragraph 606-10-25-17.

The staff thinks this view is analogous to setup activities in an outsourcing arrangement as discussed in Example 53, Nonrefundable Upfront Fee (paragraphs 606-10-55-358 through 55-360). In that example, setup activities are not considered to be part of the performance obligation because they do not transfer a good or service to a customer. Similarly, paragraph 606-10-55-52 states that if nonrefundable fees relate to a good or service, the entity should evaluate whether to account for the good or service as a separate performance obligation. Paragraph 606-10-55-53 goes on to state that "if those setup activities do not satisfy a performance obligation, the entity should disregard those activities (and related costs) when measuring progress in accordance with paragraph 606-10-55-21." That is because the costs of setup activities do not depict the transfer of services to the customer. Similarly, in this scenario, the implementation service is not a separate performance obligation and does not satisfy a

separate performance obligation. The staff also thinks costs incurred during implementation would likely be capitalized in accordance with paragraph 340-40-25-5.

The staff thinks the conclusion that the implementation is not capable of being distinct supports the conclusion that the nature of the entity's overall promise is to provide hosting services. In fact, the staff thinks including the implementation service in the measure of progress is inconsistent with the conclusion that the implementation is not capable of being distinct in accordance with paragraph 606-10-25-19(a). That is, concluding the implementation is not capable of being distinct means that the customer cannot benefit from that service (either on its own or together with other readily available resources), which also means control does not transfer. Said differently, because a service is transferred when the customer obtains control of that asset (paragraph 606-10-25-23) and control includes the customer's ability to obtain substantially all the remaining benefits from the good or service (paragraph 606-10-25-25), performing only the service that the customer cannot benefit from would not transfer control. Because the implementation services are performed before the customer benefiting from the hosting service, it should be excluded from the measure of progress pursuant to paragraph 606-10-25-34, which states that an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer.

This does not mean the staff thinks that anytime a good or service is not capable of being distinct it should be excluded entirely from the measure of progress or that all services in a combined performance obligation must commence before recognizing revenue. For example, assume an entity enters into a contract to provide Service A, Service B, and Service C. The services are bundled into a combined performance obligation because Service A commences first and is not capable of being distinct without Service B or C. Additionally, all three services are highly interrelated and not separately identifiable. Assume Service A commences in month 1, Service B commences in month 2 and Service C commences in month 3, all continue through the end of the contract period, and the entity concludes the combined performance obligation is satisfied over time. In this fact pattern, the customer would not be able to obtain any benefit until Service B commences (that is, the customer does not benefit from Service A on its own). The entity would need to consider the nature of the entity's overall promise to determine the appropriate measure of progress but would not necessarily have to wait until Service C commenced to begin recognizing revenue. That is, the entity might be able to begin recognizing revenue when Service B commences.

Scenario 2

An entity promises to provide a software license and installation services that will substantially customize the software to add significant new functionality that enables the software to interface with other customized applications used by the customer. The entity concludes that the software and services are not separately identifiable from the customized installation service and the criterion in paragraph 606-10-25-19(b) is not met. Therefore, the software and installation service is combined into a single perfor-

mance obligation. The entity also concludes that the performance obligation is satisfied over time. If the license was distinct, it would be considered a point in time license.

In the staff's view, the entity should use a measure of progress that depicts the performance of completing the customized software solution. All the revenue would be recognized over the period the customization services are performed.

While each promised good or service in the combined performance obligation is capable of being distinct, the license and installation service are inputs the entity uses to produce the combined output. As such, the nature of the combined performance obligation is developing the customized software over time. Therefore, the staff thinks that, because the creation of the customized software solution is the promise that is being performed over time, the measure of progress should be based on a method that reflects the entity's progress towards the completion of that service and, therefore, complete satisfaction of the combined performance obligation.

Scenario 3

A franchisor enters into a 10-year license agreement with a new franchisee. The franchisor also promises to provide consulting services over the first year of the license agreement. The consulting services provide the franchisee with hours of service to help it set up operations to run its franchise.

For the purpose of this example, it is assumed that the franchisor concludes that the license and services should be combined into a single performance obligation because the license and services are highly interrelated (that is, each promise is capable of being distinct because the customer can derive some benefit from each item—from the franchise license on its own and the services together with the license granted upfront—but the promises are not distinct in the context of the contract). Furthermore, the entity concludes that the license is satisfied over time. The transaction price consists of an upfront fee of CU1 million for the license and CU150,000 for a fixed number of hours of consulting service that are performed in the first year.

In the staff's view, the entity should use a measure of progress that best depicts the performance of the license. The nature of the overall performance obligation is the franchisee's right to access the license and, therefore, the measure of progress would depict the transfer of the license. For example, using a time-based output method, the entire transaction price would be recognized ratably over the 10-year period. The entire transaction price of CU1,150,000 would be recognized over the 10-year license agreement.

Because the consulting services and license are interrelated and the consulting services actually enhance the benefit the franchisee will receive over the entire license period, the staff think the nature of the overall performance obligation is the franchisee's right to access the license. Even if the franchisor's level of effort is higher over the first year than any other individual year, given the relationship between the license and services, a time-based method over the entire ten-year period would accurately depict the complete satisfaction of the performance obligation.

However, each example is illustrative, and judgment will need to be applied based on the specific facts and circumstances of an arrangement with a customer.

Question 49: How should an entity measure progress toward the complete satisfaction of a stand-ready obligation (that is, an obligation for which the entity has determined that the nature of the entity’s promise is the service of “standing ready” to perform) that is satisfied over time?

Reference(s): Section 606-10-25, Example 18 starting Paragraphs 606-10-55-20 and 606-10-55-184

The appropriate measure of progress to apply to a stand-ready obligation that is satisfied over time might vary from one type of stand-ready obligation to another, and it generally would not be appropriate under Topic 606 to default to a straight-line revenue attribution method (for example, over the contract period) for any over time performance obligation if such an attribution would not depict the entity’s performance of satisfying the performance obligation. For example, a straight-line revenue attribution resulting from a time-based measure of progress over the contract period would not generally be reasonable in an annual snow removal services contract. Even though the contract term is one year, the pattern of benefit of those services to the customer, as well as the entity’s efforts to fulfill the contract, would generally not be even throughout the year because there would be no reasonable expectation of snowfall during the warm months of the year.

However, if an entity expects that the customer will receive and consume benefit from the entity’s promise, the nature of which is to stand ready to provide goods or services, equally throughout the contract period, then a straight-line revenue attribution resulting from a time-based measure of progress would be appropriate.

Example 18, Measuring Progress When Making Goods or Services Available, in Topic 606 concludes that the nature of the entity’s promise is to stand ready to provide the customer access to its health club facilities throughout the contract period. The example at least implicitly determines this on the basis that the customer will receive an unknown quantity of services under the contract (that is, the entity does not know how often or when the customer will use its health clubs or what amenities the customer will use when they do so). The example then concludes, relevant to this question, that because the customer will benefit from the entity’s service of making the health clubs available for the customer’s use evenly throughout the contract period, that a time-based measure of progress is appropriate.

The staff thinks each of the following examples are substantially similar to the health club example, and further illustrate the appropriate considerations:

- (a) In a helpdesk support scenario, the entity does not know, and it would likely not be able to reasonably estimate, how often and/or when the customer will actually request

support, or the severity of the problem it will help solve. This suggests the nature of the entity's promise is to stand ready to provide support when-and-if it is needed. The customer benefits evenly throughout the contract period from the availability of the helpdesk support, when-and-if needed.

- (b) In a snow removal scenario, the entity does not know, and it would likely not be able to reasonable estimate, how often (or how much) and/or when it will snow. This suggests the nature of the entity's promise is to stand ready to provide those services when-and-if it is needed. In this scenario, however, as discussed above, the entity might conclude that the customer does not benefit evenly throughout the one-year contract period. As a result, the entity would select a more appropriate measure of progress (for example, one based on its expected efforts to fulfill its obligation to stand ready to perform, which may be substantially greater during the winter months than during the summer months).
- (c) In a cable or satellite television contract, the entity both (i) does not know how often and/or when the customer will make use of its television services, and (ii) does not know what content it will provide access to or make available "on-demand" throughout the contract period. This suggests the nature of the entity's promise is to stand ready to provide television services when the customer turns on his/her television. The customer benefits evenly from its continuous access to whatever content is broadcast.

While not necessarily as intuitive to some stakeholders as the examples in the paragraphs above, stand-ready obligations characterized by rights to unspecified software updates or upgrades are also often similar to those above in that the entity might not know how many updates or upgrades will become available for transfer to the customer, and it might not be able to predict what those updates or upgrades will be (that is, the entity may provide an upgrade with significantly enhanced functionality or it may only provide a minor update). Therefore, the nature of the entity's promise is to stand ready to provide updates or upgrades when-and-if they become available. The customer benefits evenly throughout the contract period from the guarantee that any updates or upgrades developed by the entity during the period will be made available. As a result, a time-based measure of progress would generally be appropriate.

Topic 606 does not establish a bias between output- and input-based measures of progress. Therefore, the staff also thinks that in some cases, a time-based input measure of progress (as outlined in paragraph 606-10-55-20), rather than an output-based measure considering the expected pattern of benefit to the customer, might be appropriate. For example:

- (a) A time-based measure of progress may also be appropriate in the health club example (Example 18) because the entity's efforts to satisfy its performance obligation (that is, keeping the health clubs open for the customer's use) are expended evenly over the contract period.
- (b) In a helpdesk support scenario, the entity's costs might be fixed regardless of the level of activity that comes through its call center each day, week, or month of the contract period.

Question 50: What factors should an entity consider when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity as the entity performs?

Reference(s): Section 606-10-25, Paragraphs 606-10-55-5 through 55-6

The staff thinks an entity should consider all relevant facts and circumstances, including the inherent characteristics of the commodity, the contract terms, and information about infrastructure or other delivery mechanisms when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity as the entity performs.

An evaluation of whether a commodity is simultaneously received and consumed is not limited to the inherent characteristics of the commodity. Rather, an entity should consider all known facts and circumstances relevant to the evaluation. For example, an entity may consider not only the inherent nature of the commodity, but also specific contract terms (for example, a continuous supply contract to meet immediate demands) and information about infrastructure or other delivery mechanisms (for example, a natural gas utility that delivers directly to residential consumers). As a result, revenue related to the sale of a commodity may or may not be recognized over time depending on whether the facts and circumstances of the contract indicate the customer will immediately receive and consume the benefits of the commodity.

The staff notes that consideration of factors other than the inherent nature of a commodity could result in revenue being recognized differently for sales of the same commodity. For example, an entity that provides natural gas for immediate consumption in a power plant may recognize revenue over time (that is, the natural gas is simultaneously received and consumed) while an entity that delivers natural gas into temporary storage for a similar power plant may recognize revenue at a point in time (that is, the natural gas is not simultaneously received and consumed).

The staff thinks an entity should consider all relevant facts and circumstances when evaluating the criteria in paragraph 606-10-25-27, and, therefore, when determining the nature of an entity's promise to its customer, regardless of whether the contract is for the delivery of a commodity or a widget.

The staff thinks it is important to highlight that before evaluating the criteria in paragraph 606-10-25-27, an entity must first evaluate all relevant facts and circumstances to appropriately identify the overall nature of the entity's promise(s) in a contract. For example, an entity may conclude that the nature of its promise in a contract to provide natural gas to a customer upon demand differs from the nature of its promise in a contract to deliver natural gas into a customer's temporary storage. That is, an entity may determine that providing natural gas upon demand is a repetitive service arrangement (or potentially a stand-ready obligation to provide a commodity to a customer on an as-needed basis) while the delivery of natural gas into temporary storage is more akin to the delivery of a good. In some cases, this evaluation will require the use of significant judgment. Furthermore, the staff thinks that this view is most consistent with how facts and circumstances are considered in some other, very similar, circumstances (for example,

the determining if multiple promised goods or services are distinct within the context of the contract) and that it may be inconsistent with other parts of Topic 606 to conclude that, in this one case, only some facts and circumstances (that many view as relevant to determining the nature of the entity's promise) should be considered.

After an entity identifies the overall nature of its promise to the customer in a contract it is in the proper position to evaluate the guidance in paragraph 606-10-25-27, including whether a customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. When making this evaluation, an entity also must consider the related implementation guidance in paragraphs 606-10-55-5 through 55-6 pertaining to the criterion in paragraph 606-10-25-27(a).

Question 51: Can control of a good or service underlying a performance obligation transfer at discrete points in time?

Reference(s): Sections 606-10-25 and 606-10-55

Some stakeholders have questioned whether an entity that is performing over time (that is, an entity that meets one of the criteria in paragraph 606-10-25-27) transfers control of a good or service underlying a performance obligation at discrete points in time.

Paragraph 606-10-25-27 includes criteria for determining whether an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time. The staff thinks that meeting one of the criteria in that paragraph implies that control does not transfer at discrete points in time. Accordingly, an appropriate measure of progress should not result in a material asset that results from an entity's performance (for example, work in process) being recognized by the entity.

The staff thinks that the guidance in paragraphs BC125, BC128, BC130, BC131, BC135, and BC142 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, clarifies that when an entity meets any of the over-time criteria in paragraph 606-10-25-27, control does not transfer at discrete points in time and an appropriate measure of progress should not result in an entity recognizing a material asset that results from the entity's performance (for example, work in process). However, the staff's view does not imply that an entity would be prohibited from recognizing revenue over time merely because there is (or might be) a gap in an entity's performance (that is, if the entity does not perform any activities towards satisfying the performance obligation in a particular financial reporting period).

The staff's view is further supported by the guidance in paragraph 606-10-55-17. The staff thinks this guidance supports the concept underpinning the criteria in paragraph 606-10-25-27. That is, if any criterion is met, a customer would control the asset created by the entity's performance.

The staff acknowledges that paragraph BC135 of Update 2014-09 states that a customer could be regarded as having control of an asset when an entity creates an asset that does not have

an alternative use to the entity. However, the staff observes that the sentence following that acknowledgment clarifies that an entity also would need to consider whether a right to payment exists in order to conclude that a customer does in fact control the asset. Accordingly, the staff does not think paragraph BC135 implies that a customer does not necessarily control an asset when a performance obligation is satisfied over time. Rather, the staff thinks this paragraph implies that a customer may not have control of an asset with alternative use if an entity does not also have a right to payment.

The staff also observes that while Example 27, Withheld Payments on a Long-Term Contract, references milestone payments, it does not conclude that milestones are the appropriate measure of progress. Rather, the intent of Example 27 is to illustrate the application of the guidance on the existence of a significant financing component in a contract.

The staff acknowledges that, in some cases, an entity's selected measure of progress may depict the pattern of an entity's performance but may not perfectly match the entity's performance. This might result in an immaterial asset (for example, work in process) being recognized.

Question 52: Over what periods should an entity recognize a nonrefundable upfront fee?

Reference(s): Section 606-10-25 and Paragraph 606-10-55-51

Consider the following example:

Entity charges a \$50 one-time activation fee and agrees to provide Customer with services on a month-to-month basis at a price of \$100 per month. Customer is under no obligation to continue to purchase the monthly service and Entity has not committed to any pricing levels for the service in future months. Because the activity of signing up Customer for service does not result in the transfer of a good or service, it does not represent an additional promised service. Rather, the activation fee is an advance payment for Entity's services and should, therefore, be deferred and recognized as the future service is provided. Entity's average customer life is two years.

The staff notes that the period over which the activation fee will be recognized depends on whether the activation fee provides the customer with a material right with respect to renewing Entity's services. When determining whether a nonrefundable upfront fee provides a material right, Entity would consider both quantitative and qualitative factors. For example, Entity would consider whether the renewal price that Customer will pay (that is, \$100 per month) compared with the price that a new customer would pay for the same service (that is, \$150, consisting of a \$50 activation fee and \$100 monthly service) provides Customer with a material right. Entity also would consider the availability and pricing of service alternatives (for example, whether Customer could obtain substantially equivalent services from another provider without paying the activation fee). Entity's average customer life also might be an indication of whether

the activation fee provides a material right. That is, an average customer life that extends well beyond the one-month contractual period might be an indication that the activation fee incentivizes Entity's customers to continue services because those customers would not incur an activation fee that they may otherwise incur if they switch service providers.

If Entity concludes that the activation fee provides a material right, the fee would be recognized over the service periods during which Customer is expected to benefit from not having to pay an activation fee upon renewal of service. Determining the expected period of benefit often will require judgment.

Conversely, if Entity concludes that the activation fee does not provide the customer with a material right, the activation fee is, in effect, an advance payment solely on the contracted services (for example, the one-month contract term). Consequently, Entity would recognize the transaction price (that is, \$150 comprised of the service and activation fees) as revenue as those services are provided in accordance with paragraph 606-10-55-51.

Question 53: How should revenue arising from pre-“Contract Establishment Date” activities be recognized?

Reference(s): Section 606-10-25

Entities sometimes commence activities on a specific anticipated contract either (a) before agreeing to the contract with the customer or (b) before the contract with the customer satisfying the criteria in Topic 606 to apply the general revenue recognition model.

For convenience, in this Q&A the date on which the criteria in paragraph 606-10-25-1 are satisfied is referred to as the “Contract Establishment Date (CED)” and the activities that an entity performs before the CED are referred to as “pre-CED activities.”

These pre-CED activities may be:

- (a) Activities, such as administrative tasks that neither result in the transfer of a good or service to the customer, nor fulfill the anticipated contract
- (b) Activities to fulfill the anticipated contract but which do not result in the transfer of a good or service, such as set-up costs
- (c) Activities that transfer a good or service to the customer at or after the CED.

The question that arises is how to account for the revenue from the pre-CED activities that result in the transfer of a good or service to the customer as at the CED. The analysis in this Q&A is relevant only when the entity concludes that a contract has not been identified for the purposes of Topic 606 before the CED.

The staff's view is that revenue should be recognized on a cumulative catch-up basis, reflecting the performance obligation(s) that are partially satisfied or satisfied as at the CED. It is the staff's

view that it would not be appropriate to recognize revenue on a prospective basis beginning on the CED.

The staff notes that the core principle of the standard as set out in paragraph 606-10-10-2 is to “recognize revenue to depict the transfer of promised goods or services to customers. . . .” If an entity has transferred promised goods or services within a performance obligation to the customer at the CED, the staff thinks that it is appropriate and consistent with that core principle that the entity should recognize revenue to reflect the promised goods or services already transferred to the customer at the CED. In other words, revenue should be recognized on a cumulative catch-up basis, reflecting the performance obligation(s) that are partially satisfied or satisfied as at the CED.

A cumulative catch-up adjustment is consistent with the overall principle of recognizing revenue to depict an entity’s performance in transferring control of goods or services to the customer (i.e. the satisfaction of an entity’s performance obligation). Hence, if the entity concludes, in accordance with Topic 606, that the pre-CED activities have resulted in progress towards satisfying a performance obligation as at the CED, it would recognize the revenue to which it expects to be entitled for that progress. A cumulative catch-up adjustment reflects the fact that control of a portion of the good or service has transferred to the customer at the CED. In assessing whether the pre-CED activities result in the transfer of control of a good or service, an entity would consider the requirements in paragraphs 606-10-25-23 through 25-30.

Paragraph 606-10-25-35 states that “As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity’s measure of progress shall be accounted for as a change in accounting estimate. . . .” Changes in accounting estimate are recognized in the period of change unless they affect future periods in accordance with Topic 250, Accounting Changes and Error Corrections.

In paragraph BC48 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, the Board noted that the requirements in paragraph 606-10-25-7 are “similar to the ‘deposit method’ that was previously included in GAAP and that was applied when there was no consummation of a sale.” Under current GAAP, entities recognize revenue (and interest income) on a cumulative catch-up basis when they subsequently apply the full accrual method after applying the deposit method (paragraph 360-20-55-17). It could be analogized from this guidance that an entity applying Topic 606 could recognize revenue as at the CED arising from pre-CED activities on a cumulative catch-up basis.

When the subject matter of a contract is established between the entity and the customer, the underlying performance obligations do not differ depending on whether the entity commences activities, for example, manufacturing or constructing goods, before or after the CED. The extent of progress towards satisfying the performance obligation(s) for which the customer has contracted is the same.

The staff notes that applying a cumulative catch-up adjustment to a contract which does not satisfy the criteria in paragraph 606-10-25-1 until the CED would result in the same cumulative

recognition of revenue at the CED and in future periods, and hence the same contract asset or contract liability position, as a contract that had met the criteria in paragraph 606-10-25-9 before the CED. From the CED, the two projects will be identical and hence economically equivalent. Therefore, a cumulative catch-up basis will better reflect the contract and so provide users of the financial statements with more decision-useful information than a prospective basis beginning on the CED. Under a prospective basis, the pattern of revenue recognition would be different after the CED, despite the two contracts being economically equivalent.

The staff considers that the Board's intention on this point is more clearly demonstrated in the reference quoted in the discussion above to paragraph BC48 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, referring to the guidance in Topic 606 being similar to the 'deposit method' under current GAAP, where revenue is recognized on a cumulative catch-up basis.

The staff therefore considers that a cumulative catch-up basis best satisfies the core principle in paragraph 606-10-10-2 that 'an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services' and is therefore the appropriate method of measuring progress at the point paragraph 606-10-25-1 is satisfied, that is, the CED.

In applying a cumulative catch-up basis, an entity should consider the requirements in paragraphs 606-10-25-23 through 25-37 to determine the goods or services which the customer controls and therefore what portion of pre-CED costs should be included in any measure of progress towards satisfaction of a performance obligation that is used to calculate the cumulative catch-up adjustment. For example, if the pre-CED costs relate to uninstalled materials that the customer does not control, the inclusion of those costs in determining how much revenue to recognize might not be appropriate.

Question 54: Can an entity that recognized revenue at a point in time under current revenue recognition guidance be required to recognize revenue over time in accordance with Topic 606?

Reference(s): Section 606-10-25

Under Topic 606, an entity determines at contract inception whether it satisfies a performance obligation over time or at a point in time. In Step 5, an entity recognizes revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer, which is when the customer obtains control of that good or service. This means that, depending on the pattern of timing of when a customer obtains control (and hence when a performance obligation is satisfied), revenue is recognized either over time or at a point in time.

An entity should assess whether a performance obligation is satisfied over time by evaluating the criteria in paragraph 606-10-25-27 (as well as the other guidance in Topic 606 about the application of that paragraph). If the performance obligation is satisfied over time, then revenue

should be recognized over time as control of the promised good or service transfers to the customer. As explained in paragraph BC124 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, the Board developed the criteria in paragraph 606-10-25-27 to provide an entity with an objective basis for assessing when control transfers over time and, in turn, when a performance obligation is satisfied over time. Examples 13 through 17 (paragraphs 606-10-55-159 through 55-182) provide illustrations of performance obligations satisfied over time.

If an entity does not satisfy a performance obligation over time (because it does not meet any of the criteria in paragraph 606-10-25-27), then the performance obligation is satisfied at a point in time and the entity should evaluate the guidance in paragraph 606-10-25-30 to determine the point in time when the customer obtains control of the promised good or service and therefore should recognize revenue.

The Board acknowledged in paragraph BC132 of Update 2014-09 that the criteria in paragraph 606-10-25-27(a) and 606-10-25-27(b) could be challenging to apply in some circumstances. To help with an entity's assessment of when control transfers over time, the Board developed the criterion in 606-10-25-27(c). The Board noted that this third criterion about no alternative use and enforceable right to payment may be necessary for services that are specific to a customer (for example, consulting services that ultimately result in a professional opinion for the customer) and also for the creation of tangible (or intangible) goods.

The following example illustrates a transaction that might be accounted for at a point in time today but would be accounted for over time under Topic 606.

An entity has contracted with a customer to provide a manufacturing service in which it will produce 1,000 units of a product per month for a 2-year period. The service will be performed evenly over the 2-year period with no breaks in production. The units produced under this service arrangement are substantially the same and are manufactured to the specifications of the customer. The entity does not incur significant upfront costs to develop the production process. Assume that its service of producing each unit is a distinct service in accordance with the criteria in paragraph 606-10-25-19. Additionally, the service is accounted for as a performance obligation satisfied over time in accordance with paragraph 606-10-25-27 because the units are manufactured specific to the customer (such that the entity's performance does not create an asset with alternative use to the entity), and if the contract were to be cancelled, the entity has an enforceable right to payment (cost plus a reasonable profit margin). Therefore, the criteria in paragraph 606-10-25-15 have both been met.

In the staff's view, an entity that currently recognizes revenue at a point in time should not presume it will recognize revenue at a point in time under Topic 606. An entity should perform an assessment of its specific facts and circumstances on the basis of the guidance in Topic 606. An entity only recognizes revenue at a point in time if it does not meet the overtime criteria in Topic 606.

While the staff's view is that an entity should perform an assessment of its specific facts and circumstances, the staff thinks that for most entities (but not every entity) that assessment will be straightforward and will not be time consuming.

The staff is aware from outreach activities that some entities that recognize revenue at a point in time under current GAAP have concluded that they will recognize revenue over time under Topic 606. An example of a fact pattern described to the staff from a few stakeholders is an entity (for example, a contract manufacturer, as described in the Example) that produces goods designed to a customer's specifications. Because the goods are designed to meet the customer's unique specifications, the entity concludes that its performance does not create an asset with an alternative use to the entity. In addition, the entity has an enforceable right to payment for performance completed to date. Consequently, the entity concludes that it meets the over-time criteria in paragraph 606-10-25-27(c) and, therefore, it will recognize revenue over time.

The staff is not implying that all entities that produce customized goods should conclude that they will recognize revenue over time under paragraph 606-10-25-27(c). An entity that recognizes revenue at a point in time under current GAAP might conclude that it should recognize revenue at a point in time under Topic 606. This would be the case, for example, if the entity does not have a right to payment. However, an entity will need to perform an assessment of its specific facts and circumstances on the basis of the guidance in Topic 606 to reach a conclusion about whether revenue should be recognized over time or at a point in time.

When an entity is evaluating whether revenue will be recognized over time or at a point in time, it might be an ideal time for the entity to also consider the relevant disclosures. Required disclosures in Topic 606 include (but are not limited to):

- (a) When the entity typically satisfies performance obligations (paragraph 606-10-50-12(a))
- (b) Judgments, and changes in judgments, used in determining the timing of satisfaction of performance obligations (paragraph 606-10-50-17(a))
- (c) For performance obligations satisfied over time, the methods used to recognize revenue (for example, a description of the input or output methods applied) and an explanation of why the methods used provide a faithful depiction of the transfer of goods and services (paragraph 606-10-10-18)
- (d) For performance obligations satisfied at a point in time, significant judgments made in evaluating when a customer obtains control of promised goods or services (paragraph 606-10-50-19).

Question 55: In assessing whether an entity's performance creates an asset with no alternative use in accordance with paragraph 606-10-25-27(c), should an entity consider the completed asset or the in-production asset?

Reference(s): Section 606-10-25, Paragraphs 606-10-55-8 through 55-10

In accordance with paragraph 606-10-25-27(c), if an entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date, the entity satisfies its performance obligation, and recognizes revenue, over time. An entity must meet both of the criteria in paragraph 606-10-25-27(c) in order to recognize revenue over time.

Paragraphs 606-10-55-8 through 55-10 provide guidance around the assessment of whether an entity's performance creates an asset with no alternative use. In assessing whether an asset does not have an alternative use to an entity in accordance with paragraph 606-10-25-28, an entity should consider both the effects of contractual restrictions and practical limitations on an entity's ability to readily direct that asset for another use, such as selling it to a different customer. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. A practical limitation exists if an entity would incur a significant economic loss to direct the asset for another use.

Stakeholders have raised a question about at which stage in production (or manufacturing) should an entity conclude that the asset has no alternate use. For example, if an asset can be sold to a different customer throughout most of the production process, but the asset that exists at the end of the production process has no alternative use, does the asset have no alternate use when evaluating the over-time criteria in paragraph 606-10-25-27(c)? In other words, stakeholders have asked whether the timing of the customization matters when assessing the criteria in paragraph 606-10-25-27(c).

Paragraph 606-10-25-28 provides guidance that an entity should consider the completed asset and BC136 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, provides further clarification of that guidance. TRG members observed that if the entity is contractually restricted or has a practical limitation on its ability to direct the asset for another use, then the asset would not have alternative use, regardless of the characteristics of the ultimate asset.

Paragraph 606-10-25-28 states that the assessment of the no alternative use criterion should be performed at contract inception and that this evaluation should not be reassessed unless the parties to the contract approve a contract modification that substantively changes the performance obligation. In addition, paragraph BC136 of Update 2014-09 states that the no alternative use criterion should be considered in the context of the asset that will ultimately be transferred to the customer.

If the asset does not have an alternative use, the entity would not automatically be required to recognize revenue over time. This is because the entity also must meet the second half of the criteria in paragraph 606-10-25-27(c) related to an enforceable right to payment. Paragraph

BC141 of Update 2014-09 states that while the notion of no alternative use is a necessary part of the criterion in paragraph 606-10-25-27(c), it is not enough to conclude that a customer controls an asset. Therefore, an entity also must have an enforceable right to payment for performance completed to date for revenue recognition to occur over time.

As discussed in paragraph BC142 of Update 2014-09, there is a link between the assessment of control and the factors of no alternative use and a right to payment because if an entity is creating an asset that has no alternative use to the entity, the entity is effectively constructing an asset at the direction of the customer. The customized asset would have no use to the entity and, therefore, the entity will require economic protection from the risk of the customer terminating the contract by requiring the customer to pay for the entity's performance completed to date if the customer terminates the contract. Because the customer is obligated to pay for the entity's performance and cannot avoid paying for that performance, the customer has obtained the benefits from the entity's performance and the performing entity should recognize revenue over time as performance occurs.

Consider the following example:

An entity enters into a contract with a customer to build equipment. The entity is in the business of building custom equipment for various customers. The customization of the equipment occurs when the manufacturing process is approximately 75% complete. In other words, for approximately 75% of the manufacturing process, the in-process asset could be redirected to fulfill another customer's equipment order (assuming there is no contractual restriction to do so). However, the equipment cannot be sold in its completed state to another customer without incurring a significant economic loss. The design specifications of the equipment are unique to the customer and the entity would only be able to sell the completed equipment at a significant loss.

In this example, the entity would evaluate at contract inception whether there is any contractual restriction or practical limitation on its ability to readily direct the asset in its completed state for another use. Because the entity cannot sell the completed equipment to another customer without incurring a significant economic loss, the entity has a practical limitation on its ability to direct the equipment in its completed state and, therefore, the asset does not have an alternative use. However, before concluding that revenue should be recognized over time, an entity must evaluate whether it has an enforceable right to payment.

When assessing whether the overtime criteria in paragraph 606-10-25-27(c) have been met, some TRG members discussed the linkage among right of payment, measure of progress, and the timing of the customization of a good. TRG members observed that the example above does not include any facts regarding right to payment. However, TRG members raised questions about the effect on the over-time assessment in scenarios in which an entity does not have a right to payment before the start of the product customization (for example, before the customization the product may be considered inventory). The staff explained that the right to payment is for performance completed to date on the contract and that performance should coincide with how an entity defines the nature of its performance obligation and its performance when measuring progress towards satisfaction of that performance obligation.

Question 56: How and when should an entity determine whether it has an enforceable right to payment in accordance with paragraph 606-10-25-27(c)?

Reference(s): Sections 606-10-25 and 606-10-55

In accordance with paragraph 606-10-25-27(c), if an entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date, the entity satisfies its performance obligation, and recognizes revenue, over time. An entity must meet both of the criteria in paragraph 606-10-25-27(c) in order to recognize revenue over time.

Paragraph 606-10-25-29 provides further guidance on the right to payment criterion.

The assessment of whether the entity has an enforceable right to payment is dependent on whether the termination payment includes a reasonable profit margin on its performance completed to date at all times throughout the duration of the contract if the contract is terminated by the customer for reasons other than the entity's failure to perform as promised, as provided in paragraph 606-10-25-29. That is, if a termination provision only compensates the entity for costs or a portion of costs, the enforceable right to payment criteria would not be met. The payment schedule specified in the contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date.

The term right to payment is intended to refer to a payment that serves as compensation for an entity's performance completed to date. The criterion in paragraph 606-10-25-27(c) was written with the intention to reinforce the notion of control because an entity would only agree to transfer control of a good or service to a customer if the entity is compensated for the costs associated with fulfilling the contract and it receives a reasonable profit margin that includes a return on those costs. If an entity concludes that it has entered into a contract with a customer to create an asset that has no alternative use, the entity would recognize revenue over time if there is an enforceable right to payment (including a reasonable profit margin) for performance completed to date.

Paragraphs 606-10-55-11 through 55-15 include considerations that an entity should use to assess whether there is an enforceable right to payment for performance completed to date, including whether there is a reasonable profit margin. Paragraph 606-10-55-11 states that an entity does not need to be entitled to the profit margin expected if the contract was fulfilled as promised, but an entity should at least be entitled to either a proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination or a reasonable return on the entity's cost of capital. Paragraph BC144 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, clarifies this guidance by stating that an entity should focus on the amount that it would be entitled upon termination rather than the amount that the entity may ultimately be willing to settle for in a negotiation.

In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. Paragraph

606-10-55-13 provides guidance that if a customer terminates a contract without having the right to terminate the contract at that time, the contract (or laws) gives the entity a right to continue to perform its obligations in accordance with the contract, which would require the customer to perform its obligation of paying the promised consideration and create an enforceable right to payment.

An entity should consider the terms of the contract, as well as any legislation or legal precedent that could supplement or override those contractual terms, when assessing the existence and enforceability of a right to payment for performance completed to date. Paragraph 606-10-55-14 explains that an entity needs to consider legislation, administrative practice, or legal precedent that confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer, relevant legal precedent that indicates that similar rights to payment for performance completed to date in similar contracts has no binding legal effect, and an entity's customary business practice of choosing not to enforce a right to payment that has resulted in the right being rendered unenforceable in that legal environment.

Paragraph BC145 of Update 2014-09 points out that the contractual payment terms in the contract might not always align with the entity's enforceable rights to payment for performance completed to date. The right to payment does not need to be a present unconditional right to payment, but rather an entity should consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised. An entity must consider both the terms of the contract and any laws or regulations that could have an effect on the existence and enforceability of right to payment on the contract.

The Board clarified in paragraph BC146 of Update 2014-09 that a nonrefundable upfront payment that represents the full transaction price would at least compensate the entity for work completed to date throughout the contract and would provide the entity a right to payment as long as the entity's right to retain the payment is enforceable if the customer terminates the contract in accordance with paragraph 606-10-25-29.

As summarized above, Topic 606 provides a framework for evaluating whether an entity has a right to payment. However, application of the guidance sometimes will require judgment. For example, paragraph 606-10-55-11 states that a right to payment should include a reasonable profit margin. This will be a matter of judgment applied to the specific facts and circumstances of the arrangement. Also, application of the guidance on right to payment will be a matter of law. Sometimes an entity's right to payment for performance completed to date might not be explicit in a contract or it might be vague in the contract. In applying the guidance in paragraph 606-10-25-29, an entity should consider contractual provisions as well as any legislation or legal precedent that could supplement or override those contractual terms.

Consider the following example:

For each of the last five years, an entity has received an order from a customer for 300 custom ice cream machines. The specifications of the ice cream machines are unique to the customer. In anticipation of the customer's order this year, the entity starts production of the custom ice cream machines before there is a contract between the

parties in the current year. The entity is willing to take the risk of beginning to manufacture custom units before there is a contract because (a) the customer has predictable purchasing behavior and (b) the entity has knowledge of the customer's performance in the current year and plans for growth from the customer's public disclosures. The entity and the customer later enter into a contract (that meets all of the criteria in Step 1 of Topic 606) for 300 units. The entity has a practical limitation on its ability to direct the equipment in its completed state because it could not do so without incurring a significant economic loss. The entity has an enforceable right to payment beginning when the contract is executed. Assume that each of the machines is distinct. At the inception of the contract, the entity has completed 50 units (that is, 50 units are in inventory awaiting shipment to the customer), has 10 units in production (that is, 10 units are in various stages of the manufacturing process), and has not begun manufacturing 240 units.

In this example, the entity begins production before the existence of a contract under Topic 606. Therefore, the entity cannot recognize revenue (whether at a point in time or over time) until a contract exists (that is, meets all of the criteria for a contract in Step 1 of Topic 606).

In the staff's view, at contract inception the entity would assess the nature of its promise(s) to the customer and identify the performance obligation(s). Each of the machines is distinct; however, the entity considers whether the arrangement is a series of distinct goods or services in accordance with paragraphs 606-10-25-14(b) through 25-15. One of the two criteria to be a series is that the performance obligation is satisfied over time. There is no alternative use for the machines because of the practical limitation noted in the fact pattern. In addition, there is an enforceable right to payment at the inception of the contract. Therefore, the entity concludes that it will recognize revenue over time in accordance with paragraph 606-10-25-27(c). The second criterion to be a series is that the same method would be used to measure progress toward complete satisfaction to transfer each distinct good or service to the customer. In this fact pattern, the 300 units in the contract are identical so the entity concludes that it would use the same measure of progress for each of the 300 distinct units. Because both of the criteria for a series are met, the entity concludes that the arrangement for 300 machines should be accounted for as a series of goods and services.

At contract inception, the entity would record a cumulative catch up adjustment for progress made as of contract inception toward complete satisfaction of the performance obligation (that is, the series comprised of 300 units), considering both the 50 completed units and the 10 in process units. The entity would continue to recognize revenue over time as progress is made on finishing the 10 units and manufacturing the 240 units.

Question 57: How should an entity determine if there is a right to payment for short-cycle manufacturing?

Reference(s): Section 606-10-25

Under the guidance in Topic 606, an entity recognizes revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An entity will need to determine whether control transfers and, in turn, whether revenue is recognized at

a point in time or over time. Step 5 of the revenue standard requires that an entity recognizes revenue over time if any one of the criteria in paragraph 606-10-25-27 is met. If none of the criteria are met, then an entity recognizes revenue at a point in time.

Because the principles in Topic 606 relate to the transfer of control, rather than risks and rewards under current GAAP, there will be cases in which an entity has a change upon adoption of the standard from recognizing revenue at a point in time to over time, and vice versa in some scenarios. One common scenario in which this change in timing may occur is in the contract manufacturing industry, which is not to say that all contracts in this industry are affected. However, in this industry it is common that the goods are customized and are customer specific. Therefore, there are cases in which the third over-time criterion is met, when there is also a right to payment for the goods. In its comment letter the AICPA's Technical Issues Committee (TIC) noted that private companies may not have internal controls over contracting, including the ability to obtain legal determinations for contracts. Therefore, it may be difficult for private companies to determine if they have a right to payment for performance completed to date.

The staff would like to clarify that there is no requirement in Topic 606 that states that companies are required to consult with legal counsel for all revenue transactions. In that regard, the staff thinks it is helpful for companies to consider the Boards' reasoning for including right to payment in the criterion in paragraph BC142 in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. As noted in the basis for conclusions, the general notion is that if a company is creating a customized asset for a customer, then it will want to protect itself by requiring payment throughout the contract. The staff thinks that this analysis will typically be straightforward and should not require exhaustive analysis in most cases. Because the right to payment is assessed at the contract level, this analysis may be more complex in scenarios in which companies have non-standard terms or enter into transactions outside of their customary business practice. In that regard, the staff thinks that the discussion on this topic is very similar to the discussion on definition of a contract.

The staff understands that questions have arisen about how to handle contracts in circumstances in which the entity creates a good with no alternative use and the contract with its customer does not specify by its written terms the entity's right to payment upon contract termination. Some stakeholders have asked whether it was the Board's intent that companies analyze every law in every jurisdiction to determine whether there is recoverability. In the staff's view, a reasonable interpretation of the guidance is that when a contract's written terms do not specify the entity's right to payment upon contract termination, an enforceable right to payment is presumed not to exist.

LICENSING

Question 58: How should an entity account for a customer's option to purchase or use additional copies of software?

Reference(s): Paragraphs 606-10-55-42 and 606-10-55-65

Some stakeholders in the software industry have questioned how the interaction of paragraphs 606-10-55-42 and 606-10-55-65 affects the accounting for a customer's option to purchase or use additional copies of software. Consider the following examples:

Example A

A vendor enters into a 3-year software arrangement with a customer. As part of that arrangement, the software vendor delivers a master copy of the software to the customer. The customer pays a fixed fee of \$300,000 for up to 500 users of the software. The customer pays an additional \$400 per user for each additional user of the software above 500. The customer has been given the technical capability and has the legal right to replicate the software and add users without any assistance from the vendor. The customer will measure the number of users and pay for any additional users each quarter. The vendor has the right to audit the customer's measurement of users.

Example B

A vendor enters into a 3-year software arrangement with a customer. As part of that arrangement, the software vendor provides access to download copies of its software to the customer. The customer pays a fixed fee of \$300,000 for up to 500 downloads of the software. Each downloaded copy can only have a single user. The customer pays an additional \$400 per copy downloaded above 500. The customer has been given the technical capability and legal right to download an unlimited number of copies without any assistance from the vendor. The number of downloads is measured, and any additional users are paid for each quarter. The vendor has the right to audit the number of copies/users in the customer's environment.

Example C

A vendor enters into a 3-year software arrangement with a customer. As part of that arrangement, the software vendor provides access to download copies of its software to the customer. The customer pays a fixed fee of \$300,000 for up to 500 downloads of the software. Each downloaded copy can only have a single user. The customer pays an additional \$400 per copy downloaded above 500. The customer has been given access codes for 500 downloads. The customer must request, and the vendor

will provide access codes for any additional downloads. The number of downloads is measured, and any additional users are paid for each quarter. The vendor has the right to audit the number of copies/users in the customer's environment.

Stakeholders have reported different views about whether Examples A through C include an "option to acquire additional goods or services," as referenced in paragraph 606-10-55-42. The staff considered the following two views could be acceptable when a customer has an option to acquire additional software rights (such as incremental user seats or incremental copies), depending on the nature of the arrangement. However, this is not to say that selection of the appropriate view is a choice; in some facts and circumstances, one view will be more appropriate than the other. TRG members agreed that, consistent with practice under previous GAAP, judgment will be needed based on the specific facts and circumstances of the arrangement to determine whether rights to additional copies, seats, or users represent a right to acquire additional licenses or variable consideration with respect to an existing license and thought the staff paper provided a useful framework for making those judgments.

- (a) View A—An option to acquire additional copies of software is an option to acquire additional licenses. An entity, therefore, would apply the guidance on customer options for additional goods and services (that is, consider whether a material right exists).
- (b) View B—Apply the guidance on sales-based or usage-based royalties. Additional users or copies represent incremental usage of the existing, previously granted license rather than an option to acquire additional licenses. Therefore, the additional usage gives rise to variable consideration (that is, a sales-based or usage-based royalty).

View A

In each of the three examples (A through C), the customer has the option to acquire additional software rights (the incremental users or copies above 500), which are akin to additional goods. Therefore, the option to acquire additional goods or services guidance is applicable to all three examples. Accordingly, the vendor must determine whether the option represents a material right. If the option does not represent a material right, then there would be no accounting for the additional purchases until the purchases occur. If the option does represent a material right in accordance with paragraph 606-10-55-42, then the company would allocate a portion of the transaction price for the initial licenses to the material right. In situations in which a material right exists, because the customer is in effect paying the vendor in advance for future licenses, the vendor would recognize revenue related to the material right when those future licenses are transferred or when the option expires.

View B

In each of the three examples (A through C), additional users or copies represent incremental usage of the software license, rather than an option to acquire additional software licenses

(additional rights). The customer's ability to access or download additional copies of the software for additional users do not change the nature, characteristics, or functionality of the software; they only affect the amount of usage of the rights the customer already controls. As such, additional usage of the software license the customer already controls (for which the customer will pay an incremental fee) is not an option to receive additional goods; instead the fees for additional usage are variable consideration for the license (that is, the rights) already transferred to the customer. Therefore, the variable consideration guidance in Topic 606 is applicable to all three examples. The variable consideration in those examples would be considered a usage-based or sales-based royalty for software (that is, additional users' equal additional usage). Accordingly, revenue would be recognized in accordance with paragraph 606-10-55-65.

The staff understands the fine-line distinction between treating additional users or seats as additional licenses (View A) or as usage of the software (View B). Naturally, increased user or seat rights reflect increased usage of software. The staff also understands why View B might be considered a preferable interpretation to some software entities. This is because the specific software exception in previous GAAP from having to consider whether a right to additional licenses of previously delivered software is a more-than-insignificant discount has been superseded. Consequently, entities would, under View A, have to undertake an evaluation of whether the right to additional licenses provides the customer with a material right and, if so, have to allocate consideration to, and account for, that material right. This effort would be incremental to what those same entities have to do today if they determine the arrangement is one for multiple licenses.

However, the staff thinks the fundamental question in those types of examples is similar to the question that arises in previous GAAP. Is the contract for a single license or for multiple licenses (that is, are additional users/seats/copies additional rights to use software)? The staff thinks it should be clear that, if the contract includes an optional right to purchase additional software licenses, then there is no basis for not considering whether the customer's right to do so is a material right. If that right is a material right, then the entity must account for that material right in the same manner as any other material right to purchase other optional goods. Under Topic 606, there is not separate guidance for different types of material rights. Consider other licensing scenarios. If additional rights are offered at a significant incremental discount to the range of discounts typically given for those rights to similar customers, the licensor would account for the initial license in the contract and a material right offered to the customer (that is, there would be two performance obligations). The staff does not think the nature of the additional rights in Examples A through C (in this case, additional capacity) rather than additional geographic or use rights should affect the accounting conclusion reached by the licensor, and also do not think an option to obtain additional geographic or use rights represent additional usage of a single license.

Judgment, based on the specific facts and circumstances of a contract, is required to determine whether an arrangement is for a single license or for multiple licenses under the previous accounting guidance in GAAP. Determining the substance of a licensing arrangement as one for a single license or for multiple licenses frequently will require judgment under Topic 606. It seems to the staff that very similar considerations and judgments would apply under Topic 606

as under previous GAAP, such as to what extent the provision or availability of additional copies of software is effectively a convenience to the customer versus correlated to the benefit the customer can derive from the arrangement (for example, when the number of seats or users grants additional rights to the customer that directly affect the number of clients the customer can service using the software), and that judgment would continue to be necessary to determine whether rights to additional copies/seats/users represent additional licenses based on the facts and circumstances of the arrangement.

Question 59: How does a minimum guarantee impact the recognition of sales-based or usage-based royalties promised in exchange for a license of symbolic intellectual property?

Reference(s): Sections 606-10-25 and 606-10-32

Stakeholders informed the staff that minimum guarantees are used in license arrangements for intellectual property in which the consideration is in the form of a sales-based or usage-based royalty. The minimum guarantee effectively establishes a floor for the amount of consideration to be paid to the licensor. For example, an arrangement might state that a licensor will receive 10% of a customer's subsequent sales as consideration, but the minimum amount of consideration will be \$1 million. Alternatively, an arrangement might state that the licensor will receive \$1 million plus 10% of a customer's sales in excess of \$10 million. For purposes of this Q&A, the term minimum guarantee refers to a contractual clause for fixed consideration that is unconditional.

Stakeholders have informed the staff that there are differing views about how a minimum guarantee impacts the accounting for sales-based or usage-based royalties promised in exchange for a symbolic license of intellectual property. The issue arises because Topic 606 includes a recognition constraint for sales-based or usage-based royalties promised in exchange for a license of intellectual property, but that constraint for royalties does not apply to fixed consideration. In effect, consideration in the form of a sales-based or usage-based royalty with a minimum guarantee includes elements of both fixed and variable consideration.

In contracts that do not include a license of intellectual property and that include variable consideration with a minimum guarantee, the minimum guarantee effectively establishes a floor for an entity's estimate of the transaction price. However, in those arrangements, an entity would include the estimated variable consideration (subject to the general constraint on variable consideration) in the transaction price. In contrast, for a license of intellectual property, an entity is precluded from recognizing the variable consideration in the form of a sales-based or usage-based royalty before the customer's subsequent sales or usage occurs because of the guidance in paragraph 606-10-55-65. An entity, however, is not precluded from estimating variable consideration in the form of a sales-based or usage-based royalty for a license of intellectual property in all cases (this is not to say that the estimate can be recognized as revenue, just that it can be estimated for other reasons).

In the staff's view, Topic 606 does not prescribe a single approach on recognizing revenue for license arrangements of symbolic intellectual property with minimum guaranteed royalties. The standard permits judgment in selecting a measure of progress, as long as the measure of progress is consistent with the guidance in paragraphs 606-10-25-31 through 25-37.

The following example will be used for to illustrate the considerations for a license of symbolic intellectual property:

An entity enters into a five-year arrangement to license a trademark. The trademark is determined to be symbolic intellectual property (IP). The license requires the customer to pay a sales-based royalty of 5% of the customer's gross sales associated with the trademark; however, the contract includes a guarantee that the entity will receive a minimum of \$5 million for the entire five-year period. The customer's actual gross sales associated with the trademark and the related royalties each year are as follows (this information, of course, is not known at the beginning of the contract): Year 1 - \$15 million (royalties equal \$750,000), Year 2 - \$30 million (royalties equal \$1.5 million), Year 3 - \$40 million (royalties equal \$2 million), Year 4 - \$20 million (royalties equal \$1 million), Year 5 - \$60 million (royalties equal \$3 million), and Total royalties equal \$8.25 million.

Minimum guarantees create tension in the application of Topic 606 in accounting for sales-based or usage-based royalties promised in exchange for a symbolic license of intellectual property because of (a) the different recognition models in Topic 606 for fixed consideration and variable consideration in the form of a royalty for a license of intellectual property and (b) the requirement in Topic 606 to select a single measure of progress for each performance obligation. For a contract for symbolic intellectual property that does not include a royalty, the measure of progress for the fixed consideration would likely be based on time elapsed because the customer simultaneously receives and consumes the benefits as the entity performs. For a contract for symbolic intellectual property that only includes a royalty, the variable consideration would be recognized at the later of when the customer's subsequent sales or usage occurs or when the performance obligation is satisfied (or partially satisfied) in accordance with paragraph 606-10-55-65. For a contract for symbolic intellectual property that includes both fixed and variable consideration, the analysis can be more challenging and require more judgment.

For symbolic licenses of intellectual property with a minimum guarantee, stakeholders have reported two broad approaches for the recognition of sales-based or usage-based royalties.

Under the first approach, an entity would estimate the total consideration (including the fixed consideration and royalties) and apply an appropriate measure of progress to recognize revenue as the entity satisfies the performance obligation (subject to the royalties constraint). An entity might apply the practical expedient in paragraph 606-10-55-18 (P x Q practical expedient) and recognize the royalties as the customer's sales or usage occurs, or an entity might estimate the consideration (including the fixed consideration and royalties) and apply an appropriate measure of progress (such as time elapsed) to recognize revenue over the term of the license, subject to the royalties constraint. This broad approach is summarized in Views A and B below.

Under the second approach, an entity would apply a measure of progress to the minimum guarantee (fixed consideration) and only recognize the royalties (variable consideration) when the cumulative royalties exceed the minimum guarantee. This approach is summarized in View C.

The following are the views that were discussed by the TRG:

- (a) View A—If an entity expects total royalties will exceed the minimum guarantee, recognize revenue as the royalties occur.
- (b) View B—Estimate the transaction price for the performance obligation (including fixed and variable consideration) and recognize revenue using an appropriate measure of progress, subject to the royalties constraint.
- (c) View C—Recognize the minimum guarantee (fixed consideration) using an appropriate measure of progress and recognize royalties only when cumulative royalties exceed the minimum guarantee.

Under View A, if an entity expects total royalties will exceed the minimum guarantee, the entity would recognize revenue from the sales-based or usage-based royalty when the customer's subsequent sales or usage occurs. An output-based measure, such as the practical expedient in paragraph 606-10-55-18, could be an appropriate measure of progress when the royalties due each period correlate directly with the value to the customer of the entity's performance to date and the entity expects the royalties will exceed the minimum guarantee. TRG Agenda Ref No. 40, *Practical Expedient for Measuring Progress toward Complete Satisfaction of a Performance Obligation*, indicated that an entity is not precluded from applying the paragraph 606-10-55-18 practical expedient in certain contracts with a guaranteed minimum if the entity expects to exceed the minimum amount of consideration. This is because a fixed minimum that an entity expects to exceed would not have an impact on the revenue recognition pattern for the selected measure of progress.

In addition, the symbolic license may constitute a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer in accordance with paragraph 606-10-25-14(b). The staff thinks that the performance obligation (the right to access the entity's intellectual property for a period of time) could be multiple distinct services of providing access each day, week, month, etc. The staff thinks that allocating the royalties to the respective periods in which the customer's sales occur could be consistent with the allocation objective. In that case, the variable consideration would be allocated to the distinct periods of access in accordance with paragraphs 606-10-32-39(b) and 606-10-32-40.

View A also would comply with the recognition constraint on sales-based royalties in paragraph 606-10-55-65 because the variable amounts are not recognized until the uncertainty is resolved (that is, when the underlying sales or usage occurs). View A applied to Example 1 would result in the following recognition pattern (in 000s):

	Y1	Y2	Y3	Y4	Y5	Total
Royalties received	750	1,500	2,000	1,000	3,000	8,250
Annual revenue	750	1,500	2,000	1,000	3,000	8,250
Cumulative revenue	750	2,250	4,250	5,250	8,250	

Under View A, it is important that an entity has an expectation that the total royalties will exceed the guaranteed minimum in order to apply the practical expedient in paragraph 606-10-55-18 or the series allocation guidance in paragraph 606-10-32-40. The practical expedient in paragraph 606-10-55-18 is designed such that an entity would recognize the same (or substantially the same) pattern of revenue as it would if the practical expedient were not applied. In cases in which the total royalties exceed the minimum guarantee, this will hold true. However, in cases in which the total royalties do not exceed the minimum guarantee, an entity would have a true up to the minimum guarantee. In this case, the pattern of revenue recognition would not be consistent with paragraph 606-10-55-18 or the series allocation guidance in paragraph 606-10-32-40.

Stakeholders should evaluate this implementation consideration for View A. A potential resolution to this issue would be for an entity that applies View A to monitor its estimate of total royalties throughout the term of the license to ensure that the application of the practical expedient in paragraph 606-10-55-18 remains appropriate. To the extent there is a change in estimate such that an entity no longer expects total royalties to exceed the minimum, the entity would need to update its measure of progress based on its assessment of value to the customer to date compared to total expected value to the customer (value to the customer could be derived from the customer’s sales or usage).

Under View B, an entity would estimate the total transaction price (including fixed and variable consideration) that will be earned over the term of the license performance obligation and apply an appropriate measure of progress to recognize revenue for the performance obligation, subject to the restriction that the cumulative revenue recognized cannot exceed the cumulative royalties once the minimum guarantee has been met. View B applied to Example 1 would result in the following recognition pattern when using a time elapsed measure of progress (in 000s and assume that the entity’s estimate of the transaction price is \$8.25 million):

	Y1	Y2	Y3	Y4	Y5	Total
Royalties received	750	1,500	2,000	1,000	3,000	8,250
Annual revenue	1,650	1,650	1,650	300	3,000	8,250
Cumulative revenue	1,650	3,300	4,950	5,250	8,250	

Under View B, because an element of the consideration is fixed (that is, the amount up to \$5 million), an entity might recognize revenue in advance of the royalty from a customer’s subsequent sales. This is illustrated in Years 1 to 3 where the annual revenue is \$1.65 million in each year based on straight line recognition of the total estimated transaction price of

\$8.25 million, however, the royalties received at the end of Year 3 are \$4.25 million. Once the minimum guarantee is met (that is, once there is no longer fixed consideration), the remaining consideration is variable, and an entity would be precluded from recognizing revenue for those sales-based royalties in advance of the underlying sales. This is illustrated in Year 4 when the annual revenue is constrained to \$0.3 million because the cumulative revenue is constrained to \$5.25 million (the total royalties received to date).

View B is intended to reflect an entity’s efforts to satisfy a performance obligation over time. If an entity did not expect that the total royalties will exceed the minimum guarantee, then the measure of progress would be applied to the minimum guarantee because the transaction price cannot be lower than the fixed amount. Because View B uses an estimate of the transaction price, that estimate would need to be updated each reporting period. Changes to the transaction price would be allocated to the partially satisfied performance obligation, subject to the constraint on cumulative royalties described above.

Under View C, the minimum guarantee is deemed to be fixed consideration and the variable consideration is only the amount in excess of the minimum guarantee. Some stakeholders are of the view that at the inception of the arrangement, only the minimum guarantee may be recognized as the entity satisfies the performance obligation because the royalties (that is, the consideration that is truly variable) cannot be recognized until the later of when subsequent sales or usage occurs or when the performance obligation has been satisfied (or partially satisfied). In Example 1, the \$5 million minimum guarantee is deemed fixed consideration and the variable consideration is only the royalties in excess of the minimum, or \$3.25 million.

Under View C, the recognition constraint on sales-based or usage-based royalties precludes the recognition of any amounts of variable consideration until the cumulative royalties exceed the minimum guarantee. An entity would apply a measure of progress to the minimum guarantee because only the minimum guarantee can be recognized until the royalty becomes unconstrained (that is, the minimum has been exceeded on a cumulative basis). In Example 1, assuming a time elapsed measure of progress is selected, an entity would recognize \$1 million per year related to the minimum guarantee.

Under View C, the variable consideration only includes the royalties in excess of the minimum guarantee, and those royalties are constrained from being recognized until the customer’s subsequent sale or usage occurs. In order to apply View C, the symbolic license would be considered a series of distinct goods or services (that is, a series of distinct time periods) and the variable consideration (the royalties in excess of the minimum guarantee) would be allocated to the distinct time periods to which they relate. The variable consideration would be recognized in the period in which it can be allocated to the distinct time periods to which it relates. View C applied to Example 1 would result in the following recognition pattern (in 000s):

	<u>Y1</u>	<u>Y2</u>	<u>Y3</u>	<u>Y4</u>	<u>Y5</u>	<u>Total</u>
Royalties received	750	1,500	2,000	1,000	3,000	8,250
Annual revenue	1,000	1,000	1,000	1,250	4,000	8,250
Cumulative revenue	1,000	2,000	3,000	4,250	8,250	

Under View C, an entity does not begin to recognize any variable consideration until the royalties received exceed \$5 million on a cumulative basis because the variable consideration is only the amount in excess of the minimum guarantee of \$5 million. Therefore, in Years 1 to 3, an entity would only recognize the \$1 million per year related to the time elapsed measure of progress for the minimum guarantee, even though cumulative royalties at the end of year 3 are \$4.25 million. In Year 4, cumulative royalties are \$5.25 million and the variable consideration of \$0.25 million (the difference between \$5.25 million and \$5 million) is allocated to Year 4 because this is the time period in which the customer's subsequent sales occurred for the \$0.25 million in variable consideration. Therefore, the variable consideration meets the series allocation criteria in paragraph 606-10-32-40. In Year 5, the entity recognizes \$1 million from the minimum guarantee and \$3 million in variable consideration representing the difference between \$8.25 million and \$5.25 million.

TRG members generally agreed that Views A, B, and C are all reasonable applications of Topic 606 depending upon facts and circumstances. However, TRG members acknowledged that there could be other acceptable applications that were not included in TRG Agenda Ref 58. TRG members observed that the revenue recognition for a license of symbolic intellectual property must be in accordance with various aspects of Topic 606, including but not limited to the following provisions:

- (a) Royalties recognition constraint in paragraph 606-10-55-65: For a license of intellectual property for which the consideration is based on the customer's subsequent sales or usage, an entity should not recognize revenue for the variable amounts before the sales or usage occurs.
- (b) Practical expedient in paragraph 606-10-55-18: The practical expedient in paragraph 606-10-55-18 is an appropriate method to measure progress if an entity has rights to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date.
- (c) Allocation of variable consideration in paragraph 606-10-32-40 (including the series provision): The allocation of variable consideration to a distinct good or service that forms part of a single performance obligation is appropriate if both (1) the terms of a variable payment relate specifically to the entity's efforts to transfer the distinct good or service and (2) allocating the variable amount of consideration entirely to the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28.
- (d) Allocation objective in paragraph 606-10-32-28: The objective when allocating the transaction price is for an entity to allocate the transaction price to each 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.
- (e) Appropriate measure of progress in paragraph 606-10-25-31: The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer.

- (f) Single measure of progress in paragraph 606-10-25-32: An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances.

The staff is aware of certain recognition models that it does not think would be reasonable applications of Topic 606. For instance, it would not be appropriate to apply multiple measures of progress to a single performance obligation, such as one measure for fixed consideration and a different measure for variable consideration. The staff also does not think it would be appropriate to purely apply the breakage model in paragraph 606-10-55-48 because a customer might not have an unexercised right in a license arrangement if the entity is providing the customer with access to its intellectual property over the entire term of the arrangement. Also, an approach that ignores that the royalties recognition constraint in paragraph 606-10-55-65 includes guidance about recognizing revenue at the later of two events would not be appropriate (see paragraph BC71 in Accounting Standards Update No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, for an example about a declining royalty rate).

The staff reminds stakeholders that Topic 606 requires an entity to disclose the significant judgments made in applying the guidance that significantly affect the determination of the amount and timing of revenue from contracts in customers. An entity is required to disclose the methods used to recognize revenue in accordance with paragraph 606-10-50-18 as well as information about significant payment terms, the timing of satisfaction of performance obligations, the methods, inputs and assumptions used for determining the transaction price and changes in the transaction price (paragraph 606-10-50-20).

Question 60: How does a minimum guarantee impact the recognition of sales-based or usage-based royalties promised in exchange for a license of functional intellectual property?

Reference(s): Section 606-10-25

Stakeholders have informed the staff that there are differing views about how a minimum guarantee impacts the accounting for sales-based or usage-based royalties promised in exchange for a license of functional intellectual property. In contrast to symbolic intellectual property, a promise to provide a customer with the right to use functional intellectual property is satisfied at a point in time. The question is whether a guaranteed amount of royalties for a license of functional intellectual property should be recognized at the point in time that control of the license is transferred to the customer.

In the staff's view, the minimum guarantee should be treated as fixed consideration and recognized at the point in time when the license transfers to the customer. A guaranteed amount is not variable consideration; therefore, it is not subject to the royalties recognition constraint.

This treatment could be considered similar to a license of functional intellectual property that has a fixed fee only, in which the revenue is recognized at the point in time the license is transferred to the customer. There is no uncertainty with regard to the minimum guarantee amount, unlike a royalty which is uncertain before the point at which the customer's subsequent sales or usage occurs. In addition, because functional intellectual property is recognized at a point in time, the consideration that is fixed should be recognized when the performance obligation is satisfied. The variable consideration (the royalties above the fixed minimum) would be recognized in accordance with the royalties recognition constraint in paragraph 606-10-55-65.

PRESENTATION

Question 61: How should an entity determine the presentation of a contract that contains multiple performance obligations?

Reference(s): Section 606-10-45, Examples 39 and 40 starting Paragraph 606-10-55-287

Paragraphs 606-10-45-1 through 45-2, together with the definitions of a contract asset and contract liability, explain when an entity has a contract asset and a contract liability. Some stakeholders have questioned whether an entity could have a contract asset and a contract liability for a single contract when, for instance, the entity has satisfied (or partially satisfied) one performance obligation in a contract for which consideration is not yet due but has received a prepayment in respect of another unsatisfied performance obligation in the contract.

Paragraph 606-10-45-1, together with the explanation in paragraph BC317 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, states that contract asset or contract liability positions are determined for each contract on a net basis. In other words, an entity nets each contract to either a contract asset or a contract liability and does not recognize separately a contract asset and a contract liability for a single contract.

In accordance with paragraph 606-10-45-1, if the contract position incorporates an unconditional right to consideration (that is, only the passage of time is required before payment of that consideration is due), that amount is, in effect, extracted from the net contract position and presented separately as a receivable. Therefore, an entity might present a receivable and a contract asset or a receivable and a contract liability (as illustrated in Example 39, Contract Asset Recognized for the Entity's Performance, and Example 40, Receivable Recognized for the Entity's Performance).

As noted in paragraph BC320 of Update 2014-09, the entity would apply other presentation guidance to determine whether to present the sum of its contract assets and the sum of its contract liabilities as separate line items in the statement of financial position. An entity would be able to describe those items using alternative descriptions in accordance with paragraph 606-10-45-5.

Question 62: How should an entity determine the presentation of two or more contracts that have been combined under Step 1 (identify the contract with the customer) in accordance with paragraph 606-10-25-9?

Reference(s): Section 606-10-25

When two or more contracts are entered into at or near the same time with the same customer (or related parties of the customer) and combined in accordance with paragraph 606-10-25-9, an entity accounts for those individual contracts as if they were a single contract. Some stakeholders think that the presentation guidance is unclear about whether the contract asset or contract liability position should be determined for (a) the combined contracts as if they were a single contract or (b) each contract separately. This issue would relate to any scenario in which contracts are combined; however, for some, this issue is more pertinent when the contracts that are combined include contracts with related parties of the customer (that is, the combined contracts are not with the same counterparty).

The contract asset or contract liability position is determined for the combined contracts because the guidance states that they are accounted for as if they were one single contract (paragraph 606-10-25-9).

Paragraph BC72 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, suggests that the objective of combining contracts is to “identify[ing] the contract that is to be accounted for as the unit of account.” In other words, the rights and obligations in the individual contracts are interdependent across the combined contracts and this is best reflected by combining the individual contracts as if they were a single contract. In paragraph BC317, it is acknowledged that the interdependencies of the rights and obligations in a contract are best reflected by accounting and presenting on a net basis the remaining rights and obligations in the statement of financial position.

Question 63: When can an entity offset other balance sheet items against the contract asset or liability?

Reference(s): Sections 606-10-45 and 210-20-15

In addition to requiring the recognition of contract assets and contract liabilities, other assets and liabilities arise when accounting for transactions under Topic 606. Accordingly, stakeholders have raised questions about whether these other assets and liabilities may be offset against the contract assets and contract liabilities. In addition, questions have been raised about whether a contract asset or liability arising from one contract could be offset against a contract asset or liability arising from another contract.

For example, assume that in a single contract, the entity has invoiced the customer and recognized a receivable for that invoiced amount (because it represents an unconditional right

to consideration). Also assume that the entity has collected on previous billed receivables in advance of performance. Therefore, the entity has recognized a receivable for the current amount billed and a contract liability for the prior amounts collected. Stakeholders question if there are any circumstances in which the receivable and contract liability could be offset against each other.

Topic 606 does not provide guidance about offsetting of balances. Current presentation guidance exists in GAAP apart from Topic 606. Most stakeholders think that an entity would apply that other presentation guidance, for example the offsetting principles in other GAAP (such as Subtopic 210-20, Balance Sheet Offsetting) to determine the appropriate netting. The staff agrees with the view of most TRG members that guidance outside of the revenue standard sometimes might need to be referenced when answering this implementation question.

CONTRACT COSTS

Question 64: What is the appropriate accounting for reimbursements from customers for out-of-pocket expenses?

Reference(s): Section 606-10-32

The staff has included detailed analysis of the key provisions in Topic 606 that affect the determination of the appropriate accounting for reimbursements from customers for out-of-pocket expenses. Topic 606 does not include any explicit guidance on the accounting for out-of-pocket expenses. As such, the staff thinks that it is critical to understand the various aspects of the five-step revenue recognition model when discussing Topic 606.

Principal versus Agent Considerations

Topic 606 includes implementation guidance on determining whether an entity is a principal or an agent, which in turn determines whether the entity recognizes revenue on a gross basis or net basis. To do this, an entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or a performance obligation to arrange for those goods or services to be provided by the other party (that is, the entity is an agent). An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. There are three indicators included in the guidance to assist entities with the control evaluation.

The principal versus agent analysis is a key aspect of the revenue standard for the out-of-pocket issue because it narrows the population of contracts affected by that issue. During the April 2018 PCC meeting, several PCC members noted that “pass through expenses” should not have to be estimated and should not have any effect on profit margins. The staff highlights that in cases in which the entity is an agent and the reimbursement is equal to the cost, the net effect on revenue would be zero (and, thus, no estimation would be required).

Identifying Performance Obligations (including a series)

The identification of performance obligations has the following effects on the accounting for out-of-pocket expenses.

- (a) The principal versus agent analysis is performed on a specified good or service, which is analogous to the performance obligation unit of account. That means that if a good or service is distinct, the entity would determine whether it is the principal or agent for that good or service. Conversely, if the good or service is not distinct, that good or service is

combined with other goods or services in the contract and the principal-agent analysis would be determined for the combined performance obligation.

- (b) Whether goods or services are distinct will affect the allocation of the transaction price, specifically whether guidance related to the allocation of variable consideration to one or more performance obligations (or one or more distinct goods or services in a series) may be applied.
- (c) In Step 5 of the five-step model, revenue is recognized either over time or at a point in time for each performance obligation. If goods or services are bundled into a single performance obligation, then an entity would recognize revenue related to that performance obligation using a single method. That is, an entity cannot use Step 5 of the model to circumvent the performance obligation guidance by selecting multiple methods of measuring progress toward satisfying a single performance obligation.

Variable Consideration and the Constraint on Variable Consideration

In applying transaction price guidance to reimbursements of out-of-pocket expenses, an entity may determine that some or all of the transaction price is constrained if any of the factors listed in paragraph 606-10-32-12 exist in the arrangement. For example, in cases in which an entity has strong historical evidence of reimbursements (such as, reimbursements typically are 10 percent of the contract price), an entity may not be constrained in its estimates. In contrast, if the contract spans several years, relates to a new type of service or new type of customer, and therefore the entity is not able to generate reliable estimates, then the transaction price may be constrained at contract inception. If a portion of the transaction price related to reimbursements of out-of-pocket expenses is constrained, an estimate of the reimbursement (or portion thereof) would not be included in the transaction price until it becomes probable that a significant revenue reversal would not occur, which may be when the underlying out-of-pocket expenses are incurred in some cases.

If an entity determines that it needs to estimate the variable consideration, it would develop an estimate using the expected value (sum of probability weighted amounts) or the most likely amount (single most likely amount in a range of estimates) methods, as described in Topic 606. An entity could use a portfolio of information to develop the estimate even if it was not considering the portfolio practical expedient in applying the revenue standard (that expedient permits an entity to apply the guidance to a portfolio of contracts with similar characteristics if the entity reasonably expects the effects on the financial statements to not materially differ). Therefore, a company could consider reimbursement rates across a pool of similar contracts to develop its estimate. For example, if the entity determines that the average rate of cost reimbursements in relation to total contract price is 10 percent, then the entity could apply that 10 percent rate across all contracts rather than determining an estimated rate per contract.

Allocation of Variable Consideration and Practical Expedients

Typically, under the guidance in Topic 606, consideration is allocated to performance obligations on the basis of a standalone selling price analysis. However, when the consideration is variable, additional guidance is provided in paragraph 606-10-32-40 to ease the application of the allocation guidance.

In circumstances in which an entity determines that its performance obligation is a series of distinct goods or services, the guidance in paragraph 606-10-32-40 requires an entity to allocate variable consideration to each distinct service (each day, in the case above) when the criteria are met. As such, the entity would not need to develop any estimates of variable consideration (that is because the variable consideration amount is resolved each and every day). This logic also applies if the contract includes multiple performance obligations and the variable consideration relates to one or some, but not all, of the performance obligations (that is, the guidance in paragraph 606-10-32-40 does not only apply to transactions accounted for as a series).

Recognizing Revenue and Measure of Progress

This section of the Q&A will describe the different methods that entities may use to recognize revenue and how those varying methods align, or don't align, with the timing of the cost expenditure.

In explaining this topic, it is important to note that Topic 606 did not broadly change accounting for costs. There is some new guidance in Topic 340-40 regarding capitalization of costs to fulfill a contract, but beyond the introduction of that new subtopic, cost accounting is largely unchanged. Accordingly, in many cases in which the timing of revenue recognition changes (whether it be accelerated or deferred, as compared to existing GAAP), there will be a change in the timing of margins, because the cost-side of the accounting is unchanged. This phenomenon exists in transactions in many industries, and the out-of-pocket cost reimbursement is one example of this broader effect of adopting the revenue standard. In Topic 606, the key drivers of this timing difference are (a) whether revenue is recognized over time or at a point in time and (b) the entity's selection of measure of progress for revenue recognized over time. Typically, under the guidance in Topic 606, revenue will be recognized over time for service contracts because either (a) the customer simultaneously receives and consumes the benefits or (b) the entity's performance does not create an asset with alternative use and the entity has right to payment for performance completed to date (paragraph 606-10-25-27).

Once an entity determines that revenue should be recognized over time, it is required to select a method for measuring progress toward satisfaction of their performance obligation. The guidance does not prescribe any particular method but, rather, provides the objective "to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation)." The revenue standard goes on to explain that input and output methods can be appropriate, as long as the objective is met.

In cases in which an entity meets the criteria in the guidance to recognize revenue over time using an output method, paragraph 606-10-55-18 includes a practical expedient, and in cases in which it is utilized, an entity would not need to select a specific output method for recognition.

If an entity applies the “as invoiced” practical expedient described in paragraph 606-10-55-18, the timing of the cost being incurred and the billing to the customer would align if the entity has the right to immediately invoice the customer for out-of-pocket expenses incurred. That is because the expedient allows the entity to recognize revenue in the amount at which the entity has a right to invoice. Applying this practical expedient also would allow an entity not to estimate the reimbursement of out-of-pocket expenses as variable consideration, and the accounting result would be similar to the outcomes under the allocation of variable consideration guidance in paragraph 606-10-32-40. For example, if an accounting firm determines that it can recognize revenue over time for performing a consulting service and the amount it may bill depends on the labor hours provided and the out-of-pocket expenses incurred, it could use the right to invoice under the practical expedient and recognize revenue for the reimbursement of out-of-pocket expenses as those costs are incurred.

If an entity applies an input method or, more specifically, if an entity selects a cost-to-cost method, the timing of the cost being incurred and the billing to the customer would also align. Under a cost-to-cost input method an entity recognizes revenue throughout the contract in proportion to the timing and magnitude of when costs are incurred.

As a very simple example of the cost-to-cost method, consider a one-year contract in which a customer estimates billing will be \$100 and costs incurred over the contract term will be \$80 (therefore, a 20 percent profit margin). As each \$1 of cost is incurred by the entity, it would recognize \$1.20 of revenue. Estimates would be updated each reporting period, and to the extent the margin changes (that is, because of a change in estimated billings or estimated costs), the entity would true-up the amounts and use the new margin amount going forward. In this example, revenue is recognized using a levelized margin over the contract period. That is, the 20 percent margin is applied to all costs to calculate revenue and an entity would not record some costs at a margin (or different margins) and other costs at zero margin.

The method described in the example above is essentially how construction entities currently account for contracts under Topic 605-35, Revenue Recognition, Construction-Type and Production-Type Contracts (formerly SOP 81-1). It is important to note that this model (both under existing GAAP and the new guidance) does not differentiate accounting for different types of costs. That is, the accounting isn’t dependent on how the billings are structured to cover costs (that is, whether the contract is fixed price or cost plus a margin or cost reimbursement with no margin). During the April 2018 PCC meeting, one of the PCC members discussed the adoption of the revenue standard by a client in the construction and engineering industry and that PCC member observed that there was little effect from the adoption of the revenue standard (as it relates to estimating cost reimbursements) for that client. The example in the paragraph above, as well as in comparison to prior accounting, explains why that is the case. In summary, in circumstances in which entities are applying a cost-to-cost measure of progress today (for example under guidance in Subtopic 605-35) and also select a cost-to-cost measure of input

under the new guidance, there should not be a difference in how reimbursements billed to customers are accounted for.

Materiality

While materiality is not a topic explicitly addressed in Topic 606, the staff thinks that consideration of materiality on this issue is important, particularly because many outreach participants noted that, in many cases, this issue has not resulted in material differences, as compared to existing GAAP, for their clients who have already adopted Topic 606.

At the April 2018 PCC meeting, several PCC members indicated that this issue would be material to private companies because the magnitude of reimbursements of out-of-pocket expenses in relation to the total contract price would be material. However, the staff thinks that materiality also could be evaluated by comparing the amount of revenue that would be recognized each period by applying Topic 606 (that is, recognizing the total expected reimbursements using the selected measure of progress) and the amount of revenue that would be recognized each period by recording revenue when the expenses are incurred. In situations in which the timing of the expenses is consistent with the measure of progress selected for the performance obligation (for example, the expenses are incurred proportionately as the service is performed), the difference between the amounts recognized as revenue under the two methods may not be material.

Consider the following example to illustrate this point. An entity is performing a one-year consulting service for \$1,000,000. The entity has assigned five consultants to the project and those consultants will incur travel expenses (hotel and airfare) throughout the duration of the contract (assume the consultants travel to the client site each week and then travel home on weekends). The entity estimates the reimbursements will be \$260,000 for the year (\$1,000 per consultant per week). Assume that the entity is not able to apply any of the practical expedients in the revenue standard and therefore would be required to estimate the reimbursements as part of the transaction price.

In this example, the staff observes that the total reimbursements of \$260,000 is clearly material in relation to the \$1,000,000 contract price. However, because the expenses are incurred evenly over the contract term, there would not be a material effect on the timing of revenue recognition if the entity decided to apply an accounting convention or policy to record the reimbursements as the costs are incurred because the difference between that method and estimating the expenses and applying a measure of progress to them is not expected to be material.

Therefore, the pattern of when the costs are incurred will affect an entity's assessment of materiality and therefore whether they may be able to apply a simpler accounting convention. As illustrated above, when costs are incurred ratably over the contract period, the effect of the revenue standard is likely to not be material. Conversely, if the cost pattern is lumpy, such as when large amounts of costs are incurred upfront or at the back end of the contract, then the effect of the revenue standard is more likely to be material.

Summary

As described above, there is not explicit guidance on the accounting for reimbursements of out-of-pocket expenses, and so, accordingly, an entity would need to consider how the five-step model applies to the contract in totality to understand the accounting for the reimbursements. On the basis of the various aspects of the guidance described in this Q&A (and that were also cited by outreach participants), the following is a summary of areas under which an entity may not be required to have a change in estimating variable consideration related to reimbursements of out-of-pocket expenses:

- (a) The entity is an agent as it relates to the specified good or service.
- (b) The variable consideration is constrained.
- (c) The variable consideration relates specifically to a performance obligation or a distinct good or service in a series.
- (d) The entity is able to apply the “as invoiced” practical expedient.
- (e) The entity applies a cost-to-cost measure of progress under existing GAAP and will provide a similar measure of progress under Topic 606.

If none of the items above apply to an entity, then it likely would be required to estimate reimbursements as part of Step 3, Determining the Transaction Price. That is because, when none of the items above are met, the reimbursement of the expenses is no different from any other consideration that the entity collects as part of its transaction price. In other words, the accounting in this case should not be different depending on how the entity structured the contract.

As described in the materiality section above, to the extent that costs are incurred in the same pattern as the performance obligation is satisfied (for example, ratably), there is not likely to be a financial reporting effect of this change. Additionally, if an entity needs to estimate the reimbursements, it may consider a portfolio of information in developing its estimates which is likely to be more operable than estimating reimbursements on a contract-by-contract basis.

In cases in which the revenue standard requires estimation, outreach participants stated that many companies are providing materiality analysis to their auditors to justify retaining their current practices. Therefore, the remaining population of contracts under which an entity would be required to estimate reimbursements appears to be narrow. The staff has struggled with defining those exact scenarios that would require estimation (that is because most contracts discussed during outreach fall under the exclusions in paragraph 51) but, broadly, it appears that it would be when the performance obligation is satisfied at a point in time or when the measure of progress timing does not align with reimbursement timing. The following is the most common example the staff could think of that would fall under this requirement because it does not fall under any of the exclusions listed above. Consider the following facts.

Entity X performs a consulting service (assume a single performance obligation) for a fixed fee of \$150,000 plus reimbursements of out-of-pocket expense for the use of a specialist. The specialist is expected to be engaged towards the end of the contract and the cost of the specialist is estimated to be \$15,000. Assume that the contract meets the criteria for over time recognition in paragraph 606-10-25-27. In selecting a measure of progress, the entity determines that a labor-hours input method best matches its level of progress towards completing the contract. The entity expects that the job will take 600 hours to complete.

At the end of the reporting period, the entity has completed 300 hours of the work. As such, the revenue recognition for the reporting period would be calculated as follows: the transaction price is \$165,000 (\$150,000 fixed fee plus \$15,000 variable consideration). The contract is 50% complete (300/600 labor hours). Revenue is \$82,500 (\$165,000 transaction price × 50%).

In summary, on the basis of the staff's outreach discussions and analysis of Topic 606 guidance, it appears that many public companies have been able to avoid the need to estimate out-of-pocket reimbursements using already existing guidance in Update No. 2014-09. In scenarios in which a company is required to estimate the reimbursement, the outreach shows that most companies retain current practice by asserting that the change is immaterial. For those companies for which the reimbursements are material, they have handled implementation by (a) developing estimates at a portfolio level, (b) implementing thresholds for the accounting (that is, only estimating reimbursements over a certain amount), or (c) implementing new tracking systems.

The staff thinks that the information described above about the application of Topic 606 and how public companies have practically dealt with implementing the guidance could serve as education for private companies to leverage in their implementation of Topic 606.

Question 65: Should customer reimbursements for pre-production costs be presented as revenue or contra expense?

Reference(s): Section 606-10-15

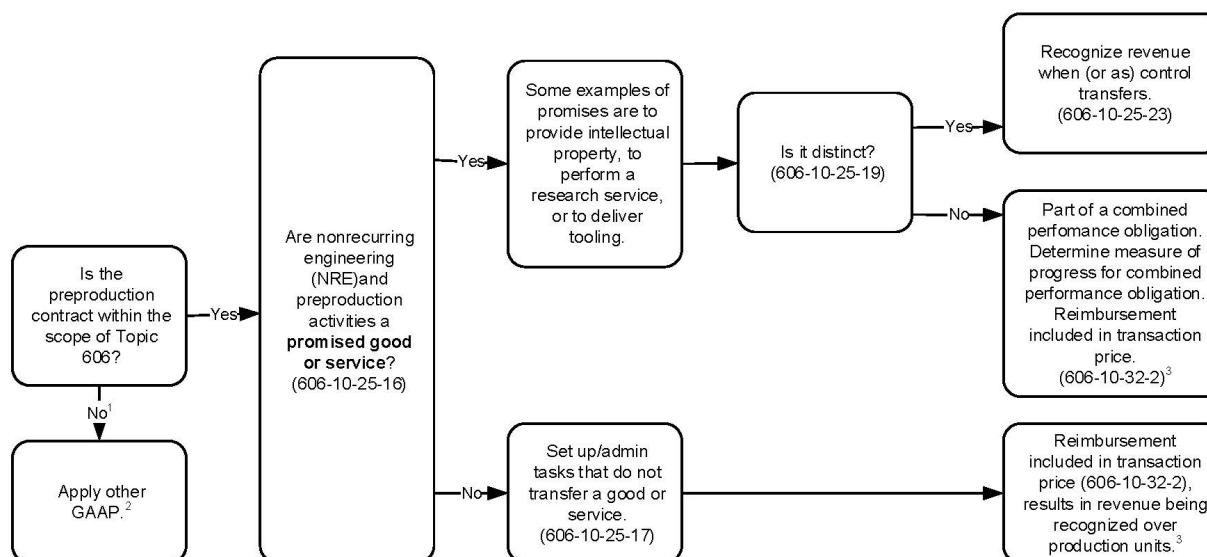
Under current GAAP, the staff understands that some entities conclude that the presentation of customer reimbursements is revenue or contra-expense (or other income) depending on whether they view the arrangements as within the scope of the revenue guidance and on the basis of their views of whether the nonrecurring engineering and pre-production is a deliverable in Topic 605, Revenue Recognition.

Upon adoption of the amendments in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, the accounting framework that will be applied to presentation of customer reimbursements, at a high level, is similar to current GAAP. First, entities will assess whether a transaction is within the scope of Topic 606. If the transaction is within the scope of Topic 606, then the entity will determine whether the activities are a performance obligation. To identify performance obligations, an entity will (a) identify promised

goods or services in the contract with a customer and (b) determine whether those promises are distinct. This assessment will require judgment.

The staff believes that when an entity is evaluating its accounting for reimbursements from customers for nonrecurring engineering and pre-production costs, it should consider the disclosure requirements for the cost guidance that is applied; the disclosures in Topic 606, if the payment is within the scope of Topic 606; the disclosure requirements about accounting policies in Topic 235; and other applicable disclosure requirements in GAAP.

The following flow chart depicts the decision process for evaluating how to present reimbursements from customers. The flow chart does not include all of the guidance in Topic 606 and is not intended as a substitute for the guidance in that Topic.



¹For example, the activities do not constitute an entity's ongoing major or central operations (Master Glossary—Revenue).

²This may result in the reimbursement being recorded as other income or as contra-expense.

³If the NRE and the subsequent production units are in a single contract or the contracts meet the criteria for contract combination in paragraph 606-10-25-9, this may result in revenue being recognized over subsequent production units.

Question 66: What guidance should be applied upon the adoption of Topic 606 to determine whether nonrecurring engineering and pre-production costs should be capitalized or expensed?

Reference(s): Section 340-10-15

Some stakeholders have raised a question about accounting for pre-production costs for contracts that previously were accounted for under Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts, which was superseded by Topic 606.

Although there was no guidance specific to pre-production in Subtopic 605-35, the staff thinks that most construction entities considered those types of costs as contract costs within the scope of that guidance. This question arises because the scope of Subtopic 340-10, Other Assets and Deferred Costs—Overall, (which was not amended by Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*), states that the guidance applies to all entities (paragraph 340-10-15-2). However, before the issuance of Update 2014-09, the guidance on costs for construction-type and production-type contracts was included in Subtopic 605-35, rather than Subtopic 340-10.

The basis for conclusions of Update 2014-09 (paragraph BC305) explains that the new cost guidance in Subtopic 340-40 is intended fill the gap arising from the withdrawal of previous revenue guidance including previous guidance on accounting for construction contracts. Therefore, the staff thinks that those costs related to contracts appropriately accounted for within the scope of Subtopic 605-35 currently should be accounted for in accordance with the new guidance in Subtopic 340-40 when applying Update 2014-09.

Upon adoption of Topic 606 (the amendments in Update 2014-09), the following cost guidance is applicable:

- (a) Subtopic 340-10, Other Assets and Deferred Costs—Overall: Pre-production costs are expensed as incurred unless a contractual guarantee for reimbursement from the customer exists. Design and development costs for molds, dies, and other tools that a supplier will not own and that will be used in producing the products under the long-term supply arrangement are capitalized if the supply arrangement provides the supplier the noncancelable right to use the molds, dies, and other tools during the supply arrangement. This guidance was not superseded and remains GAAP.
- (b) Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers: The Board issued cost guidance in Subtopic 340-40 at the same time it issued Topic 606. The guidance on costs to fulfill a contract in Subtopic 340-40 requires an entity to recognize an asset from the costs to fulfill a contract if those costs meet certain criteria. The scope in paragraph 340-40-15-3 explains that this guidance applies to costs incurred in fulfilling a contract with a customer within the scope of Topic 606 unless the costs are within the scope of another Topic or Subtopic.
- (c) Topic 730, Research and Development: Research and development is expensed as incurred. The guidance does not apply to accounting for the costs of research and development activities conducted for others under a contractual arrangement. This guidance was not superseded and remains GAAP.

Guidance on precontract costs in Subtopic 605-35, Revenue Recognition— Construction-Type and Production-Type Contracts, was superseded by Update 2014-09 and, therefore, no longer will be GAAP following the adoption of Update 2014-09. That guidance required precontract costs to be deferred when they were incurred in anticipation of a specific contract that would result in no future benefit unless the contract was obtained (such as the costs of mobilization,

engineering, architectural, or other services incurred on the basis of commitments or other indications of interest in negotiating a contract).

The following summarizes the staff's analysis on this issue.

- (a) The basis for conclusions of Update 2014-09 explains that the revenue project did not include a comprehensive cost project. Therefore, the issuance of Update 2014-09 is not expected to resolve all existing diversity in practice in cost accounting.
- (b) Stakeholders questioned the scope of the guidance in Subtopic 340-40, in part, because the scope guidance in Subtopic 340-10 and other areas of GAAP is unclear in practice for some fact patterns. Consequently, some stakeholders noted that they expect some diversity in which model is applied given the practice questions that existed before Topic 606 about the scope of the cost guidance.
- (c) The staff's view is that the scope guidance in Subtopic 340-40 is not intended to preclude entities from reassessing their historical accounting. For example, assume today an entity is applying Subtopic 340-10 or another area of GAAP by analogy because the scope of the guidance is unclear, or no GAAP directly addresses the entity's transaction. The staff thinks it would be acceptable for that entity to evaluate the scope of Subtopic 340-40 and, if appropriate, apply Subtopic 340-40.
- (d) The staff's view is that the guidance in Subtopic 340-40 does not require an entity to holistically reassess all of its historical cost capitalization practices. For example, many entities have made judgments today about which costs are eligible for capitalization, such as judgments about what constitutes direct and indirect contract costs in accordance with cost guidance in Subtopic 605-35. Today, different companies judge those questions in different, but reasonable ways. Similar judgments will be required in determining which costs constitute direct and indirect costs when complying with the cost capitalization guidance in Subtopic 340-40.
- (e) The staff's view is that when an entity is evaluating its accounting for nonrecurring engineering and pre-production costs, it should consider disclosure requirements for the cost guidance that is applied; the disclosure requirements about accounting policies in Topic 235, Notes to Financial Statements; and other applicable disclosure requirements in GAAP.

Question 67: Are the costs incremental if they are contingent on future events?

Reference(s): Sections 606-10-25 and 340-40-35

Consider the following example:

A commission is paid in installments over a period of time (for example, one fourth of the total commission is paid every six months), but the payments cease if the customer fails to perform. Would the commissions scheduled to be paid after contract inception be considered costs to obtain the contract?

The staff's view is that in the example above, the total commission from the contract (that is, the initial and each of the subsequent payments) should be capitalized at contract inception. If the customer fails to perform, any unamortized capitalized costs would be considered for impairment.

If the contract qualifies for recognition under paragraph 606-10-25-1 (that is, it "passes" Step 1—identify the contract with the customer), then the entity must have already concluded that the parties to the contract are "committed to perform their respective obligations" (paragraph 606-10-25-1(a)). Therefore, the entity should capitalize its incremental costs of obtaining the contract based on that conclusion. The fact that the payment of the earned commission will occur over time does not affect whether the full commission is capitalized upon obtaining the contract. If circumstances subsequently change, such that there is doubt about whether the customer will perform its future obligations, then the entity would both (i) reassess whether there is a valid contract between the parties and (ii) assess the contract cost asset for impairment in accordance with paragraph 340-40-35-3. The staff notes that it is important to remember that contract cost asset impairment is assessed against amounts the entity expects to receive in exchange for the goods or services to which the contract cost asset relates.

Question 68: Should commission payments subject to clawback (that is, repayment to an entity if the customer does not perform) be capitalized as an incremental cost of obtaining a contract?

Reference(s): Section 606-10-25

If the contract qualifies for recognition under paragraph 606-10-25-1 (that is, it "passes" Step 1—identify the contract with the customer), then the entity must have already concluded that the parties to the contract are "committed to perform their respective obligations" and the entity should capitalize the commission payments. If circumstances subsequently change such that there is doubt about whether the customer will perform its future obligations, then the entity would both (i) reassess whether there is a valid contract between the parties and (ii) assess the contract cost asset for impairment.

Question 69: Should commissions based on achieving cumulative targets be capitalized?

Reference(s): Sections 340-40-25 and 340-40-35

Commission plans for initial contracts and contract renewals for a specific employee might be established such that the commission is subject to a cumulative contract threshold. For instance, fixed or percentage commissions may commence or change once a specified threshold is achieved for the cumulative number or value of contracts. Some stakeholders have raised questions about how and whether commissions for those types of plans should be capitalized.

The discussion in paragraph BC302 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, was not intended to preclude entities from capitalizing costs that are payable on achieving cumulative targets because that discussion in paragraph BC302 is in the context of explaining that the Board considered whether to allow an accounting policy election for contract costs under which an entity would have been able to choose to recognize an asset from the contract acquisition costs or recognize those costs as an expense.

The following examples illustrate various cumulative threshold scenarios. For purposes of these examples, the staff has assumed the practical expedient for contract costs with an expected amortization period of one year or less does not apply.

In Example 1, once a cumulative threshold *number* of contracts is reached, commission is paid on individual contracts as a percentage of the value of each contract.

Example 1

1–5 contracts	0% commission
6–10 contracts	3% of individual contract price
11+ contracts	5% of individual contract price

In Example 2, once a cumulative threshold *value* of contracts is reached, commission is paid on individual contracts as a percentage of the value of each contract.

Example 2

First CU1 million contracts	0% commission
Next CU4 million contracts	3% of individual contract price
More than CU5 million contracts	5% of individual contract price

The staff thinks that either of the following could be acceptable based on the guidance in the Topic 340:

- (a) View 1—When the contract taking the aggregate value over CU1 million is signed, 3% of the contract price of that and successive contracts should be capitalized as an incremental cost of obtaining a contract until the CU5 million aggregate value is reached, when 5% of the contract price of that and successive contracts should be capitalized.
- (b) View 2—The entity should estimate the total amount of commission to be earned for the period, and a ratable amount of commission costs should be capitalized upon the signing of each contract.

The staff thinks that if an entity accrues commission amounts it expects to pay because they are probable and estimable (GAAP), then View 2 may be appropriate. This is because to recognize expense as the amount is accrued (Dr. Expense, Cr. Accrued Commission) during the period (and potentially across reporting periods) only to then reverse that expense in the period in which the commission is paid (Dr. Contract Cost Asset, Cr. Expense) might not produce representationally faithful results.

The staff thinks View 2 is consistent with the guidance in paragraphs 340-40-25-1 through 25-2. The costs that are being accrued and capitalized (if recoverable) are incremental to obtaining the contract that triggers the accrual and would not have been accrued had the contract not been obtained.

The staff thinks it also would be reasonable to apply View 1. The words in paragraph 340-40-25-2, as applied to this and the previous example, could reasonably be read to say that the 3% commission earned on contract 6 or on the contract that takes the salesperson’s sales total above CU4 million is incremental to obtaining that contract and was not payable until that contract was obtained.

In Example 3, once a cumulative threshold number of contracts is reached, commission is paid on that contract as a percentage of the cumulative value of that contract and the preceding contracts, taking into account any commission already paid.

Example 3

1–5 contracts	0% commission
6–10 contracts	3% of value of contracts 1–6
11+ contracts	5% of value of contracts 1–11

(including commission already paid for contracts 6–10)

Consistent with Examples 1 and 2 above, the staff thinks either View 1 or View 2 could be acceptable based on the guidance in Topic 606. The staff’s rationale for this conclusion is consistent with the rationale outlined in the discussion of those previous examples:

- (a) View 1—When contract 6 is signed, 3% of the cumulative prices of contracts 1–6 should be capitalized as an incremental cost of obtaining contract 6.
- (b) View 2—The entity should estimate the total amount of commission to be paid for the period, and a ratable amount of commission costs should be capitalized upon the signing of each contract.

The entity would then need to assess whether the commission is recoverable and the appropriate pattern of amortization.

If the entity applies View 2, the entity would amortize the commission accrued for each contract in accordance with paragraphs 340-40-35-1 through 35-2.

If the entity applies View 1 in Example 3, the entity might determine that the commission that only became payable upon obtaining contract 6 relates to the goods and services in contracts 1–6 and the commission payable on contract 11 relates to the goods and services in contracts 1–11. To do otherwise might result in counterintuitive accounting results if, for example, the commission paid upon obtaining contract 6 was large in relation to the transaction price for only contract 6. Allocating the entire commission paid upon obtaining contract 6 to only that contract might result in a margin that is not representative of the economics of the arrangement either for contract 6 or for the other contracts to which none of the commission was allocated.

Example 4, paying a lump-sum commission effectively in advance (after the first contract is obtained), has been provided to further illustrate the concepts discussed above. In this example, the first commission is paid when the first contract is signed and subsequently, once a cumulative threshold number of contracts is reached, commission is paid on that threshold contract as a fixed escalating amount, taking into account any commission already paid.

Example 4

1 contract.....	CU3,000 commission
10 contracts.....	CU5,000 cumulative commission (including CU3,000 already paid)
15 contracts.....	CU10,000 cumulative commission (including CU5,000 already paid)

Assume 11 new contracts are signed by a specific employee in the period.

Consistent with Examples 1 through 3 above, the staff thinks either View 1 or View 2 could be acceptable based on the guidance in Topic 606. The staff’s rationale for this conclusion is broadly consistent with the rationale outlined in the discussion of Examples 1 through 3. This example differs, however, from Examples 1 through 3 because, after contract 1 is executed, the entity would be required to accrue the CU3,000 it contractually owes the salesperson (under either View 1 or 2). Under View 2, the entity would recognize a contract cost asset of CU455 (assuming 11 contracts will be obtained) and a prepaid commission of CU2,545 (CU3,000 – CU455) at the time it accrues the CU3,000 owed to the salesperson. The prepaid commission

would be recharacterized as a contract cost asset as each subsequent contract was obtained (Dr. Contract Cost Asset CU455, Cr. Prepaid Commissions CU455). The contract cost asset recognized for each contract (CU455 in this example) would be amortized in accordance with paragraphs 340-40-35-1 and 35-2.

View 1

Once the first contract is signed, CU3,000 should be capitalized as an incremental cost of obtaining the contract. No additional amounts are capitalized upon signing contracts 2–9 because the next commission “tier” has not been met. Once the tenth contract is signed, an additional CU2,000 should be capitalized.

View 2

The entity should estimate the total amount of commission to be paid for the period, and a ratable amount of commission costs should be capitalized upon the signing of each contract. In this example, if the entity estimates 11 contracts will be signed, the entity would capitalize CU455 when each contract is signed (CU5,000, divided by the 11 contracts signed equals CU455 to be capitalized as the commission amount per contract).

If the entity applies View 1, the entire CU3,000 that is accrued is recognized as a contract cost asset (that is, no prepaid commission). The CU3,000 commission that became payable upon obtaining contract 1 might be disproportionately high compared to the value of contract 1 such that amortizing the contract cost asset based solely on the transfer of goods and services in contract 1 would produce results that are not representationally faithful. In this case, even if the commission is recognized entirely as a contract cost asset at the time the CU3,000 commission is incurred, the entity might reasonably determine that the commission relates to the goods and services that will be transferred in contract 1 and future anticipated contracts. When contract 10 is executed and an additional CU2,000 commission is incurred, the entity’s accounting for that incremental commission amount may vary depending on the entity’s previous determination as to what goods or services the initial CU3,000 commission relates to.

In this example, View 2 might be simpler to apply and produce more intuitive results than View 1, but as noted, the staff thinks either view could be acceptable based on the guidance. The staff notes that similar considerations to those in Example 3 would apply to determining recoverability and in subsequently assessing the contract cost asset for impairment, as well as determining the amortization period.

Question 70: How should an entity determine capitalization of commissions paid on renewals after the initial contract is obtained?

Reference(s): Section 340-40-25

This issue arises when a commission plan provides an employee with a commission for each contract obtained with a customer, as well as an additional commission each time that same customer renews the contract. In those circumstances, some have questioned what amount should be capitalized.

Consider the following example:

A sales employee is paid a commission for each contract obtained with a customer – CU100 is paid for a new customer contract. CU60 is paid each time that same customer renews the contract. Assume the CU60 renewal commission is not considered commensurate with the CU100 commission paid on the initial contract.

The staff thinks that the following view is in accordance with Topic 606: Capitalize the CU100 paid for the new customer contract at contract inception. Capitalize the CU60 for each renewal upon renewal because it is considered an incremental cost that would not have been incurred if the renewal contract was not obtained.

Question 71: How should an entity determine the amortization period of commissions paid on renewals after the initial contract is obtained?

Reference(s): Section 340-40-35

Consider the following example:

A sales employee is paid a commission for each contract obtained with a customer – CU100 is paid for a new customer contract. CU60 is paid each time that same customer renews the contract. Assume the CU60 renewal commission is not considered commensurate with the CU100 commission paid on the initial contract.

The overriding principle for amortization of contract cost assets is set out in paragraph 340-40-35-1 and further discussed in paragraph BC309 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*.

If the renewal contract is not a specifically anticipated future contract the staff thinks it would be appropriate to amortize the CU100 paid for the new customer contract over the original contract term and to amortize each capitalized renewal amount over the respective renewal period. Note that this view would also be appropriate if the renewal commission were to be considered commensurate with the initial commission.

Except in the circumstance above, the staff thinks that either of the following alternatives might be acceptable based on the guidance in Topic 606, if applied consistently to similar circumstances. Similar to current GAAP, an entity will need to consider its individual facts and circumstances to make judgments about the amortization pattern and period for capitalized contract costs.

- (a) Amortize the initial amount capitalized over the contract period that includes the specific anticipated renewals (that is, over the expected customer relationship). Amortize each capitalized renewal amount over the respective renewal period.
- (b) Separate the amortization of the CU100 capitalized into two components: amortize CU60 over the original contract term and CU40 over the period of the initial contract and the specific anticipated renewals. Upon renewal, capitalize CU60 and amortize it over the renewal period.

Question 72: How should an entity evaluate whether a commission paid for a renewal is “commensurate with” a commission paid on the initial contract (when determining the appropriate amortization period for an initial commission)?

Reference(s): Section 340-40-35

The Board clarified the guidance in paragraph 340-40-35-1 in paragraph BC309 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, that: “However, amortizing the asset over a longer period than the initial contract would not be appropriate in situations in which an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract.”

The discussion in the basis for conclusions is helpful in some scenarios (for example, if the commission paid upon renewal is similar in amount to the initial commission paid). However, questions have arisen about how an entity should interpret the phrase “commensurate with” when determining the appropriate amortization period (for example, when a commission is paid for renewals, but at an amount less than the initial commission).

The Oxford English Dictionary defines “commensurate” as “corresponding in size or degree, in proportion” giving the examples “salary will be commensurate with age and experience” and “such heavy responsibility will receive commensurate reward.”

The staff thinks that, in general, it would be reasonable for an entity to conclude that a renewal commission is “commensurate with” an initial commission if the two commissions are reasonably proportional to the respective contract value (for example, 5% of the contract value is paid for both the initial and the renewal contract). Similarly, the staff thinks it would be reasonable for an entity to conclude that a renewal commission is not “commensurate with” an initial commission if it is disproportionate to the initial commission (for example, 2% renewal

commission as compared to a 6% initial contract commission). The staff does not think entities should have to undertake complex analyses to demonstrate a proportional renewal commission is “commensurate with” an initial commission or to demonstrate that a disproportionate renewal commission is not “commensurate with” an initial contract commission.

However, in practice, it is not unusual for it to be no more difficult to obtain a renewal than it is to secure the initial contract, or it might be less difficult as the incumbent of a contract to secure a renewal (for example, if there are barriers to the customer changing supplier or it is costly or difficult to establish new customer relationships). Accordingly, in some circumstances, if the renewal commission is less than the initial commission, it might still be “commensurate with” the initial commission. This will depend on the specific facts and circumstances and, therefore, judgment might be required.

Some stakeholders informed the staff that they interpret the staff’s view above to mean that an entity can consider whether (a) the initial commission is commensurate with the level of effort to obtain the initial contract and (b) the renewal commission is commensurate with the level of effort to obtain the renewal contract. For example, assume the initial commission rate is 7% and the renewal commission rate is 2%. The entity concludes that the commission paid for the initial contract and the commission paid for the renewal contract are commensurate with the level of effort of obtaining each of those contracts. The rates are different because the sales group that obtains a new contract spends substantially more time winning new business than a different sales group spends obtaining customer renewals. Under this interpretation of some stakeholders, the anticipated contract renewal would not be included in the amortization period of the asset for the initial commission.

The staff does not think that interpretation is consistent with Subtopic 340-40. In the staff’s view, the key question is not whether a commission is commensurate with the level of effort to obtain the contract. The level of effort is about the past and it is not about the period over which the entity will transfer goods or services to which the asset relates. The staff expects that most entities pay their employees a commission that is commensurate with the level of effort required to obtain the business, whether it be to obtain an initial contract or a renewal contract. In the staff’s view, the key question is about the transfer to the customer of goods or services to which the asset relates—considering the initial contract and specific anticipated contracts.

In the staff’s view, the example provided above is a straightforward way to determine whether the renewal commission is commensurate with the initial commission. The staff thinks this approach is consistent with Topic 606 and is a practical approach to assessing whether the commissions paid for the initial and renewal contracts are commensurate.

The staff noted that assessing whether a renewal commission is commensurate with an initial commission solely on the basis of the level of effort to obtain the contract would not be consistent with the guidance in Subtopic 340-40 and the basis for conclusions of Update 2014-09.

Question 73: Should commissions earned on contract modifications that are not treated as separate contracts be capitalized?

Reference(s): Sections 606-10-25 and 340-40-25

Consider the following example:

An employee receives an initial commission based on the contract price when the contract is obtained. This commission is considered incremental, so it is capitalized under Topic 606.

Subsequently, the customer modifies the contract to purchase additional goods, and the modification does not result in the company accounting for the modification as a separate contract in accordance with paragraph 606-10-25-12. Based on the company's policy, the employee is paid an additional commission based on the increase in the contract price from the modification.

The staff's view is that even though the contract modification is not accounted for as a separate contract, the increase in the contract price results in a cost (that is, the commission) that is incremental to obtaining the modified contract. Therefore, the additional commission paid is an incremental cost of obtaining a contract and should be capitalized.

If the entity does not account for the contract modification as a separate contract in accordance with paragraph 606-10-25-12, then it is accounted for in one of two alternative ways depending on the facts and circumstances:

- (a) Firstly, it may be accounted for it as if it were "a termination of the existing contract and the creation of a new contract" under paragraph 606-10-25-13(a). In this case the additional commission is an incremental cost of obtaining the new contract and should be capitalized.
- (b) Secondly, it may be accounted for as if it were a part of the existing contract under 606-10-25-13(b). Paragraph 340-40-25-1 refers to the "incremental costs of obtaining a contract," not to the initial incremental costs of obtaining a contract. It would appear, therefore, that an additional commission paid on a contract that is accounted for as part of the existing contract should be capitalized.

Question 74: Should an entity consider fringe benefits in the assessment of determining the amount of commissions to record as incremental costs (for example, payroll taxes, pension / 401K match, FICA)

Reference(s): Section 340-40-25

The staff's view is that when fringe benefits are the result of an allocation of an employee's total benefits and wages, they are not considered part of the total incremental cost of obtaining a contract and should not be capitalized. This view would appear to be appropriate only if the fringe benefits are an allocation of costs that would have been incurred whether the contract had been obtained (for example, an allocation of company car depreciation costs) or not.

The staff's view is that when the fringe benefits are incurred as a direct result of incurring the commission (for example, payroll taxes or pension costs the entity is required to pay as a result of the commission earned by the employee for obtaining the contract), the fringe benefits should be capitalized as part of the total incremental cost of obtaining a contract if those additional costs are based on the amount of commissions paid because they are costs "that would not have been incurred if the contract had not been obtained."

Question 75: How should an entity determine the pattern of amortization for a contract cost asset that relates to multiple performance obligations that are satisfied over disparate points or periods of time?

Reference(s): Section 340-40-35

Consider the following example:

An entity enters into a contract with two performance obligations for which performance occurs over two years. The entity pays a commission to obtain the contract that is required to be capitalized under Subtopic 340-40. The capitalized asset relates to the transfer of goods and services for the entire contract.

The first performance obligation is satisfied at or near contract inception and represents 80% of the total allocable transaction price. The second performance obligation (20% of the total allocable transaction price) is satisfied over the term of the contract.

It appears that, depending on the specific facts and circumstances, either of the following views might satisfy guidance in paragraph 340-40-35-1 to "mirror" the pattern of transfer of the goods and services to the customer for the contract as a whole:

- (a) View A—Allocate the asset to the individual performance obligations on a relative basis (in proportion to the transaction price allocated to each performance obligation) and amortize the respective portion of the asset based on the pattern of performance for the

underlying performance obligation (for example, in this scenario, 80% of the contract cost asset would be amortized at or near inception and the remaining 20% over the contract term).

- (b) View B—Amortize the single asset using one measure of performance considering all of the performance obligations in the contract. Use a measure that best reflects the “use” of the asset as the goods and services are transferred. Note that this approach may result in a similar pattern of amortization as View A, but without any specific allocation of the contract cost asset to individual performance obligations.

View B may be more operational for some entities because it would not require a relative standalone selling price allocation of the contract cost asset. However, the staff would expect outcomes between View A and View B to be reasonably similar in most cases.

Stakeholders have further questions about how the amortization pattern would be affected in the above example if the entity anticipates future contracts but the number and timing of satisfaction of the performance obligations in those anticipated contracts is unknown.

The staff thinks that anticipation of future contracts does not fundamentally affect that either View A or View B could be applied. The staff thinks that either approach can be extended to include the expected profile of the transfer of the goods and services in the specifically anticipated future contracts, so that the pattern of amortization would reflect the revenue profile of the expected transfer of the goods and services in both the initial and expected future contracts.

The staff also thinks it is important to remember that most entities currently have processes in place to make estimates about the pattern and timing of amortization or depreciation for other assets that commonly are more significant than capitalized sales commissions (for example, a building, an acquired brand, or a non-compete agreement). The staff thinks in most cases the effort necessary to properly amortize capitalized sales commissions would not be more than the effort to amortize/depreciate other assets.

Finally, the staff thinks that it is important to remember that Topic 606 includes guidance about testing capitalized sales commissions for impairment. The staff thinks that if an entity selects an unreasonable amortization period, then the asset might become impaired.

Question 76: How should an entity account for fulfillment costs incurred before the Contract Establishment Date (CED)?

Reference(s): Paragraph 340-40-25 and Section 340-40-35

Entities sometimes commence activities on a specific anticipated contract either (a) before agreeing the contract with the customer or (b) before the contract with the customer satisfying the criteria in Topic 606 to apply the general revenue recognition model.

For convenience, in this Q&A the date on which the criteria in paragraph 606-10-25-1 are satisfied is referred to as the “Contract Establishment Date (CED)” and the activities that an entity performs before the CED are referred to as “pre-CED activities.”

These pre-CED activities may be:

- (a) Activities, such as administrative tasks that neither result in the transfer of a good or service to the customer, nor fulfill the anticipated contract
- (b) Activities to fulfill the anticipated contract but which do not result in the transfer of a good or service, such as set-up costs
- (c) Activities that transfer a good or service to the customer at or after the CED.

The question that arises is how to account for the costs from the pre-CED activities that result in the transfer of a good or service to the customer as at the CED. The analysis in this Q&A is relevant only when the entity concludes that a contract has not been identified for the purposes of Topic 606 before the CED.

The staff’s view is that costs incurred before the CED are costs to fulfill an anticipated contract and would be recognized as an asset under the guidance in Subtopic 340-40. Costs would be expensed immediately at the CED if they relate to progress made to date because the goods or services constituting a performance obligation have already been transferred to the customer. The remaining asset would be amortized over the period over which the goods or services to which the asset relates will be transferred to the customer.

The staff notes that applying the above view to a contract which does not satisfy the criteria in paragraph 606-10-25-1 until the CED would result in the same cumulative recognition of costs and hence margin at the CED and in future periods as a contract that had met the criteria in paragraph 606-10-25-1 from the inception of the contract. The two contracts will be identical and hence economically equivalent from the CED. Therefore, the staff thinks that this view will more accurately reflect the economics of the contract and therefore provide users of the financial statements with more decision-useful information.

However, the staff notes that certain costs may not satisfy the criteria in paragraph 340-40-25-5 for recognition as an asset, for instance general and administrative costs that are not explicitly chargeable to the customer under the contract or costs of wasted materials, labor or other resources to fulfill the contract that were not reflected in the price of the contract. In accordance with paragraph 340-40-25-8 such costs are expensed when incurred.

Additionally, costs that do not satisfy the criteria in other relevant GAAP or IFRS Standards or in the guidance in paragraph 340-40-25-5 for recognition as an asset would be expensed as incurred in accordance with paragraph 340-40-25-8.

Question 77: How should an entity account for restocking costs for expected widget returns (for example, estimated shipping or repackaging costs)?

Reference(s): Paragraph 606-10-55-27

Entities sometimes charge customers a “restocking fee” when a product is returned. Restocking fees typically are charged to compensate entities for various costs associated with a product return, such as shipping costs and repackaging costs. Restocking fees also may be charged to compensate an entity for the reduced selling price that an entity may charge other customers for a returned product.

The staff’s view is that an entity’s expected costs of restocking should be recognized as a reduction of the carrying amount of the asset expected to be recovered at the point in time control of the product transfers to the customer. The staff’s view is that the guidance in paragraph 606-10-55-27 requires an entity to accrue for restocking costs for expected widget returns at the time the widget is initially transferred to the customer. That guidance states that an asset recognized for an entity’s right to recover products from a customer on settling a refund liability initially should be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover the product (including potential decreases in the value to the entity of returned products). That is, when an entity first sells a widget to a customer, it should reduce its asset to recover returned widgets from the customer by an amount equal to its estimated costs to recover expected widget returns.

Question 78: Which costs to obtain a contract are incremental?

Reference(s): Section 340-40-25

Some stakeholders have questioned which costs to obtain a contract are “incremental” with reference to the guidance provided in paragraphs 340-40-25-1 through 25-3.

Paragraph 340-40-25-2 states that incremental costs to obtain a contract are those costs that an entity “would not have incurred if the contracts had not been obtained.” Paragraph 340-40-25-3 states that costs to obtain a contract “that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred.”

In the staff’s view, a way to think about the guidance in those paragraphs is: Would the entity incur the cost if the customer (or the entity) decided, just as the parties are about to sign the contract, that it will not enter into the contract? If the costs would have been incurred even though the contract was not executed, then they are not incremental costs of obtaining a contract. Additionally, the staff’s view is that the employee’s title or level in the organization is not a determining factor for assessing whether a sales commission is incremental. TRG members noted that there may be a broader range of costs capitalized under the new standard as compared to current practice.

In addition, stakeholders should refer to existing guidance outside of Topic 606 when determining whether and when to recognize a liability for the costs. The guidance in Subtopic 340-40 only addresses whether the costs are expensed or capitalized (that is, the other side of the liability entry).

The following examples are intended to illustrate how the guidance about incremental costs to obtain a contract could be applied to various fact patterns. Some of the questions are more basic than the ones being asked in practice, but the staff thinks they can be instructive in answering more complex questions.

Fixed Employee Salaries

Example 1

An entity pays an employee an annual salary of \$100,000. The employee's salary is based upon the employee's prior year signed contracts and the employee's projected signed contracts for the current year. The employee's salary will not change based on the current year's actual signed contracts; however, salary in future years likely will be affected by the current year's actual signed contracts. What amount, if any, should the entity record as an asset for incremental costs to obtain a contract during the year?

The staff's view is that the entity would not capitalize any portion of the employee's salary as an incremental cost to obtain a contract. The costs are not incremental costs to any contract because the costs would have been incurred regardless of the employee's signed contracts in the current year. The staff thinks that none of the employee's salary should be capitalized as an incremental cost to obtain a contract. This is because the costs associated with the employee's salary are not incremental costs that result from obtaining a specific revenue contract. Whether the employee sells 100 contracts, 10 contracts, or no contracts, the employee is still only entitled to a fixed salary.

The staff thinks it is important to note that the objective of the requirements in paragraph 340-40-25-1 is not to allocate costs that are associated in some manner with an entity's marketing and sales activity. The objective is to identify the incremental costs that an entity would not have incurred if the contract had not been obtained.

Some Costs Are Incremental and Some Costs Are Not Incremental

Example 2

An entity pays a 5% sales commission to its employees when they obtain a contract with a customer. An employee begins negotiating a contract with a prospective customer and the entity incurs \$5,000 of legal and travel costs in the process of trying to obtain the contract. The customer ultimately enters into a \$500,000 contract and, as a

result, the employee receives a \$25,000 sales commission. What amount should the entity capitalize as an incremental cost to obtain the contract?

The staff's view is that the entity should capitalize only \$25,000 for the sales commission. Those costs are the only costs that are incremental costs to obtain the contract because the entity would not have incurred the costs if the contract had not been obtained. Incremental costs to obtain a contract are costs that are incurred only as a result of obtaining a contract. The staff thinks that the sales commission is the only cost that the entity would not have incurred if the contract had not been obtained. While the entity incurs other costs that are necessary to facilitate a sale (such as legal, travel and many others), those costs would have been incurred even if the customer decided at the last moment not to execute the contract.

Consider a nearly identical situation in which an employee incurs the same type of legal and travel expenses to negotiate a contract, but the customer decides not to enter into the contract right before the contract was to be signed by both parties. In that situation, the travel and legal expenses would still have been incurred even though the contract was not obtained. However, the commission would not have been incurred.

Timing of Commission Payments

Example 3

An entity pays an employee a 4% sales commission on all of the employee's signed contracts with customers. For cash flow management, the entity pays the employee half of the commission (2% of the total contract value) upon completion of the sale, and the remaining half of the commission (2% of the total contract value) in six months. The employee is entitled to the unpaid commission, even if the employee is no longer employed by the entity when payment is due. An employee makes a sale of \$50,000 at the beginning of year one. What amount should the entity capitalize as an incremental cost to obtain the contract?

The staff's view is that the entity would capitalize the entire commission (\$2,000). The commission is an incremental cost that relates specifically to the signed contract and the employee is entitled to the unpaid commission. The staff thinks that the timing of payment does not affect whether the costs would have been incurred if the contract had not been obtained.

In this fact pattern, only the passage of time needs to occur for the entity to pay the second half of the commission. However, the staff cautions that there could be other fact patterns in which additional factors might affect the payment of a commission to an employee. For example, an entity could require that an employee sell additional services to the customer to receive the second half of the commission. Or an entity could make the second payment contingent upon the customer completing a favorable satisfaction survey about its first six months of working with the entity. An entity will need to assess its specific compensation plans to determine the appropriate accounting for incremental costs of obtaining a contract.

Commissions Paid to Different Levels of Employees

Example 4

An entity's salesperson receives a 10% sales commission on each contract that he or she obtains. In addition, the following employees of the entity receive sales commissions on each signed contract negotiated by the salesperson: 5% to the manager and 3% to the regional manager. Which commissions are incremental costs of obtaining a contract?

The staff's view is that all of the commissions are incremental because the commissions would not have been incurred if the contract had not been obtained. Topic 606 does not make a differentiation based on the function or title of the employee that receives the commission. It is the entity that decides which employee(s) are entitled to a commission directly as a result of entering into a contract.

Some stakeholders have raised concerns that this could result in an entity capitalizing several commissions payments for the same contract. In the staff's view, it is possible that several commissions payments are incremental costs of obtaining the same contract. However, the staff encourages those stakeholders to ensure that each of the commissions are incremental costs of obtaining a contract with a customer, rather than variable compensation (for example, a bonus) based on a number of factors (one of which is related to sales). In other words, stakeholders should focus on whether the entity has an obligation to make a payment to the employee as a result of obtaining the contract. Consider a compensation arrangement in which an employee receives a discretionary annual bonus based on the entity (or a business unit within the entity) achieving sales growth targets, minimum profitability levels, and progress toward various strategic goals. Although one of the factors involves sales, the bonus is not an incremental cost of obtaining a contract because there are other factors involved in determining the annual bonus. Therefore, the staff does not think the annual bonus described above would be capitalized as a cost to obtain a contract.

Commission Payments Subject to a Threshold

Example 5

An entity has a commission program that increases the amount of commission a salesperson receives based on how many contracts the salesperson has obtained during an annual period. The breakdown is as follows: 0–9 contracts (0% commission), 10–19 contracts (2% of value of contracts 1–19), and 20+ contracts (5% of value of contracts 1–20+). Which commissions are incremental costs of obtaining a contract?

The staff's view is that the costs are incremental costs of obtaining a contract with a customer and, therefore, the costs should be capitalized. The entity would apply other GAAP to determine whether a liability for the commission payments should be recognized. When a liability is

recognized, the entity would recognize a corresponding asset for the commissions. This is because the commissions are incremental costs of obtaining a contract with a customer. The entity has an obligation to pay commissions as a direct result of entering into contracts with customers. The fact that the entity's program is based on a pool of contracts (versus a program in which the entity pays 3% for all contracts) does not change the fact that the commissions would not have been incurred if the entity did not obtain the contracts with those customers.

Question 79: How should an entity determine the amortization period for an asset recognized for the incremental costs of obtaining a contract with a customer?

Reference(s): Section 340-40-35

In accordance with paragraph 340-40-35-1, an asset recognized for incremental costs of obtaining a contract with a customer should be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated (that is, future) contract. The basis for conclusions (paragraph BC309) in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, explains that amortizing the asset over a longer period than the initial contract would not be appropriate in situations in which an entity pays a commission on a renewal contract that is commensurate with the commission paid on the initial contract. In that case, the acquisition costs from the initial contract do not relate to the subsequent contract.

In the staff's view, the amortization guidance in Subtopic 340-40 is conceptually consistent with the notion of amortizing an asset over its estimated useful life in other Topics. For example, under Topic 350, Intangibles—Goodwill and Other, an intangible asset should be amortized over its useful life according to the guidance in paragraph 350-30-35-6.

In the staff's view, the use of judgment in estimating the amortization period for an asset representing the incremental costs of obtaining a contract is similar to estimating the amortization or the depreciation period for intangible assets (for example, a customer relationship acquired in a business combination or internal-use software) and tangible assets (for example, a manufacturing plant). The period is inherently subjective and, therefore, it requires judgment. Today, entities are able to estimate useful lives for those other assets and some of those assets are material to the entities' financial statements. Entities disclose the estimated useful lives and the amortization and depreciation expense for the period. The staff is not aware of issues associated with current practice on amortization or depreciation from financial statement users, preparers, or auditors.

In the staff's view, the following are some items to consider when estimating the amortization period of an asset arising from incremental costs of obtaining a contract:

- (a) Identify the contract(s) to which the commission relates—In accordance with paragraph 340-40-35-1, an entity must determine whether the capitalized incremental costs (such as sales commissions) relate to goods or services that will be transferred only as a part of the initial contract or if the costs also relate to goods or services that will be transferred as a part of a specific anticipated contract(s).
- (b) Determine whether a commission on a renewal contract is commensurate with the commission on the initial contract—If an entity pays a commission on a renewal contract, then the entity must determine whether the commission on the renewal contract is commensurate with the commission on the initial contract. If an entity determines that the renewal commission is commensurate with the initial commission, then the asset would be amortized over the initial contract term. That is because the commission from the initial contract does not relate to the renewal contract. However, if an entity determines that the renewal commission is not commensurate with the initial commission, then the entity should assess the period to which the asset relates, potentially including specific anticipated contract(s).
- (c) Evaluate facts and circumstances to determine an appropriate amortization period—If an entity determines that the commission on the renewal contract is not commensurate with the commission on the initial contract (or there is no commission on the renewal contract), the staff thinks Topic 606 requires that the amortization period extend beyond the initial contract term if there are anticipated renewals with goods or services that relate to the costs of obtaining the initial contract. An entity will need to evaluate its specific facts and circumstances to determine an appropriate amortization period. The staff does not think Topic 606 requires an entity to amortize the asset over the average customer term (or life), but rather that an entity should use judgment in its determination of the goods or services to which that asset relates, which might include not only the goods or services to be transferred during the initial contract term, but also the term of specific anticipated renewal contracts. Some entities might conclude that its best estimate of the amortization period is the average customer term because the costs to obtain a contract relate to goods or services to be provided throughout the average customer term. The staff thinks using an amortization period equal to the average customer term is a reasonable application of Topic 606 provided that the facts and circumstances do not clearly indicate that the average customer term is inconsistent with the amortization guidance in paragraph 340-40-35-1. The staff cautions that the average customer term might not always be the same as the average amount of time that a third party has been a customer. For example, assume that an entity has been in business for decades and enjoys long-term relationships with many of its customers with an average customer life of twenty years. In most industries, the goods and services that an entity was providing two decades ago are very different from the goods and services the entity currently provides to its customers. Under paragraph 340-40-35-1, an asset recognized for incremental costs of obtaining a contract with a customer should be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or

services to which the asset relates. The staff thinks it is unlikely that a commission paid twenty years ago has any relationship to the goods or services provided today.

- (d) Disclosure—Subtopic 340-40 includes disclosure requirements about costs to obtain a contract. The staff thinks that an ideal time for an entity to consider those disclosure requirements is when it is making judgments and estimates about what costs are incremental and the amortization period for those incremental costs. The disclosure requirements are included in paragraphs 340-40-50-1 through 50-3.

Question 80: How should an entity determine whether a sales commission relates to goods or services to be transferred under a specific anticipated contract?

Reference(s): Section 340-40-35, Example 2 starting 340-40-55-5

Paragraph 340-40-35-1 provides guidance that an entity should amortize the asset from incremental costs of obtaining a contract on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. During the development of Topic 606, the Board discussed whether the asset should be amortized solely based on goods or services transferred under the initial contract, or whether the asset could relate to goods or services under potential future contracts. The Board decided that the asset could relate to goods or services under a specific anticipated contract.

The staff thinks that judgment should be applied to an entity's specific facts and circumstances when determining to which contract(s) a commission relates. If an entity pays a commission based only on the initial contract without an expectation that the contract will be renewed (based on its past experience or other relevant information), the staff thinks amortizing the asset over the initial contract term would be an appropriate application of Topic 606. However, if the entity's past experience indicates that a contract renewal is likely, then the amortization period could be longer than the initial contract term if the asset relates to goods or services to be provided during the contract renewal term.

Example 2, Costs That Give Rise to an Asset, in paragraphs 340-40-55-5 through 55-9 illustrates a circumstance in which an entity pays a commission associated with an information technology outsourcing arrangement. The initial contract term is five years and the contract is renewable for subsequent one-year periods. The entity's average customer term is 7 years. In this example, the entity amortizes the asset over seven years because it concludes that the asset relates to the services transferred to the customer during the contract term of five years and the entity anticipates that the contract will be renewed for two subsequent one-year periods.

The conclusion in Example 2 that the asset relates to future contracts will not always be an appropriate conclusion in every fact pattern. For example, an entity might have no history of renewals. Therefore, an entity will need to evaluate its facts and circumstances to make a judgment about the amortization period.

OTHER

Question 81: What is the accounting for a contract asset that exists immediately before a contract modification that is treated as if it were a termination of the existing contract and creation of a new contract in accordance with paragraph 606-10-25-13(a)?

Reference(s): Section 606-10-25

A contract modification is a change to the scope or price (or both) of a contract that is approved by the parties to the contract. Paragraphs 606-10-25-10 through 25-13 provide a framework for accounting for contract modifications. The framework is intended to faithfully depict the rights and obligations arising from a modified contract by accounting for some modifications prospectively and accounting for others on a cumulative catch-up basis. Contract modifications that are treated as a termination of the existing contract and the creation of a new contract (that is, arrangements falling under paragraph 606-10-25-13(a)) are accounted for prospectively. Because paragraph 606-10-25-13(a) does not explicitly describe the accounting for any contract asset that exists immediately before a contract modification, some stakeholders questioned whether the contract asset would be written off at the termination of the existing contract (that is, debited to revenue), or rather, if the asset should be carried forward into the new contract.

In the staff's view, the contract asset is carried forward into the new modified contract and subsequently realized under the new modified contract as receivables are recognized. This approach does not lead to revenue reversals and, therefore, results in prospective accounting.

The following example illustrates the accounting for a contract asset upon a contract modification that is accounted for under paragraph 606-10-25-13(a):

An entity ("Vendor") enters into a contract to provide a good and one year of service. The transaction price is \$4,200. Assume the good and service are separate performance obligations and the service is considered a series under paragraph 606-10-25-14(b). The standalone selling price for the good is \$3,000, and the standalone selling price for the services are \$100 per month (\$1,200 for one year). Therefore, Vendor allocates \$3,000 to the good and \$1,200 to the services.

The contract does not have an upfront payment. Customer will pay 12 equal installments of \$350. Vendor will invoice Customer at the end of each month and the contract requires Customer to pay the invoice within 30 days of month end (or Vendor has the right to assess an agreed upon late payment penalty and/or exercise its enforceable rights to demand payment).

At the beginning of the first month, the good is transferred to Customer, and the revenue allocated to that performance obligation (\$3,000) is recognized. Vendor also recognizes a contract asset for \$3,000 because payment of that \$3,000 is conditional upon Vendor performance of future services.

At the end of the first month, Vendor recognizes revenue of \$100 for progress toward complete satisfaction of the performance obligation related to the services (assume the entity is using a time-based measure of progress). Vendor also recognizes accounts receivable of \$350 because that amount is not conditional. The contract asset, which had a balance of \$3,000 at the beginning of the month, would have a balance of \$2,750 at the end of the first month.

Vendor continues to make similar entries through the end of the first nine months of the contract. After nine months, \$3,900 of revenue has been recognized for the contract (\$900 of revenue for the services and \$3,000 for the good). At the end of nine months, Vendor has a receivable for \$350 (assuming Customer already paid the first eight installments). In addition, Vendor has a contract asset for \$750 (equal to $\$3,000 - (9 \times (\$350 - \$100))$).

At the end of nine months, Vendor negotiates with Customer to change the scope and price of the contract. The contract is modified to include one additional year of service beyond the initial one-year service term. The fee for the last three months of the initial one-year contract is unchanged as a result of the modification. The agreed-upon fee for the additional one year of services is \$50 per month, which is significantly below the standalone selling price of the services. Vendor determines that the additional promised services arising from the modification do not reflect the standalone selling price of the services to be provided. Because the remaining services are a series of distinct services, Vendor determines that the remaining services are distinct from the goods or services transferred before the modification. Therefore, the modification would be accounted for under paragraph 606-10-25-13(a).

[Note: For the purposes of illustrating this specific implementation question, the staff has not evaluated considerations about whether there is a significant financing component, as described in paragraphs 606-10-32-15 through 32-20.]

The staff's view is that that Vendor would retain the original contract asset at the modification date. That contract asset relates to revenue that was previously recognized but that has not been paid by the customer and that is not presented as a receivable. Vendor would perform the analysis under paragraph 606-10-25-13(a) to determine the total consideration to be allocated to the remaining performance obligations. The consideration promised by Customer that was included in the transaction price, but not yet recognized as revenue under the original contract, would be \$300 (equal to $\$4,200$ transaction price – $\$3,900$ already recognized as revenue). The additional consideration promised as part of the contract modification is \$600 (equal to 12 additional months \times \$50 per month).

Thus, the total amount of consideration allocated to the remaining distinct services is \$900 ($\$300 + \600). Vendor would allocate the \$900 to the remaining performance obligations and

recognize revenue over the remaining modified contract duration. After the contract modification, the contract asset would be evaluated and accounted in the same manner as any other contract asset.

An entity carries forward the current contract asset because it relates to a right to consideration for goods and services that have been transferred. The revenue recognized after the contract modification is the remaining amount of the transaction price from the original contract plus the consideration arising from the modification.

The staff thinks that this results in a financial reporting outcome that is consistent with Topic 606 for contract modifications accounted for under paragraph 606-10-25-13(a). The objective of paragraph 606-10-25-13(a)(1) through 25-13(a)(2) is to determine the transaction price that should be allocated to the remaining distinct goods or services in order to account for the modification prospectively. Paragraph 606-10-25-13(a)(1) explicitly states that the starting point for the determination is the transaction price in the original contract less what had already been recognized as revenue. In the example above, the staff's view demonstrates that the transaction price in the original contract (\$4,200) is reduced by the amount of previously recognized revenue (\$3,900), which includes the \$750 contract asset that exists immediately before the modification. The amount of consideration that the entity would receive after the modification (that is, the right to consideration) exceeds the transaction price allocated to the remaining performance obligations and the contract asset remains on the entity's balance sheet at the date of modification, subject to impairment.

The staff also thinks its view is consistent with paragraph BC78 of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which indicates that the intent of paragraph 606-10-25-13(a) is to account for these types of modifications on a prospective basis and that the guidance avoids adjustments to revenue for satisfied performance obligations.

When an entity analyzes the specific criteria and guidance in paragraphs 606-10-25-12 through 25-13, it should consider the overall objective of the modifications framework as it relates to the nature of its promises to the customer and the nature of the modification(s). There are many different types of contract modifications, and it is important to carefully evaluate the facts and circumstances in determining which category of modification (described in paragraphs 606-10-25-12 through 25-13) applies. For example, an entity would consider whether the additional goods or services promised are distinct and whether the additional goods or services promised reflect their standalone selling prices.

Although Update 2014-09 includes far more guidance on contract modifications than previous GAAP, the accounting for contract modifications sometimes will require the use of significant judgment, like previous GAAP.