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Global edition

Revenue from contracts with customers

Updated August 2019

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Special thanks to all the other PwC professionals who contributed to the overall quality of this guide, including the final editing and production of the document.

Preface

PwC is pleased to offer our global accounting and financial reporting guide for *Revenue from contracts with customers*. This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification) and standards issued by the IASB. It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues. The PwC guides should be read in conjunction with the applicable authoritative accounting literature.

References to US GAAP and International Financial Reporting Standards

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification and standards issued by the IASB are clearly designated, either within quotes in the regular text or enclosed within a shaded box. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other chapters and sections in this guide

When relevant, the discussion includes general and specific references to other chapters of the guide that provide additional information. References to another chapter or particular section within a chapter are indicated by the abbreviation "RR" followed by the specific section number (e.g., RR 2.2.3 refers to section 2.2.3 in chapter 2 of this guide).

References to other PwC guidance

This guide focuses on the accounting and financial reporting considerations for the revenue recognition standard. It supplements information provided by the authoritative accounting literature and other PwC guidance. This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Business combinations and noncontrolling interests (BCG)*
- *Leases (LG)*
- *Financial statement presentation (FSP)*
- *Property, plant, equipment and other assets (PPE)*

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Guidance date

This guide considers existing guidance as of August 31, 2019. Additional updates may be made to keep pace with significant developments. Users should ensure they are using the most recent edition available on CFOdirect (www.cfodirect.com) or Inform (www.pwcinform.com).

* * * * *

This guide has been prepared to support you in applying the revenue recognition standard. It should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

We hope you find the information and insights in this guide useful.

Paul Kepple
US Chief Accountant

Summary of significant changes

Included below is a summary of the noteworthy revisions to the *Revenue from contracts with customers* guide since it was last updated in September 2018.

Chapter 1: An introduction to revenue from contracts with customers

- **Section 1.1** was updated to include reference to the TRG's meeting minutes and to incorporate IFRIC agenda decisions to date.

Chapter 2: Scope and identifying the contract

- **Section 2.2.4** was added as a new subsection regarding the accounting for an arrangement in which an investor acquires rights to future cash flows.
- **Section 2.4.1** was updated to reflect guidance in ASU 2018-18 regarding when collaborative arrangements are within the scope of ASC 606.
- **Section 2.6.2** was updated to clarify Question 2-3 regarding how an entity should measure progress for a performance obligation satisfied over time when activities begin before a contract is established.
- **Section 2.9** was updated to include Question 2-4 regarding whether the contract modification guidance applies when the parties agree to terminate an existing contract and enter into a new contract.
- **Section 2.9.2** was updated to include Example 2-15 regarding the accounting for a blend-and-extend modification.
- **Section 2.9.3.1** was updated to include Example 2-17 regarding a modification accounted for prospectively.

Chapter 3: Identifying performance obligations

- **Section 3.3.2** was updated to include additional questions regarding the series guidance (Questions 3-2, 3-3, and 3-4).
- **Section 3.4** was updated to clarify the assessment of whether a good or service is distinct.

Chapter 4: Determining the transaction price

- **Section 4.3** was updated to include Question 4-1 regarding whether consideration is variable if pricing is fixed but the quantity is variable.
- **Section 4.3.3** was updated to clarify the accounting for arrangements that are determined to include variable consideration based on an index or market price, and to include a new subsection (4.3.3.11) regarding penalties and liquidated damages.

- **Section 4.4.2** was updated to include Question 4-4 regarding when an entity can use the significant financing component practical expedient.
- **Section 4.6.1** was updated to include Example 4-27 regarding consideration payable to a customer in the form of an advertising allowance.
- **Section 4.6.5** was added as a new subsection regarding settlement payments made to customers.

Chapter 5: Allocating transaction price to separate performance obligations

- **Section 5.3** was updated to include Question 5-2 regarding whether an entity could assert it is unable to estimate standalone selling price.

Chapter 6: Recognizing revenue

- **Section 6.4.1.1** was updated to include Question 6-4 regarding whether an entity can use the “right to invoice” practical expedient when a contract includes escalating fees.
- **Section 6.5.5** was updated to include Question 6-6 regarding whether payment terms linked to product acceptance impact the timing of control transfer.

Chapter 8: Practical application issues

- **Section 8.3** was updated to include Question 8-3 regarding the period over which to accrue estimated warranty costs when control transfers over time.

Chapter 9: Licenses

- **Section 9.7** was updated to include a new subsection (9.7.4) related to proceeds from a patent infringement settlement.

Chapter 11: Contract costs

- **Section 11.3** was updated to include Question 11-6 regarding whether costs to fulfill a contract can be deferred to achieve a consistent profit margin.
- **Section 11.5** was updated to include additional discussion of onerous contract guidance as well as Example 11-14 and Question 11-8.

Chapter 12: Presentation and disclosure

- **Section 12.2.1.3** was updated to include Example 12-4 regarding the balance sheet presentation of an unbilled receivable.

Chapter 13: Service concession arrangements (US GAAP)

- **Chapter 13** was added regarding the accounting for service concessions in accordance with US GAAP.

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Chapter 1:
An introduction to revenue
from contracts with
customers

1.1 Background

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

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

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

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

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

The FASB issued ASC 606, *Revenue from Contracts with Customers*, and ASC 340-40, *Other Assets and Deferred Costs—Contracts with Customers*, and the IASB issued IFRS 15, *Revenue from Contracts with Customers* (collectively, the "revenue standard") in May 2014 along with consequential amendments to existing standards. With the exception of a few discrete areas, the revenue standard is converged, eliminating most differences between US GAAP and IFRS in accounting for revenue from contracts with customers.

The boards subsequently issued multiple amendments to the new revenue standard in 2015 and 2016 as a result of feedback from stakeholders, primarily related to:

- Deferral of the effective date of the revenue standard by one year (see RR 14.2)
- Collectibility (see RR 2.6.1.5)

- Identification of performance obligations (see RR 3.3)
- Noncash consideration (see RR 4.5)
- Licenses of intellectual property (see RR 9)
- Principal versus agent guidance (see RR 10)
- Practical expedients at transition (see RR 14.3.2)

The amendments made by the FASB and IASB are not identical. For certain of the amendments, the financial reporting outcomes will be similar despite the use of different wording in ASC 606 and IFRS 15. However, there may be instances where differences in the guidance result in different conclusions under US GAAP and IFRS.

Figure 1-1 highlights the key differences between ASC 606 and IFRS 15, as amended.

Figure 1-1

Summary of key differences between ASC 606 and IFRS 15

Topic	Difference
Collectibility threshold	One of the criteria that contracts must meet before an entity applies the revenue standard is that collectibility is probable. Probable is defined in US GAAP as “likely to occur,” which is generally considered a 75%-80% threshold. IFRS defines probable as “more likely than not,” which is greater than 50%. ASC 606 contains more guidance on accounting for nonrefundable consideration received if a contract fails the collectibility assessment. Refer to RR 2.6.1.5 for further discussion of the collectibility threshold.
Noncash consideration	ASC 606, as amended, specifies that noncash consideration should be measured at contract inception and addresses how to apply the variable consideration guidance to contracts with noncash consideration. IFRS 15 has not been amended to address noncash consideration, and as a result, approaches other than that required by ASC 606 may be applied under IFRS 15. Refer to RR 4.5 for further discussion of noncash consideration.
Licenses of intellectual property	ASC 606 and IFRS 15 use different terminology to describe the nature of an entity’s promise in granting a license. As a result, there could be differences in whether a license is determined to be a “right to access” or a “right to use” intellectual property. License renewals and extensions may also be accounted for differently under the two standards. Refer to RR 9 for further discussion of licenses of intellectual property.
Practical expedients at transition and definition of completed contract	ASC 606 and IFRS 15 have some differences in practical expedients available to ease application of and transition to the revenue standard. Additionally, the two standards define a “completed contract” differently. Refer to RR 14.3 for further discussion of practical expedients.

Topic	Difference
Shipping and handling election	ASC 606 allows entities to elect to account for shipping and handling activities that occur after the customer has obtained control of a good as a fulfilment cost rather than an additional promised service. IFRS 15 does not provide this election. IFRS reporters (and US GAAP reporters that do not make this election) are required to consider whether shipping and handling services give rise to a separate performance obligation. Refer to RR 10.3 for further discussion of shipping and handling.
Presentation of sales taxes	ASC 606 allows entities to make an accounting policy election to present all sales taxes collected from customers on a net basis. IFRS 15 does not provide this election. IFRS reporters (and US GAAP reporters that do not make this election) must evaluate each type of tax on a jurisdiction-by-jurisdiction basis to determine which amounts to exclude from revenue (as amounts collected on behalf of third parties) and which amounts to include. Refer to RR 10.5.1 for further discussion of the presentation of taxes collected from customers.
Interim disclosure requirements	The general principles in the US GAAP and IFRS interim reporting standards apply to the revenue standard. The IASB amended its interim disclosure standard to require interim disaggregated revenue disclosures. The FASB amended its interim disclosure standard to require disaggregated revenue information, and added interim disclosure requirements relating to contract balances and remaining performance obligations (for public companies only). Refer to RR 12.3 for further discussion of the interim disclosure requirements.
Effective date	There are minor differences in the effective dates between ASC 606 and IFRS 15. ASC 606 is applicable for public entities for annual reporting periods (including interim periods therein) beginning after December 15, 2017 (nonpublic entities can defer adopting for an extra year), whereas IFRS 15 is applicable for all entities for annual periods beginning on or after January 1, 2018. Refer to RR 14.2 for further discussion of effective dates.
Early adoption	Entities reporting under US GAAP are not permitted to adopt the revenue standard earlier than annual reporting periods beginning after December 15, 2016. Entities reporting under IFRS are permitted to adopt IFRS 15 early without restriction. Refer to RR 14.2 for further discussion of early adoption.
Impairment loss reversal	ASC 340 does not permit entities to reverse impairment losses recognized on contract costs (that is, capitalized costs to acquire or fulfill a contract). IFRS 15 requires impairment losses to be reversed in certain circumstances similar to its existing standard on impairment of assets. Refer to RR 11.4.2 for further discussion of impairment losses.

Topic	Difference
Relief for nonpublic entities	ASC 606 gives nonpublic entities relief relating to certain disclosures and effective date. IFRS 15 applies to all IFRS reporters, public or nonpublic, except entities that apply IFRS for SMEs Standard. Refer to RR 12.3.7 and RR 14.2.2.2 for further discussion of the disclosure and effective date relief provided by ASC 606.

1.1.1 Transition resource group

In connection with the issuance of the revenue standard, the boards established a joint working group, the Revenue Recognition Transition Resource Group (TRG), to seek feedback on potential implementation issues. The TRG does not issue authoritative guidance but assists the boards in determining whether they need to take additional action, which could include amending the guidance. The TRG comprises financial statement preparers from a wide spectrum of industries, auditors, users from various geographical locations, and public and private organizations. Replays and minutes of the TRG meetings are available on the TRG pages of the [FASB](#) and [IASB's](#) websites.

Discussions of the TRG are nonauthoritative, but management should consider those discussions as they may provide helpful insight into that way the guidance might be applied in similar facts and circumstances. Entities should also consider guidance provided by their local regulators. The SEC staff, for example, has indicated that it would use the TRG discussion as a basis to assess the appropriateness of SEC registrants' revenue recognition policies.

In January 2016, the IASB announced that it does not plan to schedule additional TRG meetings. The IASB observed meetings of the US TRG in April and November 2016. In November 2016, the FASB announced that there are no further US TRG meetings scheduled, but that they will continue to assess the need for future meetings.

Figure 1-2 lists the issues discussed by the TRG with the reference to the related TRG paper. The minutes of those discussions are recorded in separate TRG papers, the reference to which is also included in the table.

Figure 1-2
Issues discussed by the TRG

Date discussed	TRG paper reference	TRG minutes paper reference	Topic discussed	Revenue guide reference
July 18, 2014	<u>1</u>	<u>5</u>	Gross versus net revenue*	RR 10
July 18, 2014	<u>2</u>	<u>5</u>	Gross versus net revenue: amounts billed to customers*	RR 10

Date discussed	TRG paper reference	TRG minutes paper reference	Topic discussed	Revenue guide reference
July 18, 2014	<u>3</u>	<u>5</u>	Sales-based and usage-based royalties in contracts with licenses and goods or services other than licenses*	RR 9.8
July 18, 2014	<u>4</u>	<u>5</u>	Impairment testing of capitalized contract costs*	RR 11.4.2
October 31, 2014	<u>6</u>	<u>11</u>	Customer options for additional goods and services and nonrefundable upfront fees	RR 7.2
October 31, 2014	<u>7</u>	<u>11</u>	Presentation of a contract as a contract asset or a contract liability	RR 12.2.1.4
October 31, 2014	<u>8</u>	<u>11</u>	Determining the nature of a license of intellectual property*	RR 9.5
October 31, 2014	<u>9</u>	<u>11</u>	Distinct in the context of the contract*	RR 3.4
October 31, 2014	<u>10</u>	<u>11</u>	Contract enforceability and termination clauses	RR 2.6 and RR 2.7
January 26, 2015	<u>12</u>	<u>25</u>	Identifying promised goods or services*	RR 3.2
January 26, 2015	<u>13</u>	<u>25</u>	Collectibility*	RR 2.6.1.5 and RR 2.6.3
January 26, 2015	<u>14</u>	<u>25</u>	Variable consideration	RR 4.3.2 and RR 5.5
January 26, 2015	<u>15</u>	<u>25</u>	Noncash consideration*	RR 7.2.6
January 26, 2015	<u>16</u>	<u>25</u>	Stand-ready obligations	RR 6.4.3

Date discussed	TRG paper reference	TRG minutes paper reference	Topic discussed	Revenue guide reference
January 26, 2015	<u>17</u>	<u>25</u>	Islamic finance transactions	RR 2.2
January 26, 2015	<u>23</u>	<u>25</u>	Costs to obtain a contract	RR 11.2
January 26, 2015	<u>24</u>	<u>25</u>	Contract modifications*	RR 2.9
March 30, 2015	<u>26</u>	<u>34</u>	Contributions*	RR 2.2.1
March 30, 2015	<u>27</u>	<u>34</u>	Series of distinct goods or services	RR 3.3.2
March 30, 2015	<u>28</u>	<u>34</u>	Consideration payable to a customer	RR 4.6
March 30, 2015	<u>29</u>	<u>34</u>	Warranties	RR 8.3
March 30, 2015	<u>30</u>	<u>34</u>	Significant financing component	RR 4.4
March 30, 2015	<u>31</u>	<u>34</u>	Variable discounts	RR 4.3 and RR 5.5.1
March 30, 2015	<u>32</u>	<u>34</u>	Exercise of a material right	RR 7.2.2, RR 7.2.4, and RR 8.4.1
March 30, 2015	<u>33</u>	<u>34</u>	Partially satisfied performance obligations	RR 2.6.2 and RR 6.4.6
July 13, 2015	<u>35</u>	<u>44</u>	Accounting for restocking fees and related costs	RR 8.2.2
July 13, 2015	<u>36</u>	<u>44</u>	Credit cards	RR 2.2
July 13, 2015	<u>37</u>	<u>44</u>	Consideration payable to a customer	RR 4.6
July 13, 2015	<u>38</u>	<u>44</u>	Portfolio practical expedient and application of variable consideration	RR 4.3.1.1

Date discussed	TRG paper reference	TRG minutes paper reference	Topic discussed	Revenue guide reference
July 13, 2015	<u>39</u>	<u>44</u>	Application of the series provision and allocation of variable consideration	RR 3.3.2, RR 4.3.3.6 and RR 5.5.1
July 13, 2015	<u>40</u>	<u>44</u>	Practical expedient for measuring progress toward complete satisfaction of a performance obligation	RR 6.4.1.1
July 13, 2015	<u>41</u>	<u>44</u>	Measuring progress when multiple goods or services are included in a single performance obligation	RR 6.4.5
July 13, 2015	<u>42</u>	<u>44</u>	Completed contracts at transition*	RR 14.3.1
July 13, 2015	<u>43</u>	<u>44</u>	Determining when control of a commodity transfers	RR 6.3.1
November 9, 2015	<u>45</u>	<u>49</u>	Licenses — Specific application issues about restrictions and renewals*	RR 9.6 and RR 9.7
November 9, 2015	<u>46</u>	<u>49</u>	Pre-production activities*	RR 3.6.1 and RR 11.3.3
November 9, 2015	<u>47</u>	<u>49</u>	Whether fixed odds wagering contracts are included or excided from the scope of Topic 606*	RR 2.2
November 9, 2015	<u>48</u>	<u>49</u>	Customer options for additional goods and services	RR 2.7, RR 3.5, and RR 7
April 18, 2016 (US only)	<u>50</u>	<u>55</u>	Scoping considerations for incentive-based capital allocations	N/A

Date discussed	TRG paper reference	TRG minutes paper reference	Topic discussed	Revenue guide reference
April 18, 2016 (US only)	<u>51</u>	<u>55</u>	Contract asset treatment in contract modifications	RR 2.9.3.1
April 18, 2016 (US only)	<u>52</u>	<u>55</u>	Scoping considerations for financial institutions	RR 2.2
April 18, 2016 (US only)	<u>53</u>	<u>55</u>	Evaluating how control transfers over time	RR 6.3 and RR 6.4.1
April 18, 2016 (US only)	<u>54</u>	<u>55</u>	Class of customer	RR 7.2
November 7, 2016 (US only)	<u>56</u>	<u>60</u>	Over time revenue recognition	RR 6.3.3.2
November 7, 2016 (US only)	<u>57</u>	<u>60</u>	Capitalization and amortization of incremental costs of obtaining a contract	RR 11.2 and RR 11.4.1
November 7, 2016 (US only)	<u>58</u>	<u>60</u>	Sales-based or usage-based royalty with minimum guarantee	RR 9.8
November 7, 2016 (US only)	<u>59</u>	<u>60</u>	Payments to customers	RR 4.6

*Amendments to one or both standards were as a result of these discussions. Refer to referenced chapters for further discussion.

1.1.2 IFRIC agenda decisions

The IFRS Interpretations Committee (IFRIC) works with the IASB in supporting the application of IFRS standards. The IFRIC discusses questions submitted by stakeholders and decides whether standard setting is needed to address the question. If the IFRIC does not recommend standard setting, it publishes an agenda decision to explain its conclusion. The IFRIC has issued several agenda decisions related to IFRS 15 as listed in Figure 1-3.

In each IFRIC Update that includes an agenda decision, the IFRIC acknowledges that an agenda decision might often result in explanatory material that provides new information that was not otherwise available and could not otherwise reasonably have been expected to be obtained. Because of this, the IFRIC notes that an entity might determine that it needs to change an accounting policy as a result of an agenda decision. The IFRIC notes that the IASB expects that an entity would be entitled to

sufficient time to make that determination and implement any change (for example, an entity may need to obtain new information or adapt its systems to implement a change).

Figure 1-3

IFRIC agenda decisions related to IFRS 15

Date issued	Topic	Revenue guide reference
March 2018	<u>Revenue recognition in a real estate contract that includes the transfer of land</u>	RR 3.4.2
March 2018	<u>Revenue recognition in a real estate contract</u>	RR 6.3.2
March 2018	<u>Right to payment for performance completed to date</u>	RR 6.3.3.2
January 2019	<u>Assessment of promised goods or services</u>	RR 8.4
June 2019	<u>Costs to Fulfil a Contract</u>	RR 11.3

1.2 What is revenue?

Revenue is defined in the revenue standard as:

Definition from ASC 606-10-20

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

Definition from IFRS 15, Appendix A

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

IFRS 15 further defines income as:

Definition from IFRS 15, Appendix A

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

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

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

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

EXAMPLE 1-1

Distinction between revenue and income

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

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

Analysis

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

1.3 High-level overview

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

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

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

1.3.1 Scope

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

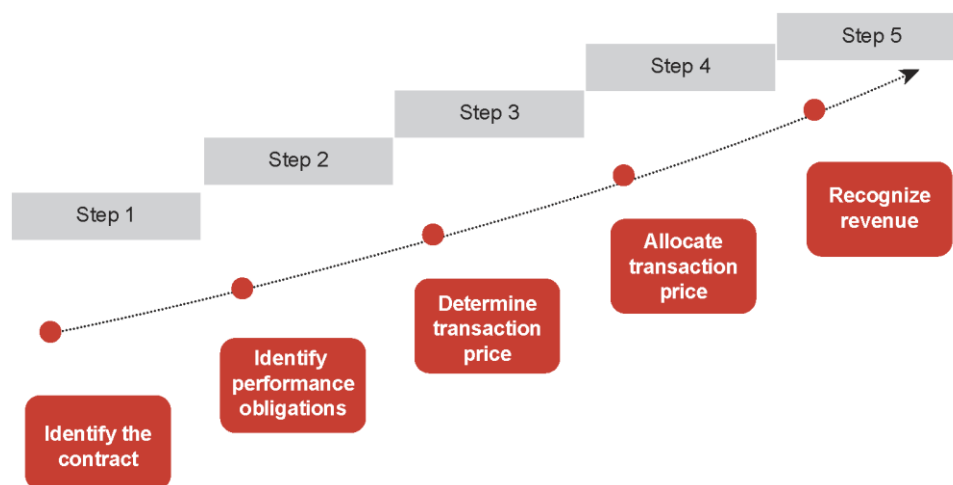
Arrangements may also include elements that are partly in the scope of other standards and partly in the scope of the revenue standard. The elements that are accounted for under other standards are separated and accounted for under those standards.

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

1.3.2 The five-step model

Figure 1-4 illustrates the five-step model the boards developed for recognizing revenue from contracts with customers:

Figure 1-4
Five-step model



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

A contract contains a promise (or promises) to transfer goods or services to a customer. A performance obligation is a promise (or a group of promises) that is distinct, as defined in the revenue standard. Identifying performance obligations can be relatively straightforward, such as an electronics store's promise to provide a television. But it can also be more complex, such as a contract to provide a new

computer system with a three-year software license, a right to upgrades, and technical support. Entities must determine whether to account for performance obligations separately, or as a group.

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

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

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

1.3.3 Portfolio approach

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

1.3.4 Contract costs

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

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

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

1.4 *Implementation guidance*

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

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

1.5 *Disclosures*

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

1.6 *Transition and effective date*

The revenue standard, as amended, is applicable for most entities in 2018. The effective date and transition guidance varies slightly for companies reporting under US GAAP and those reporting under IFRS. US GAAP requires public entities to apply the revenue standard for annual reporting periods (including interim periods therein) beginning after December 15, 2017. Nonpublic entities reporting under US GAAP are required to apply the revenue standard for annual periods beginning after

December 15, 2018. Nonpublic entities reporting under US GAAP are permitted to apply the standard early. Entities that report under IFRS are required to apply the revenue standard for annual reporting periods beginning on or after January 1, 2018, and early adoption is permitted.

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

Chapter 2:

Scope and identifying the contract

2.1 Chapter overview

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

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

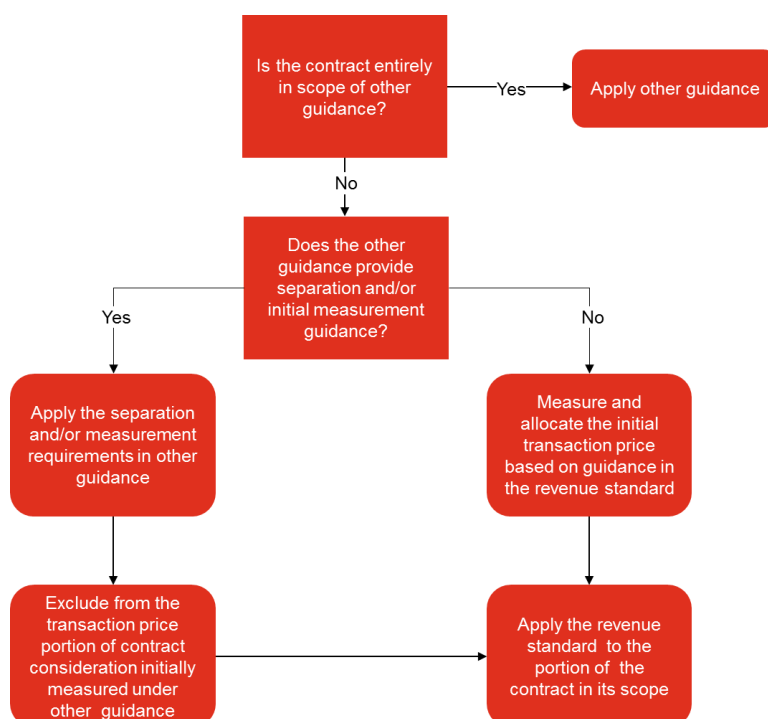
Management must also consider whether more than one contract with a customer should be combined and how to account for any subsequent modifications.

2.2 Scope

Management needs to consider all other potentially relevant accounting literature before concluding that the arrangement is in the scope of the revenue standard. Arrangements that are entirely in the scope of other guidance should be accounted for under that guidance. If another standard only applies to a portion of the contract, management will need to separate the contract, as illustrated in Figure 2-1 and discussed in RR 2.2.3.

Figure 2-1

Accounting for contracts partially in scope of the revenue standard



There are no industries completely excluded from the scope of the revenue standard; however, the standard specifically excludes from its scope certain types of transactions:

- Leases in the scope of ASC 840, *Leases*, or IAS 17, *Leases* [ASC 842, *Leases*, or IFRS 16, *Leases*, upon adoption]
- Contracts in the scope of ASC 944, *Financial Services—Insurance*, or insurance contracts in the scope of IFRS 4, *Insurance Contracts*
- Financial instruments and other contractual rights or obligations in the scope of the following guidance:
 - US GAAP: ASC 310, *Receivables*; ASC 320, *Investments—Debt and Equity Securities*; ASC 323, *Investments—Equity Method and Joint Ventures*; ASC 325, *Investments—Other*; ASC 405, *Liabilities*; ASC 470, *Debt*; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*
 - IFRS: IFRS 9, *Financial Instruments*; IFRS 10, *Consolidated Financial Statements*; IFRS 11, *Joint Arrangements*; IAS 27, *Separate Financial Statements*; and IAS 28, *Investments in Associates and Joint Ventures*
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to current or future customers
- Guarantees (other than product or service warranties — see RR 8 for further considerations related to warranties) in the scope of ASC 460, *Guarantees* (US GAAP)

Arrangements should be assessed to determine whether they are within the scope of other guidance and, therefore, outside the scope of the revenue standard. Entities may reach different scoping conclusions depending on whether they apply US GAAP or IFRS. This is because other applicable guidance for specific types of arrangements may differ. For example, the definition of a financial instrument might be different under US GAAP and IFRS. Refer to Revenue TRG Memo No. [17](#), Revenue TRG Memo No. [36](#), Revenue TRG Memo No. [47](#), US Revenue TRG Memo No. [52](#), and the related meeting minutes in Revenue TRG Memo No. [25](#), Revenue TRG Memo No. [44](#), Revenue TRG Memo No. [49](#), and Revenue TRG Memo No. [55](#), respectively, for further discussion of scoping issues discussed by the TRG. Following are examples of how to apply the scoping guidance to specific types of transactions.

- Credit card fees

Credit card fees are outside the scope of the revenue standard for entities reporting under US GAAP unless the overall nature of the arrangement is not a credit card lending arrangement. Credit card fees are addressed by specific guidance in ASC 310, *Receivables*. If a credit card arrangement is determined to be outside the scope of the revenue standard, any related reward program is also outside the scope. Management should evaluate the nature of the entity's credit card programs to assess whether they are in the scope of ASC 310 and continue to evaluate new programs as they evolve. Refer to Revenue TRG Memo No. [36](#) and the related meeting minutes in Revenue TRG Memo No. [44](#) for further discussion of this topic.

IFRS does not contain specific guidance on credit card fees. Therefore, IFRS reporters would generally apply IFRS 15 to credit card fees and related rewards programs, unless part or all of these transactions are in the scope of the financial instruments guidance.

□ Gaming contracts

Fixed-odds wagering contracts, including any associated loyalty programs, within the scope of ASC 924, *Entertainment – Casinos*, are excluded from the scope of the derivative instruments guidance (ASC 815) and, thus, are within the scope of the revenue standard for US GAAP reporting entities.

Fixed-odds wagering contracts are typically outside the scope of the revenue standard for IFRS reporting entities. Under IFRS, when a gaming entity takes a position against its customer, the resulting unsettled position is likely to meet the definition of a derivative. Therefore, those contracts should be accounted for under the financial instruments standards rather than the revenue standard. Refer to Revenue TRG Memo No. 47 and the related meeting minutes in Revenue TRG Memo No. 49 for further discussion of this topic.

□ Insurance

Under US GAAP, all contracts in the scope of ASC 944 are excluded from the revenue standard. This includes life insurance, health insurance, property and casualty insurance, title insurance, mortgage guarantee insurance, and investment contracts. Similarly, IFRS 15 provides an exception for insurance contracts in the scope of IFRS 4. The scope exception does not apply to other types of contracts that may be issued by insurance entities that are outside the scope of insurance guidance, such as asset management and claims handling (administrative services) contracts.

Contracts could also be partially within the scope of the insurance guidance and partially within the scope of the revenue standard. Management may need to apply judgment to make this determination. If a contract is entirely in the scope of the insurance guidance, activities to fulfill the contract, such as insurance risk mitigation or cost containment activities, should be accounted for under the insurance guidance.

In May 2017, the IASB published a new insurance standard, IFRS 17, *Insurance Contracts*. IFRS 17 includes scope guidance to determine which insurance arrangements (or parts thereof) are excluded from the insurance contracts standard and are therefore within the scope of another standard, such as the revenue standard. For fixed-fee service contracts that meet three specified criteria, entities have an accounting policy choice to account for them in accordance with either IFRS 17 or IFRS 15.

2.2.1 Revenue that does not arise from a contract with a customer

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

- Dividends
- Non-exchange transactions, such as donations or contributions. For example, contributions received by a not-for-profit entity are not within the scope of the revenue standard if they are not

given in exchange for goods or services (that is, they represent non-exchange transactions). Refer to Revenue TRG Memo No. 26 and the related meeting minutes in Revenue TRG Memo No. 34 for further discussion of this topic.

- Changes in the fair value of biological assets, investment properties, and the inventory of broker-traders (IFRS)
- Changes in regulatory assets and liabilities arising from alternative revenue programs for rate-regulated activities in the scope of ASC 980, *Regulated Operations* (US GAAP)

2.2.2 Evaluation of nonmonetary exchanges

As noted in RR 2.2, nonmonetary exchanges between entities in the same line of business to facilitate sales to current or future customers are excluded from the scope of the revenue standard. US GAAP reporters should assess these arrangements under ASC 845, *Nonmonetary Transactions*. Refer to PPE 5.7 for guidance on nonmonetary transactions under US GAAP. For IFRS reporters, the nature of the exchange will need to be further considered to determine the appropriate guidance to follow.

Nonmonetary exchanges with customers that are in the scope of the revenue standard are exchanges of goods or services for noncash consideration. Refer to the guidance on noncash consideration in RR 4.5.

Determining whether nonmonetary exchanges are in the scope of the revenue standard could require judgment and depends on the facts and circumstances of the arrangement. Example 2-1 illustrates an arrangement that is not within the scope of the revenue standard.

EXAMPLE 2-1

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

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

Is the contract in the scope of the revenue standard?

Analysis

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

2.2.3 Contracts with components in and out of the scope of revenue

Some contracts include components that are in the scope of the revenue standard and other components that are in the scope of other standards. For example, a contract could include a financial guarantee given by the vendor (refer to RR 4.3.3.9 for further discussion of guarantees) or a lease of property, plant, and equipment in addition to a promise to provide goods or services. An entity should

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

2.2.3.1 *US GAAP election to combine lease and non-lease components*

US GAAP reporters can elect a practical expedient (provided in ASC 842) that permits lessors to combine lease and non-lease components within a contract if certain criteria are met. The practical expedient applies to contracts that include an operating lease and a non-lease component, such as a promise to provide services. To qualify for the expedient, the pattern of transfer of the operating lease and the non-lease component must be the same (that is, on a straight-line basis over time).

If the lease and non-lease components are combined under this expedient, a lessor would account for the combined component under the revenue standard if the non-lease component is predominant, and as an operating lease if the non-lease component is not predominant. For example, if the service component (a revenue component) is predominant, the entity could apply the revenue standard to both the revenue and lease components. If the service component is not predominant, the entity could apply the lease standard to all components. If elected, the practical expedient will need to be applied consistently as an accounting policy by class of underlying asset. Refer to LG 2 for further discussion.

A similar practical expedient is not available under IFRS and the principles of IFRS 15 and IFRS 16 should be followed for the respective non-lease and lease components.

2.2.4 *Sale of future revenues*

An arrangement where an investor acquires rights to future cash flows from an entity is typically not a contract with a customer in the scope of the revenue standard. An example is an arrangement in which an entity receives cash from an investor in exchange for a specified percentage of revenue from an existing product line or business segment. US GAAP provides specific guidance in ASC 470-10-25 that includes factors indicating the cash received from the investor should be classified as debt.

ASC 470-10-25-2

While the classification of the proceeds from the investor as debt or deferred income depends on the specific facts and circumstances of the transaction, the presence of any one of the following factors independently creates a rebuttable presumption that classification of the proceeds as debt is appropriate:

- a. The transaction does not purport to be a sale (that is, the form of the transaction is debt).
- b. The entity has significant continuing involvement in the generation of the cash flows due the investor (for example, active involvement in the generation of the operating revenues of a product line, subsidiary, or business segment).
- c. The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity.
- d. The investor's rate of return is implicitly or explicitly limited by the terms of the transaction.

- e. Variations in the entity's revenue or income underlying the transaction have only a trifling impact on the investor's rate of return.
- f. The investor has any recourse to the entity relating to the payments due the investor.

Different US GAAP guidance may apply if an investor is providing research and development funding to an entity in return for future royalties resulting from the product being developed. Refer to PPE 7.3.4 for further discussion of funded research and development arrangements.

There is no similar guidance under IFRS. Each arrangement should be considered based on the substance of the transaction and the relevant financial instruments guidance. Depending on the circumstances of a particular transaction, it might be appropriate to consider factors such as those described in ASC 470-10-25-2.

2.3 *Sale or transfer of nonfinancial assets*

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

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

For US GAAP reporters, guidance on the sale or transfer of nonfinancial assets or in substance nonfinancial assets to counterparties other than customers is included in ASC 610-20. Refer to RR 2.4 and PPE 5.4.1 for further guidance on determining whether the arrangement is with a customer. ASC 610-20 refers to ASC 606 for the principles of recognition and measurement. For further discussion of ASC 610-20, refer to PPE 5. For IFRS reporters, IFRS 15 amended IAS 16 and IAS 38 to incorporate the IFRS 15 concepts in the context of the derecognition of property, plant, and equipment and disposals of intangible assets, respectively.

2.4 *Identifying the customer*

The revenue standard defines a customer as follows.

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

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

In simple terms, a customer is the party that purchases an entity's goods or services. Identifying the customer is straightforward in many instances, but a careful analysis needs to be performed in other situations to confirm whether a customer relationship exists. For example, a contract with a counterparty to participate in an activity where both parties share in the risks and benefits of the

activity (such as developing an asset) is unlikely to be in the scope of the revenue guidance because the counterparty is unlikely to meet the definition of a customer. An arrangement where, in substance, the entity is selling a good or service is likely in the scope of the revenue standard, even if it is termed a “collaboration” or something similar.

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

Example 2-2 illustrates the consideration of whether the revenue standard applies to a collaborative arrangement.

EXAMPLE 2-2

Identifying the customer — collaborative arrangement

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

Is the arrangement in the scope of the revenue standard?

Analysis

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

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

2.4.1 New guidance – collaborative arrangements (US GAAP)

In November 2018, the FASB issued ASU 2018-18, *Collaborative Arrangements (Topic 808)*. For US GAAP reporters, ASU 2018-18 amends ASC 808 and ASC 606 to clarify when transactions between parties to collaborative arrangements are in the scope of ASC 606. ASC 808 defines “collaborative arrangement” and provides guidance for the income statement presentation, classification, and disclosures related to collaborative arrangements. The guidance also provides several examples of the accounting by parties to a collaborative arrangement.

A collaborative arrangement could be partially within the scope of ASC 606. To determine whether a portion of a collaborative arrangement is in the scope of ASC 606, management will apply the guidance in ASC 606 on identifying “distinct” goods and services to identify each unit of account within the arrangement (refer to RR 3.4). Assessing whether the various activities in a collaboration

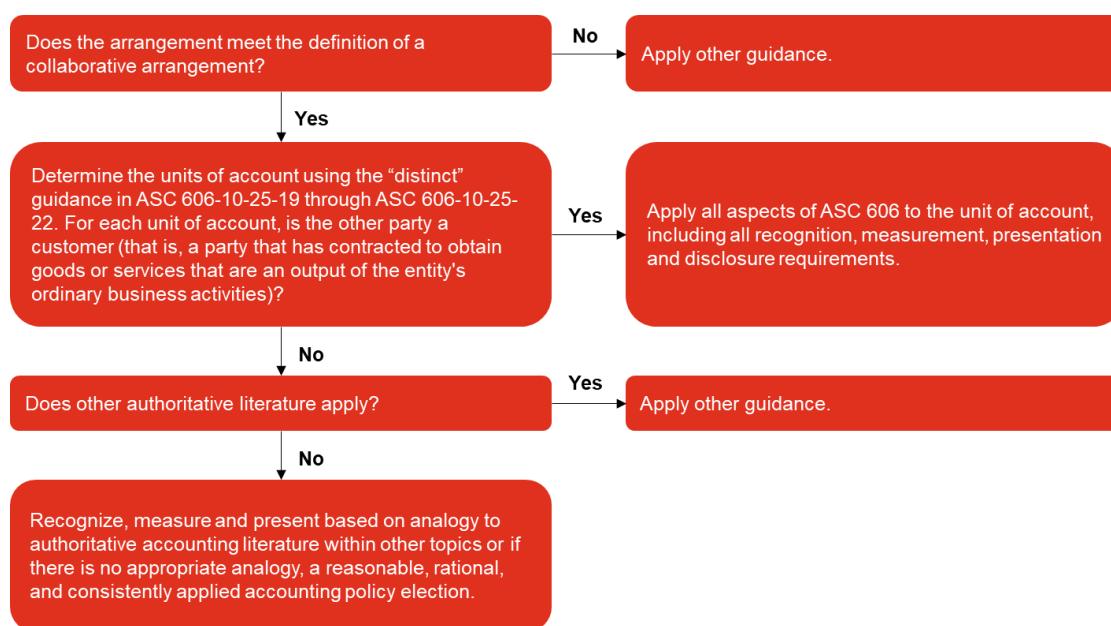
are distinct could require significant judgment, particularly when all of the activities have some level of interdependence. Once management determines the units of account, it will assess if all or part of each unit of account is a transaction with a customer. If the entire unit of account is a transaction with a customer, the entity will apply ASC 606 to that unit of account, including all recognition, measurement, presentation, and disclosure requirements.

If a unit of account is not a transaction with a customer in its entirety, that unit of account is not in the scope of ASC 606. This would be the case if, for example, the other party is not obtaining goods or services that are the output of the entity's ordinary activities for some aspect of the single unit of account. In this circumstance, an entity can apply (1) elements of the accounting under ASC 606, (2) other relevant guidance by analogy, or (3) a reasonable accounting policy if there is no appropriate analogy. Management should consider the nature of the arrangement and its business operations to determine the appropriate accounting for portions of a collaborative arrangement outside the scope of ASC 606.

Figure 2-2 illustrates the assessment of which US GAAP guidance to apply to a collaborative arrangement.

Figure 2-2

Accounting for a collaborative arrangement



Refer to FSP 3.7.5.1 for the presentation and disclosure requirements related to collaborative arrangements.

The amendments in ASU 2018-18 are effective for public business entities for fiscal years beginning after December 15, 2019, including interim periods within those years. The amendments are effective for nonpublic business entities for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early adoption is permitted.

The IASB has not issued similar guidance. Management will need to assess which parts of an arrangement are in the scope of IFRS 15 because an entity has transferred goods or services to a

customer and which parts are outside the scope of IFRS 15. As part of this assessment, management should consider the substance of the arrangement and any relevant guidance in IFRS, which might include applying IFRS 15 by analogy. Management should also consider the guidance in IAS 8.10 and IAS 8.11 for developing and applying an accounting policy when there is no IFRS that applies specifically. It might be appropriate in some situations to consider the US GAAP guidance when there is no specific IFRS guidance.

2.5 *Arrangements with multiple parties*

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

Arrangements with three or more parties, particularly if there are separate contracts with each of the parties, require judgment to evaluate the substance of those relationships. Management will need to assess which parties are customers and whether the contracts meet the criteria to be combined, as discussed in RR 2.8, when applying the guidance in the revenue standard.

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

An entity also needs to identify which party is its customer in a transaction with multiple parties in order to determine whether payments made to any of the parties meet the definition of “consideration payable to a customer” under the revenue standard. Refer to RR 4.6 for further discussion on consideration payable to a customer.

2.6 *Identifying the contract*

The revenue standard defines a contract as follows.

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

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

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

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

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

2.6.1 Contracts with customers — required criteria

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

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

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

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

These criteria are discussed further in RR 2.6.1.1 through RR 2.6.1.5.

2.6.1.1 The contract has been approved and the parties are committed

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

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

The parties must also be committed to perform their respective obligations under the contract. Termination clauses are a key consideration in determining whether a contract exists. Refer to RR 2.7 for further discussion on evaluating the contract term.

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

Example 2-3, Example 2-4, Example 2-5, and Example 2-6 illustrate the considerations in determining whether a contract has been approved and the parties are committed.

EXAMPLE 2-3

Identifying the contract — product delivered without a written contract

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

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

Analysis

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

EXAMPLE 2-4

Identifying the contract — contract extensions

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

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

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

Analysis

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

However, since the original arrangement expired and did not include any provision for automatic extension, determining whether a contract exists during the intervening period from December to February requires an understanding of the legal enforceability of the arrangement in the relevant jurisdiction in the absence of a written contract. If both parties have enforceable rights and obligations during the renegotiation period, a contract exists and revenue should not be deferred merely because the formal written contract has not been signed.

If management concludes a contract exists during the renegotiation period, the guidance on variable consideration applies to the estimate of the transaction price, including whether any amounts should be constrained (refer to RR 4.3).

EXAMPLE 2-5

Identifying the contract – free trial period

ServiceProvider offers to provide three months of free service on a trial basis to all potential customers to encourage them to sign up for a paid subscription. At the end of the three-month trial period, a customer signs up for a noncancellable paid subscription to continue the service for an additional twelve months.

Should ServiceProvider record revenue related to the three-month free trial period?

Analysis

No. A contract does not exist until the customer commits to purchase the twelve months of service. The rights and obligations of the contract only include the future twelve months of paid subscription services, not the free trial period. Therefore, ServiceProvider should not record revenue related to the three-month free trial period (that is, none of the transaction price should be allocated to the three months already delivered). The transaction price should be recognized as revenue on a prospective basis as the twelve months of services are transferred.

EXAMPLE 2-6

Identifying the contract – free trial period with early acceptance

ServiceProvider offers to provide three months of free service on a trial basis to all potential customers to encourage them to sign up for a paid subscription. One month before the free trial period is completed (during month two of the three-month trial period), a customer signs up for a twelve-month service arrangement.

Should ServiceProvider record revenue for the remaining portion of the free trial period?

Analysis

It depends. Since the contract was signed before the free trial period was completed, judgment will be required to determine if the remaining free trial period is part of the contract with the customer. Management needs to assess if the rights and obligations in the contract include the one month remaining in the free trial period or only the future twelve months of paid subscription service. If management concludes that the remaining free trial period is part of the contract with the customer, revenue should be recognized on a prospective basis over 13 months, as services are transferred over the remaining trial period and the twelve-month subscription period.

2.6.1.2 The entity can identify each party's rights

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

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

2.6.1.3 *The entity can identify the payment terms*

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

2.6.1.4 *The contract has commercial substance*

A contract has commercial substance if the risk, timing, or amount of the entity's future cash flows will change as a result of the contract. If there is no change, it is unlikely the contract has commercial substance. A change in future cash flows does not only apply to cash consideration. Future cash flows can also be affected when the entity receives noncash consideration as the noncash consideration might result in reduced cash outflows in the future. There should also be a valid business reason for the transaction to occur. Determining whether a contract has commercial substance can require judgment, particularly in complex arrangements where vendors and customers have several arrangements in place between them.

2.6.1.5 *Collection of the consideration is probable*

The objective of the collectibility assessment is to determine whether there is a substantive transaction (that is, a valid contract) between the entity and a customer. An entity only applies the revenue guidance to contracts when it is "probable" that the entity will collect the consideration it is entitled to in exchange for the goods or services it transfers to the customer. The assessment of whether an amount is probable of being collected is made after considering any price concessions expected to be provided to the customer. Management should first determine whether it expects the entity to accept a lower amount of consideration than that which the customer is contractually obligated to pay (refer to "Impact of price concessions" section below). An entity that expects to provide a price concession should assess the probability of collection for the amount it expects to enforce (that is, the transaction price adjusted for estimated concessions).

The entity's assessment of this probability must reflect both the customer's ability and intent to pay as amounts become due. An assessment of the customer's intent to pay requires management to consider all relevant facts and circumstances, including items such as the entity's past practices with its customers as well as, for example, any collateral obtained from the customer.

The threshold used to assess probability differs between US GAAP and IFRS. This is because the term "probable" under US GAAP is generally interpreted as a 75–80% likelihood, while under IFRS it means more likely than not (that is, greater than 50% likelihood). Despite different thresholds, in a majority of transactions, an entity will not enter into a contract with a customer if there is significant credit risk without also having protection to ensure it can collect the consideration to which it is entitled. Therefore, we believe there will be limited situations in which a contract would pass the "probable" threshold under IFRS but fail under US GAAP (that is, contracts where probability of collection falls between 50% and 80%).

Additional implementation guidance is included in ASC 606 to clarify how management should assess collectibility.

Excerpt from ASC 606-10-55-3C

When assessing whether a contract meets the [collectibility] criterion...an entity should determine whether the contractual terms and its customary business practices indicate that the entity's exposure to credit risk is less than the entire consideration promised in the contract because the entity has the ability to mitigate its credit risk. Examples of contractual terms or customary business practices that might mitigate the entity's credit risk include the following:

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

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

This additional guidance explains that management should consider the entity's ability to mitigate its exposure to credit risk as part of the collectibility assessment (for example, by requiring advance payments or ceasing to provide goods or services in the event of nonpayment). The guidance clarifies that the collectibility assessment is not based on collecting all of the consideration promised in the contract, but on collecting the amount to which the entity will be entitled in exchange for the goods or services it will transfer to the customer. These concepts are illustrated in Example 1 of ASC 606 (ASC 606-10-55-95 through ASC 606-10-55-98L).

IFRS 15 does not include the same implementation guidance and examples related to the collectibility assessment; however, the IASB included discussion in its basis for conclusions that describes similar principles as the ASC 606 implementation guidance.

Excerpt from IFRS 15 BC46C

[The collectibility]...assessment considers the entity's exposure to the customer's credit risk and the business practices available to the entity to manage its exposure to credit risk throughout the contract. For example, an entity may be able to stop providing goods or services to the customer or require advance payments.

We therefore expect the application of the collectibility assessment to be similar under ASC 606 and IFRS 15, with the exception of the limited situations impacted by the difference in the definition of “probable,” as discussed above.

Impact of price concessions

Distinguishing between an anticipated price concession and the entity’s exposure to the customer’s credit risk may require judgment. The distinction is important because a price concession is variable consideration (which affects the transaction price) rather than a factor to consider in assessing collectibility (when assessing whether the contract is valid). Refer to RR 4.3 for further discussion on variable consideration.

Factors to consider in assessing whether a price concession exists include an entity’s customary business practices, published policies, and specific statements regarding the amount of consideration the entity will accept. The assessment should not be limited to past business practices. For example, an entity might enter into a contract with a new customer expecting to provide a price concession to develop the relationship. Refer to Revenue TRG Memo No. 13 and the related meeting minutes in Revenue TRG Memo No. 25 for further discussion of this topic. These concepts are illustrated in Examples 2 and 3 of the revenue standard (ASC 606-10-55-99 through ASC 606-10-55-105 and IFRS 15.IE7 through IFRS 15.IE13).

Question 2-1 addresses the accounting implications of extended payment terms.

Question 2-1

An entity provides payment terms that are extended beyond normal terms in a contract with a new customer. Should management conclude that the amounts subject to the extended payment terms are not probable of collection?

PwC response

It depends. Extended payment terms should be considered when assessing the customer’s ability and intent to pay the consideration when it is due; however, the mere existence of extended payment terms is not determinative in the collectibility assessment. Management’s conclusion about whether collection is probable will depend on the relevant facts and circumstances. Management should also consider in this fact pattern whether the entity expects to provide a concession to the customer and whether the payment terms indicate that the arrangement includes a significant financing component (refer to RR 4.4).

Assessing collectibility for a portfolio of contracts

It is not uncommon for an entity’s historical experience to indicate that it will not collect all of the consideration related to a portfolio of contracts. In this scenario, management could conclude that collection is probable for each contract within the portfolio (that is, all of the contracts are valid) even though it anticipates some (unidentified) customers will not pay all of the amounts due. The entity should apply the revenue model to determine transaction price (including an assessment of any expected price concessions) and recognize revenue assuming collection of the entire transaction price. Management should separately evaluate the contract asset or receivable for impairment under the applicable financial instruments standard (ASC 310 or IFRS 9). Refer to Revenue TRG Memo No. 13

and the related meeting minutes in Revenue TRG Memo No. 25 for further discussion of this topic. Example 2-7 illustrates this accounting.

EXAMPLE 2-7

Identifying the contract — assessing collectibility for a portfolio of contracts

Wholesaler sells sunglasses to a large volume of customers under similar contracts. Before accepting a new customer, Wholesaler performs customer acceptance and credit check procedures designed to ensure that it is probable the customer will pay the amounts owed. Wholesaler will not accept a new customer that does not meet its customer acceptance criteria.

In January 20X8, Wholesaler delivers sunglasses to multiple customers in exchange for consideration totaling \$100,000. Wholesaler concludes that control of the sunglasses has transferred to the customers and there are no remaining performance obligations.

Wholesaler's concludes, based on its procedures, that collection is probable for each customer; however, historical experience indicates that, on average, Wholesaler will collect only 95% of the amounts billed. Wholesaler believes its historical experience reflects its expectations about the future. Wholesaler intends to pursue full payment from customers and does not expect to provide any price concessions.

How much revenue should Wholesaler recognize?

Analysis

Because collection is probable for each customer, Wholesaler should recognize revenue of \$100,000 when it transfers control of the sunglasses. Wholesaler's historical collection experience does not impact the transaction price in this fact pattern because it concluded that the collectibility threshold was met (that is, the contracts were valid) and it did not expect to provide any price concessions. Wholesaler should evaluate the related receivable for impairment based on the relevant financial instruments standard.

2.6.2 Arrangements where criteria are not met

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

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

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

When a contract with a customer does not meet the criteria ... and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when [one or more [US GAAP]/either [IFRS]] of the following events [have [US GAAP]/has [IFRS]] occurred:

- a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.
- b. The contract has been terminated, and the consideration received from the customer is nonrefundable.
- c. [The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable [US GAAP].]

The third criterion included in ASC 606 is intended to clarify when revenue should be recognized in situations where it is unclear whether the contract has been terminated. IFRS 15 does not include the third criterion; however, the basis for conclusions indicates that an entity could conclude a contract has been terminated when it stops providing goods or services to the customer. Example 2-8 illustrates the accounting for a contract for which collection is not probable and therefore, a contract does not exist.

EXAMPLE 2-8**Identifying the contract — collection not probable**

EquipCo sells equipment to its customer with three years of maintenance for total consideration of \$1 million, due in monthly installments over the three-year term. At contract inception, EquipCo determines that the customer does not have the ability to pay as amounts become due and therefore collection of the consideration is not probable. EquipCo intends to pursue collection and does not intend to provide a price concession. EquipCo delivers the equipment at the inception of the contract. At the end of the first year of the contract, the customer makes a partial payment of \$200,000. EquipCo continues to provide maintenance services, but concludes that collection of the remaining consideration is not probable.

Can EquipCo recognize revenue for the partial payment received?

Analysis

No. EquipCo cannot recognize revenue for the partial payment received because it has concluded that collection is not probable. EquipCo cannot recognize revenue for cash received from the customer until it meets one of the criteria outlined in RR 2.6.2. In this example, EquipCo has not terminated the contract and continues to provide services to the customer. EquipCo should continue to reassess collectibility each reporting period.

Question 2-2 addresses the accounting implications if an entity continues to pursue collection for remaining amounts owed.

Question 2-2

Can an entity recognize revenue for nonrefundable consideration received if it continues to pursue collection for remaining amounts owed under the contract (for an arrangement that does not meet all of the criteria to establish a contract with enforceable rights and obligations in RR 2.6.1)?

PwC response

It depends. Entities sometimes pursue collection for a considerable period of time after they have stopped transferring promised goods or services to the customer. Management should assess whether the criteria in RR 2.6.2 are met. We believe that management could conclude that a contract has been terminated even if the entity continues to pursue collection as long as the entity has stopped transferring goods and services and has no obligation to transfer additional goods or services to the customer.

Question 2-3 addresses how an entity should measure progress for a performance obligation satisfied over time if activities begin before a contract is established.

Question 2-3

If an entity begins activities related to a performance obligation for which control will transfer over time (for example, begins manufacturing a customized good) before a contract meets the criteria described in RR 2.6.1, how should progress be measured once the contract subsequently meets the criteria?

PwC response

The measure of progress for a performance obligation satisfied over time should reflect the entity's performance in transferring control of goods or services. Thus, once a contract is established, an entity should generally recognize revenue for any promised goods or services that have already transferred to the customer (that is, revenue is recognized on a cumulative catch-up basis). Refer to RR 6.4.6 and Revenue TRG Memo No. 33 and the related meeting minutes in Revenue TRG Memo No. 34 for further discussion of this topic.

Entities generally should not recognize revenue on a cumulative catch-up basis for distinct goods or services provided for no consideration prior to contract inception (for example, as part of a "free trial"). Refer to Example 2-6.

2.6.3 Reassessment of criteria

Once an arrangement has met the criteria in RR 2.6.1, management does not reassess the criteria again unless there are indications of significant changes in facts and circumstances. The determination of whether there is a significant change in facts or circumstances depends on the specific situation and requires judgment.

For example, assume an entity determines that a contract with a customer exists, but subsequently the customer's ability to pay deteriorates significantly in relation to goods or services to be provided in the

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

Example 4 in the revenue standard (ASC 606-10-55-106 through ASC 606-10-55-109 and IFRS 15.IE14 through IFRS 15.IE17) provides an illustration of a situation when the change in a customer's financial condition is so significant that it necessitates a reassessment of the criteria discussed in RR 2.6.1. Also refer to Revenue TRG Memo No. 13 and the related meeting minutes in Revenue TRG Memo No. 25 for further discussion of this topic.

2.7 *Determining the contract term*

The contract term is the period during which the parties to the contract have present and enforceable rights and obligations. Determining the contract term is important as it impacts the determination and allocation of the transaction price and recognition of revenue.

Excerpt from ASC 606-10-25-3 and IFRS 15.11

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

Entities should consider termination clauses when assessing contract duration. If a contract can be terminated early for no compensation, enforceable rights and obligations would likely not exist for the entire stated term. The contract may, in substance, be a shorter-term contract with a right to renew. In contrast, a contract that can be terminated early, but requires payment of a substantive termination penalty, is likely to have a contract term equal to the stated term. This is because enforceable rights and obligations exist throughout the stated contract period. Refer to Revenue TRG Memo No. 10 and Revenue TRG Memo No. 48, and the related meeting minutes in Revenue TRG Memo Nos. 11 and Revenue TRG Memo No. 49, respectively, for further discussion of this topic.

We believe that termination penalties could take various forms, including cash payments or the transfer of an asset to the vendor (see Example 2-12). Additionally, a payment need not be labelled a “termination penalty” to create enforceable rights and obligations. For example, a substantive termination penalty might exist if a customer must repay a portion of an upfront discount if the customer terminates the contract.

Management should apply judgment in determining whether a termination penalty is substantive. There are no “bright lines” for making this assessment. The objective is to determine the period over which the parties have enforceable rights and obligations. Factors to consider, among others, include the business purpose for contract terms that include termination rights and related penalties and the entity's past business practices.

An entity should not account for termination rights that do not have substance, similar to any other non-substantive contract provision. For example, a termination right may not have substance if it allows a customer to cancel a contract that has been paid in full, but does not require the vendor to refund any consideration upon cancellation.

Example 2-9, Example 2-10, Example 2-11, and Example 2-12 illustrate the impact of termination rights and penalties on the assessment of contract term.

EXAMPLE 2-9

Determining the contract term — both parties can terminate without penalty

ServiceProvider enters into a contract with a customer to provide monthly services for a three-year period. Each party can terminate the contract at the end of any month for any reason without compensating the other party (that is, there is no penalty for terminating the contract early).

What is the contract term for purposes of applying the revenue standard?

Analysis

The contract should be treated as a month-to-month contract despite the three-year stated term. The parties do not have enforceable rights and obligations beyond the month (or months) of services already provided.

EXAMPLE 2-10

Determining the contract term — only the customer can terminate without penalty

ServiceProvider enters into a contract with a customer to provide monthly services for a three-year period. The customer can terminate the contract at the end of any month for any reason without compensating ServiceProvider to terminate the contract.

What is the contract term for purposes of applying the revenue standard?

Analysis

The contract should be accounted for as a month-to-month contract with a customer option to renew each month. This is consistent with discussion in the basis for conclusions that customer cancellation rights can be similar to a renewal option. In this fact pattern, the three-year cancellable contract is equivalent to a one-month renewable contract. Refer to RR 7.3 for further discussion on the accounting for renewal options, including the assessment of whether such options provide the customer with a material right. Additionally, refer to Revenue TRG Memo No. [48](#) and the related meeting minutes in Revenue TRG Memo No. [49](#) for further discussion of this topic.

EXAMPLE 2-11

Determining the contract term — impact of termination penalty

ServiceProvider enters into a contract with a customer to provide monthly services for a three-year period. The customer can terminate the contract at the end of any month for any reason. The customer must pay a termination penalty if the customer terminates the contract during the first twelve months.

What is the contract term for purposes of applying the revenue standard?

Analysis

It depends. Management should assess whether the termination penalty is substantive such that it creates enforceable rights and obligations for the first twelve months of the contract. The contract term would be one year if the termination penalty is determined to be substantive.

EXAMPLE 2-12

Determining the contract term — license of intellectual property

Biotech enters into a ten-year term license arrangement with Pharma under which Biotech transfers to Pharma the exclusive rights to sell product using its intellectual property in a particular territory. There are no other performance obligations in the arrangement. Pharma makes an upfront nonrefundable payment of \$25 million and is obligated to pay an additional \$1 million at the end of each year throughout the stated term.

Pharma can cancel the contract for convenience at any time, but must return its rights to the licensed intellectual property to Biotech upon cancellation. Pharma does not receive any refund of amounts previously paid upon cancellation.

What is the contract term for purposes of applying the revenue standard?

Analysis

Biotech would likely conclude that the contract term is ten years because Pharma cannot cancel the contract without incurring a substantive termination penalty. The substantive termination penalty in this arrangement is Pharma's obligation to transfer an asset to Biotech through the return of its exclusive rights to the licensed intellectual property without refund of amounts paid.

The assessment of whether a substantive termination penalty is incurred upon cancellation could require significant judgment for arrangements that include a license of intellectual property. Factors to consider include the nature of the license, the payment terms (for example, how much of the consideration is paid upfront), the business purpose of contract terms that include termination rights, and the impact of contract cancellation on other performance obligations, if any, in the contract. If management concludes that a termination right creates a contract term shorter than the stated term, management should assess whether the arrangement contains a renewal option that provides the customer with a material right (refer to RR 7.3).

2.8 Combining contracts

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

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

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

- a. The contracts are negotiated as a package with a single commercial objective;
- b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract; [or [IFRS]]
- c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation

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

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

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

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

2.9 Contract modifications

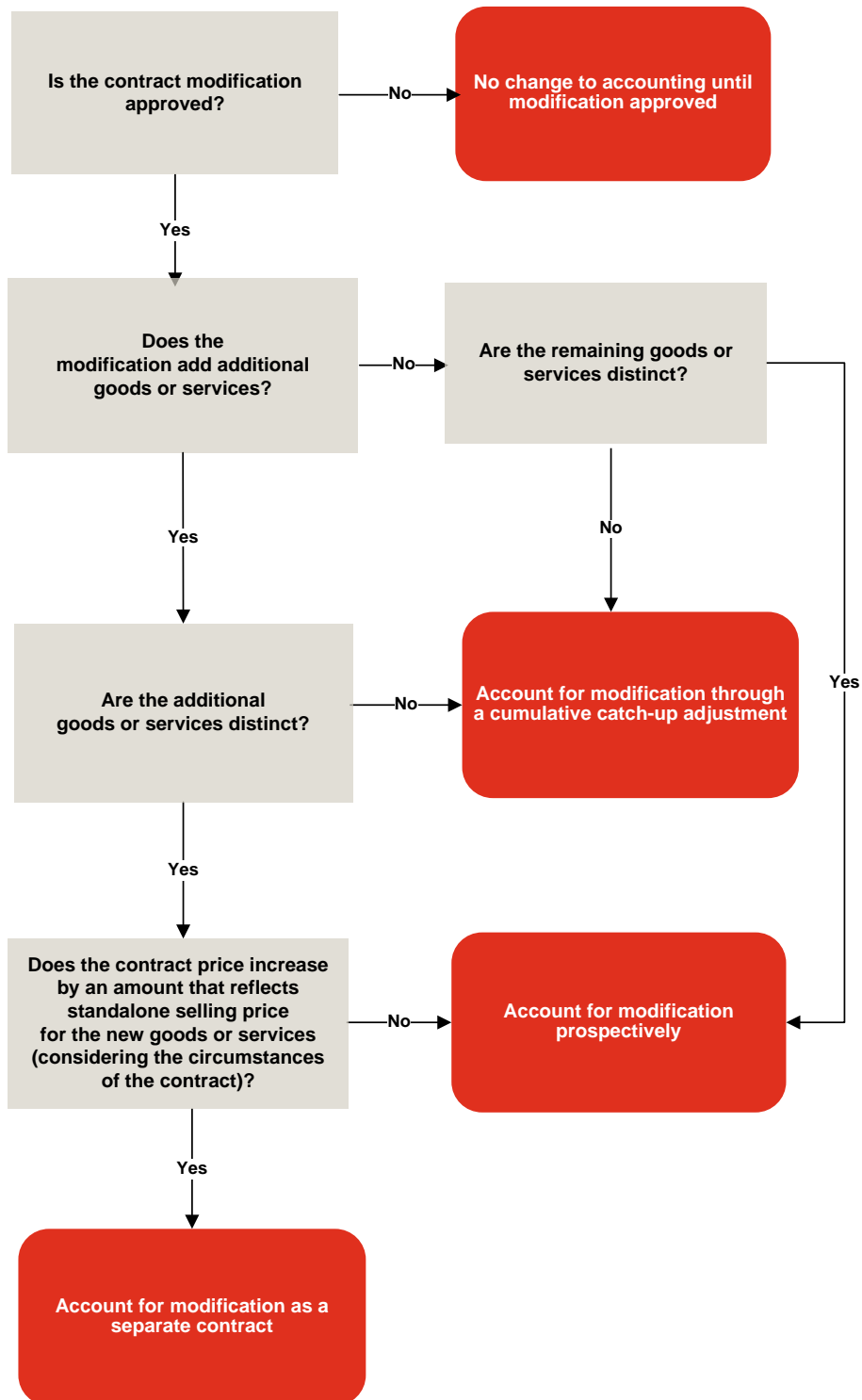
A change to an existing contract is a modification. A contract modification could change the scope of the contract, the price of the contract, or both. A contract modification exists when the parties to the contract approve the modification either in writing, orally, or based on the parties’ customary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

A new agreement with an existing customer could be a modification of an existing contract even if the agreement is not structured as a modification to the terms and conditions of the existing contract. For example, a vendor may enter into a contract to provide services to a customer over a two-year period. During the contract period, the vendor could enter into a new contract to provide different goods or services to the same customer. Management should assess whether the new contract is a modification to the existing contract. Factors to consider could include whether the terms and conditions of the new contract were negotiated separately from the original contract and whether the pricing of the new contract depends on the pricing of the existing contract. If the new contract transfers distinct goods or services to the customer that are priced at their standalone selling prices, the new contract would be accounted for separately (whether or not it is viewed as a contract modification). If the goods or services are priced at a discount to standalone selling price, management will need to evaluate the reason for the discount as this may be an indicator that the new contract is a modification of the existing contract.

An agreement to modify a contract could include adjustments to the transaction price of goods or services already transferred to the customer. For example, in connection with a contract modification, an entity may agree to provide a partial refund due to customer satisfaction issues related to goods already delivered. The refund should be accounted for separately because it is an adjustment to the transaction price of the previously transferred goods. Thus, the amount of the refund would be recognized immediately as a reduction of revenue and excluded from the application of the modification guidance summarized in Figure 2-3. Determining when a portion of a price modification should be accounted for separately could require significant judgment. This concept is illustrated in Example 5, Case B, of the revenue standard (ASC 606-10-55-114 through ASC 606-10-55-116 and IFRS 15.IE22 through IFRS 15.IE24).

Contract modifications are accounted for as either a separate contract or as part of the existing contract, depending on the nature of the modification, as summarized in Figure 2-3.

Figure 2-3
Accounting for contract modifications



Question 2-4 addresses whether the contract modification guidance applies when the parties agree to terminate the original contract.

Question 2-4

An entity and its customer agree to terminate an existing contract and enter into a new contract rather than modify the existing contract. Does the contract modification guidance apply in this situation?

PwC response

We believe management should apply the contract modification guidance to determine the appropriate accounting if, in substance, the parties have modified the existing contract even if it is structured as a termination of the existing contract and creation of a new contract.

2.9.1 Assessing whether a contract modification is approved

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

Where the parties to an arrangement have agreed to a change in scope, but not the corresponding change in price (for example, an unpriced change order), the entity should estimate the change to the transaction price in accordance with the guidance on estimating variable consideration (refer to RR 4). Management should assess all relevant facts and circumstances (for example, prior experience with similar modifications) to determine whether there is an expectation that the price will be approved. Example 2-13 illustrates a contract modification with an unpriced change order. This concept is also illustrated in Example 9 of the revenue standard (ASC 606-10-55-134 through ASC 606-10-55-135 and IFRS 15.IE42 through IFRS 15.IE43).

EXAMPLE 2-13

Contract modifications — unpriced change order

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

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

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

Analysis

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

2.9.2 ***Modification is accounted for as a separate contract***

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

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

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

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

The guidance provides some flexibility in what constitutes "standalone selling price" to reflect the specific circumstances of the contract. For example, an entity might provide a discount to a recurring customer that it would not provide to new customers. The objective is to determine whether the pricing reflects the amount the entity would have negotiated independent of other existing contracts.

Example 2-14 and Example 2-15 illustrate contract modifications that are accounted for as separate contracts. This concept is also illustrated in Example 5 of the revenue standard (ASC 606-10-55-111 through ASC 606-10-55-116 and IFRS 15.IE19 through IFRS 15.IE24).

EXAMPLE 2-14

Contract modifications — sale of additional goods

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

Should Manufacturer account for the modification as a separate contract?

Analysis

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

EXAMPLE 2-15**Contract modifications — blend-and-extend modification**

Manufacturer enters into a three-year noncancellable contract to deliver 100 products each year at a fixed price of \$90 per unit. Market prices for the products decline in the period following contract inception. At the end of the second year, when the market price is \$80 per unit, the parties agree to modify the contract to: (1) extend the sales contract for an additional year (same fixed annual quantity); and (2) lower the sales price to a “blended” rate of \$85 per unit for all remaining units (\$90 x 100 remaining units from the original contract plus \$80 x 100 additional units). Manufacturer concludes the products to be delivered in the future are distinct from those previously delivered and concludes the standalone selling price is \$80 per unit.

How should Manufacturer account for the modification?

Analysis

The “blend-and-extend” modification allows the customer to immediately take advantage of a lower price; however, the substance of the modification in this fact pattern is that the parties agreed to add distinct goods for additional consideration that reflects standalone selling price. It may therefore be appropriate for Manufacturer to account for the modification as a separate contract. Under this approach, Manufacturer would continue to recognize revenue of \$90 per unit for the remaining period of the original contract and recognize \$80 per unit in the following year.

Management should consider all of the relevant facts and circumstances to determine whether the additional consideration reflects standalone selling price, which may require significant judgment. If the additional consideration does not reflect standalone selling price, the modification should be accounted for as the termination of the existing contract and creation of a new contract, and revenue would be recognized based on the blended price for all units. For example, the additional consideration may not reflect standalone selling price in situations when quantities are variable (as opposed to fixed), prices are expected to change significantly in the future (such that the standalone selling price for future years is expected to differ from the contract price), or the arrangement contains a significant financing component (to provide the benefit of advanced cash flow).

2.9.3 Modification is not a separate contract

A modification that does not meet both of the criteria to be accounted for as a separate contract is accounted for as an adjustment to the existing contract, either prospectively or through a cumulative catch-up adjustment. The determination depends on whether the remaining goods or services to be provided to the customer under the modified contract are distinct.

2.9.3.1 **Modification is accounted for prospectively**

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

An entity will also account for a contract modification prospectively if the contract contains a single performance obligation that comprises a series of distinct goods or services, such as a monthly cleaning service (refer to RR 3.3.2). In other words, the modification will only affect the accounting for the remaining distinct goods and services to be provided in the future, even if the series of distinct goods or services is accounted for as a single performance obligation.

Example 2-16 and Example 2-17 illustrate contract modifications accounted for prospectively. This concept is also illustrated in Example 7 of the revenue standard (ASC 606-10-55-125 through ASC 606-10-55-128 and IFRS 15.IE33 through IFRS 15.IE36).

EXAMPLE 2-16

Contract modifications — series of distinct services

ServeCo enters into a three-year noncancellable service contract with Customer for \$450,000 (\$150,000 per year). The standalone selling price for one year of service at inception of the contract is \$150,000 per year. ServeCo accounts for the contract as a series of distinct services (refer to RR 3.3.2).

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

How should ServeCo account for the modification?

Analysis

The modification would be accounted for as if the existing arrangement was terminated and a new contract created (that is, on a prospective basis) because the remaining services to be provided are distinct. The modification should not be accounted for as a separate contract, even though the remaining services to be provided are distinct, because the price of the contract did not increase by an amount of consideration that reflects the standalone selling price of the additional services.

ServeCo should reallocate the remaining consideration to all of the remaining services to be provided (that is, the obligations remaining from the original contract and the new obligations). ServeCo will recognize a total of \$420,000 (\$120,000 + \$300,000) over the remaining four-year service period (one year remaining under the original contract plus three additional years), or \$105,000 per year.

EXAMPLE 2-17**Contract modifications — modification accounted for on a prospective basis**

Supplier enters into a noncancellable contract with Retailer to supply 100,000 goods on an annual basis for \$3 per unit for three years. At the beginning of the third year, Supplier and Retailer agree to renegotiate the contract because the market price for the goods has declined. Under the modified agreement, the parties agree to (1) extend the contract for an additional year (same fixed annual quantity) and (2) reduce the price per unit to \$2 for the remaining 200,000 units to be delivered. Supplier also agrees as part of the modification to make a one-time payment of \$10,000 to Retailer. There is no dispute between the parties regarding prior performance, and both parties have performed according to the terms of the contract.

Supplier concludes the remaining goods are distinct from those previously delivered and concludes the additional consideration does not reflect standalone selling price.

How should Supplier account for the modification?

Analysis

Supplier should account for the modification on a prospective basis. The transaction price of \$390,000 (\$2 per unit x 200,000 remaining goods less \$10,000 payment to Retailer) should be allocated to the remaining performance obligations, resulting in revenue of \$1.95 per unit (\$390,000 / 200,000 goods). The \$10,000 payment to Retailer is a reduction of the transaction price allocated to the remaining goods in this fact pattern because the payment was made in conjunction with the renegotiation of the contract and there is no indication that the payment relates to prior performance.

In contrast, if there was evidence of a dispute or failure to perform according to the contract terms related to the previously delivered goods, this might indicate that Supplier agreed to make a concession that reduces the transaction price for the previously delivered goods. In that case, the amount that represents a concession would be recorded immediately. Determining when a portion of a modification is in substance a price concession could require significant judgment. This concept is illustrated in Example 5, Case B of the revenue standard (ASC 606-10-55-114 through ASC 606-10-55-116 and IFRS 15.IE22 through IFRS 15.IE24).

Question 2-5 addresses the accounting for a contract asset when a contract is modified.

Question 2-5

Should an existing contract asset be written off as a reduction of revenue when a modification is accounted for as the termination of the original contract and creation of a new contract?

PwC response

Generally, no. Although the original contract is considered “terminated,” modifications of this type should be accounted for on a prospective basis. That is, the contract asset would typically relate to a right to consideration for goods and services that have already been transferred. Management should consider, however, whether the facts and circumstances of the modification result in an impairment of the contract asset. Refer to US Revenue TRG Memo No. 51 and the related meeting minutes in Revenue TRG Memo No. 55 for further discussion of this topic.

2.9.3.2 ***Modification results in a cumulative catch-up adjustment***

An entity accounts for a modification through a cumulative catch-up adjustment if the goods or services in the modification are not distinct and are part of a single performance obligation that is only partially satisfied when the contract is modified. This concept is illustrated in Example 8 of the revenue standard (ASC 606-10-55-129 through ASC 606-10-55-133 and IFRS 15.IE37 through IFRS 15.IE41).

This type of contract modification is treated as if it were part of the original contract. Modifications of contracts that include a single performance obligation that is a series of distinct goods or services will not be accounted for using a cumulative catch-up adjustment; rather, these modifications will be accounted for prospectively (refer to RR 2.9.3.1).

Example 2-18 illustrates a contract modification accounted for through a cumulative catch-up adjustment.

EXAMPLE 2-18

Contract modifications — cumulative catch-up adjustment

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

How should Builder account for the modification?

Analysis

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

2.9.4 ***Changes in the transaction price***

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

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

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

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

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

Example 6 in the revenue standard (ASC 606-10-55-117 through ASC 606-10-55-124 and IFRS 15.IE25 through IFRS 15.IE32) illustrates the accounting for a change in the transaction price after a contract modification.

Chapter 3:

Identifying performance obligations

3.1 Chapter overview

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

3.2 Promises in a contract

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

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

- Transferring produced goods or reselling purchased goods
- Arranging for another party to transfer goods or services
- Standing ready to provide goods or services in the future
- Building, designing, manufacturing, or creating an asset on behalf of a customer
- Granting a right to use or access to intangible assets, such as intellectual property (refer to RR 9.5)
- Granting an option to purchase additional goods or services that provides a material right to the customer (refer to RR 3.5)
- Performing contractually agreed-upon tasks

3.2.1 Immaterial promises

ASC 606 states that an entity is not required to separately account for promised goods or services that are immaterial in the context of the contract.

ASC 606-10-25-16A

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

ASC 606-10-25-16B

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

Assessing whether promised goods or services are immaterial in the context of the contract requires judgment. Management should consider the nature of the contract and the relative significance of a particular promised good or service to the arrangement as a whole. Management should evaluate both quantitative and qualitative factors, including the customer's perspective, in this assessment. For example, if a promised good or service is featured prominently in the entity's marketing materials, this likely indicates that the good or service is not immaterial from the customer's perspective. If multiple goods or services are considered to be individually immaterial in the context of the contract, but those items are material in the aggregate, management should not disregard those goods or services when identifying performance obligations.

If revenue is recognized prior to transferring immaterial goods or services, the related costs should be accrued. The requirement to accrue costs related to immaterial promises only applies to items that are, in fact, promises to the customer. For example, costs that will be incurred to operate a call desk that is broadly available to answer questions about a product would typically not be accrued as this activity would not fulfill a promise to a customer.

IFRS 15 does not include the same specific guidance on immaterial promises. IFRS reporters should, however, consider the overall objective of IFRS 15 and the application of materiality concepts when identifying performance obligations.

3.3 *Identifying performance obligations*

A performance obligation is a promise to provide a distinct good or service or a series of distinct goods or services as defined by the revenue standard.

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

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

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

3.3.1 *Promise to transfer a distinct good or service*

Each distinct good or service that an entity promises to transfer is a performance obligation (refer to RR 3.4 for guidance on assessing whether a good or service is distinct). Goods and services that are not distinct are bundled with other goods or services in the contract until a bundle of goods or services

that is distinct is created. The bundle of goods or services in that case is a single performance obligation.

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

A series of distinct goods or services provided over a period of time is a single performance obligation if the distinct goods or services are substantially the same and have the same pattern of transfer to the customer. The guidance sets out criteria for determining whether a series of distinct goods or services has the “same pattern of transfer.”

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

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

- a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria...to be a performance obligation satisfied over time. [and [IFRS]]
- b. ...the same method would be used to measure the entity’s progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

A series can consist of distinct time increments of service (for example, a series of daily or monthly services). Examples of promises to transfer a series of distinct services could include certain maintenance services, software-as-a-service (SaaS), transaction processing, IT outsourcing, licenses that provide a right to access IP (refer to RR 9), and asset management services if the service being provided each time period is substantially the same.

In contrast, a service for which each day incorporates the previous day’s effort toward achieving an end result would generally not be a series of distinct services because the service being performed each time period is not substantially the same. Examples of this type of service could include certain consulting services, engineering services, and research and development (R&D) efforts.

While the aforementioned examples relate to services, the series guidance also applies to goods as long as the criteria to be a performance obligation satisfied over time are met for the individual distinct goods within the series.

An entity is required to account for a series of distinct goods or services as one performance obligation if the criteria are met (the “series guidance”), even though the underlying goods or services are distinct. Judgment will often be needed to determine whether the criteria for applying the series guidance are met.

Management will apply the principles in the revenue standard to the single performance obligation when the series criteria are met, rather than the individual goods or services that make up the single performance obligation. The exception is that management should consider each distinct good or service in the series, rather than the single performance obligation, when accounting for contract modifications and allocating variable consideration. Refer to further discussion on contract modifications in RR 2.9 and allocating variable consideration to a series of distinct goods or services in RR 5.5.1.1.

The series guidance is intended to simplify the application of the revenue model to arrangements that meet the criteria; however, application of the series guidance is not optional. The assessment of whether a contract includes a series could impact both the allocation of revenue and timing of recognition. This is because the series guidance requires that goods and services in the series be accounted for as a single performance obligation. As a result, revenue is not allocated to each distinct good or service based on relative standalone selling price. Management will instead determine a measure of progress for the single performance obligation that best depicts the transfer of goods or services to the customer. Refer to further discussion of measures of progress in RR 6.4. Additionally, refer to Revenue TRG Memo No. [27](#) and the related meeting minutes in Revenue TRG Memo No. [34](#) for further discussion of this topic.

Question 3-1 addresses whether services with multiple underlying activities could qualify as a series.

Question 3-1

Could a continuous service (for example, hotel management services) qualify as a series of distinct services if the underlying activities performed by the entity vary from day to day (for example, employee management, accounting, procurement, etc.)?

PwC response

Possibly. The series guidance requires each distinct good or service to be “substantially the same.” Management should evaluate this requirement based on the nature of its promise to the customer. For example, a promise to provide hotel management services for a specified contract term could meet the series criteria. This is because the entity is providing the same service of “hotel management” each period, even though some of the underlying activities may vary each day. The underlying activities (for example, reservation services, property maintenance) are activities to fulfill the hotel management service rather than separate promises. The distinct service within the series is each time increment of performing the service (for example, each day or month of service). Example 12A in ASC 606-10-55-157B through ASC 606-10-55-158 illustrates this concept. Also refer to Revenue TRG Memo No. [39](#) and the related meeting minutes in Revenue TRG Memo No. [44](#) for further discussion.

Question 3-2 addresses whether a stand-ready obligation is a series.

Question 3-2

Is a promise to stand ready to provide goods or services (that is, a “stand-ready obligation”) a series of distinct goods or services?

PwC response

Yes. A stand-ready obligation will typically meet the criteria to be accounted for as a series of distinct goods or services and therefore, a single performance obligation. Management will need to apply judgment to determine whether the nature of an entity’s promise is to stand ready to provide goods or services or a promise to provide specified goods or services. Refer to RR 6.4.3.

Question 3-3 addresses the measure of progress for a performance obligation that is a series.

Question 3-3

Is it always acceptable to use a time-based measure of progress (that is, straight-line recognition) for a performance obligation that is a series of distinct goods or services?

PwC response

No. It is not appropriate to default to a time-based measure of progress for a series; however, straight-line recognition over the contract period will be reasonable in many cases. Management should select the method that best depicts the entity's progress in transferring control of the goods or services. Refer to RR 6.4.

Question 3-4 addresses whether goods and services need to be delivered consecutively to qualify as a series.

Question 3-4

Do goods and services need to be delivered consecutively to qualify as a series of distinct goods or services?

PwC response

No. There is no requirement to deliver goods or services consecutively to qualify as a series of distinct goods or services. The series guidance could apply despite gaps in performance or concurrent transfer of individual distinct goods or services within the series. Refer to Revenue TRG Memo No. 27 and the related meeting minutes in Revenue TRG Memo No. 34 for further discussion of this topic.

Example 3-1 illustrates a contract that includes a series of distinct goods. See Examples 7 and 31 in the revenue standard (ASC 606-10-55-125 through ASC 606-10-55-128 and ASC 606-10-55-248 through ASC 606-10-55-250 and IFRS 15.IE33 through IFRS 15.IE36 and IFRS 15.IE56 through IFRS 15.IE58) for additional illustration of a series of distinct goods or services.

EXAMPLE 3-1

Series of distinct goods – a single performance obligation

Contract Manufacturer has a contract to provide 50 units of Product A over a 36-month period. Product A is fully developed such that design services are not included in the contract.

Contract Manufacturer has concluded that each unit is a distinct good. An individual unit meets the criteria to be recognized over time because it has no alternative use and Contract Manufacturer has the right to payment for its performance as the goods are manufactured (refer to RR 6.3).

How many performance obligations are in the contract?

Analysis

The promise to provide 50 units of Product A is a single performance obligation. The contract is a series of distinct goods because (a) each unit is substantially the same, (b) each unit would meet the

criteria to be a performance obligation satisfied over time, and (c) the same method would be used to measure the entity's progress to depict the transfer of each unit. If any of these criteria were not met, each unit would be a separate performance obligation.

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

Each distinct good or service is a performance obligation. Performance obligations are the unit of account for purposes of applying the revenue standard and form the basis for how and when revenue is recognized. When there are multiple promises in a contract, management will need to determine whether goods or services are distinct, and therefore separate performance obligations. The assessment of whether a good or service is distinct is a two-pronged test; the good or service must be both: (1) capable of being distinct and (2) separately identifiable.

ASC 606-10-25-19 and IFRS 15.27

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

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

3.4.1 *Capable of being distinct*

A good or service is capable of being distinct if the customer can benefit from that good or service on its own or with other resources that are readily available. A customer can benefit from a good or service if it can be used, consumed, or sold (for an amount greater than scrap value) to generate economic benefits. A good or service is also typically capable of being distinct if an entity regularly sells that good or service on a standalone basis.

A good or service that cannot be used on its own, but can be used with readily available resources, also meets this criterion, as the entity has the ability to benefit from it. Readily available resources are goods or services that are sold separately, either by the entity or by others in the market. Readily available resources also include resources that the customer has already obtained, either from the entity or through other means. As a result, the timing of delivery of goods or services (that is, whether a necessary resource is delivered before or after another good or service) can impact the assessment of whether the customer can benefit from the good or service.

“Capable of being distinct” is only the first criterion of the distinct assessment. Management will also have to assess whether the promised good or service is “separately identifiable” from other goods or services in the contract (refer to RR 3.4.2).

Examples 10 and 11 of the revenue standard (ASC 606-10-55-137 through ASC 606-10-55-150K and IFRS 15.IE45 through IFRS 15.IE58K) illustrate the assessment of whether a good or service is capable of being distinct.

3.4.2 *Separately identifiable*

After determining that a good or service is capable of being distinct, the next step is assessing whether the good or service is separately identifiable from other promises in the contract. Understanding what a customer expects to receive as a final product is necessary to assess whether a good or service is separately identifiable or whether it should be combined with other goods or services into a single performance obligation. Some contracts contain a promise to deliver multiple goods or services, but the customer is not purchasing the individual items. Rather, the customer is purchasing the final good or service (the combined item or items) that those individual items (the inputs) create when they are combined. Judgment is needed to determine whether there is a single performance obligation or multiple separate performance obligations. Management needs to consider the terms of the contract and all other relevant facts, including the economic substance of the transaction, to make this assessment.

ASC 606-10-25-21 and IFRS 15.29

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

- a. The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
- b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
- c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

The factors are intended to help an entity determine whether its performance in transferring multiple goods or services in a contract is fulfilling a single promise to a customer. The factors above are not an exhaustive list and should also not be used as a checklist.

Management should consider whether the combined item is greater than, or substantially different from, the sum of the individual goods and services. In other words, management should consider whether there is a transformative relationship between the goods or services in the process of fulfilling the contract. For example, a contract to construct a wall could include promises to provide labor, lumber, and sheetrock. The individual inputs (the labor, lumber, and sheetrock) are being used to

create a combined item (the wall) that is substantially different from the sum of the individual inputs. The promise to construct a wall is therefore a single performance obligation in this example.

Management should consider the level of integration, interrelation, and interdependence among the promises to transfer goods or services. The goods and services in a contract should not be combined solely because one of the goods or services would not have been purchased without the others. For example, a contract that includes delivery of equipment and routine installation is not necessarily a single performance obligation even though the customer would not purchase the installation if it had not purchased the equipment. The fact that the one item depends on the other (in this example, the installation cannot be performed without the customer first purchasing the equipment) does not, on its own, support a conclusion that there is a single performance obligation.

Management should also consider whether the entity could fulfill its promise to provide a good or service if it did not provide other goods or services identified in the contract. If the entity's performance in providing a good or service in the contract would differ significantly if it did not provide the other goods or services, this may indicate that the goods or services are highly interdependent or highly interrelated and therefore, are not separately identifiable.

The IFRIC Agenda Decision, *[Revenue recognition in a real estate contract that includes the transfer of land](#)*, issued in March 2018 illustrates the application of these principles to the assessment of whether a promise to transfer land and construct a building are separately identifiable.

Example 3-2, Example 3-3, Example 3-4, and Example 3-5 illustrate the application of the “separately identifiable” guidance. This concept is also illustrated in Examples 10 and 11 of the revenue standard (ASC 606-10-55-137 through ASC 606-10-55-150K and IFRS 15.IE45 through IFRS 15.IE58K).

EXAMPLE 3-2

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

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

How many performance obligations are in the contract?

Analysis

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

However, the goods and services are not separately identifiable from other promises in the contract. Contractor's overall promise in the contract is to transfer a combined item (the house) to which the individual goods or services are inputs. This conclusion is supported by the fact that Contractor

provides a significant service of integrating the various goods and services into the home that the homeowner has contracted to purchase.

EXAMPLE 3-3

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

SoftwareCo enters into a contract with a customer to provide a perpetual software license, installation services, and three years of postcontract customer support (unspecified future upgrades and telephone support). The installation services require the entity to configure certain aspects of the software, but do not significantly modify the software. These services do not require specialized knowledge, and other sophisticated software technicians could perform similar services. The upgrades and telephone support do not significantly affect the software's benefit or value to the customer.

How many performance obligations are in the contract?

Analysis

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

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

SoftwareCo concludes that each good and service is separately identifiable because the software license, installation services, unspecified future upgrades, and telephone support are not inputs into a combined item the customer has contracted to receive. SoftwareCo can fulfill its promise to transfer each of the goods or services separately and does not provide any significant integration, modification, or customization services.

EXAMPLE 3-4

Distinct goods or services — contractual requirement to use the vendor's service

SoftwareCo enters into a contract with a customer to provide a perpetual software license, installation services, and three years of postcontract customer support (unspecified future upgrades and telephone support). The installation services require the entity to configure certain aspects of the software, but do not significantly modify the software. These services do not require specialized knowledge, and other sophisticated software technicians could perform similar services. The upgrades and telephone support do not significantly affect the software's benefit or value to the customer. The customer is contractually required to use SoftwareCo's installation services.

How many performance obligations are in the contract?

Analysis

The contractual requirement to use SoftwareCo's installation services does not change the evaluation of whether the goods and services are distinct. SoftwareCo concludes that there are four performance

obligations: (1) software license, (2) installation services, (3) unspecified future upgrades, and (4) telephone support.

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

SoftwareCo concludes that each good and service is separately identifiable because the software license, installation services, unspecified future upgrades, and telephone support are not inputs into a combined item the customer has contracted to receive. SoftwareCo can fulfill its promise to transfer each of the goods or services separately and does not provide any significant integration, modification, or customization services.

EXAMPLE 3-5

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

SoftwareCo enters into a contract with a customer to provide a perpetual software license, installation services, and three years of postcontract customer support (unspecified future upgrades and telephone support). The installation services require SoftwareCo to substantially customize the software by adding significant new functionality enabling the software to function with other computer systems owned by the customer. The upgrades and telephone support do not significantly affect the software's benefit or value to the customer.

How many performance obligations are in the contract?

Analysis

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

SoftwareCo determines that the promise to the customer is to provide a customized software solution. The software and customization services are inputs into the combined item for which customer has contracted and, as a result, the software license and installation services are not separately identifiable and should be combined into a single performance obligation. This conclusion is further supported by the fact that SoftwareCo is performing a significant service of integrating the licensed software with the customer's other computer systems. The nature of the installation services also results in the software being significantly modified and customized by the service.

The unspecified future upgrades and telephone support are separate performance obligations because they are not inputs into a combined item the customer has contracted to receive. SoftwareCo can fulfill its promise to transfer each of the goods or services separately and does not provide any significant integration, modification, or customization services.

3.5 Options to purchase additional goods or services

Contracts frequently include options for customers to purchase additional goods or services in the future. Customer options that provide a material right to the customer (such as a free or discounted good or service) give rise to a separate performance obligation. In this case, the performance

obligation is the option itself, rather than the underlying goods or services. Management will allocate a portion of the transaction price to such options, and recognize revenue allocated to the option when the additional goods or services are transferred to the customer, or when the option expires. Refer to RR 7 for further considerations related to customer options.

The additional consideration that would result from a customer exercising an option in the future is not included in the transaction price for the current contract. This is the case even if management concludes it is probable, or even virtually certain, that the customer will purchase additional goods or services. For example, customers could be economically compelled to make additional purchases due to exclusivity clauses or other facts and circumstances. Management should not include an estimate of future purchases as a promise in the current contract unless those purchases are enforceable by law regardless of the probability that the customer will make additional purchases. Judgment may be required to identify the enforceable rights and obligations in a contract, as well as the existence of implied or explicit contracts that should be combined with the present contract.

Judgment may also be required to distinguish optional goods or services from promises to provide goods or services in exchange for a variable fee. An example is a contract to deliver a photocopy machine to a customer in exchange for a fee based on the number of copies made by the customer. In this example, the promise to the customer is to transfer the machine. The number of photocopies that the customer will make is unknown at contract inception; however, the customer's future actions (that create photocopies) are not a separate buying decision to purchase additional distinct goods or services from the entity. The fee in this case is variable consideration (refer to RR 4.3 for further discussion).

In contrast, consider a contract to deliver a photocopy machine that also provides pricing for replacement ink cartridges that the customer can elect to purchase in the future. The future purchases of ink cartridges are options to purchase goods in the future and, therefore, should not be considered a promise in the current contract. The entity should evaluate, however, whether the customer option provides a material right. Refer to Revenue TRG Memo No. [48](#) and the related meeting minutes in Revenue TRG Memo No. [49](#) for further discussion of this topic.

The assessment of whether future purchases are optional could have a significant impact on the accounting for a contract when the transaction price is allocated to multiple performance obligations. Disclosures are also affected. For example, entities would not include optional goods or services in their disclosures of the remaining transaction price for a contract and the expected periods of recognition. Refer to RR 12 for further discussion of the disclosure requirements.

Example 3-6 illustrates the assessment of whether goods and services are optional purchases.

EXAMPLE 3-6

Optional purchases — sale of equipment and consumables

DeviceCo, a medical device company, sells a highly complex surgical instrument and consumables that are used in conjunction with the instrument. DeviceCo sells the instrument for \$100,000 and the consumables for \$100 per unit. A customer purchases the instrument, but does not commit to any specific level of consumable purchases. The customer cannot operate the instrument without the consumables and cannot purchase the consumables from any other vendor. DeviceCo expects that the customer will purchase 1,000 consumables each year throughout the estimated life of the instrument. DeviceCo concludes that the instrument and the consumables are distinct.

Should DeviceCo include the estimated consumable purchases as a performance obligation in the current contract?

Analysis

DeviceCo should not include the estimated consumable purchases as part of the current contract as they are optional purchases. Even though the customer needs the consumables to operate the instrument, there is no enforceable obligation for the customer to make the purchases. The customer makes a decision to purchase additional distinct goods each time it submits a purchase order for consumables.

DeviceCo should consider whether the option to purchase consumables in the future provides a material right to the customer (for example, if the customer receives a discount on future purchases of the consumables that is incremental to the range of discounts typically given to other customers as a result of entering into the current contract). A material right is accounted for as a performance obligation, as discussed in RR 7.

3.6 Other considerations

Performance obligations can result from other common contract terms or promises implied by an entity's customary business practices. The assessment of whether certain contract terms or implicit promises create performance obligations requires judgment in some situations.

3.6.1 Activities that are not performance obligations

Activities that an entity undertakes to fulfill a contract that do not transfer goods or services to the customer are not performance obligations. For example, administrative tasks to set up a contract or mobilization efforts are not performance obligations if those activities do not transfer a good or service to the customer. Judgment may be required to determine whether an activity transfers a good or service to the customer.

Entities in certain industries undertake pre-production activities, including the design and development of products or the creation of a new technology based on the needs of a customer. An example is an entity that enters into an arrangement with an auto manufacturer to design and develop tooling prior to the production of automotive parts. Management should first evaluate if the arrangement with the manufacturer, whether in connection with a supply contract or in anticipation of one, is in the scope of the revenue standard; for example, management might conclude the pre-production activities are not a revenue-generating activity because they are not part of the entity's ongoing major or central operations. Arrangements not in the scope of the revenue standard are subject to other applicable guidance; therefore, any related payments or reimbursements would not be presented as revenue from contracts with customers. For arrangements in the scope of the revenue standard, management should evaluate whether the pre-production activities represent a performance obligation (that is, whether control of a good or service is transferred to the customer). Pre-production activities that do not transfer a good or service to the customer are activities to fulfill the performance obligations in the contract. Refer to Revenue TRG Memo No. 46 and the related meeting minutes in Revenue TRG Memo No. 49 for further discussion of this topic. Additionally, refer to RR 11 for further discussion on accounting for costs to fulfill a contract.

Revenue is not recognized when an entity completes an activity that is not a performance obligation, as illustrated by Example 3-7 and Example 3-8.

EXAMPLE 3-7

Identifying performance obligations — activities

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

How many performance obligations are in the contract?

Analysis

There is one performance obligation in the contract, which is the right provided to the customer to access the health clubs. FitCo's activity of registering the customer is not a service to the customer and therefore does not represent satisfaction of a performance obligation. Refer to RR 8.4 for considerations related to the treatment of the upfront fee paid by the customer.

EXAMPLE 3-8

Identifying performance obligations — activities

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

How many performance obligations are in the arrangement?

Analysis

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

3.6.2 Implicit promises in a contract

The customer's perspective should be considered when assessing whether an implicit promise gives rise to a performance obligation. Customers might make current purchasing decisions based on expectations implied by an entity's customary business practices or marketing activities. A performance obligation exists if there is a valid expectation, based on the facts and circumstances, that additional goods or services will be delivered for no additional consideration.

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

Implied promises made by the entity to the customer in exchange for the consideration promised in the contract do not need to be enforceable by law in order for them to be evaluated as a performance obligation. This is in contrast to optional customer purchases in exchange for additional consideration, which are not included as performance obligations in the current contract unless the customer option provides a material right (refer to RR 3.5). Implied promises can create a performance obligation under a contractual agreement, even when enforcement is not assured because the customer has an expectation of performance by the entity. The boards noted in the basis for conclusions to the revenue standard that failing to account for these implied promises could result in all of the revenue being recognized even when the entity has unsatisfied promises with the customer. Example 12 in the revenue standard (ASC 606-10-55-151 through ASC 606-10-55-157 and IFRS 15.IE59 through IFRS 15.IE65A) illustrates a contract containing an implicit promise to provide services.

3.6.3 *Product liability and patent infringement protection*

An entity could be required (for example, by law or court order) to pay damages if its products cause damage or harm to others when used as intended. A requirement to pay damages to an injured party is not a separate performance obligation. Such payments should be accounted for in accordance with guidance on loss contingencies (US GAAP) and provisions (IFRS). Compensation provided to a customer for failing to comply with the terms of the contract or to resolve customer complaints would generally be accounted for as consideration payable to a customer and recorded as a reduction of revenue (refer to RR 4.3.3.11).

Promises to indemnify a customer against claims of patent, copyright, or trademark infringements are also not separate performance obligations, unless the entity's business is to provide such protection. These protections are similar to warranties that ensure that the good or service operates as intended. These types of obligations are accounted for in accordance with the guidance on loss contingencies (US GAAP) and provisions (IFRS). Refer to RR 8.3 for further considerations related to warranties, including certain types of warranties that are accounted for as performance obligations.

3.6.4 *Shipment of goods to a customer*

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

Shipping and handling services may be considered a separate performance obligation if control of the goods transfers to the customer before shipment, but the entity has promised to ship the goods (or arrange for the goods to be shipped). In contrast, if control of a good does not transfer to the customer before shipment, shipping is not a promised service to the customer. This is because shipping is a fulfillment activity as the costs are incurred as part of transferring the goods to the customer.

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

ASC 606 includes an accounting policy election that permits entities to account for shipping and handling activities that occur after the customer has obtained control of a good as a fulfillment cost rather than as an additional promised service. Entities that make this election will recognize revenue when control of the good transfers to the customer. A portion of the transaction price would not be allocated to the shipping service; however, the costs of shipping and handling should be accrued when the related revenue is recognized. Management should apply this election consistently to similar transactions and disclose the use of the election, if material, in accordance with ASC 235, *Notes to Financial Statements*. The policy election should not be applied by analogy to other services. IFRS 15 does not include a similar accounting policy election.

Example 3-9 and Example 3-10 illustrate the potential accounting outcomes for sale of a product and a promise to ship the product.

EXAMPLE 3-9

Identifying performance obligations — shipping and handling services

Manufacturer enters into a contract with a customer to sell five flat screen televisions. The customer requests that Manufacturer arrange for delivery of the televisions. The delivery terms state that legal title and risk of loss pass to the customer when the televisions are given to the carrier.

The customer obtains control of the televisions at the time they are shipped and can sell them to another party. Manufacturer is precluded from selling the televisions to another customer (for example, redirecting the shipment) once the televisions are picked up by the carrier at Manufacturer's shipping dock. Manufacturer does not elect to treat shipping and handling activities as a fulfillment cost under US GAAP.

How many performance obligations are in the arrangement?

Analysis

There are two performance obligations: (1) sale of the televisions and (2) shipping service. The shipping service does not affect when the customer obtains control of the televisions, assuming the shipping service is distinct. Manufacturer will recognize revenue allocated to the sale of the televisions when control transfers to the customer (that is, upon shipment) and recognize revenue allocated to the shipping service when performance occurs.

Since Manufacturer is arranging for the shipment to be performed by another party (that is, a third-party carrier), it must also evaluate whether to record the revenue allocated to the shipping services on a gross basis as principal or on a net basis as agent. Refer to RR 10 for further discussion of the principal versus agent assessment.

EXAMPLE 3-10**Identifying performance obligations — shipping and handling accounting election (US GAAP)**

Manufacturer enters into a contract with a customer to sell five flat screen televisions. The customer requests that Manufacturer arrange for delivery of the televisions. The delivery terms state that legal title and risk of loss pass to the customer when the televisions are given to the carrier.

The customer obtains control of the televisions at the time they are shipped and can sell them to another party. Manufacturer is precluded from selling the televisions to another customer (for example, redirecting the shipment) once the televisions are picked up by the carrier at Manufacturer's shipping dock. Manufacturer elects to account for shipping and handling activities as a fulfillment cost (permitted for US GAAP only).

How many performance obligations are in the arrangement?

Analysis

There is one performance obligation in the arrangement under US GAAP because Manufacturer has elected to account for shipping and handling activities as a fulfillment cost. Manufacturer will recognize revenue and accrue the shipping and handling costs when control of the televisions transfers to the customer upon shipment. Manufacturer does not need to assess whether it is the principal or agent for the shipping service since the shipping service is not accounted for as a promise in the contract. Manufacturer should disclose its election with its accounting policy disclosures.

Chapter 4:

Determining the transaction price

4.1 Chapter overview

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

4.2 Determining the transaction price

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

ASC 606-10-32-2 and IFRS 15.47

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

The transaction price is the amount that an entity allocates to the performance obligations identified in the contract and, therefore, represents the amount of revenue recognized as those performance obligations are satisfied. The transaction price excludes amounts collected on behalf of third parties, such as sales taxes the entity collects on behalf of the government. Refer to RR 10.4 and RR 10.5 for further discussion of amounts collected from customers on behalf of third parties.

Determining the transaction price can be straightforward, such as where a contract is for a fixed amount of consideration in return for a fixed number of goods or services in a reasonably short timeframe. Complexities can arise where a contract includes any of the following:

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

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

The amounts to which the entity is entitled under the contract could in some instances be paid by other parties. For example, a manufacturer might offer a coupon to end customers that will be redeemed by retailers. The retailer should include the consideration received from both the end customer and any reimbursement from the manufacturer in its assessment of the transaction price.

Management should assume that the contract will be fulfilled as agreed upon and not cancelled, renewed, or modified when determining the transaction price. The transaction price also generally does not include estimates of consideration from the future exercise of options for additional goods and services, because until a customer exercises that right, the entity does not have a right to consideration (refer to RR 3.5). An exception is provided as a practical alternative for customer options that meet certain criteria (for example, certain contract renewals) that allows management to estimate goods or services to be provided under the option when determining the transaction price (refer to RR 7.3).

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

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

4.3 Variable consideration

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

ASC 606-10-32-5 and IFRS 15.50

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

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

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

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

Question 4-1 addresses whether the consideration is variable if pricing is fixed but the quantity is variable.

Question 4-1

If a contract contains a promise to provide an unspecified quantity of outputs, but the contractual rate per unit is fixed, is the consideration variable?

PwC response

Generally, yes. An example is a promise to provide a service when the rate per hour is fixed, but the total number of hours that will be incurred to fulfill the promise is variable. Refer to Revenue TRG Memo No. 39 and the related meeting minutes in Revenue TRG Memo No. 44 for further discussion of this topic. Judgment may be required to distinguish between a promise with a variable fee and an arrangement permitting the customer to purchase a variable number of goods or services. Refer to RR 3.5 for further discussion of this distinction.

4.3.1 Estimating variable consideration

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

The revenue standard provides two methods for estimating variable consideration.

ASC 606-10-32-8 and IFRS 15.53

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

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

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

of transactions processed. Management may need to use the most likely amount to estimate one bonus and the expected value method to estimate the other if the underlying characteristics of the variable consideration are different.

4.3.1.1 Expected value method

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

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

An entity considers evidence from other, similar contracts by using a “portfolio of data” to develop an estimate when it estimates variable consideration using the expected value method. This, however, is not the same as applying the optional portfolio practical expedient that permits entities to apply the guidance to a portfolio of contracts with similar characteristics (refer to RR 1.3.3). Considering historical experience with similar transactions does not necessarily mean an entity is applying the portfolio practical expedient. Refer to Revenue TRG Memo No. [38](#) and the related meeting minutes in Revenue TRG Memo No. [44](#) for further discussion of this topic.

4.3.1.2 Most likely amount method

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

4.3.1.3 Examples of estimating variable consideration

Example 4-1 and Example 4-2 illustrate how the transaction price should be determined when there is variable consideration. This concept is also illustrated in Examples 20 and 21 of the revenue standard (ASC 606-10-55-194 through ASC 606-10-55-200 and IFRS 15.IE102 through IFRS 15.IE108).

EXAMPLE 4-1

Estimating variable consideration — performance bonus with multiple outcomes

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

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

How should Contractor determine the transaction price?

Analysis

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

Probability-weighted consideration

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

The total transaction price is \$147,500 based on the probability-weighted estimate. Contractor will update its estimate at each reporting date.

This example does not consider the potential need to constrain the estimate of variable consideration included in the transaction price. Depending on the facts and circumstances of each contract, an entity might need to constrain its estimate of variable consideration even if it uses the expected value method to determine the transaction price. Refer to RR 4.3.2 for further discussion of application of the constraint on variable consideration.

EXAMPLE 4-2

Estimating variable consideration — performance bonus with two outcomes

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

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

How should Contractor determine the transaction price?

Analysis

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

4.3.2 *Constraint on variable consideration*

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

ASC 606-10-32-11 and IFRS 15.56

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

The boards noted in the basis for conclusions to the revenue standard that the threshold of “probable” under US GAAP and “highly probable” under IFRS are generally interpreted to have the same meaning.

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

Variable consideration is not constrained if the potential reversal of cumulative revenue recognized is not significant. Significance should be assessed at the contract level (rather than the performance obligation level or in relation to the financial position of the entity). Management should therefore consider revenue recognized to date from the entire contract when evaluating the significance of any potential reversal of revenue. Refer to Revenue TRG Memo No. 14 and the related meeting minutes in Revenue TRG Memo No. 25 for further discussion of this topic.

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

The revenue standard provides factors to consider when assessing whether variable consideration should be constrained. All of the factors should be considered and no single factor is determinative. Judgment should be applied in each case to decide how best to estimate the transaction price and apply the constraint. In performing this assessment, a portfolio of data might be used to estimate the transaction price (refer to RR 4.3.1.1) and used to apply the constraint on variable consideration. In that case, the estimated transaction price might not be a possible outcome of the individual contract. Refer to Example 4-7 for an illustration of this fact pattern.

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

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

- a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.
- b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
- d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- e. The contract has a large number and broad range of possible consideration amounts.

4.3.2.1 Amount is highly susceptible to external factors

Factors outside an entity's influence can affect an entity's ability to estimate the amount of variable consideration. An example is consideration that is based on the movement of a market, such as the value of a fund whose assets are based on stock exchange prices.

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

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

4.3.2.2 Uncertainty is not expected to be resolved in the near term

A long period of time until the uncertainty is resolved might make it more challenging to determine a reasonable range of outcomes of that uncertainty, as other variables might be introduced over the period that affect the outcome. This makes it more difficult to assert that it is probable (US GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue recognized will not occur. Management might be able to more easily conclude that variable consideration is not constrained when an uncertainty is resolved in a short period of time.

Management should consider all facts and circumstances, however, as in some situations a longer period of time until the uncertainty is resolved could make it easier to conclude that a significant

reversal of cumulative revenue will not occur. Consider, for example, a performance bonus that will be paid if a specific sales target is met by the end of a multi-year contract term. Depending on existing and historical sales levels, that target might be considered easier to achieve due to the long duration of the contract.

4.3.2.3 *Entity's experience is limited or of limited predictive value*

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

4.3.2.4 *Entity offers price concessions or changes payment terms*

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

4.3.2.5 *Contract has numerous or wide ranges of consideration amounts*

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

4.3.2.6 *Examples of applying the constraint*

Example 4-3, Example 4-4, Example 4-5, Example 4-6, and Example 4-7 illustrate the application of the constraint on variable consideration. This concept is also illustrated in Examples 23 and 25 of the revenue standard (ASC 606-10-55-208 through ASC 606-10-55-215, ASC 606-10-55-221 through ASC 606-10-55-225, IFRS 15.IE116 through IFRS 15.IE123, and IFRS 15.IE129 through IFRS 15.IE133).

EXAMPLE 4-3

Variable consideration — consideration is constrained

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

Should Land Owner include variable consideration in the transaction price?

Analysis

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

EXAMPLE 4-4

Variable consideration — subsequent reassessment

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

Two years after contract inception:

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

How should Land Owner account for the change in circumstances?

Analysis

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

EXAMPLE 4-5

Variable consideration — multiple forms of variable consideration

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

- ☐ Bonus A: \$2 million if the facility is completed within six months

- Bonus B: \$1 million if the facility receives a stipulated environmental certification upon completion

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

How should Construction Inc. determine the transaction price?

Analysis

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

EXAMPLE 4-6

Variable consideration — milestone payments

Biotech licenses a drug compound that is currently in Phase II development to Pharma. Biotech also performs clinical trial services as part of the arrangement. In addition to an upfront payment, Biotech is eligible to receive additional consideration in the form of milestone payments as follows:

- Milestone A: \$25 million upon the completion of Phase II clinical trials
- Milestone B: \$50 million upon regulatory approval of the drug compound

Biotech has concluded it is probable that it will achieve Milestone A because Biotech has extensive experience performing clinical trial services in similar arrangements and the drug compound has successfully completed Phase I clinical trials. There are significant uncertainties related to achieving regulatory approval of the drug compound, which is subject to the judgments and actions of a third party. Biotech has concluded the milestone payments are outside the scope of guidance for financial instruments.

How should Biotech determine the transaction price?

Analysis

Both milestone payments are forms of variable consideration. The \$25 million payable upon achieving Milestone A should be included in the transaction price because it is probable (US GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue recognized will not occur in the future when the uncertainty relating to Milestone A is subsequently resolved.

Biotech would likely conclude that the \$50 million payable upon achieving Milestone B is constrained. The current stage of development of the drug compound, uncertainties related to obtaining approval, and the fact that regulatory approval is subject to factors outside Biotech's influence would support

this conclusion. Therefore, Biotech would exclude the \$50 million payable upon achieving Milestone B from the transaction price at contract inception.

Biotech will need to update its estimates for both milestones at each reporting date until the uncertainty associated with each milestone is resolved.

EXAMPLE 4-7

Variable consideration — expected value method and applying the constraint

Entity L is a law firm that offers various legal services to its customers. For some services (“Specific Services”), Entity L will only collect payment from its customer if the customer wins the case. The payment for Entity L in each case is \$1,000. Management has determined that revenue for these services should be recognized over time.

Entity L has a group of 1,000 similar contracts on homogeneous cases that include Specific Services. Management’s experience with contracts with similar characteristics to this group over the last five years is that 60% of Entity L’s customers won their cases, and success rates varied between 50% and 70% on a monthly basis throughout the period. Management has used this data to conclude that it is probable (US GAAP) or highly probable (IFRS) that it would collect payment in 50% of cases.

Management believes that the expected value approach provides a better prediction of the transaction price than the most likely amount.

How should Entity L determine the transaction price?

Analysis

Management of Entity L can use the data from previous contracts to estimate the transaction price and to apply the constraint on variable consideration. Management therefore would include \$500,000 (equating to \$500 per contract) of the variable consideration in the transaction price. The evidence provided by its experience with previous transactions would support its conclusion that it is probable (US GAAP) or highly probable (IFRS) that there would not be a significant revenue reversal if \$500 is estimated as the transaction price for each contract. In making this assessment, management will have applied a consistent approach in estimating the transaction price and applying the constraint of variable consideration guidance.

4.3.2.7 **Recording minimum amounts**

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

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

Example 4-8 illustrates the inclusion of a minimum amount of variable consideration in the transaction price.

EXAMPLE 4-8

Variable consideration — determining a minimum amount

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

Service Inc estimates that it will be able to reduce Manufacture Co's costs by 20%. Service Inc, however, considers the constraint on variable consideration and concludes that it is probable (US GAAP) or highly probable (IFRS) that estimating a 10% reduction in costs will not result in a significant reversal of cumulative revenue recognized. This assessment is based on Service Inc's experience achieving at least that level of cost reduction in comparable contracts. Service Inc has achieved levels of 20% or above, but not consistently.

How should Service Inc determine the transaction price?

Analysis

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

4.3.3 Common forms of variable consideration

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

4.3.3.1 Price concessions

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

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

Example 4-9 illustrates the effect of a price concession.

EXAMPLE 4-9**Variable consideration — price concessions**

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

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

What is the transaction price in this arrangement?

Analysis

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

4.3.3.2 Prompt payment discounts

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

4.3.3.3 Volume discounts

Contracts with customers often include volume discounts that are offered as an incentive to encourage additional purchases and customer loyalty. Volume discounts typically require a customer to purchase a specified amount of goods or services, after which the price is either reduced prospectively for additional goods or services purchased in the future or retroactively reduced for all purchases. Prospective volume discounts should be assessed to determine if they provide the customer with a material right, as discussed in RR 7.2.3. Arrangements with retroactive volume discounts include variable consideration because the transaction price for current purchases is not known until the uncertainty of whether the customer's purchases will exceed the amount required to obtain the discount is resolved. Both prospective and retrospective volume discounts will typically result in a deferral of revenue if the customer is expected to obtain the discount.

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

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

Example 4-10 and Example 4-11 illustrate how volume discounts affect transaction price. This concept is also illustrated in Example 24 of the revenue standard (ASC 606-10-55-216 through ASC 606-10-55-220 and IFRS 15.IE124 through IFRS 15.IE128).

EXAMPLE 4-10

Variable consideration — volume discounts

On January 1, 20X8, Chemical Co enters into a one-year contract with Municipality to deliver water treatment chemicals. The contract stipulates that the price per container will be adjusted retroactively once Municipality reaches certain sales volumes, defined as follows:

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

Volume is determined based on sales during the calendar year. There are no minimum purchase requirements. Chemical Co estimates that the total sales volume for the year will be 2.8 million containers based on its experience with similar contracts and forecasted sales to Municipality.

Chemical Co sells 700,000 containers to Municipality during the first quarter ended March 31, 20X8 for a contract price of \$100 per container.

How should Chemical Co determine the transaction price?

Analysis

The transaction price is \$90 per container based on Chemical Co's estimate of total sales volume for the year, since the estimated cumulative sales volume of 2.8 million containers would result in a price per container of \$90.

Chemical Co concludes that, based on a transaction price of \$90 per container, it is probable (US GAAP) or highly probable (IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. Revenue is therefore recognized at a selling price of \$90 per container as each container is sold. Chemical Co will recognize a liability for cash received in excess of the transaction price for the first one million containers sold at \$100 per container (that is, \$10 per container) until the cumulative sales volume is reached for the next pricing tier and the price is retroactively reduced.

For the quarter ended March 31, 20X8, Chemical Co recognizes revenue of \$63 million (700,000 containers * \$90) and a liability of \$7 million (700,000 containers * (\$100–\$90)).

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

EXAMPLE 4-11

Variable consideration — reassessment of estimated volume discounts

On January 1, 20X8, Chemical Co enters into a one year contract with Municipality to deliver water treatment chemicals. The contract stipulates that the price per container will be adjusted retroactively once Municipality reaches certain sales volumes, defined as follows:

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

Volume is determined based on sales during the calendar year. There are no minimum purchase requirements. Chemical Co estimates that the total sales volume for the year will be 2.8 million containers based on its experience with similar contracts and forecasted sales to Municipality.

The following occurs in the first and second quarters of the year:

- Chemical Co sells 700,000 containers to Municipality during the first quarter ended March 31, 20X8 for a contract price of \$100 per container.
- Chemical Co sells 800,000 containers of chemicals during the second reporting period ended June 30, 20X8.
- Municipality commences a new water treatment project during the second quarter of the year, which increased its need for chemical supplies.
- In light of this new project, Chemical Co increases its estimate of total sales volume to 3.1 million containers at the end of the second reporting period. As a result, Chemical Co will be required to retroactively reduce the price per container to \$85.

How should Chemical Co account for the change in estimate?

Analysis

Chemical Co should update its calculation of the transaction price to reflect the change in estimate. The updated transaction price is \$85 per container based on the new estimate of total sales volume. Consequently, Chemical Co recognizes revenue of \$64.5 million for the quarter ended June 30, 20X8, calculated as follows:

Total consideration

\$85 per container * 800,000 containers sold in Q2	\$	68,000,000
Less: \$5 per container (\$90–\$85) * 700,000 containers sold in Q1	\$	(3,500,000)
	\$	64,500,000

The cumulative catch-up adjustment reflects the amount of revenue that Chemical Co would have recognized if, at contract inception, it had the information that is now available.

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

4.3.3.4 Rebates

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

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

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

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

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

Example 4-12 illustrates how customer rebates affect the transaction price.

EXAMPLE 4-12**Variable consideration — customer rebates**

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

ShaveCo estimates that 20% to 25% of eligible rebates will be redeemed based on its experience with similar programs and rebate redemption rates available in the marketplace for similar programs. ShaveCo concludes that the transaction price should incorporate an assumption of 25% rebate redemption as this is the amount for which it is probable (US GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue will not occur if estimates of the rebates change.

How should ShaveCo determine the transaction price?

Analysis

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

4.3.3.5 Pricing based on an index or market

Consideration that is calculated based on an index or market price at a specified future date could be a form of variable consideration. Contract consideration could be linked to indices such as a consumer price index or financial indices (for example, the S&P 500), or the market price of a financial instrument or commodity.

Management should first consider whether the arrangement contains a derivative that should be accounted for under the relevant financial instruments guidance (for example, an arrangement with an embedded derivative that should be separately accounted for under ASC 815 or a “fixed price” contract that does not meet the “own use” exemption in IFRS 9). Management should also consider whether to apply the financial instruments guidance when the entity has satisfied its performance obligation and recorded a financial asset, but the amount of consideration continues to be linked to a future market price (for example, a provisionally priced commodity contract). Variability in pricing or value that is accounted for under the relevant financial instruments guidance does not affect measurement of the transaction price under the revenue standard (that is, the amount of revenue recognized).

For arrangements that are determined to include variable consideration based on an index or market price (in the scope of ASC 606 or IFRS 15), applying the constraint (refer to RR 4.3.2) will require judgment. Arrangements with fees that vary based on market or asset performance are common in the asset management and broker-dealer industries. One or more of the factors indicating that variable consideration should be constrained are often present in these arrangements. Specifically, the consideration is likely to be highly susceptible to factors outside the entity’s influence (for example, market volatility or the length of time an investor remains invested in a fund), past experience may have limited predictive value, the contract may have a broad range of possible consideration amounts, and the uncertainty may not be resolved for a long period of time. The existence of these factors will likely indicate that all or a portion of the fees should be constrained until the uncertainty is resolved.

This concept is illustrated in Example 25 of the revenue standard (ASC 606-10-55-221 through ASC 606-10-55-225 and IFRS 15.IE129 through IFRS 15.IE133).

Question 4-2 addresses whether the constraint applies to foreign currency exchange rate fluctuations.

Question 4-2

Does an entity need to consider the variability caused by fluctuations in foreign currency exchange rates in applying the variable consideration constraint?

PwC response

No. Exchange rate fluctuations do not result in variable consideration as the variability relates to the form of the consideration (that is, the currency) and not other factors. Therefore, changes in foreign currency exchange rates should not be considered for purposes of applying the constraint on variable consideration.

4.3.3.6 Pricing based on a formula

A contract could include variable consideration if the pricing is based on a formula or a contractual rate per unit of outputs and there is an undefined quantity of outputs. The transaction price is variable because it is based on an unknown number of outputs. For example, a hotel management company enters into an arrangement to manage properties on behalf of a customer for a five-year period. Contract consideration is based on a defined percentage of daily receipts. The consideration is variable for this contract as it will be calculated based on daily receipts. The promise to the customer is to provide management services for the term of the contract; therefore, the contract contains a variable fee as opposed to an option to make future purchases. Refer to RR 3.5 for further discussion on assessing whether a contract contains variable fees or optional purchases. Refer also to Revenue TRG Memo No. 39 and the related meeting minutes in Revenue TRG Memo No. 44 for further discussion of this topic.

4.3.3.7 Periods after a contract expires but prior to renewal

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

Management will need to estimate the transaction price if it concludes that there are enforceable obligations prior to finalizing the new contract. Management should consider the potential terms of the renewal, including whether any adjustments to terms will be applied retroactively or only prospectively. Anticipated adjustments as a result of renegotiated terms should be assessed under the variable consideration guidance, including the constraint on variable consideration.

This situation differs from contract modifications where the transaction price is not expected to be variable at the inception of the arrangement, but instead changes because of a future event. Refer to RR 2.9 for discussion of contract modifications.

4.3.3.8 **Price protection and price matching**

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

Example 4-13 illustrates how price protection clauses affect the transaction price.

EXAMPLE 4-13

Variable consideration — price protection guarantee

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

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

How should Manufacturer determine the transaction price?

Analysis

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

Some arrangements allow for price protection only on the goods that remain in a customer’s inventory. Management needs to estimate the number of units to which the price protection guarantee applies in such cases to determine the transaction price, as the reimbursement does not apply to units already sold by the customer.

4.3.3.9 **Guarantees (including service level agreements)**

Contracts with a customer sometimes include guarantees made by the vendor. Guarantees in the scope of other guidance, such as ASC 460, *Guarantees*, or IFRS 9, *Financial Instruments*, should be accounted for following that guidance. Guarantees that are not in the scope of other guidance should be assessed to determine whether they result in a variable transaction price.

For example, an entity might guarantee a customer that is a reseller a minimum margin on sales to its customers. Consideration will be paid to the customer if the specified margin is not achieved. This type of guarantee is not within the scope of ASC 460 as it constitutes a vendor rebate based on the guaranteed party's sales (and thus meets the scope exception in ASC 460-10-15-7(e)), and it does not meet the definition of a financial guarantee contract within the scope of IFRS 9. Since the guarantee does not fall within the scope of other guidance, the variable consideration guidance in the revenue standard needs to be considered in this situation given the uncertainty in the transaction price created by the guarantee.

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

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

Example 4-14 and Example 4-15 illustrate the accounting for a guaranteed profit margin and a service level agreement.

EXAMPLE 4-14

Variable consideration — profit margin guarantee

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

What is the transaction price in this arrangement?

Analysis

ClothesCo's practice of guaranteeing a minimum margin for its customers results in variable consideration. The transaction price in this arrangement is \$900,000, calculated as the amount ClothesCo bills Department Store (\$1 million) less the estimated refund to provide the Department Store its minimum margin (\$100,000). ClothesCo will update its estimate at each reporting period until the uncertainty is resolved.

EXAMPLE 4-15**Variable consideration — service level agreement**

SoftwareCo enters into a one-year contract with Customer A to provide access to its Software-as-a-Service (SaaS) platform for a \$1 million annual fee. Included in the contract is a guarantee that the SaaS platform will maintain a 99.99% uptime during the year, or Customer A will be entitled to a partial refund of the annual fee. Based on its experience, SoftwareCo refunds on average approximately 5% of the annual fee under this guarantee. SoftwareCo has also concluded that variable consideration is not constrained in these circumstances.

What is the transaction price in this arrangement?

Analysis

The platform availability guarantee results in variable consideration. The transaction price in this arrangement is \$950,000 (\$1 million annual fee less 5% estimated refund). SoftwareCo will need to update its estimate of the refund at each reporting date until the uncertainty is resolved.

4.3.3.10 Claims

It is common for entities in certain industries, such as engineering and construction, to submit claims to their customers for additional contract consideration if the scope of the contract changes. Claims that are enforceable under the existing terms of the contract, but for which the price is not yet determined, are accounted for as variable consideration. For example, an entity might submit a claim as a result of higher-than-expected costs and interpret the contract to provide clear grounds for recovery of cost overruns. Thus, the estimated amount that the entity will collect is included in the transaction price if it is probable (US GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue will not occur when the uncertainty is resolved.

In contrast, if the parties are negotiating a modification to a contract and the change in scope and/or price is not yet enforceable, the modification should not be accounted for until it is approved, as discussed in RR 2.9.1.

Example 4-16 illustrates the accounting for a claim. This concept is also illustrated in Example 9 of the revenue standard (ASC 606-10-55-134 through ASC 606-10-55-135 and IFRS 15.IE42 through IFRS 15.IE43).

EXAMPLE 4-16**Variable consideration — claims for additional cost reimbursement**

Contractor enters into a contract for a satellite launch for Entity A. The contract price is \$250 million and the contract is expected to take three years to complete. Contractor determines that the performance obligation will be satisfied over time. One year after contract inception, Contractor incurs significant costs in excess of the original estimates due to customer-caused delays. Contractor submits a claim against Entity A to recover a portion of the overrun costs. The claims process is in its early stages, but Contractor concludes that the claim is enforceable under the contract.

How should Contractor account for the claim?

Analysis

Contractor should update the transaction price based on its conclusion that it has an enforceable right to the claim. The claim amount is variable consideration and therefore, Contractor should include in the transaction price the estimated amount it will receive, adjusted for any amounts that are constrained under the variable consideration guidance. When applying the variable consideration constraint, Contractor should evaluate factors such as its relevant experience with similar claims and the period of time before resolution of the claim, in addition to whether the amount it will receive is highly susceptible to factors outside of its influence.

4.3.3.11 Penalties and liquidated damages

Terms that provide for cash payments to the customer for failure to comply with the terms of the contract or failure to meet agreed-upon specifications (for example, penalties and liquidated damages) should generally be accounted for as variable consideration. These terms differ from a warranty provision that requires a vendor to repair or replace a product that does not function as expected. Refer to RR 8.3 for further discussion of warranty provisions.

4.3.4 Changes in the estimate of variable consideration

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

4.3.5 Royalties received in exchange for licenses of IP

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

4.4 Existence of a significant financing component

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

ASC 606-10-32-15 and IFRS 15.60

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

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

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

Some contracts contain a financing component (either explicitly or implicitly) because payment by a customer occurs either significantly before or significantly after performance. This timing difference can benefit either the customer, if the entity is financing the customer's purchase, or the entity, if the customer finances the entity's activities by making payments in advance of performance. A significant financing component may exist in an arrangement when a customer makes an advance payment because the entity requires financing to fulfill its obligations under the contract that it would otherwise need to obtain from a third party.

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

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

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

Question 4-3 addresses whether a significant financing component relates to all performance obligations.

Question 4-3

Can a significant financing component relate to one or more, but not all, of the performance obligations in a contract?

PwC response

Possibly. We believe it may be reasonable in certain circumstances to attribute a significant financing component to one or more, but not all, of the performance obligations in a contract. This assessment will likely require judgment. Management should consider whether it is appropriate to apply the guidance on allocating a discount (refer to RR 5.4) or allocating variable consideration (refer to RR

5.5) by analogy. Refer to Revenue TRG Memo No. 30 and the related meeting minutes in Revenue TRG Memo No. 34 for further discussion of this topic.

4.4.1 Identifying a significant financing component

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

Management does not need to consider the effects of the financing component if the effect would not materially change the amount of revenue that would be recognized under the contract. The determination of whether a financing component is significant should be made at the contract level. A determination does not have to be made regarding the effect on all contracts collectively. In other words, the financing effects can be disregarded if they are immaterial at the contract level, even if the combined effect for a portfolio of contracts would be material to the entity as a whole. While an entity is not required to recognize the financing effects if they are immaterial at the contract level, an entity is not precluded from accounting for a financing component that is not significant. Refer to Revenue TRG Memo No. 30 and the related meeting minutes in Revenue TRG Memo No. 34 for further discussion of this topic.

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

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

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

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

A significant difference between the amount of contract consideration and the amount that would be paid if cash were paid at the time of performance indicates that an implicit financing arrangement exists. In some cases, the stated interest rate in an arrangement could be zero (for example, interest-free financing) such that the consideration to be received over the period of the arrangement is equal to the cash selling price. Management should not automatically conclude that there is no financing component in zero-percent financing arrangements. All relevant facts and circumstances should be evaluated, including assessing whether the cash selling price reflects the price that would be paid absent the financing. Refer to Revenue TRG Memo No. 30 and the related meeting minutes in Revenue TRG Memo No. 34 for further discussion of this topic.

The longer the period between when a performance obligation is satisfied and when cash is paid for that performance obligation, the more likely it is that a significant financing component exists.

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

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

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

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

4.4.1.1 *Timing of control transfer is at the customer's discretion*

The effects of the financing component do not need to be considered when the timing of performance is at the discretion of the customer. This is because the purpose of these types of contracts is not to provide financing. An example is the sale of a gift card. The customer uses the gift card at his or her discretion, which could be in the near term or take an extended period of time. Similarly, customers who purchase goods or services and are simultaneously awarded loyalty points or other credits that can be used for free or discounted products in the future decide when those credits are used.

4.4.1.2 *Consideration is variable and based on future events*

The amount of consideration to be received when it is variable could vary significantly and might not be resolved for an extended period of time. The substance of the arrangement is not a financing if the amount or timing of the variable consideration is determined by an event that is outside the control of the parties to the contract. One example is in an arrangement for legal services when an attorney is paid only upon a successful outcome. The litigation process might extend for several years. The delay in receiving payment is not a result of providing financing in this situation. Another example is a license to a patented technology when the licensor is compensated based on a sales-based royalty that will be received over multiple years. Although the performance obligation is satisfied upfront, the delay in receiving payment is not the result of providing financing in the context of the revenue standard.

4.4.1.3 *Timing difference arises for reasons other than financing*

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

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

Example 4-17 illustrates a situation in which a difference in the timing of payment and the timing of transfer of control of goods or services arises for reasons other than providing financing. This concept is also illustrated in Examples 27 and 30 of the revenue standard (ASC 606-10-55-233 through ASC 606-10-55-234, ASC 606-10-55-244 through ASC 606-10-55-246, IFRS 15.IE141 through IFRS 15.IE142, and IFRS 15.IE152 through IFRS 15.IE154).

EXAMPLE 4-17

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

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

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

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

Analysis

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

4.4.2 *Significant financing component practical expedient*

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

ASC 606-10-32-18 and IFRS 15.63

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

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

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

Some contracts include a single payment stream for multiple performance obligations that are satisfied at different times. It may not be clear, in these circumstances, whether the timing difference between performance and payment is greater than 12 months. Management should apply judgment to assess whether cash payments relate to a specific performance obligation based on the terms of the contract. It might be appropriate to allocate the payments received between the multiple performance obligations in the event payments are not tied directly to a particular good or service. Refer to Revenue TRG Memo No. [30](#) and the related meeting minutes in Revenue TRG Memo No. [34](#) for further discussion of this topic.

Question 4-4 addresses when an entity can use the practical expedient.

Question 4-4

Can an entity use the practical expedient to disregard the effects of a significant financing when a contract is explicit that it contains a financing, but the period of the financing is less than one year?

PwC response

Yes. The entity may elect to apply the practical expedient if the difference between the timing of performance and timing of payment is one year or less.

4.4.3 *Determining the discount rate*

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

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

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

Management should adjust the contract consideration to reflect the significant financing benefit using a discount rate that reflects the rate that would be used in a separate financing transaction between the entity and its customer. This rate should reflect the credit risk of the party obtaining financing in the arrangement (which could be the customer or the entity).

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

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

The revenue standard does not include specific guidance on how to calculate the adjustment to the transaction price due to the financing component (that is, the interest income or expense). Entities should refer to the applicable guidance in ASC 835-30, *Interest—Imputation of Interest*, and IFRS 9, *Financial Instruments*, to determine the appropriate accounting. Refer to Revenue TRG Memo No. [30](#) and the related meeting minutes in Revenue TRG Memo No. [34](#) for further discussion of this topic.

4.4.4 Examples of accounting for a significant financing component

Example 4-18 and Example 4-19 illustrate how the transaction price is determined when a significant financing component exists. This concept is also illustrated in Examples 26, 28, and 29 of the revenue standard (ASC 606-10-55-227 through ASC 606-10-55-232, ASC 606-10-55-235 through ASC 606-10-55-243, IFRS 15.IE135 through IFRS 15.IE140, and IFRS 15.IE143 through IFRS 15.IE151).

EXAMPLE 4-18**Significant financing component — determining the appropriate discount rate**

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

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

Analysis

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

EXAMPLE 4-19

Significant financing component — payment prior to performance

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

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

What is the transaction price in this arrangement?

Analysis

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

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

4.5 Noncash consideration

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

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

4.5.1 **Measurement date for noncash consideration**

ASC 606 specifies that the measurement date for noncash consideration is contract inception, which is the date at which the criteria in RR 2.6.1 are met. Changes in the fair value of noncash consideration after contract inception are excluded from revenue. Management should also consider the accounting guidance in ASC 815, *Derivatives and Hedging*, to determine whether an arrangement with a right to noncash consideration contains an embedded derivative.

Management should apply the applicable guidance to account for noncash consideration upon receipt. For example, financial instruments guidance would apply if the consideration is in the form of shares. It might be necessary to recognize an immediate impairment if the noncash consideration is received after contract inception and the value of the noncash consideration has subsequently decreased. If an entity satisfies a performance obligation in advance of receiving noncash consideration, management should evaluate any resulting contract asset or receivable for impairment in accordance with the guidance in ASC 310, *Receivables*.

IFRS 15 does not specify the measurement date for noncash consideration; therefore, management should apply judgment to determine the measurement date. Different conclusions might be reached under US GAAP and IFRS.

Example 4-20 illustrates the accounting for noncash consideration. This concept is also illustrated in Example 31 of the revenue standard (ASC 606-10-55-248 through ASC 606-10-55-250 and IFRS 15.IE156 through IFRS 15.IE158).

EXAMPLE 4-20

Noncash consideration — determining the transaction price

Security Inc enters into a contract to provide security services to Manufacturer over a six-month period in exchange for 12,000 shares of Manufacturer's common stock. The contract is signed and work commences on January 1, 20X1. The performance is satisfied over time and Security Inc will receive the shares at the end of the six-month contract. For purposes of this example, assume that the arrangement does not include a derivative.

How should Security Inc determine the transaction price?

Analysis

US GAAP assessment: Security Inc should measure the fair value of the 12,000 shares at contract inception (that is, on January 1, 20X1). Security Inc will measure its progress toward complete satisfaction of the performance obligation and recognize revenue each period based on the fair value determined at contract inception. Security Inc should not reflect any changes in the fair value of the shares after contract inception in revenue. Security Inc should, however, assess any contract asset or receivable for impairment in accordance with the guidance on receivables. Security Inc will apply the relevant financial instruments guidance upon receipt of the shares to determine whether and how any changes in the fair value that occurred after contract inception should be recognized.

IFRS assessment: IFRS 15 does not prescribe a measurement date for the shares. Security Inc might conclude it should measure the fair value of the shares at contract inception, as it completes the service, or once it receives the shares.

4.5.2 *Variability related to noncash consideration*

Changes in the fair value of noncash consideration can relate to the form of the consideration or to other reasons. For example, an entity might be entitled to receive equity of its customer as consideration, and the value of the equity could change before it is transferred to the entity. Changes in the fair value of noncash consideration that are due to the form of the consideration are not subject to the constraint on variable consideration.

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

Judgment may be needed to determine the reasons for a change in the value of noncash consideration, particularly when the change relates to both the form of the consideration and to the entity's performance. ASC 606 specifies that if there is variability due to both the form of the consideration and other reasons, an entity should apply the variable consideration guidance only to the variability resulting from reasons other than the form of the consideration. IFRS 15 does not include the same explicit guidance; therefore, judgment should be applied to determine how to account for the variability.

Example 4-21 illustrates variability that results for reasons other than the form of the consideration.

EXAMPLE 4-21

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

MachineCo enters into a contract to build a machine for Manufacturer and is entitled to a bonus in the form of 10,000 shares of Manufacturer common stock if the machine is delivered within six months. MachineCo does not have a history of building similar machines within six months and cannot conclude that it is probable (US GAAP) or highly probable (IFRS) that a significant reversal will not occur with regards to the bonus. For purposes of this example, assume that the arrangement does not include a derivative.

How should MachineCo account for the noncash bonus?

Analysis

MachineCo should consider the guidance on variable consideration since the consideration varies based on whether the machine is delivered by a specific date. MachineCo should not include the shares in the transaction price as the amount of variable consideration is constrained. MachineCo should update its estimate each period to determine if and when the shares should be included in the transaction price.

4.5.3 *Noncash consideration provided to facilitate contract fulfillment*

Noncash consideration could be provided by a customer to an entity to assist in completion of the contract. For example, a customer might contribute goods or services to facilitate an entity's

fulfillment of a performance obligation. An entity should include the customer's contribution of goods or services in the transaction price as noncash consideration only if the entity obtains control of those goods or services. Assessing whether the entity obtains control of the contributed goods or services could require judgment.

Example 4-22 and Example 4-23 illustrate noncash consideration provided by a customer to assist an entity in fulfilling the contract.

EXAMPLE 4-22

Noncash consideration — materials provided by customer to facilitate fulfillment

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

How should ManufactureCo determine the transaction price?

Analysis

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

EXAMPLE 4-23

Noncash consideration — processing arrangements

WireCo enters into an arrangement with CopperCo to process raw copper into finished wire for CopperCo. CopperCo provides WireCo raw copper with a fair value of \$500,000 that is used in the fabrication of the wire and pays WireCo \$1 million in cash. CopperCo retains title to the copper as it is processed and CopperCo has concluded the arrangement is not a lease.

How should WireCo determine the transaction price?

Analysis

WireCo would likely conclude that it is providing a service of processing the copper and that it does not obtain control of the copper in this arrangement. Therefore, WireCo should not include the fair value of the raw materials in the transaction price. Judgment may be required in some fact patterns to determine whether an entity obtains control of customer-provided materials. If an entity concludes they obtain control then they would likely include the fair value of the noncash consideration in the transaction price.

4.6 Consideration payable to a customer

An entity might pay, or expect to pay, consideration to its customer. The consideration payable can be cash, either in the form of rebates or upfront payments, or could alternatively be a credit or some other

form of incentive that reduces amounts owed to the entity by a customer. The revenue standard addresses the accounting for consideration payable to a customer as follows. (See RR 4.6.6 for amendments issued in June 2018.)

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

Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to a customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service...that the customer transfers to the entity.

Management should consider whether payments to customers are related to a revenue contract even if the timing of the payment is not concurrent with a revenue transaction. Such payments could nonetheless be economically linked to a revenue contract; for example, the payment could represent a modification to the transaction price in a contract with a customer. Management will therefore need to apply judgment to identify payments to customers that are economically linked to a revenue contract. Refer to Revenue TRG Memo No. [37](#) and the related meeting minutes in Revenue TRG Memo No. [44](#) for further discussion of this topic.

4.6.1 *Income statement classification of payments to a customer*

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

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

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

Example 4-24, Example 4-25, Example 4-26, and Example 4-27 illustrate the accounting for consideration payable to a customer. This concept is also illustrated in Example 32 of the revenue standard (ASC 606-10-55-252 through ASC 606-10-55-254 and IFRS 15.IE160 through IFRS 15.IE162).

EXAMPLE 4-24**Consideration payable to customers — no distinct good or service received**

Producer sells energy drinks to Retailer, a convenience store. Producer also pays Retailer a fee to ensure that its products receive prominent placement on store shelves (that is, a slotting fee).

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

Analysis

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

EXAMPLE 4-25**Consideration payable to customers — payment for a distinct service**

MobileCo sells 1,000 phones to Retailer for \$100,000. The contract includes an advertising arrangement that requires MobileCo to pay \$10,000 toward a specific advertising promotion that Retailer will provide. Retailer will provide the advertising on strategically located billboards and in local advertisements. MobileCo could have elected to engage a third party to provide similar advertising services at a cost of \$10,000.

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

Analysis

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

EXAMPLE 4-26**Consideration payable to customers — payment for a distinct service in excess of fair value**

MobileCo sells 1,000 phones to Retailer for \$100,000. The contract includes an advertising arrangement that requires MobileCo to pay \$10,000 toward a specific advertising promotion that Retailer will provide. Retailer will provide the advertising on strategically located billboards and in local advertisements. MobileCo could have elected to engage a third party to provide similar advertising services at a cost of \$8,000.

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

Analysis

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

the transaction price for the sale of phones. The transaction price for the sale of the phones is \$98,000.

EXAMPLE 4-27

Consideration payable to customers — advertising allowance

Manufacturer enters into a contract to sell toys to Retailer. As part of the contract, Manufacturer agrees to provide Retailer an advertising allowance equal to 3% of total purchases made by Retailer, payable at the end of each quarter. Retailer has discretion over use of the allowance and is not required to provide Manufacturer with supporting documentation of how the allowance was utilized.

How should Manufacturer account for the advertising allowance?

Analysis

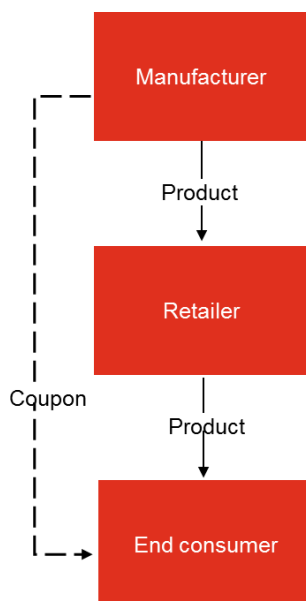
Manufacturer would likely conclude in this fact pattern that it does not receive a distinct good or service in exchange for the allowance paid to Retailer. The allowance is in substance a discount on the purchases made by Retailer. Manufacturer should therefore account for the allowance as a reduction of the transaction price of the toys sold to Retailer.

4.6.2 Identifying an entity's “customer”

An entity might make payments directly to its customer, or make payments to another party that purchases the entity's goods or services from its customer (that is, a “customer's customer” within the distribution chain), as illustrated in Figure 4-1 below.

Figure 4-1

Example of a payment to a customer's customer in the distribution chain



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

Example 4-28 illustrates an arrangement with a payment made by an entity to its reseller's customer.

EXAMPLE 4-28

Consideration payable to customers — payment to reseller's customer

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

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

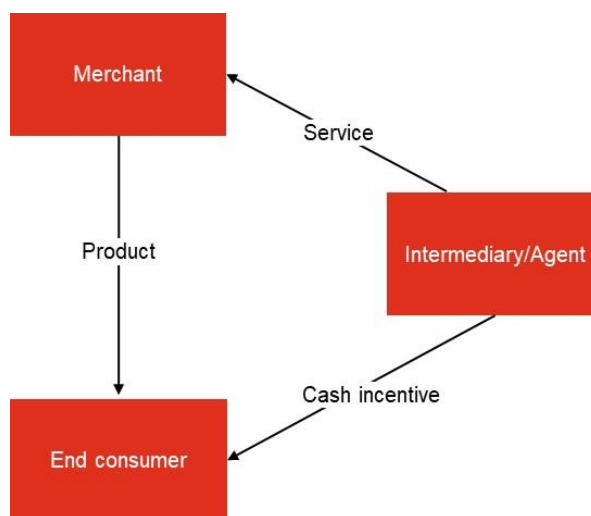
Analysis

ElectronicsCo should account for the rebate in the same manner as if it were paid directly to the Retailer. Payments to a customer's customer within the distribution chain are accounted for in the same way as payments to a customer under the revenue standard.

In certain arrangements, entities provide cash incentives to end consumers that are not their direct customers and do not purchase the entities' goods or services within the distribution chain, as depicted in Figure 4-2.

Figure 4-2

Example of a payment to an end consumer that does not purchase the entity's goods or services



Management must first identify whether the end consumer is the entity's customer under the revenue standard. This assessment could require judgment. Management should also consider whether a payment to an end consumer is contractually required pursuant to the arrangement between the entity and its customer (for example, the merchant in Figure 4-2) in the transaction. In that case, the payment to the end consumer would be treated as consideration payable to a customer as it is being

made on the customer's behalf. Refer to Revenue TRG Memo No. 37 and the related meeting minutes in Revenue TRG Memo No. 44 for further discussion of this topic.

Example 4-29 illustrates an arrangement with a payment made by an agent to an end consumer.

EXAMPLE 4-29

Consideration payable to customers — agent's payment to end consumer

TravelCo sells airline tickets to end consumers on behalf of Airline. TravelCo concludes that it is acting as an agent in the airline ticket sale transactions (refer to RR 10 for further discussion on principal versus agent considerations). TravelCo offers a \$10 coupon to end consumers in order to increase the volume of airline ticket sales on which it earns a commission.

How should TravelCo account for the coupons offered to end consumers?

Analysis

TravelCo must identify its customer (or customers) in order to determine whether the coupons represent consideration payable to a customer. The coupons represent consideration payable to a customer if (1) TravelCo determines the end consumers are its customers, or (2) TravelCo determines the end consumers are not its customers, but it is making the payment on behalf of Airline (its customer). In either of these situations, TravelCo would record the coupons as a reduction of its agency commission as it does not receive a distinct good or service in exchange for the payment (see RR 4.6.1). Conversely, the coupons would generally be recorded as a marketing expense if the coupons do not represent consideration payable to a customer.

4.6.3 *Timing of recognition of payments made to a customer*

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

ASC 606-10-32-27 and IFRS 15.72

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

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

Management should consider whether a payment it expects to make to a customer (for example, a rebate) is a price concession when assessing the terms of the contract. A price concession is a form of variable consideration, as discussed in RR 4.3.3.1, and should be estimated, including assessment of the variable consideration constraint. A payment to a customer should also be accounted for if it is implied, even if the entity has not yet explicitly communicated its intent to make the payment to the

customer. Judgment may be required to determine whether an entity intends to make a customer payment in the form of a price concession and whether a payment is implied by the entity's customary business practices. Refer to Revenue TRG Memo No. 37 and the related meeting minutes in Revenue TRG Memo No. 44 for further discussion of this topic.

Example 4-30 illustrates the timing of recognition for payments to customers that are a reduction of revenue.

EXAMPLE 4-30

Consideration payable to customers — implied promise to pay consideration

CoffeeCo sells coffee products to Retailer. On December 1, 20X1, CoffeeCo decides that it will issue coupons directly to end consumers that provide a \$1 discount on each bag of coffee purchased. CoffeeCo has a history of providing similar coupons.

CoffeeCo delivers a shipment of coffee to Retailer on December 28, 20X1 and recognizes revenue. The coupon is offered to end consumers on January 2, 20X2 and CoffeeCo reasonably expects that the coupons will be used to purchase products already shipped to Retailer. CoffeeCo will reimburse Retailer for any coupons redeemed by end consumers.

When should CoffeeCo record the revenue reduction for estimated coupon redemptions?

Analysis

CoffeeCo should reduce the transaction price for estimated coupon redemptions when it recognizes revenue upon transfer of the coffee to Retailer on December 28, 20X1. Although CoffeeCo has not yet communicated the coupon offering, CoffeeCo has a customary business practice of providing coupons and has the intent to provide coupons (a form of price concession) related to the shipment. Therefore, CoffeeCo should account for the coupons following the guidance on variable consideration.

4.6.4 Payments to customers that exceed the transaction price

In some cases, a payment to a customer that is not in exchange for a distinct good or service could exceed the transaction price for the current contract. Accounting for the excess payment ("negative revenue") could require judgment. Management should obtain an understanding of the reason for making the payment to the customer and the rights and obligations in the related contracts. Entities should also appropriately disclose their related judgments, if material.

To determine the accounting for the excess payment amount, including timing of recognition in income and presentation in the income statement, management should assess whether the payment also relates to other current or past contracts. If the entity has recognized revenue from the same customer related to other contracts, the excess payment might represent a modification to the transaction price of those contracts. Refer to Revenue TRG Memo No. 37 and the related meeting minutes in Revenue TRG Memo No. 44 for further discussion of this topic.

Management should also assess whether the payment relates to anticipated future contracts. For example, entities sometimes make advance payments to customers to reimburse them for costs to change vendors and/or to secure exclusivity in anticipation of future purchases even though the entity may not have an enforceable right to them. Payments to a customer that relate to anticipated contracts

could meet the definition of an asset. Payments capitalized would be amortized as a reduction to future revenues from that customer. Assets should be assessed for recoverability, which would generally be based on expected future revenues from the customer. Refer to US Revenue TRG Memo No. 59 and the related meeting minutes in Revenue TRG Memo No. 60 for further discussion of this topic.

If the payment does not relate to any other contracts (including past contracts or anticipated future contracts) with the customer, management should consider the substance of the payment to determine the appropriate presentation of the amount in excess of the transaction price. For example, management might conclude the excess payment should be presented as an expense because the arrangement no longer represents a contract with a customer when the transaction price is negative.

Example 4-31 illustrates the accounting when payments to a customer exceed the transaction price.

EXAMPLE 4-31

Consideration payable to customers — payment exceeds transaction price

ToyCo sells 1,000 products to Retailer for total consideration of \$100,000. ToyCo is an emerging business and therefore, to receive desirable placement in Retailer's store, ToyCo pays Retailer a one-time payment of \$150,000. This payment is not in exchange for a distinct good or service and ToyCo does not have any other past or current contracts with the Retailer at the time of payment. Although ToyCo aspires to sell additional products to Retailer in the future, ToyCo does not currently anticipate specific future contracts with Retailer.

How should ToyCo account for the payment to Retailer?

Analysis

ToyCo should account for the payment as a reduction of the transaction price of the contract with Retailer because it does not receive a distinct good or service in exchange for the payment. ToyCo has determined that the excess amount of \$50,000 (\$100,000 contract price less \$150,000 payment) does not relate to any other contracts with Retailer; therefore, the excess amount should be presented based on the substance of the payment. In this fact pattern, ToyCo would likely conclude that the \$50,000 excess payment should be presented as an expense.

4.6.5 Settlement payments made to customers

Entities may be required to make payments to customers to settle litigation claims or other disputes. These payments will generally represent a payment to a customer and will be presented as a reduction of revenue because the entity does not receive a distinct good or service in exchange for the payment. In some cases, it may not be clear whether the payment relates to past or future transactions. Cash payments made to customers to settle disputes often represent adjustments to the transaction price of a completed contract. In other words, the entity agrees as part of the settlement to make a price concession related to the past transaction. In these situations, the payments should be recorded as an immediate adjustment to revenue.

In other situations, a cash payment may represent an incentive for the customer to enter into a new contract. For example, an entity may settle a class action lawsuit by issuing coupons to a large group of customers that can be used in connection with future purchases. It may be appropriate to account for these coupons when the future purchases are made if the coupons are viewed as incentives to enter

into new contracts as opposed to adjustments to the transaction price for prior purchases. This assessment may require significant judgment.

Cash payments that relate to a contract in process should generally be accounted for as a modification to the contract. Refer to RR 2.9 for guidance on accounting for modifications.

4.6.6 New guidance – payments to customers in the form of equity

In June 2018, the FASB issued ASU 2018-07, *Compensation—stock compensation (Topic 718)—Improvements to nonemployee share-based payment accounting*. For US GAAP reporters, ASU 2018-07 amends ASC 606 to clarify that consideration payable to a customer also includes equity instruments (for example, shares, share options, or other equity instruments). The accounting for the equity instrument (including measurement, classification, recognition, and disclosure) depends on whether the equity instrument is payment in exchange for a distinct good or service. Payments to customers in the form of an entity's own equity instruments in exchange for a distinct good or service are accounted for in accordance with ASC 718, *Compensation—stock-compensation*, similar to other share-based payments to nonemployees.

Consideration paid to a customer in the form of equity instruments that is not in exchange for a distinct good or service is a reduction of the transaction price. Because the guidance as currently written (see note about ongoing standard setting below) states that these transactions are outside the scope of ASC 718, we believe it would be acceptable to apply ASC 606 to account for the equity instrument. Under ASC 606, equity instruments would be measured at contract inception, similar to the measurement of noncash consideration received from a customer under ASC 606 (refer to RR 4.5). If the number of equity instruments or terms of such instruments (such as the exercise price or contractual term) varies based on future events (for example, vesting or issuance of the instruments depends on certain future events or achieving certain performance targets), the consideration would likely be accounted for as variable consideration, similar to the accounting described in RR 4.5.2. However, changes in the value of the instrument due to changes in the entity's stock price are not considered variable consideration. Management may need to apply judgment to determine whether certain features of equity instruments should be viewed as variable consideration or whether they should be incorporated into the determination of fair value of the instrument at contract inception.

The amendments in ASU 2018-07 are effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, but no earlier than an entity's adoption date of ASC 606.

The IASB has not issued similar guidance. Transactions in which an entity acquires distinct goods and services in exchange for its own equity instruments would be in the scope of IFRS 2, *Share based payments*. The guidance in IFRS 15 for payments to customers in which an entity does not receive distinct goods or services, is not restricted to cash payments. Therefore, we believe that the fair value of shares issued to a customer in these circumstances would be accounted for as a reduction of revenue. IFRS 15 does not specify the measurement date for noncash consideration; therefore, management should apply judgment to determine the measurement date. Different conclusions regarding measurement date might be reached under US GAAP and IFRS.

Note about ongoing standard setting (US GAAP)

As of the content cutoff date of this publication (August 31, 2019), the FASB has an active project to clarify the measurement date and classification of equity instruments issued to a customer. The FASB released an exposure draft for public comment in March 2019 proposing that entities measure and classify such instruments in accordance with ASC 718 (that is, equity instruments would be measured on their grant date and assessed for equity versus liability classification based on the guidance in ASC 718), although the resulting value would still be considered a payment to a customer under ASC 606. In July 2019, the FASB deliberated comments received on the exposure draft and authorized the issuance of a final standard, which is expected during the fourth calendar quarter of 2019. Financial statement preparers and other users of this publication are encouraged to monitor the status of the project.

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

5.1 Chapter overview

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

ASC 606-10-32-28 and IFRS 15.73

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

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

5.2 Determining standalone selling price

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

ASC 606-10-32-31 and IFRS 15.76

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

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

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

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

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

Question 5-1 addresses whether the standalone selling price can be based on a range of prices.

Question 5-1

Can an entity use a range of prices when determining the standalone selling prices of individual goods or services?

PwC response

We believe it would be acceptable for an entity to use a range of prices when determining the standalone selling prices of individual goods or services, provided that the range reflects reasonable pricing of each product or service as if it were priced on a standalone basis for similar customers.

The allocation guidance does not specifically refer to the use of a range, but we believe using a range of standalone selling prices is consistent with the overall allocation objective. Entities will need to apply judgment to determine an appropriate range of standalone selling prices.

If an entity decides to use a range to determine standalone selling prices, the contractual price can be considered the standalone selling price if it falls within the range. There may, however, be situations in which the contractual price of a good or service is outside of that range. In those cases, entities should apply a consistent method to determine the standalone selling price within the range for that good or service (for example, the midpoint of the range or the outer limit closest to the stated contractual price).

Example 5-1 and Example 5-2 illustrate the allocation of transaction price when the goods and services are also sold separately. These concepts are also illustrated in Example 33 of the revenue standard (ASC 606-10-55-256 through ASC 606-10-55-258 and IFRS 15.IE164 through IFRS 15.IE166).

EXAMPLE 5-1

Allocating transaction price — standalone selling prices are directly observable

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

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

Analysis

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

Boat:	\$27,857	$(\$32,500 \times (\$30,000 / \$35,000))$
Mooring services:	\$4,643	$(\$32,500 \times (\$5,000 / \$35,000))$

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

EXAMPLE 5-2

Allocating transaction price — use of a range when estimating standalone selling prices

Marine sells boats and provides mooring facilities for its customers. Marine sells the boats on a standalone basis for \$29,000 – \$32,000 each and provides mooring facilities for \$5,000 per year. Marine concludes that the goods and services are distinct and accounts for them as separate performance obligations.

Marine enters into a contract to sell a boat and one year of mooring services to a customer. The stated contract prices for the boat and the mooring services are \$31,000 and \$1,500, respectively.

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

Analysis

The contract price for the boat (\$31,000) falls within the range Marine established for standalone selling prices; therefore, Marine could use the stated contract price for the boat as the standalone selling price in the allocation:

Boat:	\$27,986	$(\$32,500 \times (\$31,000 / \$36,000))$
Mooring services:	\$4,514	$(\$32,500 \times (\$5,000 / \$36,000))$

If the contract price for the boat did not fall within the range (for example, the boat was priced at \$28,000), Marine would need to determine a price within the range to use as the standalone selling price of the boat in the allocation, such as the midpoint. Marine should apply a consistent method for determining the price within the range to use as the standalone selling price.

5.3 Standalone selling price not directly observable

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

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

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

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

Question 5-2 addresses whether an entity could assert it is unable to estimate standalone selling price.

Question 5-2

Are there instances when an entity could assert it is unable to estimate standalone selling price?

PwC response

No. The revenue standard requires an entity to estimate standalone selling price for each distinct good or service in an arrangement. The residual approach (refer to RR 5.3.3) may only be used if specific criteria are met.

5.3.1 Adjusted market assessment approach

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

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

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

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

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

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

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

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

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

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

5.3.2 *Expected cost plus a margin*

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

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

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

The objective is to determine what factors and conditions affect what an entity would be able to charge in a particular market. Judgment will often be needed to determine an appropriate margin, particularly when sufficient historical data is not readily available or when a product or service has not

been previously sold on a standalone basis. Estimating a reasonable margin will often require an assessment of both entity-specific and market factors.

Example 5-3 illustrates some of the approaches to estimating standalone selling price.

EXAMPLE 5-3

Allocating transaction price – standalone selling prices are not directly observable

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

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

Analysis

Biotech analyzes the transaction as follows:

License

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

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

Research services

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

5.3.3 Residual approach

The residual approach involves deducting from the total transaction price the sum of the estimated standalone selling prices of other goods and services in the contract to estimate a standalone selling price for the remaining goods or services. Use of a residual approach to estimate standalone selling price is permitted in certain circumstances.

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

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

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

5.3.3.1 When the residual approach can be used

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

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

5.3.3.2 Additional considerations if a residual approach is used

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

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

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

When a residual approach is used, management still needs to compare the results obtained to all reasonably available observable evidence to ensure the method meets the objective of allocating the transaction price based on standalone selling prices. Allocating little or no consideration to a

performance obligation suggests the method used might not be appropriate, because a good or service that is distinct is presumed to have value to the purchaser.

Example 5-4 and Example 5-5 illustrate the use of the residual approach to estimate standalone selling price.

EXAMPLE 5-4

Estimating standalone selling price – residual approach

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

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

Analysis

Seller can use the residual approach to estimate the standalone selling price of Product C because Seller has not previously sold or established a price for Product C. Prior to using the residual approach, Seller should assess whether any other observable data exists to estimate the standalone selling price. For example, although Product C is a new product, Seller may be able to estimate a standalone selling price through other methods, such as using expected cost plus a margin.

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

EXAMPLE 5-5

Estimating standalone selling price – residual approach is not appropriate

SoftwareCo enters into a contract with a customer to license software and provide post-contract customer support (PCS) for a total transaction price of \$1.1 million. SoftwareCo regularly sells PCS for \$1 million on a standalone basis. SoftwareCo also regularly licenses software on a standalone basis for a price that is highly variable, ranging from \$500,000 to \$5 million.

Can SoftwareCo use the residual approach to determine the standalone selling price of the software license?

Analysis

No. Because the seller has observable evidence that PCS sells for \$1 million, the residual approach results in a nominal allocation of selling price to the software license. As the software is typically sold separately for \$500,000 to \$5 million, this is not an estimate that faithfully represents the price of the software license if it was sold separately. As such, the allocation objective of the standard is not met and SoftwareCo should use another method to estimate the standalone selling price of the license.

5.4 *Allocating discounts*

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

ASC 606-10-32-36 and IFRS 15.81

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

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

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

ASC 606-10-32-37 and IFRS 15.82

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

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

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

Example 5-6 and Example 5-7 illustrate the allocation of a discount. These concepts are also illustrated in Example 34 of the revenue standard (ASC 606-10-55-259 through ASC 606-10-55-269 and IFRS 15.IE167 through IFRS 15.IE177).

EXAMPLE 5-6

Allocating transaction price – allocating a discount

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

How should Retailer allocate the transaction price to the products?

Analysis

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

Chair and couch:	\$4,400
Table:	\$1,000

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

EXAMPLE 5-7

Allocating transaction price – allocating a discount and applying the residual approach

Seller enters into a contract with a customer to sell Products A, B, and C for a total transaction price of \$100,000. On a standalone basis, Seller regularly sells Product A for \$25,000 and Product B for \$45,000. Product C is a new product that has not been sold previously, has no established price, and is not sold by competitors in the market. Products A and B are regularly sold as a bundle for \$60,000 (that is, at a \$10,000 discount). Seller concludes the residual approach is appropriate for determining the standalone selling price of Product C.

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

Analysis

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

5.5 *Impact of variable consideration*

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

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

5.5.1 *Allocating variable consideration*

Variable consideration is generally allocated to all performance obligations in a contract based on their relative standalone selling prices. However, similar to a discount, there are criteria for assessing whether variable consideration is attributable to one or more, but not all, of the performance obligations in an arrangement. This allocation guidance is a requirement, not a policy election. This concept is illustrated in Example 35 of the revenue standard (ASC 606-10-55-270 through ASC 606-10-55-279 and IFRS 15.IE178 through IFRS 15.IE187).

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

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

ASC 606-10-32-40 and IFRS 15.85

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

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

Question 5-3 addresses whether an allocation must reflect relative standalone selling price to conclude it is consistent with the allocation objective.

Question 5-3

Does an entity have to perform a relative standalone selling price allocation to conclude that the allocation of variable consideration to one or more, but not all, performance obligations is consistent with the allocation objective?

PwC response

The boards noted in the basis for conclusions that standalone selling price is the “default method” for determining whether the allocation objective is met; however, other methods could be used in certain cases. Therefore, a relative standalone selling price allocation could be utilized, but is not required, to assess the reasonableness of the allocation. In the absence of specific guidance on other methods, entities will have to apply judgment to determine whether the allocation results in a reasonable outcome. Refer to Revenue TRG Memo No. [39](#) and the related meeting minutes in Revenue TRG Memo No. [44](#) for further discussion of this topic.

Question 5-4 addresses which allocation guidance an entity should apply when a discount causes the transaction price to be variable.

Question 5-4

Which guidance should an entity apply to determine how to allocate a discount that causes the transaction price to be variable?

PwC response

Certain discounts are also variable consideration within a contract. For example, an electronics store may sell a customer a television, speakers, and a DVD player at their standalone selling prices, but also grant the customer a \$50 mail-in rebate on the total purchase. There is a \$50 discount on the bundle, but it is variable as it is contingent on the customer redeeming the rebate.

Entities should first apply the guidance for allocating variable consideration to a discount that is also variable. If those criteria are not met, entities should then consider whether the criteria for allocating a discount, discussed in RR 5.4, are met. A contract might have both variable and fixed discounts. The guidance on allocating a discount should be applied to any fixed discount. Refer to Revenue TRG Memo No. [31](#) and the related meeting minutes in Revenue TRG Memo No. [34](#) for further discussion of this topic.

5.5.1.1 Allocating variable consideration to a series

A series of distinct goods or services is accounted for as a single performance obligation if it meets certain criteria (see further discussion in RR 3). When a contract includes a series accounted for as a single performance obligation and also includes an element of variable consideration, management should consider the distinct goods or services (rather than the series) for the purpose of allocating variable consideration. In other words, the series is not treated as a single performance obligation for purposes of allocating variable consideration. Management should apply the guidance in ASC 606-10-32-40 and IFRS 15.85 (refer to RR 5.5.1) to determine whether variable consideration should be allocated entirely to a distinct good or service within a series.

Example 5-8, Example 5-9, and Example 5-10 illustrate the allocation of variable consideration in an arrangement that is a series of distinct goods and services. This concept is also illustrated in Example 12A of ASC 606 (606-10-55-157B through ASC 606-10-55-158).

EXAMPLE 5-8

Allocating variable consideration to a series – performance bonus

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

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

Air Inc has not previously used its systems for buildings in this region. Air Inc therefore does not include any variable consideration related to the performance bonus in the transaction price during the first six months of providing service, as it does not believe that it is probable (US GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue recognized will not occur if its estimate of customer cost savings changes. At the end of the first six months, the customer's costs have decreased by 12% over the prior comparative period and Air Inc becomes entitled to the performance bonus.

How should Air Inc account for the performance bonus?

Analysis

Air Inc should allocate the performance bonus to the distinct services to which it relates (that is, the related six-month period) if management concludes the results are consistent with the allocation objective. Assuming this is the case, Air Inc would recognize the performance bonus (the change in the estimate of variable consideration) immediately because it relates to distinct services that have already been performed. It would not be appropriate to allocate the change in variable consideration to the entire performance obligation (that is, recognize the amount over the entire three-year contract).

EXAMPLE 5-9

Allocating variable consideration to a series – pricing varies based on usage

Transaction Processor (TP) enters into a two-year contract with a customer whereby TP will 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 unknown. TP charges the customer a monthly fee calculated as \$0.03 per transaction processed during the month.

TP concludes that the nature of its promise is a series of distinct monthly processing services and accounts for the two-year contract as a single performance obligation.

How should TP allocate the variable consideration in this arrangement?

Analysis

TP should allocate the variable monthly fee to the distinct monthly service to which it relates, assuming the results are consistent with the allocation objective. TP would determine that the allocation objective is met because the fees are priced consistently throughout the contract and the rates are consistent with the entity's pricing practices with similar customers.

Assessing whether the allocation objective is met will require judgment. For example, if the rate per transaction processed was not consistent throughout the contract, TP would have to evaluate the reasons for the varying rates to assess whether the results of allocating each month's fee to the monthly service are reasonable. TP should consider, among other factors, whether the rates are based on market terms and whether changes in the rate are substantive and linked to changes in value provided to the customer. For example, if the terms were structured to simply recognize more revenue earlier in the contract, this is a circumstance when the allocation objective would not be met. Management should also consider whether arrangements with declining prices include a future discount for which revenue should be deferred. Refer to Revenue TRG Memo No. 39 and the related meeting minutes in Revenue TRG Memo No. 44 for further discussion of this topic.

EXAMPLE 5-10**Allocating variable consideration to a series – contract with an upfront fee**

CloudCo enters into a contract to provide a customer with a cloud-based solution to process payroll over a one-year period. The customer cannot take possession of the software at any time during the hosting period; therefore, the contract does not include a license. CloudCo charges the customer an upfront fee of \$1 million and a monthly fee of \$2 for each employee's payroll processed through the cloud-based solution. If the customer renews the contract, it will have to pay a similar upfront fee.

CloudCo concludes that the nature of its promise is a series of distinct monthly services and accounts for the one-year contract as a single performance obligation.

In the first quarter of the year, the monthly fees for payroll processed in January, February, and March are \$50,000, \$51,000, and \$52,000, respectively.

How should CloudCo recognize revenue from this arrangement?

Analysis

CloudCo should determine an appropriate measure of progress to recognize the \$1 million upfront fee, which would likely be a time-based measure (that is, ratable recognition over the contract term). CloudCo should allocate the variable monthly fees to the distinct monthly service to which they relate (that is, \$50,000 to January, \$51,000 to February, and \$52,000 to March). The allocation objective is met because the \$2 monthly fee per employee is consistent throughout the contract and the variable consideration can be allocated to the distinct service to which it relates, which is the monthly payroll processing service in January, February, and March.

The resulting accounting is that the upfront fee is spread ratably, but the variable fee is not. This does not mean that the entity is using multiple measures of progress. The single measure of progress for the contract is a time-based measure, but the variable fee is allocated to specific time periods in accordance with the allocation guidance as described in RR 5.5.1.

5.5.2 *Allocating subsequent changes in transaction price*

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

ASC 606-10-32-43 and IFRS 15.88

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

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

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

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

Example 5-11 illustrates the accounting for a change in transaction price after the inception of an arrangement.

EXAMPLE 5-11

Allocating transaction price – change in transaction price

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

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

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

Contractor anticipates completing the building addition by March 1 and allocates an additional \$250,000 to just the building addition performance obligation, resulting in an allocated transaction price of \$4,250,000. Contractor concludes that this result is consistent with the allocation objective in these facts and circumstances.

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

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

Analysis

As of December 31, Contractor should allocate an incremental bonus of \$250,000 to the building addition performance obligation, for a total of \$4,500,000. The change to the bonus estimate is allocated entirely to the building addition because the allocation criteria discussed in RR 5.5.1 were met. Contractor should recognize \$3,375,000 ($75\% \times \$4,500,000$) as revenue on a cumulative basis for the building addition as of December 31.

5.6 Other considerations

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

5.6.1 Transaction price exceeds sum of standalone selling prices

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

5.6.2 Nonrefundable upfront fees

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

5.6.3 No “contingent revenue cap”

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

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

Chapter 6:

Recognizing revenue

6.1 Chapter overview

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

6.2 Control

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

ASC 606-10-25-23 and IFRS 15.31

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

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

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

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

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

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

6.3 *Performance obligations satisfied over time*

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

The assessment of whether control transfers over time or at a point in time is critical to the timing of revenue recognition. It will also affect an entity's determination of whether a contract is a series of distinct goods or services that should be accounted for as a single performance obligation. In order to qualify as a series, each distinct good or service in the series must meet the criteria for over time recognition. Refer to RR 3.3.2 for further discussion of the series guidance and its implications.

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

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

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

- a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs...
- b. The entity's performance creates or enhances an asset (for example, work in [process [US GAAP]/progress [IFRS]]) that the customer controls as the asset is created or enhanced...
- c. The entity's performance does not create an asset with an alternative use to the entity...and the entity has an enforceable right to payment for performance completed to date

6.3.1 *Customer receives and consumes benefits as the entity performs*

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

This criterion could also apply to arrangements that are not typically viewed as services, such as contracts to deliver electricity or other commodities. For example, an entity that provides a continuous supply of natural gas upon demand might conclude that the natural gas is simultaneously received and consumed by the customer. This assessment could require judgment. Refer to Revenue TRG Memo No. [43](#) and the related meeting minutes in Revenue TRG Memo No. [44](#) for further discussion of this topic.

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

Contractual or practical limitations that prevent an entity from transferring the remaining obligations to another entity are not considered in this assessment. The objective is to determine whether control transfers over time using a hypothetical assessment of whether another entity would have to reperform work completed to date. Limitations that would prevent an entity from practically transferring a contract to another entity are therefore disregarded.

Example 6-1 illustrates a customer simultaneously receiving and consuming the benefits provided by an entity's performance. This concept is also illustrated in Example 13 of the revenue standard (ASC 606-10-55-159 through ASC 606-10-55-160 and IFRS 15.IE67 through IFRS 15.IE68).

EXAMPLE 6-1

Recognizing revenue — simultaneously receiving and consuming benefits

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

When should RailroadCo recognize revenue from this contract?

Analysis

RailroadCo would recognize revenue as it transports the goods because the performance obligation is satisfied over that period. RailroadCo would determine the extent of transportation service delivered at the end of each reporting period and recognize revenue in proportion to the service delivered.

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

6.3.2 ***Entity creates or enhances an asset that the customer controls***

This criterion applies in situations where the customer controls the work in process as the entity manufactures goods or provides services. The asset being created can be tangible or intangible. Such arrangements could include construction or manufacturing contracts in which the customer controls the work in process, or research and development contracts in which the customer owns the findings. For example, if an entity is constructing a building on a customer's land, the customer would generally control any work in process arising from the entity's performance.

Management should apply the principle of control to determine whether the customer obtains control of an asset as it is created, which could require judgment. The control principle should be applied to the asset that the entity's performance creates or enhances. For example, if the entity is constructing an asset, management should assess whether the customer controls that asset as it is constructed. The IFRIC Agenda Decision, [*Revenue recognition in a real estate contract*](#), issued in March 2018 highlighted that the customer's ability to sell or pledge a right to obtain the asset in the future is not evidence of control of the asset itself.

As discussed in BC 129, the Boards included this criterion to address situations in when the customer clearly controls the asset being created or enhanced. Absent evidence that the customer controls the

asset (based on the control definition and indicators discussed in RR 6.5), management would need to assess the other criteria to conclude whether control transfers over time.

6.3.3 *Asset has no alternative use and the entity has right to payment*

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

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

6.3.3.1 *No alternative use*

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

Management should assess at contract inception whether the asset that will ultimately be transferred to the customer has an alternative use. This assessment is only updated if there is a contract modification that substantively changes the terms of the arrangement.

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

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

Practical limitations can also indicate that an asset has no alternative use. An asset that requires significant rework (at a significant cost) for it to be suitable for another customer or for another purpose will likely have no alternative use. For example, a highly specialized part that can only be used by a specific customer is unlikely to be sold to another customer without requiring significant rework. A practical limitation would also exist if the entity could only sell the asset to another customer at a significant loss. It may require significant judgment in some cases to determine whether practical limitations exist in an arrangement.

6.3.3.2 *Right to payment for performance to date*

This criterion is met if an entity is entitled to payment for performance completed to date, at all times during the contract term, if the customer terminates the contract for reasons other than the entity's nonperformance. The assessment of whether a right to payment exists may not be straight forward and depends on the contract terms and relevant laws and regulations. Management will generally have to assess the right to payment on a contract-by-contract basis; therefore, variances in contract terms could result in recognizing revenue at a point in time for some contracts and over time for others, even when the products promised in the contracts are similar. Refer to US Revenue TRG Memo No. [56](#) and the related meeting minutes in Revenue TRG Memo No. [60](#) for further discussion of this topic.

An entity's right to payment for performance completed to date does not have to be a present unconditional right; that is, the contract does not have to contain explicit contractual terms that entitle the entity to invoice at any point throughout the contract period. Many arrangements include terms that stipulate that progress or milestone payments are required only at specified intervals, or only upon completion of the contract. Regardless of the stated payment terms or payment schedule, management needs to determine whether the entity would have an enforceable right to demand payment if the customer cancelled the contract for other than a breach or nonperformance. A right to payment would also exist if the contract (or other laws) entitles the entity to continue fulfilling the contract and demand payment from the customer under the terms of the contract in the event the customer attempts to terminate the contract.

Assessing whether a right to payment is enforceable

An entity's enforceable right to payment for performance completed to date will generally be evidenced by the contractual terms agreed to by the parties. However, the revenue standard provides that legislation or legal precedent in the relevant jurisdiction might supplement or override the contractual terms. An entity asserting that it has an enforceable right to payment despite the lack of a contractual right should have sufficient legal evidence to support this conclusion. The fact that the entity would have a basis for making a claim against the counterparty in a court of law is not sufficient to support that there is an enforceable right to payment.

If the contractual terms do not provide for a right to payment, we do not believe management is required to do an exhaustive search for legal evidence that might support an enforceable right to payment; however, it would be inappropriate for an entity to ignore evidence that clearly provides for such a right. Similarly, if the contractual terms do provide for a right to payment, it would be inappropriate to ignore evidence that clearly indicates such rights have no binding legal effect. This concept was discussed in the IFRIC Agenda Decision, [*Right to payment for performance completed to date*](#), issued in March 2018.

Even if an entity has a customary business practice of not enforcing right to payment clauses in its contracts, this generally does not mean there is no longer an enforceable right to payment. Such a business practice would only impact the assessment if it renders the right unenforceable in a particular legal environment.

Question 6-1 addresses how an acceptance provision affects the assessment of whether a right to payment is enforceable.

Question 6-1

Can an entity conclude it has an enforceable right to payment for performance if the contract includes an acceptance provision?

PwC response

It depends. If the nature of the acceptance provision is to confirm that the entity has performed in accordance with the contract, we believe the provision would not impact the assessment of whether the entity has an enforceable right to payment. However, if the acceptance provision relates primarily to subjective specifications and allows a customer to avoid paying for performance to date for reasons other than a breach or nonperformance, an enforceable right to payment would likely not exist. Refer to RR 6.5.5 for further discussion of acceptance provisions.

Assessing whether a right to payment compensates the entity for performance to date

The amount of the payment that the entity can enforce must at least compensate the entity for performance to date at any point during the contract. The amount should reflect the selling price of the goods or services provided to date. For example, an entity would have an enforceable right to payment if it is entitled to receive an amount that covers its cost plus a reasonable profit margin for work completed. An entity that is entitled only to recover costs incurred does not have a right to payment for the work to date if the selling price of the finished goods or completed services includes a profit margin.

The revenue standard describes a reasonable profit margin as follows.

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

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

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

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

Customer deposits and other upfront payments should also be assessed to determine if they compensate the entity for performance completed to date. A significant nonrefundable upfront payment could meet the requirement if the entity has the right to retain that payment in the event the

customer terminates the contract, and the payment would at least compensate the entity for work performed to date throughout the contract. The requirement would also be met even if a portion of the customer deposit is refundable as long as the amount retained by the entity provides compensation for work performed to date throughout the contract.

In assessing whether the entity has a right to payment for performance completed to date, management should only consider payments it has a right to receive from the customer. That is, management should not include payments it might receive from other parties (for example, payments it might receive upon resale of the good). Refer to the [March 2018 IFRIC Agenda Decisions](#) for an example scenario illustrating this concept.

Question 6-2 addresses the assessment of whether an entity has a right to payment when the contract is priced at cost or at a loss.

Question 6-2

Can a right to payment for performance completed to date exist when the contract is priced at cost or at a loss, and thus the right to payment does not include a profit margin?

PwC response

Yes. The principle for assessing whether an entity has a right to payment for performance is based on whether the entity has a right to be compensated at an amount that approximates the selling price of the goods or services transferred to date. While the selling price for a contract will often be based on estimated costs plus a profit margin, selling price will not include a margin if the contract is priced at cost or at a loss. For example, an entity might be willing to incur a loss on a sale if it has a strong expectation of obtaining a profit on future orders from the customer, even though such orders are not contractually guaranteed. We believe the analysis of right to payment should be focused on whether the entity has a right to a proportionate amount of the selling price (reflecting performance to date) rather than solely based on whether such amount is equal to costs incurred plus a profit margin.

6.3.3.3 Examples of no alternative use and right to payment

Example 6-2, Example 6-3, Example 6-4, and Example 6-5 illustrate the assessment of alternative use and right to payment. These concepts are also illustrated in Examples 14-17 of the revenue standard (ASC 606-10-55-161 through ASC 606-10-55-182 and IFRS 15.IE69 through IFRS 15.IE90).

EXAMPLE 6-2

Recognizing revenue — asset with an alternative use

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

How should Manufacturer recognize revenue from this contract?

Analysis

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

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

EXAMPLE 6-3**Recognizing revenue — highly specialized asset without an alternative use**

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

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

How should Cruise Builder recognize revenue from this contract?

Analysis

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

EXAMPLE 6-4**Recognizing revenue — right to payment**

Design Inc enters into a contract with EquipCo to deliver the next piece of specialized equipment produced. The contract price is \$1 million, which includes a profit margin of 30%. EquipCo can terminate the contract at any time. EquipCo makes a nonrefundable deposit at contract inception to

cover the cost of materials that Design Inc will procure to produce the specialized equipment. The contract precludes Design Inc from redirecting the equipment to another customer. EquipCo does not control the equipment as it is produced.

How should Design Inc recognize revenue for this contract?

Analysis

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

EXAMPLE 6-5

Recognizing revenue — no right to payment for standard components

MachineCo enters into a contract to build a large, customized piece of equipment for Manufacturer. Because of the unique customer specifications, MachineCo cannot redeploy the equipment to other customers or otherwise modify the design and functionality of the equipment without incurring a substantial amount of rework.

MachineCo purchases or manufactures various standard components used to construct the equipment. MachineCo is entitled to payment for costs incurred plus a reasonable margin if Manufacturer terminates the contract early. MachineCo is not entitled to payment for standard components until they have been integrated into the customized equipment that will be delivered to the customer. This is because MachineCo can use those components in other projects before they are integrated into the customized equipment.

Does MachineCo have an enforceable right to payment for performance completed to date?

Analysis

MachineCo has an enforceable right to payment for performance completed to date because it will be compensated for costs incurred plus a reasonable margin once the standard components have been integrated into the customized equipment. The revenue standard requires an entity to have a right to payment for *performance completed* at all times during the contract term. MachineCo's performance related to the contract occurs once it begins to incorporate the standard components into the customized equipment.

MachineCo has an enforceable right to payment and the equipment does not have an alternative use; therefore, MachineCo should recognize revenue over time as it constructs the equipment. MachineCo would record standard components as inventory prior to integration into the customized equipment.

6.4 Measures of progress

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

ASC 606-10-25-31 and IFRS 15.39

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

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

Methods for measuring progress include:

- Output methods, that recognize revenue based on direct measurements of the value transferred to the customer
- Input methods, that recognize revenue based on the entity's efforts to satisfy the performance obligation

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

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

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

Excerpt from ASU 2014-09 BC159 and IFRS 15 BC159

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

6.4.1 *Output methods*

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

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

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

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

The measure selected should depict the entity's performance to date, and should not exclude a material amount of goods or services for which control has transferred to the customer. Measuring progress based on units produced or units delivered, for example, might be a reasonable proxy for measuring the satisfaction of performance obligations in some, but not all, circumstances. These measures should not be used if they do not take into account work in process for which control has transferred to the customer.

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

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

Question 6-3 addresses whether control can transfer at discrete points in time when a performance obligation is satisfied over time.

Question 6-3

Can control of a good or service transfer at discrete points in time when a performance obligation is satisfied over time?

PwC response

Generally, no. Although the revenue standard cites milestones reached, units produced, and units delivered as examples of output methods, management should use caution in selecting these methods as they may not reflect the entity's progress in satisfying its performance obligations. Management will need to assess whether the measure of progress is correlated to performance and whether the entity has transferred material goods or services that are not captured in the output measure. An appropriate

measure of progress should not result in an entity accumulating a material asset (such as work in process) as that would indicate that the measure does not reflect the entity's performance. Refer to US Revenue TRG Memo No. 53 and the related meeting minutes in Revenue TRG Memo No. 55 for further discussion of this topic.

Example 6-6 illustrates measuring progress toward satisfying a performance obligation using an output method.

EXAMPLE 6-6

Measuring progress — output method

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

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

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

How should Construction Co recognize revenue?

Analysis

An output method using units of track replaced to measure Construction Co's progress under the contract would appear to be most representative of services performed as the effort is consistent across each unit of track replaced. Additionally, this method appropriately depicts the entity's performance as all work in process for which control has transferred to the customer would be captured in this measure of progress. The progress toward completion is 75% (75 units/100 units), so Construction Co would recognize revenue equal to 75% of the total contract price, or \$75,000.

6.4.1.1 ***“Right to invoice” practical expedient***

Management can elect a practical expedient to recognize revenue based on amounts invoiced to the customer in certain circumstances.

Excerpt from ASC 606-10-55-18 and IFRS 15.B16

As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.

Evaluating whether an entity's right to consideration corresponds directly with the value transferred to the customer will require judgment. Management should not presume that a negotiated payment schedule automatically implies that the invoiced amounts represent the value transferred to the

customer. The market prices or standalone selling prices of the goods or services could be evidence of the value to the customer; however, other evidence could also be used to demonstrate that the amount invoiced corresponds directly with the value transferred to the customer. Refer to Revenue TRG Memo No. 40 and the related meeting minutes in Revenue TRG Memo No. 44 for further discussion of this topic.

The revenue standard refers to an example of a “fixed amount for each hour of service,” but this does not preclude application of the practical expedient to contracts with pricing that varies over the term of the contract. Entities will need sufficient evidence that the variable pricing reflects “value to the customer” throughout the contract.

Consider a contract to provide electricity to a customer for a three-year period at rates that increase over the contract term. The entity might conclude that the increasing rates reflect “value to the customer” if, for example, the rates reflect the forward market price of electricity at contract inception. In contrast, consider an arrangement to provide monthly payroll processing services with a payment schedule requiring lower monthly payments during the first part of the contract and higher payments later in the contract because of the customer’s short-term cash flow requirements. In this case, the increasing rates do not reflect “value to the customer.”

Other payment streams within a contract could affect an entity’s ability to elect the practical expedient. For example, the presence of an upfront payment (or back-end rebate) in a contract may indicate that the amounts invoiced do not reflect value to the customer for the entity’s performance completed to date. Management should consider the nature of such payments and their size relative to the total arrangement.

Entities electing the “right to invoice” practical expedient can also elect to exclude certain disclosures about the remaining performance obligations in the contract. Refer to RR 12.3.3.2 for further discussion of the disclosure requirements.

Question 6-4 addresses whether an entity can use the “right to invoice” practical expedient when a contract includes escalating fees.

Question 6-4

An entity enters into a four-year, noncancellable service contract with a customer that includes a series of distinct services. The contractual pricing increases 10% annually. Can the entity use the “right to invoice” practical expedient and record revenue based on the contractual pricing each year?

PwC response

It depends. Management will need to assess whether the requirements to apply the practical expedient are met. In order to use the practical expedient, the escalating fees in the contract need to correspond directly with the value to the customer of the entity’s performance (that is, the value of the services in the second year are 10% higher than the value of the services in the first year). Management should consider factors such as the business reasons for the escalating fees and expected pricing of the services in future years. If the scheduled price increases in the contract do not correspond directly with the increase in value to the customer of the entity’s performance, management will not be able to elect the practical expedient and will need to determine another appropriate measure of progress. For example, it may be appropriate to use a time-based measure of progress (that is, straight-line

recognition). A time-based measure of progress would result in recognition of the total transaction price ratably over the four-year period.

6.4.2 *Input methods*

Input methods measure progress toward satisfying a performance obligation indirectly.

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

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

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

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

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

6.4.2.1 *Input methods based on cost incurred*

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

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

- ☐ Direct labor
- ☐ Direct materials
- ☐ Subcontractor costs
- ☐ Allocations of costs related directly to contract activities if those depict the transfer of control to the customer
- ☐ Costs explicitly chargeable to the customer under the contract
- ☐ Other costs incurred solely due to the contract

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

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

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

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

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

- ❑ Wasted materials
- ❑ Abnormal amounts of labor or other costs

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

Example 6-7 illustrates measuring progress toward satisfying a performance obligation using an input method.

EXAMPLE 6-7

Measuring progress — “cost-to-cost” method

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

Additional contract characteristics are:

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

Contractor concludes that the performance obligation is satisfied over time as Government controls the aircraft carrier as it is created. Contractor also concludes that an input method using costs incurred

to total cost expected to be incurred is an appropriate measure of progress toward satisfying the performance obligation.

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

Analysis

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

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

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

6.4.2.2 Uninstalled materials

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

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

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

Example 6-8 illustrates accounting for an arrangement that includes uninstalled materials. This concept is also illustrated in Example 19 of the revenue standard (ASC 606-10-55-187 through ASC 606-10-55-192 and IFRS 15.IE95 through IFRS 15.IE100).

EXAMPLE 6-8

Measuring progress — uninstalled materials

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

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

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

Analysis

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

6.4.2.3 Learning curve

Learning curve is the effect of gaining efficiencies over time as an entity performs a task or manufactures a product. When an entity becomes more efficient over time in an arrangement that contains a single performance obligation satisfied over time, an entity could select a method of measuring progress (such as a cost-to-cost method) that results in recognizing more revenue and expense in the earlier phases of the contract.

For example, if an entity has a single performance obligation to process transactions for a customer over a five-year period, the entity might recognize more revenue and expense for the earlier transactions processed relative to the later transactions if it incurs greater costs in the earlier periods due to the effect of the learning curve. Refer to RR 11.3.2 for further discussion on the accounting for learning curve costs.

6.4.3 Time-based methods

Time-based methods to measure progress might be appropriate in situations when a performance obligation is satisfied evenly over a period of time or the entity has a stand-ready obligation to perform over a period of time. Judgment will be needed to determine the appropriate method to measure progress toward satisfaction of a stand-ready obligation. It is not appropriate to default to straight-line

attribution; however, straight-line recognition over the contract period will be reasonable in many cases. Examples include a contract to provide technical support related to a product sold to customers or a contract to provide a customer membership to a health club. This concept is illustrated in Example 18 of the revenue standard (ASC 606-10-55-184 through ASC 606-10-55-186 and IFRS 15.IE92 through IFRS 15.IE94).

Judgment is required to determine whether the nature of an entity's promise is to stand ready to provide goods or services or a promise to provide specified goods or services. For example, a promise to provide one or more specified upgrades to a software license is not a stand-ready performance obligation. A contract to deliver unspecified upgrades on a when-and-if-available basis, however, would typically be a stand-ready performance obligation. This is because 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. Refer to Revenue TRG Memo No. 16 and the related meeting minutes in Revenue TRG Memo No. 25 for further discussion of this topic.

A measure of progress based on delivery or usage (rather than a time-based method) will best reflect the entity's performance in some instances. For example, a promise to provide a fixed quantity of a good or service (when the quantity of remaining goods or services to be provided diminishes with customer usage) is typically a promise to deliver the underlying good or service rather than a promise to stand ready. In contrast, a contract that contains a promise to deliver an unlimited quantity of a good or service might be a stand-ready obligation for which a time-based measure of progress is appropriate.

Example 6-9 and Example 6-10 illustrate the assessment of whether a time-based method is appropriate for measuring progress toward satisfying a performance obligation.

EXAMPLE 6-9

Measuring progress — stand-ready obligation

SoftwareCo enters into a contract with a customer to provide a software license and unlimited access to its call center for a one-year period. SoftwareCo determines that the software license and support services are separate performance obligations. Customers typically utilize the call center throughout the one-year term of the contract.

How should SoftwareCo recognize revenue for the unlimited support services?

Analysis

SoftwareCo would conclude its promise to the customer is a stand-ready obligation to provide unlimited access to its call center. SoftwareCo would then determine a measure of progress that best reflects its performance in satisfying this obligation. Assuming a time-based measure, SoftwareCo would recognize revenue for the support services on a straight-line basis over the one-year service period.

EXAMPLE 6-10

Measuring progress — obligation to provide a specified quantity of services

SoftwareCo enters into a contract with a customer to provide a software license and 100 hours of call center support for a one-year period. SoftwareCo determines that the software license and support

services are separate performance obligations. SoftwareCo monitors customer usage of support hours to determine when the hours have been utilized. Customers are charged an additional fee for call center usage beyond 100 hours. Customers frequently use more than 100 hours of support.

How should SoftwareCo recognize revenue for the 100 hours of support services?

Analysis

SoftwareCo would conclude that its promise to the customer is to provide 100 hours of call center support. SoftwareCo would then determine an output method. Assuming a conclusion that hours of service provided best reflects its efforts in satisfying the performance obligation, revenue would be recognized based on the customer's usage of the support services.

6.4.4 *Inability to estimate progress*

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

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

6.4.5 *Measuring progress when multiple items form a single performance obligation*

A single performance obligation could contain a bundle of goods or services that are not distinct. The guidance requires that entities apply a single method to measure progress for each performance obligation satisfied over time.

It could be challenging to identify a single method to measure progress that reflects the entity's performance, particularly when the individual goods or services included in the single performance obligation will be transferred over different periods of time. An entity should consider the nature of its overall promise for the performance obligation to determine the appropriate measure of progress. In making this assessment, an entity should consider the rationale for combining the individual goods or services into a single performance obligation. Refer to Revenue TRG Memo No. [41](#) and the related meeting minutes in Revenue TRG Memo No. [44](#) for further discussion of this topic.

For contracts that include multiple payment streams, such as upfront payments, contingent performance bonuses, and reimbursement of out-of-pocket expenses, entities should apply a single measure of progress to each performance obligation satisfied over time to recognize revenue. That is, all payment streams should be included in the total transaction price and recognized according to the identified measure of progress, regardless of the timing of payment. For example, an upfront payment should not be amortized on a straight-line, time-elapsed basis if another measure, such as costs incurred, labor hours, or units produced, is used to measure progress for the related performance obligation. Refer to RR 8.4 for further discussion of upfront payments.

6.4.6 *Partially satisfied performance obligations*

Entities sometimes commence activities on a specific anticipated contract before finalizing the contract with the customer or meeting the contract criteria (refer to RR 2.6.1). At the date the contract criteria are met, an entity should recognize revenue for any promised goods or services that have already been transferred (that is, revenue should be recognized on a cumulative catch-up basis). Refer to Revenue TRG Memo No. 33 and the related meeting minutes in Revenue TRG Memo No. 34 for further discussion of this topic.

Example 6-11 illustrates the accounting for a performance obligation that is partially satisfied prior to obtaining a contract with a customer.

EXAMPLE 6-11

Measuring progress — partial satisfaction of performance obligations prior to obtaining a contract

Manufacturer enters into a long-term contract with a customer to manufacture a highly customized good. The customer issues purchase orders for 60 days of supply on a rolling calendar basis (that is, every 60 days a new purchase order is issued). Purchase orders are non-cancellable and Manufacturer has a contractual right to payment for all work in process for goods once an order is received.

Manufacturer pre-assembles some goods in order to meet the anticipated demand from the customer based on a non-binding forecast provided by the customer. At the time the customer issues a purchase order, Manufacturer typically has some goods on hand that are completed and others that are partially completed. Manufacturer has determined that each customized good represents a performance obligation satisfied over time. That is, the customized goods have no alternative use and Manufacturer has an enforceable right to payment once it receives the purchase order.

On January 1, 20X6, Manufacturer receives a purchase order from the customer for 100 goods. At that time, Manufacturer has completed 30 of the goods and partially completed 20 goods based on the forecast previously provided by the customer. Manufacturer determines that the 20 partially completed goods are 50% complete based on a cost-to-cost input method of measuring progress. The transaction price is \$200 per unit and the contract includes no other promised goods or services.

How should Manufacturer account for its progress completed to date when it receives the purchase order from the customer?

Analysis

The contract criteria are met when Manufacturer receives the purchase order. On that date, Manufacturer should recognize revenue for any promised goods or services already transferred. Manufacturer should recognize \$8,000 of revenue for performance satisfied to date ((30 completed units * \$200) + (20 partially completed units * \$100)) because the performance obligation is satisfied over time as the goods are assembled.

6.4.7 *Measuring progress of acquired contracts after the acquisition*

In the acquisition of a business, entities may acquire an in-process contract with a customer that contains performance obligations satisfied over time. Any balances associated with the contract acquired (for example, contract assets or liabilities) are recognized in accordance with the relevant

business combinations guidance and generally at fair value (refer to BCG 2.5.20). The entity will need to determine the measure of progress to recognize revenue for the in-process contract during the post-acquisition period. The measure of progress should be based on the acquirer's estimate of the remaining post-acquisition performance. For example, if the "cost-to-cost" method is used, the acquirer should measure progress based on the estimated costs to complete the contract as of the acquisition date as opposed to the estimated costs to complete the contract from inception. In other words, the acquired contract is effectively viewed as a new performance obligation that is 0% complete as of the acquisition date.

6.5 Performance obligations satisfied at a point in time

A performance obligation is satisfied at a point in time if none of the criteria for satisfying a performance obligation over time are met. The guidance on control (see RR 6.2) should be considered to determine when the performance obligation is satisfied by transferring control of the good or service to the customer. In addition, the revenue standard provides five indicators that a customer has obtained control of an asset:

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

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

6.5.1 Entity has a present right to payment

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

6.5.2 Customer has legal title

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

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

Example 6-12 illustrates retention of legal title as a protective right.

EXAMPLE 6-12**Recognizing revenue — legal title retained as a protective right**

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

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

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

Analysis

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

6.5.3 Customer has physical possession

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

Example 6-13 illustrates a fact pattern in which a customer has physical possession, but does not have control of an asset.

EXAMPLE 6-13**Recognizing revenue — sale of goods with resale restrictions**

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

Can Publisher recognize revenue upon delivery of the books to Retailer?

Analysis

It depends. Publisher will need to assess whether Retailer has the ability to direct the use of and receive the benefit from the books. Generally, we expect Publisher will conclude that Retailer does not control the books until the resale restriction lapses and Retailer can sell the book. Thus, Publisher would not recognize revenue until the restriction lapses.

Publisher should consider all relevant facts and circumstances to determine when control of the books transfers to the Retailer. For example, if Retailer is restricted from selling the books to consumers but could sell them to another distributor, with the restrictions on resale to consumers, this might indicate Retailer has the ability to direct the use of and receive the benefit from the books; that is, Publisher might conclude in this fact pattern that Retailer has obtained control of the books.

6.5.4 Customer has significant risks and rewards of ownership

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

Retained risks could result in separate performance obligations in some fact patterns. This would require management to allocate some of the transaction price to the additional obligation. Management should exclude any risks that give rise to a separate performance obligation when evaluating the risks and rewards of ownership.

Question 6-5 addresses whether an entity's customary practice of replacing goods in transit impacts the timing of control transfer.

Question 6-5

Can control of a good transfer prior to delivery to the customer's location if an entity has a customary practice of replacing or crediting the customer for lost or damaged goods in transit?

PwC response

It depends. Management would need to determine when the customer obtains control of the good considering the definition of control as well as the five indicators. The fact that the entity has a practice of replacing lost or damaged goods in transit is not determinative, on its own. If the entity concludes control transfers at shipping point in this fact pattern, it should consider whether there is an additional performance obligation or guarantee related to the goods while in transit.

6.5.5 Customer has accepted the asset

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

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

An acceptance clause that relates primarily to subjective specifications is not likely a formality because the entity cannot ensure the specifications are met prior to shipment. Management might not be able

to conclude that control has transferred to the customer until the customer accepts the goods in such cases. A customer also does not control products received for a trial period if it is not committed to pay any consideration until it has accepted the products. This accounting differs from a right of return, as discussed in RR 8.2, which is considered in determining the transaction price.

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

Question 6-6 addresses whether payment terms linked to product acceptance impact the timing of control transfer.

Question 6-6

The payment terms for a contract to sell a product to a customer specify that the final 10% of the fee is not due until the customer accepts the product. Control of the product transfers at a point in time and there are no other performance obligations in the contract. Do these payment terms indicate that control of the product does not transfer until customer acceptance?

PwC response

It depends. Payment terms alone are not determinative in the assessment of when control transfers to the customer. Management would need to assess the substance of the acceptance provision, including whether the acceptance relates to objective or subjective specifications, and consider the other indicators of control transfer discussed in RR 6.5. The total transaction price should be recognized at the point in time control of the product transfers to the customer; that is, it would not be appropriate to recognize 90% of the transaction price prior to acceptance and the final 10% upon acceptance.

Chapter 7:

Options to acquire additional goods or services

7.1 Chapter overview

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

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

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

7.2 Customer options that provide a material right

The revenue standard provides the following guidance on customer options.

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

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

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

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

The evaluation of whether an option provides a material right to a customer requires judgment. Both quantitative and qualitative factors should be considered, including whether the right accumulates (for example, loyalty points). Management should consider relevant transactions, including the cumulative value of rights received in the current transaction, rights that have accumulated from past transactions, and additional rights expected from future transactions with the customer. Refer to

Revenue TRG Memo No. 6 and the related meeting minutes in Revenue TRG Memo No. 11 for further discussion of accumulating rights.

Management should also consider whether a future discount offered to a customer is incremental to the range of discounts typically given to the same class of customer. Future discounts do not provide a material right if the customer could obtain the same discount without entering into the current transaction. The “class of customer” used in this assessment should include comparable customers (for example, customers in the same geographical location or market) that did not make the same prior purchases. For example, if a retailer offers a 50% discount off of a future purchase to customers that purchase a television, management should assess whether the discount is incremental to discounts provided to customers that did not purchase a television. Refer to US Revenue TRG Memo No. 54 and the related meeting minutes in Revenue TRG Memo No. 55 for further discussion of class of customer.

Example 7-1, Example 7-2, and Example 7-3 illustrate how to assess whether an option provides a material right. This concept is also illustrated in Examples 49, 50, and 51 of the revenue standard (ASC 606-10-55-336 through ASC 606-10-55-352 and IFRS 15.IE250 through IFRS 15.IE266).

EXAMPLE 7-1

Customer options – option that does not provide a material right

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

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

Does the option to purchase additional consulting services provide a material right to the customer?

Analysis

No, the option does not provide a material right in this example. The discount is not incremental to the discount offered to a similar class of customers because it reflects the standalone selling price of hours offered to similar customers that did not enter into a current transaction to purchase the machinery. The option is a marketing offer that is not part of the current contract. The option would be accounted for when it is exercised by the customer.

EXAMPLE 7-2

Customer options – option that does not provide a material right

Telecom enters into a contract to provide unlimited telecom services under a multi-line “family” plan on a monthly basis. The customer has the option to add additional lines to the plan each month for a specified package price that reflects a decrease in the monthly service fee per line as additional lines are added. When customers add or subtract lines from the plan, they are making a decision on a month-to-month basis regarding which family plan to purchase that month (for example, a three-line plan vs. a four-line plan).

Does the option to add an additional line to the plan provide the customer with a material right?

Analysis

No, the option does not provide the customer with a material right. The pricing for the family plan is based on the number of lines purchased that month and is consistent across customers, regardless of the plan a customer purchased in prior months. The customer is not receiving a discount based on its prior purchases.

EXAMPLE 7-3

Customer options — option that provides a material right

Retailer has a loyalty program that awards its customers one loyalty point for every \$10 spent in Retailer's store. Program members can exchange their accumulated points for free product sold by Retailer. Based on historical data, customers frequently accumulate enough points to receive free product.

Customer purchases a product from Retailer for \$50 and earns five loyalty points. Retailer estimates a standalone selling price of \$0.20 per point (a total of \$1 for the five points earned) on the basis of the likelihood of redemption.

Do the loyalty points provide a material right?

Analysis

Yes, the loyalty points provide a material right. Although the five points earned in this transaction might not be individually material, the points accumulate and provide the customer the right to a free product. A portion of the revenue from the transaction should be allocated to the loyalty points and recognized when the points are redeemed or expire.

7.2.1 Determining the standalone selling price of customer options

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

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

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

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

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

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

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

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

Management should consider the factors discussed in RR 4.3.2 (variable consideration), as well as the entity's history and the history of others with similar arrangements, when assessing its ability to estimate the number of options that will not be exercised. An entity should recognize a reduction for breakage only if it is probable (US GAAP) or highly probable (IFRS) that doing so will not result in a subsequent significant reversal of cumulative revenue recognized. Refer to RR 4 for further discussion of the constraint on variable consideration.

Judgment is needed to estimate the standalone selling price of options in many cases, as no one method is prescribed. Management may use option-pricing models to estimate the standalone selling price of an option. An option's price should include its intrinsic value, which is the value of the option if it were exercised today. Option-pricing models typically include time value, but the revenue standard does not require entities to include time value in the estimate of the standalone selling price of the option.

Certain options, such as customer loyalty points, are not typically sold on a standalone basis. Management should consider whether the price charged when loyalty points are sold separately is reflective of the standalone selling price in an arrangement with multiple goods or services.

Example 7-4 illustrates how to account for an option that provides a material right.

EXAMPLE 7-4**Customer options — option that provides a material right**

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

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

Analysis

Retailer should account for the option as a separate performance obligation, as it provides a material right. The discount is incremental to the 10% discount offered to a similar class of customers during the period. The customers are in effect paying Retailer in advance for future goods or services. The standalone selling price of the option is \$150, calculated as the estimated average purchase price of additional products (\$400) multiplied by the incremental discount (50%), multiplied by the likelihood of exercise (75%). The transaction price allocated to the discount, based on its relative standalone selling price, will be recognized upon exercise of the coupon (that is, upon purchase of the additional product) or expiry.

7.2.2 Accounting for the exercise of a customer option

When a customer exercises an option, the customer pays the remaining consideration (if any) for the good or service underlying the option. There are two supportable approaches to account for the exercise of an option:

- Account for the exercise of the option as a contract modification. Refer to RR 2.9 for further discussion on contract modifications.
- Account for the exercise of the option as a continuation of the contract. Any additional consideration is allocated to the goods or services underlying the material right and revenue is recognized when control transfers.

Similar transactions should be accounted for in the same manner. The financial reporting outcome of applying either method will be the same in many fact patterns. Refer to Revenue TRG Memo No. [32](#) and the related meeting minutes in Revenue TRG Memo No. [34](#) for further discussion of this topic.

Example 7-5 illustrates the two approaches to account for the exercise of a customer option.

EXAMPLE 7-5

Customer options — exercise of an option

ServeCo enters into a contract with Customer to provide two years of Service A for \$200. The arrangement also includes an option for Customer to purchase one year of Service B for \$100. The standalone selling prices of Services A and B are \$200 and \$160, respectively. ServeCo concludes that the option to purchase Service B at a discount provides Customer with a material right. ServeCo's estimate of the standalone selling price of the option is \$50, which incorporates the likelihood that Customer will exercise the option.

ServeCo allocates the \$200 transaction price to each performance obligation as follows:

Service A $((\$200 / \$250) \times \$200)$	\$160
Option to purchase Service B $((\$50 / \$250) \times \$200)$	\$ 40

ServeCo recognizes the revenue allocated to Service A over the two-year service period. The revenue allocated to the option to purchase Service B is deferred until Service B is transferred to Customer or the option expires.

Three months after entering into the contract, Customer elects to exercise its option to purchase Service B for \$100. Service B is a distinct service (that is, Service B would not be combined with Service A into a single performance obligation).

How should ServeCo account for the exercise of the option to purchase Service B?

Analysis

ServeCo can account for Customer's exercise of its option as a continuation of the contract or as a contract modification. Under the first approach, ServeCo would allocate the additional \$100 paid by Customer upon exercise of the option to Service B and recognize a total of \$140 (\$100 plus \$40 originally allocated to the option) over the period Service B is transferred to Customer.

Under the second approach, ServeCo would account for Service B by applying the contract modification guidance. This would require assessing whether the additional consideration reflects the standalone selling price of the additional goods or services. Refer to RR 2.9 for guidance on applying the contract modification guidance.

7.2.3 Volume discounts

Volume discounts are often offered to customers as an incentive to encourage additional purchases and customer loyalty. Some volume discounts apply retroactively once the customer completes a specified volume of purchases. Other volume discounts only apply prospectively to future purchases that are optional.

Discounts that are retroactive should be accounted for as variable consideration because the transaction price is uncertain until the customer completes (or fails to complete) the specified volume of purchases. Refer to RR 4.3.3.3 for discussion of retroactive volume discounts. Discounts that apply only to future, optional purchases should be assessed to determine if they provide a material right. Both prospective and retrospective volume discounts will typically result in deferral of revenue if the customer is expected to make future purchases.

Volume discounts take various forms and management may need to apply judgment to determine whether discounted pricing for optional future purchases provides a material right. Example 7-6 illustrates the accounting for a prospective volume discount.

EXAMPLE 7-6

Volume discount — pricing of optional purchases provides a material right

Manufacturer enters into a three-year contract with Customer to deliver high performance plastics. The contract stipulates that the price per container will decrease as sales volume increases during the calendar year as follows:

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

Management believes that total sales volume for the year will be 2.5 million containers based on its experience with similar contracts and forecasted sales to Customer; however, Customer is not committed to purchase any minimum volume of containers. Assume that management has concluded that the volume discount provides a material right to Customer.

How should Manufacturer account for the prospective volume discount?

Analysis

Manufacturer should account for the prospective volume discount as a separate performance obligation in the form of a material right (option to purchase additional products at a discount) and allocate the transaction price to the goods (high performance plastics) and the option based on their relative standalone selling prices.

Assuming Manufacturer elects to apply the practical alternative in ASC 606-10-55-45 and IFRS 15.B43 (because the discounted goods to be purchased in the future are the same as the initial goods being purchased (refer to RR 7.3)), it would allocate the transaction price based on the consideration for those additional goods as follows:

1,000,000 containers @ \$100 each	\$100,000,000
1,500,000 containers @ \$90 each	\$135,000,000
Total expected consideration	\$235,000,000
Total expected volume of containers	2,500,000
Transaction price allocated per container (\$235,000,000/2,500,000)	\$94
Transaction price allocated to material right on first 1,000,000 containers (\$100 - \$94)	\$6

Manufacturer would therefore recognize revenue of \$94 for each of the first 1,000,000 containers, with \$6 (\$100 price paid by customer in excess of the \$94 transaction price allocated to a container) deferred as a contract liability for the material right not yet satisfied. The contract liability would accumulate until the discounted containers (those purchased by the customer for \$90) are delivered, at which time it would be recognized as revenue as the containers are delivered.

Manufacturer would update its estimate of the total sales volume at each reporting date with a corresponding adjustment to cumulative revenue and the value of the contract liability.

7.2.4 Significant financing component considerations

Options to acquire additional goods and services are often outstanding for periods extending beyond one year (for example, point and loyalty programs). Management is not required to consider whether there is a significant financing component associated with options to acquire additional goods or services if the timing of redemption is at the discretion of the customer. However, an option could include a significant financing component if the timing of redemption is not at the discretion of the customer (for example, if the option can only be exercised on a defined date(s) one year or more after

the date cash is received). Refer to RR 4.4 for further discussion of significant financing components. Refer also to Revenue TRG Memo No. 32 and the related meeting minutes in Revenue TRG Memo No. 34 for further discussion of this topic.

7.2.5 Customer loyalty programs

Customer loyalty programs are used to build brand loyalty and increase sales volume. Examples of customer loyalty programs are varied and include airlines that offer “free” air miles and retail stores that provide future discounts after a specified number of purchases. The incentives may go by different names (for example, points, rewards, air miles, or stamps), but they all represent discounts that the customer can choose to use in the future to acquire additional goods or services. Obligations related to customer loyalty programs can be significant even where the value of each individual incentive is insignificant, as illustrated in Example 7-3 above.

A portion of the transaction price should be allocated to the material right (that is, the points). The amount allocated is based on the relative standalone selling price of the points determined in accordance with the guidance outlined in RR 7.2.1, not the cost of fulfilling awards earned. Revenue is recognized when the entity has satisfied its performance obligation relating to the points or when the points expire. This concept is illustrated in Example 52 of the revenue standard (ASC 606-10-55-353 through ASC 606-10-55-356 and IFRS 15.IE267 through IFRS 15.IE270).

Some arrangements allow a customer to earn points that the customer can choose to redeem in a variety of ways. For example, a customer that earns points from purchases may be able to redeem those points to acquire free or discounted goods or services, or use them to offset outstanding amounts owed to the seller. Refer to RR 7.2.6 for accounting considerations when a customer is offered cash as an incentive. The accounting for these arrangements can be complex.

Customer loyalty programs typically fall into one of three types:

- Points earned from the purchase of goods or services can only be redeemed for goods and services provided by the issuing entity.
- Points earned from the purchase of goods or services can be used to acquire goods or services from other entities, but cannot be redeemed for goods or services sold by the issuing entity.
- Points earned from the purchase of goods or services can be redeemed either with the issuing entity or with other entities.

Management needs to consider the nature of its performance obligation in each of these situations to determine the accounting for the loyalty program.

7.2.5.1 Points redeemed solely by issuer

An entity that operates a program where points can only be redeemed with the entity, recognizes revenue when the customer redeems the points or the points expire (refer to further discussion of accounting for breakage at RR 7.4). The entity is typically the principal for both the sale of the goods or services and satisfying the performance obligation relating to the loyalty points in this situation.

Example 7-7 illustrates the accounting when a customer redeems points solely with the issuer of the points.

EXAMPLE 7-7**Customer options — loyalty points redeemable solely by issuer**

Airline A has a frequent flyer program that rewards customers with frequent flyer miles based on amounts paid for flights. A customer purchases a ticket for \$500 (the standalone selling price) and earns 2,500 miles based on the price of the ticket. Miles are redeemable at a rate of 50 miles for \$1 (\$0.02 per mile). The miles may only be redeemed for flights with Airline A.

Ignoring breakage, how should the consideration be allocated between the miles (accumulating material right) and the flight?

Analysis

The transaction price of \$500 should be allocated between the flight and miles based on the relative standalone selling prices of \$500 for the flight and \$50 (2,500 points x \$0.02) for the miles as follows:

Performance Obligation	Standalone Selling Price	%	Allocated Transaction Price
Flight	\$500	91%	\$455
Miles	\$50	9%	\$45
	<u>\$550</u>		

Airline A would recognize revenue of \$455 when the flight occurs. It would defer revenue of \$45 and recognize it upon redemption or expiration of the miles.

7.2.5.2 Points redeemed solely by others

An entity that operates a program in which points can only be redeemed with a third party needs to first consider whether it is the principal or an agent in the arrangement as it relates to the customer loyalty points redeemed by others. Depending on the entity's conclusions regarding its principal versus agent assessment, the entity would determine the appropriate timing of revenue recognition. The entity should recognize revenue for the net fee or commission retained in the exchange if it is an agent in the arrangement. Refer to RR 10 for further discussion of principal and agent considerations.

The entity recognizes revenue when it satisfies its performance obligation relating to the points and recognizes a liability for the amount the entity expects to pay to the party that will redeem the points. The boards noted in the basis for conclusions to the revenue standard that in instances where the entity is the agent, the entity might satisfy its performance obligation when the points are transferred to the customer, as opposed to when the customer redeems the points with the third party.

Example 7-8 illustrates the accounting where a customer is able to redeem points solely with others.

EXAMPLE 7-8**Customer options — loyalty points redeemable by another party**

Retailer participates in a customer loyalty program in partnership with Airline that awards one air travel point for each dollar a customer spends on goods purchased from Retailer. Program members can only redeem the points for air travel with Airline. The transaction price allocated to each point based on its relative estimated standalone selling price is \$.01. Retailer pays Airline \$.009 for each point redeemed.

Retailer sells goods totaling \$1 million and grants one million points during the period. Retailer allocates \$10,000 of the transaction price to the points, calculated as the number of points issued (one million) multiplied by the allocated transaction price per point (\$.01).

Retailer concludes that its performance obligation is to arrange for the loyalty points to be provided by Airline to the customer and that it is an agent in this transaction in accordance with the guidance in the revenue standard (refer to RR 10).

How should Retailer account for points issued to its customers?

Analysis

Retailer would measure its revenue as the commission it retains for each point redeemed because it concluded that it is an agent in the transaction. The commission is \$1,000, which is the difference between the transaction price allocated to the points (\$10,000) and the \$9,000 paid to Airline. Retailer would recognize its commission when it transfers the points to the customer (upon purchase of goods from Retailer) because Retailer has satisfied its promise to arrange for the loyalty points to be provided by Airline to the customer.

7.2.5.3 Points redeemed by issuer or other third parties

Management needs to consider the nature of the entity's performance obligation if it issues points that can be redeemed either with the issuing entity or with other entities. The issuing entity satisfies its performance obligation relating to the points when it transfers the goods or services to the customer, it transfers the obligation to a third party (and the entity therefore no longer has a stand-ready obligation), or the points expire.

Management will need to assess whether the entity is the principal or an agent in the arrangement if the customer subsequently chooses to redeem the points for goods or services from another party. The entity should recognize revenue for the net fee or commission retained in the exchange if it is an agent in the arrangement. Refer to RR 10 for further discussion of principal and agent considerations.

Example 7-9 illustrates the accounting when a customer is able to redeem points with multiple parties.

EXAMPLE 7-9**Customer options — loyalty points redeemable by multiple parties**

Retailer offers a customer loyalty program in partnership with Hotel whereby Retailer awards one customer loyalty point for each dollar a customer spends on goods purchased from Retailer. Program members can redeem the points for accommodation with Hotel or discounts on future purchases with

Retailer. The transaction price allocated to each point based on its relative estimated standalone selling price is \$.01.

Retailer sells goods totaling \$1 million and grants one million points during the period. Retailer allocates \$10,000 of the transaction price to the points, calculated as the number of points issued (one million) multiplied by the allocated transaction price per point (\$.01). Retailer concludes that it has not satisfied its performance obligation as it must stand ready to transfer goods or services if the customer elects not to redeem points with Hotel.

How should Retailer account for points issued to its customers?

Analysis

Retailer should not recognize revenue for the \$10,000 allocated to the points when they are issued as it has not satisfied its performance obligation. Retailer should recognize revenue upon redemption of the points by the customer with Retailer, when the obligation is transferred to Hotel, or when the points expire. Retailer will need to assess whether it is the principal or an agent in the arrangement if the customer elects to redeem the points with Hotel.

7.2.6 Noncash and cash incentives

Incentives can include a "free" product or service, such as a free airline ticket provided to a customer upon reaching a specified level of purchases. Management needs to consider whether it is providing more than one promise in the arrangement and therefore needs to account for the "noncash" incentive as a separate performance obligation similar to the accounting for customer loyalty points. Management should also consider whether it is the principal or an agent in the transaction if it concludes that the incentive is a separate performance obligation and it is fulfilled by another party.

Cash incentives, on the other hand, are not performance obligations, but are instead accounted for as a reduction of the transaction price. Refer to RR 4 for discussion of determining transaction price. It may require judgment in certain situations to determine whether an incentive is "cash" or "noncash." An incentive that is, in substance, a cash payment to the customer is a reduction of the transaction price, and is not a promise of future products or services. Management also needs to consider whether items such as gift certificates or gift cards that can be broadly used in the same manner as cash are in-substance cash payments.

7.2.7 Incentives offered or modified after arrangement inception

An entity may offer a certain type of incentive when items are originally offered for sale, but then decide to provide a different or additional incentive on that item if it is not sold in an expected timeframe. This is particularly common where entities sell their goods through distributors to end customers and sales to end customers are not meeting expectations. This can occur even after revenue has been recorded for the initial sale to the distributor.

Management needs to consider whether a change to incentives or an additional incentive is a contract modification. A change to an incentive that provides cash (or additional cash) back to a customer (or a customer's customer) is a contract modification that affects the measurement of the transaction price. Refer to RR 2.9 for discussion on accounting for contract modifications.

Additional goods or services offered after the initial contract is completed and without additional consideration might not be performance obligations if those promises did not exist at contract inception (explicitly or implicitly based on the entity's customary business practice). Example 12, Case C, of the revenue standard (ASC 606-10-55-156 through ASC 606-10-55-157A and IFRS 15.IE64 through IFRS 15.IE65A) illustrates this fact pattern. Management should consider in this scenario whether it has established a business practice of providing the free good or service when evaluating whether there is an implied promise in future contracts.

Example 7-10 illustrates the accounting for a change in incentive offered by a vendor.

EXAMPLE 7-10

Customer options — change in incentives offered to customer

Electronics Co sells televisions to Retailer. Electronics Co provides Retailer a free Blu-ray player to be given to customers that purchase the television to help stimulate sales. Retailer then sells the televisions with the free Blu-ray player to end customers. Control transfers and revenue is recognized when the televisions and Blu-ray players are delivered to Retailer.

Electronics Co subsequently adds a \$200 rebate to the end customer to assist Retailer with selling the televisions in its inventory in the weeks leading up to a popular sporting event. The promotion applies to all televisions sold during the week prior to the event. Electronics Co has not offered a customer rebate previously and had no expectation of doing so when the televisions were sold to Retailer.

How should Electronics Co account for the offer of the additional \$200 rebate?

Analysis

The offer of the additional customer rebate is a contract modification that affects only the transaction price. Electronics Co should account for the \$200 rebate as a reduction to the transaction price for the televisions held in stock by Retailer that are expected to be sold during the rebate period, considering the guidance on contract modifications as discussed in RR 2.9.4 and variable consideration as discussed in RR 4.3.

Electronics Co will need to consider whether it plans to offer similar rebates in future transactions (or that the customer will expect such rebates to be offered) and whether those rebates impact the transaction price at the time of initial sale.

7.3 Renewal and cancellation options

Entities often provide customers the option to renew their existing contracts. For example, a customer may be allowed to extend a two-year contract for an additional year under the same terms and conditions as the original contract. A cancellation option that allows a customer to cancel a multi-year contract after each year might effectively be the same as a renewal option, because a decision is made annually whether to continue under the contract.

Management should assess a renewal or cancellation option to determine if it provides a material right similar to other types of customer options. For example, a renewal option that is offered for an extended period of time without price increases might be a material right if prices for the product in that market are expected to increase. The amount of the transaction price for the original contract that

is allocated to the material right associated with a contract renewal is initially deferred. When the customer renews the contract, the deferred amount, as well as the additional transaction price resulting from the renewal, is allocated to the goods or services transferred during the renewal period.

Determining the standalone selling price of a renewal option that provides a material right requires judgment. Factors that management might consider include:

- Historical data (adjusted to reflect current factors)
- Expected renewal rates
- Budgets
- Marketing studies
- Data used to set the pricing terms of the arrangement
- Discussions with customer during or after negotiations about the arrangement
- Industry data, particularly if the service is homogenous

Contracts that include multiple renewal options introduce complexity, as management would theoretically need to assess the standalone selling price of each option. The revenue standard provides the following practical alternative regarding customer renewals.

ASC 606-10-55-45 and IFRS 15.B43

If a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, then an entity may, as a practical alternative to estimating the standalone selling price of the option, allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration. Typically, those types of options are for contract renewals.

Arrangements involving customer loyalty points or discount vouchers are unlikely to qualify for the practical alternative associated with contract renewals. The goods or services provided in the future in such arrangements often differ from those provided in the initial contract and/or are provided under different pricing terms (for example, a hotel chain may change the number of points a customer must redeem to receive a free stay).

Example 7-11 illustrates the accounting for a contract renewal option.

EXAMPLE 7-11

Customer options — renewal option that provides a material right

SpaMaker enters into an arrangement with Retailer to sell an unlimited number of hot tubs for \$3,000 per hot tub for 12 months. Retailer has the option to renew the contract at the end of the year for an additional 12 months. The contract renewal will be for the same products and under the same terms as the original contract. SpaMaker typically increases its prices 15% each year.

How should SpaMaker account for the renewal option?

Analysis

The renewal option represents a material right to Retailer as it will be charged a lower price for the hot tubs than similar customers if the contract is renewed. SpaMaker is not required to determine a standalone selling price for the renewal option as both criteria for the use of the practical expedient have been met. SpaMaker could instead elect to include the estimated total number of hot tubs to be sold at \$3,000 per hot tub over 24 months (the initial period and the renewal period) in the initial measurement of the transaction price.

7.4 Unexercised rights (breakage)

Customers sometimes do not exercise all of their rights or options in an arrangement. These unexercised rights are often referred to as “breakage” or forfeiture. Breakage applies to not only sales incentive programs, but also to any situations where an entity receives prepayments for future goods or services. The revenue standard requires breakage to be recognized as follows.

ASC 606-10-55-48 and IFRS 15.B46

If an entity expects to be entitled to a breakage amount in a contract liability, the entity [should [US GAAP]/shall [IFRS]] recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, the entity [should [US GAAP]/shall [IFRS]] recognize the expected breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote. To determine whether an entity expects to be entitled to a breakage amount, the entity [should [US GAAP]/shall [IFRS]] consider the guidance in paragraphs [606-10-32-11 through 32-13 [US GAAP]/56-58 [IFRS]] on constraining estimates of variable consideration.

Receipt of a nonrefundable prepayment creates an obligation for an entity to stand ready to perform under the arrangement by transferring goods or services when requested by the customer. A common example is the purchase of gift cards. Gift cards are often not redeemed for products or services in their full amount. Another common example is “take-or-pay” arrangements, in which a customer pays a specified amount and is entitled to a specified number of units of goods or services. The customer pays the same amount whether they take all of the items to which they are entitled or leave some rights unexercised.

Both prepayments and customer options create obligations for an entity to transfer goods or services in the future. All or a portion of the transaction price should be allocated to those performance obligations and recognized as revenue when those obligations are satisfied. An entity should recognize revenue when control of the goods or services is transferred to the customer in satisfaction of the performance obligations.

An entity should recognize estimated breakage as revenue in proportion to the pattern of exercised rights. For example, an entity would recognize 50 percent of the total estimated breakage upon redemption of 50 percent of customer rights. Management that cannot conclude whether there will be any breakage, or the extent of such breakage, should consider the constraint on variable consideration, including the need to record any minimum amounts of breakage. Refer to RR 4.3 for further

discussion of variable consideration. Breakage that is not expected to occur should be recognized as revenue when the likelihood of the customer exercising its remaining rights becomes remote.

The assessment of estimated breakage should be updated at each reporting period. Changes in estimated breakage should be accounted for by adjusting the contract liability to reflect the remaining rights expected to be redeemed. Estimating breakage and updating these estimates could be complex, particularly for customer loyalty programs, which may extend for significant periods of time, or never expire. The accounting for these programs will often require a significant amount of data tracking in order to update estimates each reporting period. Management should not adjust the standalone selling price originally allocated to a customer option when updating its estimate of breakage (for example, when updating the number of loyalty points it expects customers to redeem).

Legal requirements for unexercised rights vary among jurisdictions. Certain jurisdictions require entities to remit payments received from customers for rights that remain unexercised to a governmental entity (for example, unclaimed property or “escheat” laws). An entity should not recognize estimated breakage as revenue related to consideration received from a customer that must be remitted to a governmental entity if the customer never demands performance. Management must understand its legal rights and obligations when determining the accounting model to follow.

Example 7-12, Example 7-13, and Example 7-14 illustrate the accounting for breakage related to customer prepayments (gift cards) and customer options (loyalty programs).

EXAMPLE 7-12

Breakage — sale of gift cards

Restaurant Inc sells 1,000 gift cards in 20X1, each with a face value of \$50, that are redeemable at any of its locations. Any unused gift card balances are not subject to escheatment to a government entity. Restaurant Inc expects breakage of 10%, or \$5,000 of the face value of the cards, based on history with similar gift cards.

Customers redeem \$22,500 worth of gift cards during 20X2.

How should Restaurant Inc account for the gift cards redeemed during 20X2?

Analysis

Restaurant Inc should recognize revenue of \$25,000 in 20X2, calculated as the value of the gift cards redeemed (\$22,500) plus breakage in proportion to the total rights exercised (\$2,500). This amount would be calculated as the total expected breakage (\$5,000) multiplied by the proportion of gift cards redeemed ($\$22,500 \text{ redeemed} / \$45,000 \text{ expected to be redeemed}$).

EXAMPLE 7-13

Breakage — customer loyalty points

Hotel Inc has a loyalty program that rewards its customers with two loyalty points for every \$25 spent on lodging. Each point is redeemable for a \$1 discount on a future stay at the hotel in addition to any other discount being offered. Customers collectively spend \$1 million on lodging in 20X1 and earn 80,000 points redeemable for future purchases. The standalone selling price of the purchased lodging is \$1 million, as the price charged to customers is the same whether the customer participates in the

program or not. Hotel Inc expects 75% of the points granted will be redeemed. Hotel Inc therefore estimates a standalone selling price of \$0.75 per point (\$60,000 in total), which takes into account the likelihood of redemption.

Hotel Inc concludes that the points provide a material right to customers that they would not receive without entering into a contract; therefore, the points provided to the customers are separate performance obligations.

Hotel Inc allocates the transaction price of \$1 million to the lodging and points based on their relative standalone selling prices as follows:

Lodging ($\$1,000,000 \times (\$1,000,000 / \$1,060,000)$)	\$	943,396
Points ($\$1,000,000 \times (\$60,000 / \$1,060,000)$)	\$	56,604
Total transaction price	\$	1,000,000

Customers redeem 40,000 points during 20X2 and Hotel Inc continues to expect total redemptions of 60,000 points.

How should Hotel Inc account for the points redeemed during 20X2?

Analysis

Hotel Inc should recognize revenue of \$37,736, calculated as the total transaction price allocated to the points (\$56,604) multiplied by the ratio of points redeemed during 20X2 (40,000) to total points expected to be redeemed (60,000). Hotel Inc would maintain a contract liability of \$18,868 for the consideration allocated to the remaining points expected to be redeemed.

EXAMPLE 7-14

Breakage — customer loyalty points, reassessment of breakage estimate

Hotel Inc has a loyalty program that rewards its customers with two loyalty points for every \$25 spent on lodging. Each point is redeemable for a \$1 discount on a future stay at the hotel in addition to any other discount being offered. Customers collectively spend \$1 million on lodging in 20X1 and earn 80,000 points redeemable for future purchases. The standalone selling price of the purchased lodging is \$1 million, as the price charged to customers is the same whether the customer participates in the program or not. Hotel Inc expects 75% of the points granted will be redeemed. Hotel Inc therefore estimates a standalone selling price of \$0.75 per point (\$60,000 in total), which takes into account the likelihood of redemption.

Hotel Inc concludes that the points provide a material right to customers that they would not receive without entering into a contract; therefore, the points provided to the customers are separate performance obligations.

Hotel Inc allocates the transaction price of \$1 million to the lodging and points based on their relative standalone selling prices as follows:

Lodging ($\$1,000,000 \times (\$1,000,000 / \$1,060,000)$)	\$	943,396
Points ($\$1,000,000 \times (\$60,000 / \$1,060,000)$)	\$	56,604
Total transaction price	\$	1,000,000

In 20X2, customers redeem 40,000 points and Hotel Inc recognizes \$37,736 related to the points. In 20X3, customers redeem an additional 20,000 points and Hotel Inc increases its estimate of total points to be redeemed from 60,000 to 70,000.

How should Hotel Inc account for the points redeemed during 20X3?

Analysis

Hotel Inc should recognize revenue of \$10,782 calculated as follows:

Total points redeemed cumulatively (40,000 + 20,000)	60,000
Divided by	/
Total points expected to be redeemed	70,000
Multiplied by	X
Amount originally allocated to the points	\$ 56,604
Cumulative revenue to be recognized	\$ 48,518
Less: Revenue previously recognized	\$ 37,736
Revenue recognized in 20X3	\$ 10,782

The remaining contract liability of \$8,086 (1/7 of the amount originally allocated to the points) will be recognized as revenue as the outstanding points are redeemed.

Question 7-1 addresses the accounting for a customer option that does not expire.

Question 7-1

When should an entity recognize revenue allocated to a customer option that does not expire?

PwC response

Revenue allocated to a customer option is recognized when the future goods or services underlying the option are transferred, or when the option expires. In cases when a customer option does not expire, we believe revenue allocated to the option (which reflects an initial estimate of breakage) should be recognized when the likelihood of the customer exercising the option becomes remote.

Chapter 8:

Practical application issues

8.1 Chapter overview

The revenue standard provides implementation guidance to assist entities in applying the guidance to more complex arrangements or specific situations. The revenue standard includes specific guidance on rights of return, warranties, nonrefundable upfront fees, bill-and-hold arrangements, consignments, and repurchase rights.

8.2 Rights of return

Many entities offer their customers a right to return products they purchase. Return privileges can take many forms, including:

- The right to return products for any reason
- The right to return products if they become obsolete
- The right to rotate stock
- Trade-in agreements for newer products
- The right to return products upon termination of an agreement

Some of these rights are explicit in the contract, while others are implied. Implied rights can arise from statements or promises made to customers during the sales process, statutory requirements, or an entity's customary business practice. These practices are generally driven by the buyer's desire to mitigate risk (risk of dissatisfaction, technological risk, or the risk that a distributor will not be able to sell the products) and the seller's desire to ensure customer satisfaction.

A right of return often entitles a customer to a full or partial refund of the amount paid or a credit against the value of previous or future purchases. Some return rights only allow a customer to exchange one product for another. Understanding the rights and obligations of both parties in an arrangement when return rights exist is critical to determining the accounting.

A right of return is not a separate performance obligation, but it affects the estimated transaction price for transferred goods. Revenue is only recognized for those goods that are not expected to be returned.

The estimate of expected returns should be calculated in the same way as other variable consideration. The estimate should reflect the amount that the entity expects to repay or credit customers, using either the expected value method or the most-likely amount method, whichever management determines will better predict the amount of consideration to which it will be entitled. See RR 4 for further details about these methods. The transaction price should include amounts subject to return only if it is probable (US GAAP) or highly probable (IFRS) that there will not be a significant reversal of cumulative revenue if the estimate of expected returns changes.

It could be probable (US GAAP) or highly probable (IFRS) that some, but not all, of the variable consideration will not result in a significant reversal of cumulative revenue recognized. The entity must consider, as illustrated in Example 8-1 and also in Example 22 in the revenue standard (ASC 606-10-55-202 through ASC 606-10-55-207 and IFRS 15.IE110 through IFRS 15.IE115), whether there is some minimum amount of revenue that would not be subject to significant reversal if the estimate of

returns changes. Management should consider all available information to estimate its expected returns.

EXAMPLE 8-1

Right of return – sale of products to a distributor

Producer utilizes a distributor network to supply its product to end consumers. Producer allows distributors to return any products for up to 120 days after the distributor has obtained control of the products. Producer has no further obligations with respect to the products and distributors have no further return rights after the 120-day period. Producer is uncertain about the level of returns for a new product that it is selling through the distributor network.

How should Producer recognize revenue in this arrangement?

Analysis

Producer must consider the extent to which it is probable (US GAAP) or highly probable (IFRS) that a significant reversal of cumulative revenue will not occur from a change in the estimate of returns. Producer needs to assess, based on its historical information and other relevant evidence, if there is a minimum level of sales for which it is probable (US GAAP) or highly probable (IFRS) there will be no significant reversal of cumulative revenue, as revenue needs to be recorded for those sales.

For example, if at inception of the contract Producer estimates that including 70% of its sales in the transaction price will not result in a significant reversal of cumulative revenue, Producer would record revenue for that 70%. Producer will need to update its estimate of expected returns at each period end.

The revenue standard requires entities to account for sales with a right of return as follows.

ASC 606-10-55-23 and IFRS 15.B21

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

- a. Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for the products expected to be returned)
- b. A refund liability [and [IFRS]]
- c. An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

The refund liability represents the amount of consideration that the entity does not expect to be entitled to because it will be refunded to customers. The refund liability is remeasured at each reporting date to reflect changes in the estimate of returns, with a corresponding adjustment to revenue.

The asset represents the entity's right to receive goods (inventory) back from the customer. The asset is initially measured at the carrying amount of the goods at the time of sale, less any expected costs to recover the goods and any expected reduction in value. In some instances, the asset could be immediately impaired if the entity expects that the returned goods will have diminished or no value at

the time of return. For example, this could occur in the pharmaceutical industry when product is expected to have expired at the time of return.

The return asset is presented separately from the refund liability. The amount recorded as an asset should be updated whenever the refund liability changes and for other changes in circumstances that might suggest an impairment of the asset. Example 8-2 illustrates this accounting treatment.

EXAMPLE 8-2

Right of return – refund obligation and return asset

Game Co sells 1,000 video games to Distributor for \$50 each. Distributor has the right to return the video games for a full refund for any reason within 180 days of purchase. The cost of each game is \$10. Game Co estimates, based on the expected value method, that 6% of sales of the video games will be returned and it is probable (US GAAP) or highly probable (IFRS) that returns will not be higher than 6%. Game Co has no further obligations after transferring control of the video games.

How should Game Co record this transaction?

Analysis

Game Co should recognize revenue of \$47,000 ($\50×940 games) and cost of sales of \$9,400 ($\10×940 games) when control of the games transfers to Distributor. Game Co should also recognize an asset of \$600 ($\10×60 games) for expected returns, and a liability of \$3,000 (6% of the sales price) for the refund obligation.

The return asset will be presented and assessed for impairment separate from the refund liability. Game Co will need to assess the return asset for impairment, and adjust the value of the asset if it becomes impaired.

Question 8-1 addresses the presentation and disclosure guidance for refund liabilities.

Question 8-1

Are refund liabilities subject to the same presentation and disclosure guidance as contract liabilities?

PwC response

No. The revenue standard defines a “contract liability” as an obligation to transfer goods or services to a customer. A refund liability is an obligation to transfer cash. Therefore, refund liabilities do not meet the definition of a contract liability. While the revenue standard requires contract assets and contract liabilities arising from the same contract to be offset and presented as a single asset or liability, it does not provide presentation guidance for refund liabilities. The assessment of whether a refund liability may be offset against an asset arising from the same contract (for example, a contract asset or receivable) should be based on the offsetting guidance in ASC 210-20 (US GAAP) and IAS 1 (IFRS). Disclosures about obligations for returns and refunds are required as part of disclosures about performance obligations (refer to RR 12.3).

8.2.1 *Exchange rights*

Some contracts allow customers to exchange one product for another.

Excerpt from ASC 606-10-55-28 and IFRS 15.B26

Exchanges by customers of one product for another of the same type, quality, condition and price (for example, one color or size for another) are not considered returns

No adjustment of the transaction price is made for exchange rights. A right to exchange an item that does not function as intended for one that is functioning properly is a warranty, not a right of return. Refer to RR 8.3 for further information on accounting for warranties.

8.2.2 *Restocking fees*

Entities sometimes charge customers a “restocking fee” when a product is returned to compensate the entity for various costs associated with a product return. These costs can include shipping fees, quality control re-inspection costs, and repackaging costs. Restocking fees may also be charged to discourage returns or to compensate an entity for the reduced selling price that an entity will charge other customers for a returned product.

A product sale with a restocking fee is no different than a partial return right and should be accounted for similarly. For goods that are expected to be returned, the amount the entity expects to repay its customers (that is, the estimated refund liability) is the consideration paid for the goods less the restocking fee. As a result, the restocking fee should be included in the transaction price and recognized when control of the goods transfers to the customer. An asset is recorded for the entity’s right to recover the goods upon settling the refund liability. The entity’s expected restocking costs should be recognized as a reduction of the carrying amount of the asset as they are costs to recover the goods. Refer to Revenue TRG Memo No. 35 and the related meeting minutes in Revenue TRG Memo No. 44 for further discussion of this topic.

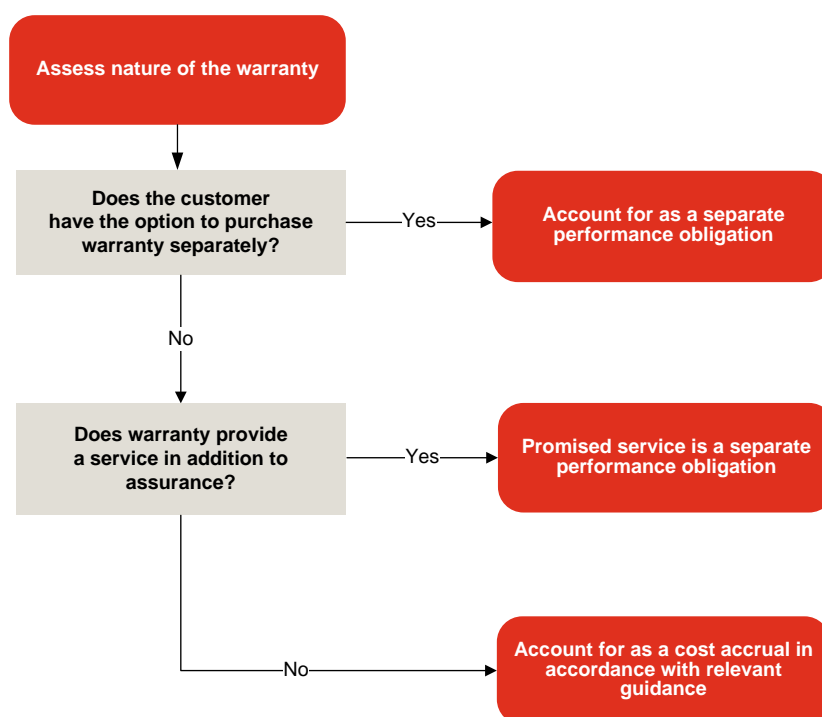
8.3 *Warranties*

Entities often provide customers with a warranty in connection with the sale of a good or service. The nature of a warranty can vary across entities, industries, products, or contracts. It could be called a standard warranty, a manufacturer’s warranty, or an extended warranty. Warranties might be written in the contract, or they might be implicit as a result of either customary business practices or legal requirements.

Terms that provide for cash payments to the customer (for example, liquidated damages for failing to comply with the terms of the contract) should generally be accounted for as variable consideration, as opposed to a warranty. Refer to RR 4.3 for further discussion of variable consideration. Cash payments to customers might be accounted for as warranties in limited situations, such as a direct reimbursement to a customer for costs paid by the customer to a third party for repair of a product.

Figure 8-1 summarizes the considerations when determining the accounting for warranty obligations.

Figure 8-1
Accounting for warranty obligations



A warranty that a customer can purchase separately from the related good or service (that is, it is priced or negotiated separately) is a separate performance obligation. The fact that it is sold separately indicates that a service is being provided beyond ensuring that the product will function as intended. Revenue allocated to the warranty is recognized over the warranty period.

Warranties that cannot be purchased separately must be assessed to determine whether the warranty provides a service that should be accounted for as a separate performance obligation.

Warranties that provide assurance that a product will function as expected and in accordance with certain specifications are not separate performance obligations. The warranty is intended to safeguard the customer against existing defects and does not provide any incremental service to the customer. Costs incurred to either repair or replace the product are additional costs of providing the initial good or service. These warranties are accounted for in accordance with other guidance (ASC 460, *Guarantees*, or IAS 37, *Provisions, Contingent Liabilities, and Contingent Assets*) if the customer does not have the option to purchase the warranty separately. The estimated costs are recorded as a liability when the entity transfers the product to the customer.

Other warranties provide a customer with a service in addition to the assurance that the product will function as expected. The service provides a level of protection beyond defects that existed at the time of sale, such as protecting against wear and tear for a period of time after sale or against certain types of damage. Judgment will often be required to determine whether a warranty provides assurance or an additional service. The additional service provided in a warranty is accounted for as a promised service in the contract and therefore a separate performance obligation, assuming the service is distinct from

other goods and services in the contract. An entity that cannot reasonably account for a service element of a warranty separate from the assurance element should account for both together as a single performance obligation that provides a service to the customer. Refer to Revenue TRG Memo No. 29 and the related meeting minutes in Revenue TRG Memo No. 34 for further discussion of this topic.

A number of factors need to be considered when assessing whether a warranty that cannot be purchased separately provides a service that should be accounted for as a separate performance obligation.

ASC 606-10-55-33 and IFRS 15.B31

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

- a. Whether the warranty is required by law—If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.
- b. The length of the warranty coverage period—The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.
- c. The nature of the tasks that the entity promises to perform—If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

Question 8-2 addresses the accounting for repairs provided outside of the contractual warranty period.

Question 8-2

Should repairs provided outside of the contractual warranty period be accounted for as a separate performance obligation?

PwC response

It depends. Management should assess the nature of the services provided to determine whether they are a separate performance obligation, or if there is simply an implied assurance-type warranty that extends beyond the contractual warranty period. This assessment should consider the factors noted in ASC 606-10-55-33 (US GAAP) or IFRS 15.B31 (IFRS).

Question 8-3 addresses the period over which to accrue estimated warranty costs when control of equipment transfers over time.

Question 8-3

Manufacturer constructs customized equipment for which control transfers to the customer over time. Manufacturer provides a one-year warranty on the equipment, which begins once the equipment is delivered to the customer. Should Manufacturer accrue the estimated warranty costs over the construction period or at the point in time it delivers the equipment to the customer?

PwC response

Manufacturer should generally accrue the estimated warranty costs over the construction period, consistent with the transfer of control of the equipment to the customer.

Question 8-4 addresses the accounting for the right to return a defective product.

Question 8-4

Is the right to return a defective product in exchange for cash or credit accounted for as an assurance-type warranty or a right of return?

PwC response

A return in exchange for cash or credit should generally be accounted for as a right of return (refer to RR 8.2). If customers have the option to return a defective good for cash, credit, or a replacement product, management should estimate the expected returns in exchange for cash or credit as part of its accounting for estimated returns. Returns in exchange for a replacement product should be accounted for under the warranty guidance.

Example 8-3 illustrates the assessment of whether a warranty provides assurance or additional services. This concept is also illustrated in Example 44 of the revenue standard (ASC 606-10-55-309 through ASC 606-10-55-315 and IFRS 15.IE223 through IFRS 15.IE229).

EXAMPLE 8-3

Warranty – assessing whether a warranty is a performance obligation

Telecom enters into a contract with Customer to sell a smart phone and provide a one-year warranty against both manufacturing defects and customer-inflicted damages (for example, dropping the phone into water). The warranty cannot be purchased separately.

How should Telecom account for the warranty?

Analysis

This arrangement includes the following goods or services: (1) the smart phone; (2) product warranty; and (3) repair and replacement service.

Telecom would account for the product warranty (against manufacturing defect) in accordance with other guidance on product warranties, and record an expense and liability for expected repair or replacement costs related to this obligation. Telecom would account for the repair and replacement

service (that is, protection against customer-inflicted damages) as a separate performance obligation, with revenue recognized as that obligation is satisfied.

If Telecom cannot reasonably separate the product warranty and repair and replacement service, it should account for the two warranties together as a single performance obligation.

8.4 Nonrefundable upfront fees

It is common in some industries for entities to charge customers a fee at or near inception of a contract. These upfront fees are often nonrefundable and could be labeled as fees for set up, access, activation, initiation, joining, or membership.

An entity needs to analyze each arrangement involving upfront fees to determine whether any revenue should be recognized when the fee is received.

Excerpt from ASC 606-10-55-51 and IFRS 15.B49

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

No revenue should be recognized upon receipt of an upfront fee, even if it is nonrefundable, if the fee does not relate to the satisfaction of a performance obligation. Nonrefundable upfront fees are included in the transaction price and allocated to the separate performance obligations in the contract. Revenue is recognized as the performance obligations are satisfied. This concept is illustrated in Example 53 of the revenue standard (ASC 606-10-55-358 through ASC 606-10-55-360 and IFRS 15.IE272 through IFRS 15.IE274).

The IFRIC Agenda Decision, [*Assessment of promised goods or services*](#), issued in January 2019, illustrates the application of this guidance to a scenario involving a contract between a stock exchange and a customer that includes a nonrefundable upfront fee. In that example, the IFRIC observed that the activities performed by the stock exchange at or near contract inception do not transfer a service to the customer; therefore, the upfront fee is an advanced payment for future services.

There could be situations, as illustrated in Example 8-4, when an upfront fee relates to separate performance obligations satisfied at different points in time.

EXAMPLE 8-4

Upfront fee allocated to separate performance obligations

Biotech enters into a contract with Pharma for the license and development of a drug compound. The contract requires Biotech to perform research and development (R&D) services to get the drug

compound through regulatory approval. Biotech receives an upfront fee of \$50 million, fees for R&D services, and milestone-based payments upon the achievement of specified acts.

Biotech concludes that the arrangement includes two separate performance obligations: (1) license of the intellectual property and (2) R&D services. There are no other performance obligations in the arrangement.

How should Biotech allocate the consideration in the arrangement, including the \$50 million upfront fee?

Analysis

Biotech needs to determine the transaction price at the inception of the contract, which will include both the fixed and variable consideration. The fixed consideration is the upfront fee. The variable consideration includes the fees for R&D services and the milestone-based payments and is estimated based on the principles discussed in RR 4. Once Biotech determines the total transaction price, it should allocate that amount to the two performance obligations. See RR 5 for further information on allocation of the transaction price to performance obligations.

Entities sometimes perform set-up or mobilization activities at or near contract inception to be able to fulfill the obligations in the contract. These activities could involve system preparation, hiring of additional personnel, or mobilization of assets to where the service will take place. Nonrefundable fees charged at the inception of an arrangement are often intended to compensate the entity for the cost of these activities. Set-up or mobilization efforts might be critical to the contract, but they typically do not satisfy performance obligations, as no good or service is transferred to the customer. The nonrefundable fee, therefore, is an advance payment for the future goods and services to be provided.

Set-up or mobilization costs should be disregarded in the measure of progress for performance obligations satisfied over time if they do not depict the transfer of services to the customer. Some mobilization costs might be capitalized as fulfillment costs, however, if certain criteria are met. See RR 11 for further information on capitalization of contract costs.

8.4.1 *Accounting for upfront fees when a renewal option exists*

Contracts that include an upfront fee and a renewal option often do not require a customer to pay another upfront fee if and when the customer renews the contract. The renewal option in such a contract might provide the customer with a material right, as discussed in RR 7.3. An entity that provides a customer a material right should determine its standalone selling price and allocate a portion of the transaction price to that right because it is a separate performance obligation. Alternatively, transactions that meet the requirements can apply the practical alternative for contract renewals discussed in RR 7.3 and estimate the total transaction price based on the expected number of renewals.

Management should consider both quantitative and qualitative factors to determine whether an upfront fee provides a material right when a renewal right exists. For example, management should consider the difference between the amount the customer pays upon renewal and the price a new customer would pay for the same service. An average customer life that extends beyond the initial contract period could also be an indication that the upfront fee incentivizes customers to renew the

contract. Refer to Revenue TRG Memo No. [32](#) and the related meeting minutes in Revenue TRG Memo No. [34](#) for further discussion of this topic.

Example 8-5 illustrates the accounting for upfront fees and a renewal option.

EXAMPLE 8-5

Upfront fee – health club joining fees

FitCo operates health clubs. FitCo enters into contracts with customers for one year of access to any of its health clubs. The entity charges an annual membership fee of \$60 as well as a \$150 nonrefundable joining fee. The joining fee is to compensate, in part, for the initial activities of registering the customer. Customers can renew the contract each year and are charged the annual membership fee of \$60 without paying the joining fee again. If customers allow their membership to lapse, they are required to pay a new joining fee.

How should FitCo account for the nonrefundable joining fees?

Analysis

The customer does not have to pay the joining fee if the contract is renewed and has therefore received a material right. That right is the ability to renew the annual membership at a lower price than the range of prices typically charged to newly joining customers.

The joining fee is included in the transaction price and allocated to the separate performance obligations in the arrangement, which are providing access to health clubs and the option to renew the contract, based on their standalone selling prices. FitCo's activity of registering the customer is not a service to the customer and therefore does not represent satisfaction of a performance obligation. The amount allocated to the right to access the health club is recognized over the first year, and the amount allocated to the renewal right is recognized when that right is exercised or expires.

As a practical alternative to determining the standalone selling price of the renewal right, FitCo could allocate the transaction price to the renewal right by reference to the future services expected to be provided and the corresponding expected consideration. For example, if FitCo determined that a customer is expected to renew for an additional two years, then the total consideration would be \$330 (\$150 joining fee and \$180 annual membership fees). FitCo would recognize this amount as revenue as services are provided over the three years. See RR 7.3 for further information about the practical alternative and customer options.

8.4.2 *Layaway sales*

Layaway sales (sometimes referred to as “will call”) involve the seller setting aside merchandise and collecting a cash deposit from the customer. The seller may specify a time period within which the customer must finalize the purchase, but there is often no fixed payment commitment. The merchandise is typically released to the customer once the purchase price is paid in full. The cash deposit and any subsequent payments are forfeited if the customer fails to pay the entire purchase price. The seller must refund the cash paid by the customer for merchandise that is lost, damaged, or destroyed before control of the merchandise transfers to the customer.

Management will first need to determine whether a contract exists in a layaway arrangement. A contract likely does not exist at the onset of a typical layaway arrangement because the customer has not committed to perform its obligation (that is, payment of the full purchase price). The entity should not recognize revenue for these arrangements until the contract criteria are met (refer to RR 2.6.1) or until the events described in RR 2.6.2 have occurred.

Some layaway sales could be in substance a credit sale if management concludes that the customer is committed to the purchase and a contract exists. Management will need to determine in those circumstances when control of the goods transfers to the customer. An entity that can use the selected goods to satisfy other customer orders and replace them with similar goods during the layaway period likely has not transferred control of the goods. Management should consider the bill-and-hold criteria discussed in RR 8.5 to determine when control of the goods has transferred.

8.4.3 *Gift cards*

Entities often sell gift cards that can be redeemed for goods or services at the customer's request. An entity should not record revenue at the time a gift card is sold, as the performance obligation is to provide goods or services in the future when the card is redeemed. The payment for the gift card is an upfront payment for goods or services in the future. Revenue is recognized when the card is presented for redemption and the goods or services are transferred to the customer.

Often a portion of gift certificates sold are never redeemed for goods or services. The amounts never redeemed are known as "breakage." An entity should recognize revenue for amounts not expected to be redeemed proportionately as other gift card balances are redeemed. An entity should not recognize revenue, however, for consideration received from a customer that must be remitted to a governmental entity if the customer never demands performance. Refer to RR 7.4 for further information on breakage and an example illustrating the accounting for gift card sales.

8.5 *Bill-and-hold arrangements*

Bill-and-hold arrangements arise when a customer is billed for goods that are ready for delivery, but the entity does not ship the goods to the customer until a later date. Entities must assess in these cases whether control has transferred to the customer, even though the customer does not have physical possession of the goods. Revenue is recognized when control of the goods transfers to the customer. An entity will need to meet certain additional criteria for a customer to have obtained control in a bill-and-hold arrangement in addition to the criteria related to determining when control transfers (refer to RR 6.2).

Excerpt from ASC 606-10-55-83 and IFRS 15.B81

For a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

- a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).
- b. The product must be identified separately as belonging to the customer.
- c. The product currently must be ready for physical transfer to the customer. [and [IFRS]]

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

A bill-and-hold arrangement should have substance. A substantive purpose could exist, for example, if the customer requests the bill-and-hold arrangement because it lacks the physical space to store the goods, or if goods previously ordered are not yet needed due to the customer's production schedule.

The goods must be identified as belonging to the customer, and they cannot be used to satisfy orders for other customers. Substitution of the goods for use in other orders indicates that the goods are not controlled by the customer and therefore revenue should not be recognized until the goods are delivered, or the criterion is satisfied. The goods must also be ready for delivery upon the customer's request.

A customer that can redirect or determine how goods are used, or that can otherwise benefit from the goods, is likely to have obtained control of the goods. Limitations on the use of the goods, or other restrictions on the benefits the customer can receive from those goods, indicates that control of the goods may not have transferred to the customer.

An entity that has transferred control of the goods and met the bill-and-hold criteria to recognize revenue needs to consider whether it is providing custodial services in addition to providing the goods. If so, a portion of the transaction price should be allocated to each of the separate performance obligations (that is, the goods and the custodial service).

Example 8-6 and Example 8-7 illustrate these considerations in bill-and-hold transactions. This concept is also illustrated in Example 63 of the revenue standard (ASC 606-10-55-409 through ASC 606-10-55-413 and IFRS 15. IE323 through IFRS 15. IE327).

EXAMPLE 8-6

Bill-and-hold arrangement – industrial products industry

Drill Co orders a drilling pipe from Steel Producer. Drill Co requests the arrangement be on a bill-and-hold basis because of the frequent changes to the timeline for developing remote gas fields and the long lead times needed for delivery of the drilling equipment and supplies. Steel Producer has a history of bill-and-hold transactions with Drill Co and has established standard terms for such arrangements.

The pipe, which is separately warehoused by Steel Producer, is complete and ready for shipment. Steel Producer cannot utilize the pipe or direct the pipe to another customer once the pipe is in the warehouse. The terms of the arrangement require Drill Co to remit payment within 30 days of the pipe being placed into Steel Producer's warehouse. Drill Co will request and take delivery of the pipe when it is needed.

When should Steel Producer recognize revenue?

Analysis

Steel Producer should recognize revenue when the pipe is placed into its warehouse because control of the pipe has transferred to Drill Co. This is because Drill Co requested the transaction be on a bill-and-hold basis, which suggests that the reason for entering the bill-and-hold arrangement is substantive, Steel Producer is not permitted to use the pipe to fill orders for other customers, and the pipe is ready

for immediate shipment at the request of Drill Co. Steel Producer should also evaluate whether a portion of the transaction price should be allocated to the custodial services (that is, whether the custodial service is a separate performance obligation).

EXAMPLE 8-7

Bill-and-hold arrangement – retail and consumer industry

Game Maker enters into a contract during 20X6 to supply 100,000 video game consoles to Retailer. The contract contains specific instructions from Retailer about where the consoles should be delivered. Game Maker must deliver the consoles in 20X7 at a date to be specified by Retailer. Retailer expects to have sufficient shelf space at the time of delivery.

As of December 31, 20X6, Game Maker has inventory of 120,000 game consoles, including the 100,000 relating to the contract with Retailer. The 100,000 consoles are stored with the other 20,000 game consoles, which are all interchangeable products; however, Game Maker will not deplete its inventory below 100,000 units.

When should Game Maker recognize revenue for the 100,000 units to be delivered to Retailer?

Analysis

Game Maker should not recognize revenue until the bill-and-hold criteria are met or if Game Maker no longer has physical possession and all of other criteria related to the transfer of control have been met. Although the reason for entering into a bill-and-hold transaction is substantive (lack of shelf space), the other criteria are not met as the game consoles produced for Retailer are not separated from other products.

8.5.1 **Government vaccine stockpile programs**

Vaccine manufacturers may participate in government vaccine stockpile programs that require the manufacturer to hold a certain amount of vaccine inventory for use by a government at a later date. Control transfer should be assessed against the bill and hold criteria in the standard, considering for example, whether the stockpile inventory is separately identified as belonging to the customer and the impact of any requirement to rotate the inventory. Management will also need to consider whether the government has return rights and whether there are other performance obligations within the arrangement, such as the storage, maintenance, and shipping of vaccines.

SEC reporters should apply the SEC's interpretative release,¹ which states that vaccine manufacturers should recognize revenue and provide the appropriate disclosures when vaccines are placed into US government stockpile programs because control of the vaccines has transferred to the customer (the government) and the criteria in ASC 606 for recognizing revenue in a bill-and-hold arrangement are satisfied. This interpretation is only applicable to childhood disease vaccines, influenza vaccines, and other vaccines and countermeasures sold to the US government for placement in the Strategic National Stockpile.

¹ Updates to Commission Guidance Regarding Accounting for the Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile (August 29, 2017)

8.6 Consignment arrangements

Some entities ship goods to a distributor, but retain control of the goods until a predetermined event occurs. These are known as consignment arrangements. Revenue is not recognized upon delivery of a product if the product is held on consignment. Management should consider the following indicators to evaluate whether an arrangement is a consignment arrangement.

ASC 606-10-55-80 and IFRS 15.B78

Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:

- a. The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.
- b. The entity is able to require the return of the product or transfer the product to a third party (such as another dealer). [and [IFRS]]
- c. The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

Revenue is recognized when the entity has transferred control of the goods to the distributor. The distributor has physical possession of the goods, but might not control them in a consignment arrangement. For example, a distributor that is required to return goods to the manufacturer upon request might not have control over those goods; however, an entity should assess whether these rights can be enforced.

A consignment sale differs from a sale with a right of return or put right. The customer has control of the goods in a sale with right of return or a sale with a put right, and can decide whether to put the goods back to the seller.

Example 8-8 and Example 8-9 illustrate the assessment of consignment arrangements.

EXAMPLE 8-8

Consignment arrangement – retail and consumer industry

Manufacturer provides household products to Retailer on a consignment basis. Retailer does not take title to the products until they are scanned at the register and has no obligation to pay Manufacturer until they are sold to the consumer, unless the goods are lost or damaged while in Retailer's possession. Any unsold products, excluding those that are lost or damaged, can be returned to Manufacturer, and Manufacturer has discretion to call products back or transfer products to another customer.

When should Manufacturer recognize revenue?

Analysis

Manufacturer should recognize revenue when control of the products transfers to Retailer. Control has not transferred if Manufacturer is able to require the return or transfer of those products. Revenue

should be recognized when the products are sold to the consumer, or lost or damaged while in Retailer's possession.

EXAMPLE 8-9

Consignment arrangement – industrial products industry

Steel Co develops a new type of cold-rolled steel sheet that is significantly stronger than existing products, providing increased durability. The newly developed product is not yet widely used.

Manufacturer enters into an arrangement with Steel Co whereby Steel Co will provide 50 rolled coils of the steel on a consignment basis. Manufacturer must pay a deposit upon receipt of the coils. Title transfers to Manufacturer upon shipment and the remaining payment is due when Manufacturer consumes the coils in the manufacturing process. Each month, both parties agree on the amount consumed by Manufacturer. Manufacturer can return, and Steel Co can demand return of, unused products at any time.

When should Steel Co recognize revenue?

Analysis

Steel Co should recognize revenue when the coils are used by Manufacturer. Although title transfers when the coils are shipped, control of the coils has not transferred to Manufacturer because Steel Co can demand return of any unused product.

Control of the steel would transfer to Manufacturer upon shipment if Steel Co did not retain the right to demand return of the inventory, even if Manufacturer had the right to return the product. However, Steel Co needs to assess the likelihood of the steel being returned and might need to recognize a refund liability in that case. Refer to RR 8.2.

8.7 Repurchase rights

Repurchase rights are an obligation or right to repurchase a good after it is sold to a customer. Repurchase rights could be included within the sales contract, or in a separate arrangement with the customer. The repurchased good could be the same asset, a substantially similar asset, or a new asset of which the originally purchased asset is a component.

There are three forms of repurchase rights:

- A seller's obligation to repurchase the good (a forward)
- A seller's right to repurchase the good (a call option)
- A customer's right to require the seller to repurchase the good (a put option)

An arrangement to repurchase a good that is negotiated between the parties after transferring control of that good to a customer is not a repurchase agreement because the customer is not obligated to resell the good to the entity as part of the initial contract. The subsequent decision to repurchase the item does not affect the customer's ability to direct the use of or obtain the benefits of the good.

For example, a car manufacturer that decides to repurchase inventory from one dealership to meet an inventory shortage at another dealership has not entered into a forward, call option, or put option unless the original contract requires the dealership to sell the cars back to the manufacturer upon request. However, when such repurchases are common, even if not specified in the contract, management will need to consider whether that common practice affects the assessment of transfer of control to the customer upon initial delivery.

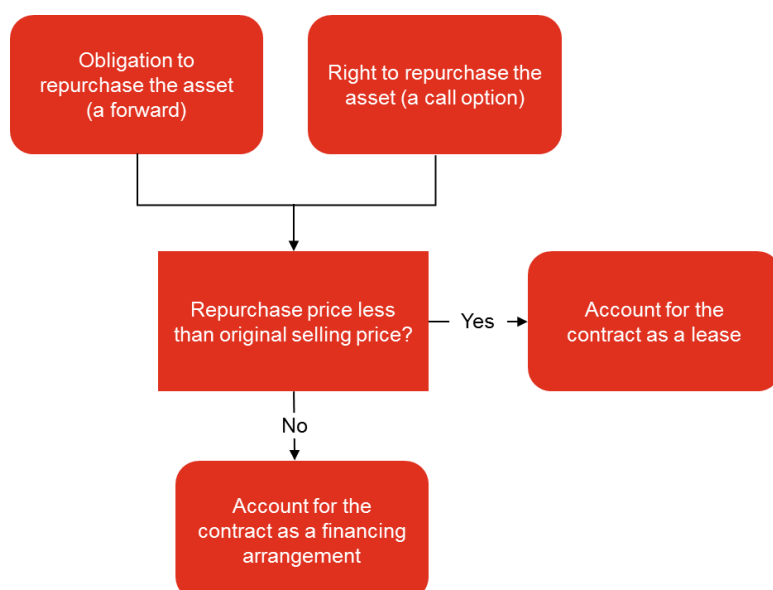
Some arrangements do not include a repurchase right, but instead provide a guarantee in the form of a payment to the customer for the deficiency, if any, between the amount received in a resale of the product and a guaranteed resale value. The guidance on repurchase rights (described in RR 8.7.1 and RR 8.7.2) does not apply to these arrangements because the entity does not reacquire control of the asset. The guarantee payment should be accounted for in accordance with the applicable guidance on guarantees. Refer to RR 4.3.3.9 for further discussion of guarantees.

8.7.1 *Forwards and call options*

An entity that transfers a good and retains a substantive forward repurchase obligation or call option (that is, a repurchase right) should not recognize revenue when the good is initially transferred to the customer because the repurchase right limits the customer's ability to control the good. While some such provisions may be deemed to lack substance based on specific facts and circumstances, in general a negotiated contract term is presumed to be substantive.

Figure 8-2 summarizes the considerations when determining the accounting for forwards and call options.

Figure 8-2
Accounting for forwards and call options



The accounting for an arrangement with a forward or a call option depends on the amount the entity can or must pay to repurchase the good. The likelihood of exercise is not considered in this assessment. The arrangement is accounted for as either:

- a lease, if the repurchase price is less than the original sales price of the asset and, for US GAAP reporters (and for IFRS reporters upon adoption of IFRS 16), the arrangement is not part of a sale-leaseback transaction (in which case the entity is the lessor); or
- a financing arrangement, if the repurchase price is equal to or more than the original sales price of that good (in which case the customer is providing financing to the entity).

An entity that enters into a financing arrangement continues to recognize the transferred asset and recognizes a financial liability for the consideration received from the customer. The entity recognizes any amounts that it will pay upon repurchase in excess of what it initially received as interest expense over the period between the initial agreement and the subsequent repurchase and, in some situations, as processing or holding costs. The entity derecognizes the liability and recognizes revenue if it does not exercise a call option and it expires.

The comparison of the repurchase price to the original sales price of the good should include the effect of the time value of money, including contracts with terms of less than one year. This is because the effects of time value of money could change the determination of whether the forward or call option is a lease or financing arrangement. For example, if an entity enters into an arrangement with a call option and the stated repurchase price, excluding the effects of the time value of money, is equal to or greater than the original sales price, the arrangement might be a financing arrangement. Including the effect of the time value of money might result in a repurchase price that is less than the original sale price, and the arrangement would be accounted for as a lease.

Example 8-10 illustrates the accounting for an arrangement that contains a call option. A similar scenario is illustrated in Example 62, Case A, of the revenue standard (ASC 606-10-55-402 through ASC 606-10-55-404 and IFRS 15.IE316 through IFRS 15.IE318).

EXAMPLE 8-10

Repurchase rights – call option accounted for as lease

Machine Co sells machinery to Manufacturer for \$200,000. The arrangement includes a call option that gives Machine Co the right to repurchase the machinery in five years for \$150,000. The arrangement is not part of a sale-leaseback (US GAAP).

Should Machine Co account for this transaction as a lease or a financing transaction?

Analysis

Machine Co should account for the arrangement as a lease. The five-year call period indicates that the customer is limited in its ability to direct the use of or obtain substantially all of the remaining benefits from the machinery. Machine Co can repurchase the machinery for an amount less than the original selling price of the asset; therefore, the transaction is a lease. Machine Co would account for the arrangement in accordance with the leasing guidance.

8.7.1.1 Conditional call rights

Some call rights are not unilaterally exercisable by the seller, but instead only become exercisable if certain conditions are met. The revenue standard does not provide specific guidance for assessing conditional repurchase features; therefore, judgment will be required to assess the impact of these provisions. Conditional rights should be accounted for based on their substance, with an objective of assessing whether control has transferred to the customer.

As noted in RR 8.7.1, the likelihood of the entity exercising an active call right should not be considered when assessing whether control has transferred. In certain circumstances, however, an entity might conclude a conditional call right does not preclude transfer of control. For example, if the call right only becomes active based on factors outside of the entity's control, this may indicate that control has transferred to the customer despite the existence of the conditional call right.

To assess whether a conditional call right precludes transfer of control to the customer, management should consider the following factors, among others:

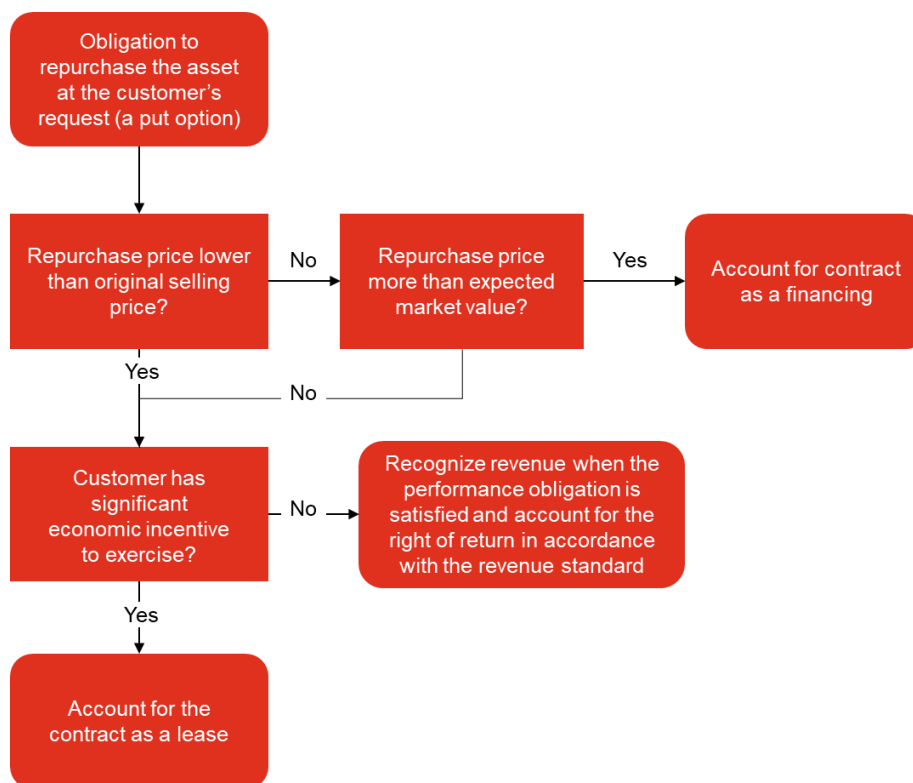
- The nature of the conditions that result in the rights becoming active
- The likelihood that the conditions will be met that result in the rights becoming active
- Whether the conditions are based on factors within the seller's or customer's control

8.7.2 Put options

A put option allows a customer, at its discretion, to require the entity to repurchase a good and indicates that the customer has control over that good. The customer has the choice of retaining the item, selling it to a third party, or selling it back to the entity.

Figure 8-3 summarizes the considerations in determining the accounting for put options.

Figure 8-3
Accounting for put options



The accounting for an arrangement with a put option depends on the amount the entity must pay when the customer exercises the put option, and whether the customer has a significant economic incentive to exercise its right. An entity accounts for a put option as:

- a financing arrangement, if the repurchase price is equal to or more than the original sales price and more than the expected market value of the asset (in which case the customer is providing financing to the entity);
- a lease, if the repurchase price is less than the original sales price and the customer has a significant economic incentive to exercise that right and, for US GAAP reporters (and for IFRS reporters upon adoption of IFRS 16), the arrangement is not part of a sale-leaseback transaction (in which case the entity is the lessor);
- a sale of a product with a right of return, if the repurchase price is less than the original sales price and the customer does not have a significant economic incentive to exercise its right; or
- a sale of a product with a right of return, if the repurchase price is equal to or more than the original sales price, but less than or equal to the expected market value of the asset, and the customer does not have a significant economic incentive to exercise its right.

An entity that enters into a financing arrangement continues to recognize the transferred asset and recognize a financial liability for the consideration received from the customer. The entity recognizes any amounts that it will pay upon repurchase in excess of what it initially received as interest expense

(over the term of the arrangement) and, in some situations, as processing or holding costs. An entity derecognizes the liability and recognizes revenue if the put option lapses unexercised.

Similar to forwards and calls, the comparison of the repurchase price to the original sales price of the good should include the effect of the time value of money, including the effect on contracts whose term is less than one year. The effect of the time value of money could change the determination of whether the put option is a lease or financing arrangement because it affects the amount of the repurchase price used in the comparison.

8.7.2.1 ***Significant economic incentive to exercise a put option***

The accounting for certain put options requires management to assess at contract inception whether the customer has a significant economic incentive to exercise its right. A customer that has a significant economic incentive to exercise its right is effectively paying the entity for the right to use the good for a period of time, similar to a lease.

Management should consider various factors in its assessment, including the following:

- How the repurchase price compares to the expected market value of the good at the date of repurchase
- The amount of time until the right expires

A customer has a significant economic incentive to exercise a put option when the repurchase price is expected to significantly exceed the market value of the good at the time of repurchase.

Example 8-11 and Example 8-12 illustrate the accounting for arrangements that contain a put option. This concept is also illustrated in Example 62, Case B, of the revenue standard (ASC 606-10-55-405 through ASC 606-10-55-407 and IFRS 15.IE319 through IFRS 15.IE321).

EXAMPLE 8-11

Repurchase rights – put option accounted for as a right of return

Machine Co sells machinery to Manufacturer for \$200,000. Manufacturer can require Machine Co to repurchase the machinery in five years for \$75,000. The market value of the machinery at the repurchase date is expected to be greater than \$75,000. Machine Co offers Manufacturer the put option because an overhaul is typically required after five years. Machine Co can overhaul the equipment, sell the refurbished equipment to a customer, and receive a significant margin on the refurbished goods. Assume the time value of money would not affect the overall conclusion.

Should Machine Co account for this transaction as a sale with a return right, a lease, or a financing transaction?

Analysis

Machine Co should account for the arrangement as the sale of a product with a right of return. Manufacturer does not have a significant economic incentive to exercise its right since the repurchase price is less than the expected market value at date of repurchase. Machine Co should account for the transaction consistent with the model discussed in RR 8.2.

EXAMPLE 8-12

Repurchase rights – put option accounted for as lease

Machine Co sells machinery to Manufacturer for \$200,000 and stipulates that Manufacturer can require Machine Co to repurchase the machinery in five years for \$150,000. The repurchase price is expected to significantly exceed the market value at the date of the repurchase. Assume the time value of money would not affect the overall conclusion.

Should Manufacturer account for this transaction as a sale with a return right, a lease, or a financing transaction?

Analysis

Machine Co should account for the arrangement as a lease in accordance with the leasing guidance. Manufacturer has a put option to resell the machinery to Machine Co and has a significant economic incentive to exercise this right, because the guarantee price significantly exceeds the expected market value at date of repurchase. Lease accounting is required given the repurchase price is less than the original selling sales price of the machinery.

Chapter 9:

Licenses

9.1 Chapter overview

A license arrangement establishes a customer's rights related to an entity's intellectual property (IP) and the obligations of the entity to provide those rights. Licenses are common in the following industries:

- Technology – software and patents
- Entertainment and media – motion pictures, music, and copyrights
- Pharmaceuticals and life sciences – drug compounds, patents, and trademarks
- Retail and consumer – trade names and franchises

Licenses come in a variety of forms, and can be term-based or perpetual, as well as exclusive or nonexclusive. Consideration received for licenses can also vary significantly from fixed to variable and from upfront (or lump sum) to over time in installments.

Management should assess each arrangement where licenses are sold with other goods or services to conclude whether the license is distinct and therefore a separate performance obligation. Management will need to determine whether a license provides *a right to access* IP or *a right to use* IP, since this will determine when revenue is recognized. Revenue recognition will also be affected if a license arrangement includes sales- or usage-based royalties.

Note about ongoing standard setting (US GAAP)

As of the content cutoff date of this publication (August 31, 2019), the EITF has an active project related to the application of the revenue standard to licensing arrangements; specifically, the EITF is addressing (1) certain aspects of accounting for renewals and other license modifications and (2) the accounting for the revocation of licensing rights. Financial statement preparers and other users of this publication are encouraged to monitor the status of the project.

9.2 Overview of the licenses guidance

The revenue standard includes specific implementation guidance for accounting for licenses of IP. The overall framework is similar, but there are some differences between US GAAP and IFRS (refer to Figure 9-2 below). In particular, there is different guidance for evaluating whether a license is a right to access IP or a right to use IP.

The first step is to determine whether the license is distinct or combined with other goods or services. The revenue recognition pattern for distinct licenses is based on whether the license is a right to access IP (revenue recognized over time) or a right to use IP (revenue recognized at a point in time). For licenses that are bundled with other goods or services, management will apply judgment to assess the nature of the combined item and determine whether the combined performance obligation is satisfied at a point in time or over time.

Figure 9-1 illustrates the overall framework for accounting for licenses.

Figure 9-1

Accounting for licenses of intellectual property

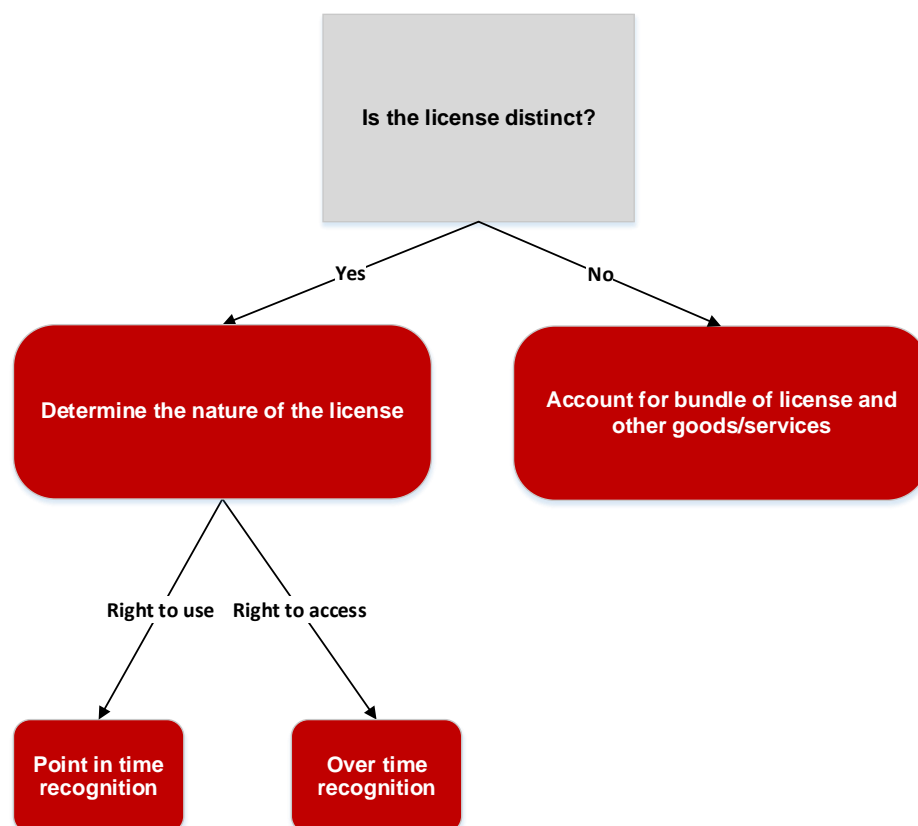


Figure 9-2 summarizes the differences between the US GAAP and IFRS guidance, as discussed further in this chapter.

Figure 9-2

Summary of key differences between ASC 606 and IFRS 15 – licenses of IP

Topic	Difference
Accounting for a license bundled with other goods or services	ASC 606 specifies that an entity should consider the nature of its promise in granting a license (that is, whether the license is a right to access or a right to use IP) when applying the general revenue recognition model to a combined performance obligation that includes a license and other goods or services. IFRS 15 does not contain the same specific guidance. However, we expect entities to reach similar conclusions under both standards.

Topic	Difference
Determining the nature of a license	ASC 606 defines two categories of IP—functional and symbolic—for purposes of assessing whether a license is a right to access or a right to use IP. Under IFRS 15, the nature of a license is determined based on whether the entity’s activities significantly change the IP to which the customer has rights. We expect that the outcome of applying the two standards will be similar; however, there will be fact patterns for which outcomes could differ.
Restrictions of time, geography, or use	ASC 606 and IFRS 15 use different words to explain that a contract could contain multiple licenses that represent separate performance obligations, and that contractual restrictions of time, geography, or use within a single license are attributes of the license. ASC 606 also includes additional examples to illustrate these concepts. We believe the concepts in the two standards are similar; however, entities might reach different conclusions under the two standards given that ASC 606 contains more detailed guidance.
License renewals	ASC 606 specifies that an entity cannot recognize revenue from the renewal of a license of IP until the beginning of the renewal period. IFRS 15 does not contain this specific guidance; therefore, entities applying IFRS might reach a different conclusion regarding recognition of license renewals.

9.3 *Determining whether a license is distinct*

Management should consider the guidance for identifying performance obligations to determine if a license is distinct when it is included in an arrangement with other goods or services. Refer to RR 3 for a discussion of how to identify separate performance obligations.

Licenses that are not distinct include:

Excerpt from ASC 606-10-55-56 and IFRS 15.B54

- a. A license that forms a component of a tangible good and that is integral to the functionality of the good.
- b. A license that the customer can benefit from only in conjunction with a related service (such as an online service provided by the entity that enables, by granting a license, the customer to access content).

US GAAP includes specific guidance for determining whether a hosting arrangement includes a software license in ASC 985-20, *Costs of Software to be Sold, Leased, or Marketed*. Entities applying US GAAP that enter into hosting arrangements should assess that guidance, which includes determining whether (a) the customer has the contractual right to take possession of the software without significant penalty and (b) it is feasible for the customer to run the software on its own or by contracting with an unrelated third party. The arrangement does not include a distinct license unless these criteria are met.

Judgment may be required to determine whether a license is distinct. For example, “hybrid cloud” arrangements typically include both a license to on-premise software and access to software-as-a-service (SaaS). Assessing whether the license to the on-premise software is distinct or should be combined with the service will require an understanding of the standalone functionality of each and the degree to which the license and the service affect each other.

Example 9-1, Example 9-2, and Example 9-3 illustrate the analysis of whether a license is distinct. This concept is also illustrated in Examples 11, 54, 55, and 56 of the revenue standard (both US GAAP and IFRS) (ASC 606-10-55-141 through ASC 606-10-55-150K, ASC 606-10-55-362 through ASC 606-10-55-374, IFRS 15.IE49 through IFRS 15.IE58K, and IFRS 15.IE276 through IFRS 15.IE288), as well as Example 10, Case C (US GAAP only) (ASC 606-10-55-140D through ASC 606-10-55-140F).

EXAMPLE 9-1

License that is distinct – license of IP and R&D services

Biotech licenses a drug compound to Pharma. Biotech also provides research and development (R&D) services as part of the arrangement. The contract requires Biotech to perform the R&D services, but the services are not complex or specialized—that is, the services could be performed by Pharma or another qualified third party. The R&D services are not expected to significantly modify or customize the initial IP (the drug compound).

Is the license in this arrangement distinct?

Analysis

The license is distinct because the license is capable of being distinct and separately identifiable from the other promises in the contract. Pharma can benefit from the license together with R&D services that it could perform itself or obtain from another vendor. The license is separately identifiable from other promises in the contract because the R&D services are not expected to significantly modify or customize the IP.

Whether a license is distinct from R&D services depends on the specific facts and circumstances. In the case of very early stage IP (for example, within the drug discovery cycle) when the R&D services are expected to involve significant further development of the initial IP, an entity might conclude that the IP and R&D services are not distinct and, therefore, constitute a single performance obligation.

EXAMPLE 9-2

License that is distinct – license of IP and installation

SoftwareCo provides a perpetual software license to Engineer. SoftwareCo will also install the software as part of the arrangement. SoftwareCo offers the software license to its customers with or without installation services, and Engineer could select a different vendor for installation. The installation does not result in significant customization or modification of the software.

Is the license in this arrangement distinct?

Analysis

The software license is distinct because Engineer can benefit from the license on its own, and the license is separable from other promises in the contract. This conclusion is supported by the fact that SoftwareCo licenses the software separately (without installation services) and other vendors are able to install the software. The license is separately identifiable because the installation services do not significantly modify the software. The license is therefore a separate performance obligation that should be accounted for in accordance with the guidance in RR 9.5.

EXAMPLE 9-3**License that is distinct – license of IP and data storage service**

SoftwareCo enters into a contract with its customer for on-premise data analytics software and cloud data storage. The on-premise software utilizes the customer's data stored on the cloud to provide data analysis. The on-premise software can also utilize data stored on the customer's premises or data stored by other vendors.

Is the license in this arrangement distinct?

Analysis

It is likely that SoftwareCo would conclude that the on-premise software license is distinct from the cloud data storage service. The cloud data storage could be provided by other vendors and is capable of being distinct. The software license and cloud data storage service are separately identifiable because a customer could gain substantially all of the benefits of the on-premise software when data is stored on the customer's premises or with another vendor.

Alternatively, if SoftwareCo's on-premise software and cloud data storage are used together in such a manner that the customer gains significant functionality that would not be available without the cloud data storage service, SoftwareCo might conclude that the license is not distinct from the storage service.

9.4 Accounting for a license bundled with other goods or services

Licenses that are not distinct should be combined with other goods and services in the contract until they become a bundle of goods or services that is distinct. Entities should recognize revenue when (or as) it satisfies the combined performance obligation. Management will need to determine whether the combined performance obligation is satisfied over time or at a point in time and, if satisfied over time, an appropriate measure of progress.

Management may need to consider the nature of the license included in the bundle (that is, whether the license is a right to access or a right to use IP) in order to assess the accounting for the combined performance obligation. Management should also consider why the license and other goods or services are bundled together to help determine the accounting for the bundle.

ASC 606 specifically addresses how an entity should account for a combined performance obligation that includes a license.

Excerpt from ASC 606-10-55-57

When a single performance obligation includes a license (or licenses) of intellectual property and one or more other goods or services, the entity considers the nature of the combined good or service for which the customer has contracted...in determining whether that combined good or service is satisfied over time or at a point in time... and, if over time, in selecting an appropriate method for measuring progress...

IFRS 15 does not include the same specific guidance as ASC 606, but the IASB states in its basis for conclusions that the entity would apply the license guidance to determine if the performance obligation is a right to access or a right to use when the license is distinct or the performance obligation includes a license as its primary or dominant component.

Although ASC 606 and IFRS 15 use different words, we believe entities will often reach similar conclusions under the two standards.

An example of a bundle that includes a license and other goods and services is a license to IP with a 10-year term that is bundled with a one-year service into a single performance obligation. The nature of the license could impact the accounting for the combined performance obligation in this fact pattern. If the license is a right to access IP, revenue would likely be recognized over the 10-year license term. In contrast, if the license is a right to use IP, the entity might conclude that revenue should be recognized over the one-year service period.

Accounting for a combined performance obligation that includes a license will require judgment. Management should consider the nature of the promise and the item for which the customer has contracted. This would include assessing the relative significance of the license and the other goods or services to the bundle. For example, if the license is incidental to the bundle, the assessment of whether the license is a right to access or a right use IP would not be relevant to the accounting for the bundle.

9.5 *Determining the nature of a license*

Rights provided through licenses of IP can vary significantly due to the different features and underlying economic characteristics of licensing arrangements. Recognition of revenue related to a license of IP differs depending on the nature of the entity's promise in granting the license. The revenue standard identifies two types of licenses of IP: a right to access IP and a right to use IP.

Licenses that provide a right to access an entity's IP are performance obligations satisfied over time, and therefore revenue is recognized over time. Management should select an appropriate measure of progress to determine the pattern of recognition of a right to access IP. We believe a straight-line approach will often be an appropriate method for recognizing revenue because the benefit to the customer often transfers ratably throughout a license period. There might be circumstances where the nature of the IP or the related activities indicate that another method of progress better reflects the transfer to the customer. Refer to RR 6 for discussion of measures of progress.

Licenses that provide a right to use an entity's IP are performance obligations satisfied at a point in time. Management should refer to the guidance on transfer of control to determine the point in time at which control of the license transfers. Refer to RR 6 for discussion of the indicators of transfer of control.

Under US GAAP, revenue cannot be recognized before the beginning of the period the customer is able to use and benefit from its right to access or its right to use an entity's IP. This is typically the beginning of the stated license period, assuming the customer has the ability to use and benefit from the IP at that time. IFRS 15 states that revenue cannot be recognized before the customer is able to use and benefit from its right to use an entity's IP, but is not specific regarding a license that provides a right to access IP. Although IFRS guidance is not specific on this point, we believe entities should reach similar conclusions under the two standards.

9.5.1 *Determining the nature of a license (US GAAP)*

To assist entities in determining whether a license provides a right to access IP or a right to use IP, ASC 606 defines two categories of licenses: functional and symbolic.

ASC 606-10-55-59

To determine whether the entity's promise to provide a right to access its intellectual property or a right to use its intellectual property, the entity should consider the nature of the intellectual property to which the customer will have rights. Intellectual property is either:

- a. **Functional intellectual property.** Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality.
- b. **Symbolic intellectual property.** Intellectual property that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities.

9.5.1.1 *Functional IP (US GAAP)*

Functional IP includes software, drug formulas or compounds, and completed media content. Patents underlying highly functional items (such as a specialized manufacturing process that the customer can use as a result of the patent) are also classified as functional IP. Functional IP is a right to use IP because the IP has standalone functionality and the customer can use the IP as it exists at a point in time.

The guidance provides an exception to point in time recognition if the criteria in ASC 606-10-55-62 are met.

ASC 606-10-55-62

A license to functional intellectual property grants a right to use the entity's intellectual property as it exists at the point in time at which the license is granted unless both of the following criteria are met:

- a. The functionality of the intellectual property to which the customer has rights is expected to substantively change during the license period as a result of activities of the entity that do not transfer a promised good or service to the customer (see paragraphs 606-10-25-16 through 25-18). Additional promised goods or services (for example, intellectual property upgrade rights or rights to use or access additional intellectual property) are not considered in assessing this criterion.
- b. The customer is contractually or practically required to use the updated intellectual property resulting from criterion (a).

If both of those criteria are met, then the license grants a right to access the entity's intellectual property.

We believe it will be unusual for the above criteria to be met because changes to IP typically transfer a good or service to the customer. An example is a distinct license to software (functional IP) that will substantively change as a result of updates to the software during the license period. The updates to the software license are an additional good or service transferred to the customer; therefore, the criteria above are not met and the software license is a right to use IP. The entity would also need to assess whether the software license and the subsequent updates are distinct in this example; that is, revenue would likely be recognized over time if the license and updates are combined into a single performance obligation. Examples 54, 59, and 61A of ASC 606 (US GAAP only) (ASC 606-10-55-362 through ASC 606-10-55-363B, ASC 606-10-55-389 through ASC 606-10-55-392D, and ASC 606-10-55-399A through ASC 606-10-55-399J) illustrate arrangements that are licenses to functional IP.

9.5.1.2 Symbolic IP (US GAAP)

Symbolic IP includes brands, logos, team names, and franchise rights. Symbolic IP is a right to access IP because of the entity's obligation to support or maintain the IP over time. Revenue from symbolic IP is recognized over the license period, or the remaining economic life of the IP, if shorter. Examples 57, 58, and 61 of ASC 606 (US GAAP only) (ASC 606-10-55-375 through ASC 606-10-55-388 and ASC 606-10-55-395 through ASC 606-10-55-399) illustrate arrangements that are licenses to symbolic IP.

9.5.2 Determining the nature of a license (IFRS)

IFRS 15 states that the determination of whether an entity's promise to grant a license provides a right to access IP or a right to use IP is based on whether the IP is significantly affected by the entity's activities.

9.5.2.1 Licenses that provide access to an entity's IP (IFRS)

A license of IP that changes over time as a result of an entity's activities likely provides a customer (the licensee) a right to access the IP as it exists throughout the arrangement. This is because the customer is not able to direct the use of and obtain substantially all of the remaining benefits from the license when it initially transfers. Rather, the benefit is consumed as the entity provides access to the IP over the license period. Licenses that meet all the criteria in IFRS 15.B58 provide access to an entity's IP.

IFRS 15.B58

The nature of an entity's promise in granting a license is a promise to provide a right to access the entity's intellectual property if all of the following criteria are met:

- a. The contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights.
- b. The rights granted by the license directly expose the customer to any positive or negative effects of the entity's activities identified in paragraph B58(a).
- c. Those activities do not result in the transfer of a good or a service to the customer as those activities occur.

Examples 57, 58, and 61 of IFRS 15 (IFRS 15.IE289 through IFRS 15.IE302 and IFRS 15.IE309 through IFRS 15.IE313) illustrate arrangements that provide a right to access an entity's IP.

The licensor will undertake activities that significantly affect the IP

The first criterion requires an assessment of whether the licensor will undertake activities that significantly affect the IP to which the customer has rights, but that are not otherwise performance obligations. These activities could be specified in the contract, or they could be expected by the customer based on the entity's published policies or customary business practices.

IFRS 15 provides further guidance regarding whether an entity's activities "significantly affect" the IP.

IFRS 15.B59A

An entity's activities significantly affect the intellectual property to which the customer has rights when either:

- a. those activities are expected to significantly change the form (for example, the design or content) or the functionality (for example, the ability to perform a function or task) of the intellectual property; or
- b. the ability of the customer to obtain benefit from the intellectual property is substantially derived from, or dependent upon, those activities. For example, the benefit from a brand is often derived from, or dependent upon, the entity's ongoing activities that support or maintain the value of the intellectual property.

Accordingly, if the intellectual property to which the customer has rights has significant stand-alone functionality, a substantial portion of the benefit of that intellectual property is derived from that functionality. Consequently, the ability of the customer to obtain benefit from that intellectual property would not be significantly affected by the entity's activities unless those activities significantly change its form or functionality. Types of intellectual property that often have significant stand-alone functionality include software, biological compounds or drug formulas, and completed media content (for example, films, television shows and music recordings).

Judgment will be required to assess whether activities will significantly affect the IP. An entity should consider how the IP provides a benefit to the customer when assessing whether the entity's activities significantly affect the IP to which the customer has rights. If the benefit is derived from the form or functionality, only activities that change that form or functionality will significantly affect the IP. If the benefit is derived from other activities, it might not be necessary for activities to change the form or functionality to significantly affect the IP. For example, the benefit from brand name is often derived from its value and therefore, the entity's activities to support or maintain that value will significantly affect the IP.

IFRS 15.B59A clarifies that IP that has significant standalone functionality derives a substantial portion of its benefit from that functionality. IFRS 15 does not define significant standalone functionality. Management needs to apply judgment to determine if IP has significant standalone functionality and therefore, activities would not significantly affect the IP unless those activities change that functionality.

The rights granted directly expose the customer to the effects of the above activities

The second criterion requires that the effects, either positive or negative, of any activities identified in the first criterion affect the customer (licensee). Activities that do not affect what the license provides to the customer, or what the customer controls, do not meet this criterion. An entity is only changing its own asset if its activities do not affect the customer; therefore, the rights that the license provides are not affected.

For example, a customer may have the right to use a university's logo on apparel. The university performs research, maintains selective admissions, and sponsors athletics programs, among other activities, that affect its public reputation and hence the value of the IP, and the customer is directly exposed to those effects.

The licensor's activities do not otherwise transfer a good or service

The third criterion requires that the activities that might affect the IP are not additional performance obligations in the contract. The assessment of whether a license provides a right to use or a right to access IP is not affected by other goods or services promised in the arrangement (that is, other performance obligations).

Judgment could be required to determine whether an activity undertaken by a licensor is a separate performance obligation. IP might be significantly affected by activities undertaken by the licensor. However, this criterion would not be satisfied if those activities provide a distinct good or service to the customer. An example is a distinct software license that will substantively change as a result of updates to the software during the license period. The updates to the software license are an additional good or service transferred to the customer; therefore, this criterion is not met.

9.5.2.2 Licenses that provide a right to use an entity's IP (IFRS)

Licenses that do not meet all three criteria to be accounted for as a right to access IP are accounted for as a right to use IP. Revenue is recognized in those circumstances at a point in time, because the customer is able to direct the use of and obtain substantially all of the benefits from the license at the time that control of the license is transferred to the licensee. Examples 54 and 59 of IFRS 15 (IFRS 15.IE276 through IFRS 15.IE277 and IFRS 15.IE303 through IFRS 15.IE306) illustrate arrangements that are licenses that provide a right to use an entity's IP.

9.5.3 *Examples of determining the nature of a license (US GAAP & IFRS)*

Example 9-4 and Example 9-5 illustrate the assessment of the nature of a license.

EXAMPLE 9-4

License that provides a right to access IP

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

What is the nature of the license in this arrangement?

Analysis

US GAAP assessment: The IP underlying the license in this example is symbolic IP because the character images do not have significant standalone functionality. The license is therefore a right to access IP.

IFRS assessment: CartoonCo's continued production and marketing of the show, and development of the characters, indicates that CartoonCo will undertake activities that significantly affect the IP (the character images). Retailer is directly exposed to any positive or negative effects of CartoonCo's activities, as Retailer must use the latest images that could be more or less positively received by the public as a result of CartoonCo's activities. These activities are not separate performance obligations because they do not transfer a good or service to Retailer separate from the license. The license therefore meets the criteria for a right to access IP.

Under both US GAAP and IFRS, the license provides a right to access CartoonCo's IP and CartoonCo would therefore recognize revenue over time. Revenue recognition will commence when the show first airs because this is when the customer is able to benefit from the license.

EXAMPLE 9-5

License that provides a right to use IP

SoftwareCo provides a fixed-term software license to TechCo. The terms of the arrangement allow TechCo to download the software by using a unique digital key provided by SoftwareCo. TechCo can use the software on its own server. The software is functional when it transfers to TechCo. TechCo also purchases post-contract customer support (PCS) with the software license. There is no expectation for SoftwareCo to undertake any activities other than the PCS. The license and PCS are distinct as TechCo can benefit from the license on its own and the license is separable from the PCS.

What is the nature of the license in this arrangement?

Analysis

US GAAP assessment: The IP underlying the license in this example is functional IP because the software has significant standalone functionality. The criteria in ASC 606-10-55-62, which provide the exception for functional IP, are not met because changes to the IP (PCS) transfer a good or service to the customer. The license is therefore a right to use IP.

IFRS assessment: PCS is not considered an “activity” that affects the IP because it is a separate performance obligation. The IP has significant standalone functionality and SoftwareCo is not expected to perform any activities that affect that functionality. Therefore, SoftwareCo’s does not perform activities that significantly affect the IP to which the customer has rights. The three criteria required for a right to access IP over time are not met. The license is a right to use IP.

Under both US GAAP and IFRS, the license provides a right to use IP. SoftwareCo would recognize revenue at a point in time when TechCo is able to use and benefit from the license (no earlier than the beginning of the license term). PCS is a separate performance obligation in this arrangement and does not impact the assessment of the nature of the license.

9.6 *Restrictions of time, geography or use*

Many licenses include restrictions of time, geographical region, or use. For example, a license could stipulate that the IP can only be used for a specified term or can only be used to sell products in a specified geographical region. Both ASC 606 and IFRS 15 require entities to first assess whether a contract includes multiple licenses that represent separate performance obligations or a single license with contractual restrictions.

Some contractual provisions might indicate that the entity has promised to transfer multiple distinct licenses to the customer. For example, a contract could include a distinct license that is a right to use IP in Geography A and a separate distinct license that is a right to use IP in Geography B. Management should allocate revenue to the distinct licenses in the contract if it concludes there are multiple distinct licenses; however, the timing of revenue recognition is not affected if the customer can use and benefit from both licenses at the same time (that is, the distinct licenses are coterminous). On the other hand, the timing of revenue recognition would be affected if, for example, the term of the license to use IP in Geography B does not commence until a future date.

Contractual restrictions of time, geography, or use within a *single* license are attributes of that license. Restrictions in a single license therefore do not impact whether the license is a right to access or a right to use IP or the number of promised goods or services.

ASC 606 and IFRS 15 use different words to explain these concepts. ASC 606 also includes Examples 61A and 61B (ASC 606-10-55-399A through ASC 606-10-55-399O), which illustrate the accounting impact of license restrictions. We believe the concepts in the two standards are similar; however, entities might reach different conclusions under the two standards given that ASC 606 contains more detailed guidance. Significant judgment may be required to assess whether a contractual provision in a license creates an obligation to transfer multiple licenses (and therefore separate performance obligations) or whether the provision is a restriction that represents an attribute of a single license.

Example 9-6 and Example 9-7 illustrate the impact of restrictions in a license to IP.

EXAMPLE 9-6

Licence restrictions – restrictions are an attribute of the licence

Producer licenses to CableCo the right to broadcast a television series. The license stipulates that CableCo must show the episodes of the television series in sequential order. Producer transfers all of the content of the television series to CableCo at the same time. The contract does not include any other goods or services.

What is the impact of the contractual provisions that restrict the use of the IP in this arrangement?

Analysis

The contract includes a single license. The requirement that CableCo show the episodes in sequential order is an attribute of the license. This restriction does not impact the accounting for the license, including the assessment of whether the license is a right to access or a right to use IP. The license is a right to use IP and, therefore, Producer would recognize revenue when control of the license transfers to CableCo and CableCo has the ability to use and benefit from the license (that is, when CableCo is first able to broadcast the television series).

EXAMPLE 9-7

Licence restrictions – contract includes multiple licences

Pharma licenses to Customer its patent rights to an approved drug compound for eight years beginning on January 1, 20X0. Customer can only utilize the IP to sell products in the United States for the first year of the license. Customer can utilize the IP to sell products in Europe beginning on January 1, 20X1. The contract does not include any other goods or services.

Pharma concludes that the contract includes two distinct licenses: a right to use the IP in the United States and a right to use the IP in Europe.

What is the impact of the contractual provisions that restrict the use of IP in this arrangement?

Analysis

Pharma should allocate the transaction price to the two separate performance obligations because it has concluded that there are two distinct licenses. The allocation should be based on relative standalone selling prices and revenue should be recognized when the customer has the ability to use and benefit from its right to use the IP. The revenue allocated to the license to use the IP in the United States would be recognized on January 1, 20X0. The revenue allocated to the license to use the IP in Europe would be recognized on January 1, 20X1.

9.7 Other considerations

9.7.1 License renewals

ASC 606 specifies that revenue from the renewal or extension of a license cannot be recognized until the customer can use and benefit from the license renewal (that is, the beginning of the renewal

period). Example 59, Case B in ASC 606 (ASC 606-10-55-392A through ASC 606-10-55-392D) illustrates the accounting for the renewal of a license.

Excerpt from ASC 606-10-55-58C

...an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.

IFRS 15 does not include specific guidance on license renewals. Entities applying IFRS should therefore evaluate whether a renewal or extension agreed to after the contract is initially signed should be accounted for as a new license or the modification of an existing license. This may result in recognition of revenue from renewals at an earlier date as compared to US GAAP in some cases.

Management should also consider whether a renewal right offered at contract inception provides a material right. Refer to RR 7 for guidance on material rights.

Note about ongoing standard setting (US GAAP)

As of the content cutoff date of this publication (August 31, 2019), the EITF has an active project related to the application of the revenue standard to licensing arrangements, including certain aspects of accounting for renewals and other license modifications. Financial statement preparers and other users of this publication are encouraged to monitor the status of the project.

9.7.2 Guarantees

Guarantees to defend a patent are disregarded in the assessment of whether a license is a right to use or a right to access IP. Maintaining a valid patent and defending that patent from unauthorized use are important aspects in supporting an entity's IP. However, the guarantee to do so is not a performance obligation or an activity for purposes of assessing the nature of a license. Rather, it represents assurance that the customer is utilizing a license with the contractually agreed-upon specifications.

9.7.3 Payment terms and significant financing components

Licenses are often long-term arrangements and payment schedules between a licensee and licensor may not coincide with the pattern of revenue recognition. Payments made over a period of time do not necessarily indicate that the license provides a right to access the IP.

Management will need to consider whether a significant financing component exists when the time between recognition of revenue and cash receipt (other than sales- or usage-based royalties) is expected to exceed one year. For example, consider a license that provides a right to use IP for which revenue is recognized when control transfers to the licensee, but payment for the license is made over a five-year period. Alternatively, consider a license that provides a right to access IP for which payment is made upfront. Management needs to consider whether the intent of the payment terms within a contract is to provide a financing, and therefore whether a significant financing component exists. See RR 4.4 for further discussion of accounting for a significant financing component.

9.7.4 *Proceeds from a patent infringement settlement*

Parties to patent infringement disputes often enter into license agreements in connection with settling their disputes. For example, an entity alleging that another party has sold product using its technology (intellectual property) may agree to settle the dispute by granting the party a license to its IP prospectively and releasing the party from any claims of infringement in exchange for cash or noncash consideration. The license to IP is in the scope of the revenue standard if licensing IP is part of the entity's ordinary business activities.

To determine the accounting for settlement proceeds, management will need to identify all of the components of the litigation settlement. In addition to a prospective license to IP, the settlement may include other components, such as royalties related to past sales, recovery of legal fees, or damages (punitive or otherwise). If the settlement includes both components in the scope of the revenue standard and components in the scope of other standards, the entity should generally allocate consideration received to the various components on a relative standalone selling price basis (refer to RR 2.2.3). Determining the standalone selling price for certain non-revenue components (for example, damages) may be challenging; determining the standalone selling price of such components utilizing a residual approach might be appropriate if the criteria described in RR 5.3.3 are met.

9.8 *Sales- or usage-based royalties*

Licenses of IP frequently include fees that are based on the customer's subsequent usage of the IP or sale of products that contain the IP. The revenue standard includes an exception for the recognition of sales- or usage-based royalties promised in exchange for a license of IP.

Excerpt from ASC 606-10-55-65 and IFRS 15.B63

Notwithstanding the guidance in paragraphs [606-10-32-11 through 32-14 [US GAAP] /56-59 [IFRS]], an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

- a. The subsequent sale or usage occurs [and [IFRS]].
- b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

This guidance is an exception to the general principles for accounting for variable consideration (refer to RR 4 for further discussion of variable consideration). The exception only applies to licenses of IP and should not be applied to other fact patterns by analogy. Further, entities that sell, rather than license, IP cannot apply the sales- or usage-based royalty exception. Sales- or usage-based royalties received in arrangements other than licenses of IP should be estimated as variable consideration and included in the transaction price, subject to the constraint (refer to RR 4).

The above "later of" guidance for royalties is intended to prevent the recognition of revenue prior to an entity satisfying its performance obligation. Royalties should be recognized as the underlying sales or usages occur, as long as this approach does not result in the acceleration of revenue ahead of the entity's performance. As noted in RR 9.5, the revenue standard does not prescribe a method for measuring an entity's performance for a right to access IP (that is, a license for which revenue is recognized over time). Management should therefore apply judgment to determine whether

recognizing royalties due each period results in accelerating revenue recognition ahead of performance for a right to access IP. It may be appropriate, in some instances, to conclude that royalties due each period correlate directly with the value to the customer of the entity's performance.

Question 9-1 addresses the accounting for royalties promised in exchange for an in-substance sale of IP.

Question 9-1

How should entities account for sales- or usage-based royalties promised in exchange for a license of IP that in substance is the sale of IP?

PwC response

The exception for sales- or usage-based royalties applies to licenses of IP and not to sales of IP. The FASB noted in its basis for conclusions that an entity should not distinguish between licenses and in-substance sales in deciding whether the royalty exception applies. The IASB did not make a similar observation; thus, judgment is required to determine if an entity needs to assess whether an arrangement is a license or sale of IP under IFRS.

Question 9-2, Question 9-3, and Question 9-4 address the application of the exception for sales- or usage-based royalties.

Question 9-2

Is an entity permitted to recognize sales- or usage-based royalties prior to the period the sales or usages occur if management believes it has historical experience that is highly predictive of the amount of royalties that will be received?

PwC response

No, application of the exception is not optional. Sales- or usage-based royalties in the scope of the exception cannot be recognized prior to the period the uncertainty is resolved (that is, when the customer's subsequent sales or usages occur).

Question 9-3

Should sales- or usage-based royalties promised in exchange for a license of IP be recognized in the period the sales or usages occur or the period such sales or usages are reported by the customer (assuming the related performance obligation has been satisfied)?

PwC response

The exception states that royalties should be recognized in the period the sales or usages occur (assuming the related performance obligation has been satisfied). It may therefore be necessary for management to estimate sales or usages that have occurred, but have not yet been reported by the customer.

Question 9-4

An entity (an agent) distributes licenses of IP on behalf of the owner of the IP (the licensor). The entity is a distribution agent and accordingly, performs an agency service for the licensor. The agent's compensation is in the form of a specified percentage of the royalties the licensor receives from its customers. Those royalties are calculated based on the licensor's customers' sales (that is, a sales-based royalty). Can the agent also apply the exception for sales- or usage-based royalties?

PwC response

We believe it would be acceptable for the agent to apply the exception for sales- or usage-based royalties. As discussed in BC415, applying the exception in this case is consistent with the reasons the boards concluded that entities should not estimate royalties from licenses of IP and provided the royalty exception. Additionally, in this fact pattern, the service provided by the agent is directly related to the license of IP. Application of the sales- or usage-based royalty exception may not be appropriate in circumstances when an entity receives a share of a royalty stream as compensation, but its performance is clearly unrelated to the license of IP.

We believe it would also be acceptable for the agent to conclude its fee is not subject to the exception for sales- or usage-based royalties. This conclusion would be based on the fact that the agent's performance obligation is a service, not the license of IP. An entity concluding its fee is not subject to the exception would apply the general guidance on variable consideration, which would require the entity to estimate its transaction price and apply the variable consideration constraint. The entity's conclusion should be applied consistently to similar arrangements.

9.8.1 *Royalty related to both a license and other goods or services*

Some arrangements include sales- or usage-based royalties that relate to both a license of IP and other goods or services. The revenue standard includes the following guidance for applying the sales- or usage-based royalty exception in these fact patterns.

Excerpt from ASC 606-10-55-65A and IFRS 15.B63A

The [guidance [US GAAP]/requirement [IFRS]] for a sales-based or usage-based royalty... applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates (for example, when... the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

The revenue standard does not further define “predominant” or “significantly more value” and, therefore, judgment may be required to make this assessment. Management will either apply the exception to the royalty stream in its entirety (if the license to IP is predominant) or apply the general variable consideration guidance (if the license to IP is not predominant). Management should not “split” the royalty and apply the exception to only a portion of the royalty stream.

Example 9-8 and Example 9-9 illustrate the assessment of whether a license of IP is predominant when the related fee is in the form of a sales- or usage-based royalty. This concept is also illustrated in Example 60 of the revenue standard (ASC 606-10-55-393 through ASC 606-10-55-394 and IFRS 15.IE307 through IFRS 15.IE308).

EXAMPLE 9-8**Sales- or usage-based royalties – license of IP is not predominant**

Biotech and Pharma enter into a multi-year agreement under which Biotech licenses its IP to Pharma and agrees to manufacture the commercial supply of the product as it is needed. In this agreement, the license and the promise to manufacture are each distinct, and the value of each is determined to be about the same. The only compensation for Biotech in this arrangement is a percentage of Pharma's commercial sales of the product.

Does the sales- or usage-based royalty exception apply to this arrangement?

Analysis

No, the exception does not apply because the license of IP is not predominant in this arrangement. The customer would not ascribe significantly more value to the license than to the promise to manufacture product. Biotech would apply the general variable consideration guidance to estimate the transaction price, and allocate the transaction price between the license and manufacturing. The portion attributed to the license will be recognized by Biotech when the IP has been transferred and Pharma is able to use and benefit from the license. The remaining transaction price would be allocated to the manufacturing and recognized when (or as) control of the product is transferred to Pharma.

EXAMPLE 9-9**Sales- or usage-based royalties – license of IP is predominant**

Pharma licenses to Customer its patent rights to an approved drug compound for eight years. The drug is a mature product. Pharma also promises to provide training and transition services related to the manufacturing of the drug for a period not to exceed three months. The manufacturing process is not unique or specialized, and the services are intended to help Customer maximize the efficiency of its manufacturing process. Pharma concludes that both the license of IP and the services are distinct. The only compensation for Pharma in this arrangement is a percentage of Customer's commercial sales of the product.

Does the sales- or usage-based royalty exception apply to this arrangement?

Analysis

Yes, the exception applies because the license of IP is predominant in this arrangement. The customer would ascribe significantly more value to the license of IP than to the training and transition services included in the arrangement. As such, Pharma would allocate the transaction price to the license and the services and recognize revenue as the subsequent sales occur (assuming Pharma has satisfied its performance obligations).

9.8.2 In substance sales- or usage-based royalties

Management will need to consider the nature of any variable consideration promised in exchange for a license of IP to determine if, in substance, the variable consideration is a sales- or usage-based royalty. Examples include arrangements with milestone payments based upon achieving certain sales or usage

targets and arrangements with an upfront payment that is subject to “claw back” if the licensee does not meet certain sales or usage targets.

Example 9-10 and Example 9-11 illustrate the assessment of whether the sales- or usage-based royalty exception applies.

EXAMPLE 9-10

Sales- or usage-based royalties – milestone payments

TechCo licenses IP to Manufacturer that Manufacturer will utilize in products it sells to its customers over the license period. TechCo will receive a fixed payment of \$10 million in exchange for the license and milestone payments as follows:

- An additional \$5 million payment if Manufacturer’s cumulative sales exceed \$100 million over the license period
- An additional \$10 million payment if Manufacturer’s cumulative sales exceed \$200 million over the license period

TechCo concludes that the license is a right to use IP. There are no other promises included in the contract.

Does the sales- or usage-based royalty exception apply to the milestone payments?

Analysis

Yes, the exception applies to the milestone payments, which are contingent on Manufacturer’s subsequent sales. TechCo would recognize the \$10 million fixed fee when control of the license transfers to Manufacturer. TechCo would recognize the milestone payments in the period(s) that sales exceed the cumulative targets.

EXAMPLE 9-11

Sales- or usage-based royalties – claw back of upfront payment

TechCo licenses IP to Manufacturer that Manufacturer will utilize in products it sells to its customers over the license period. TechCo will receive an upfront payment of \$20 million and the contract provides for clawback of \$5 million in the event Manufacturer’s cumulative sales do not exceed \$100 million over the license period. TechCo concludes it is probable that Manufacturer’s cumulative sales will exceed the target.

Does the sales- or usage-based royalty exception apply to this arrangement?

Analysis

Yes, the arrangement consists of a \$15 million fixed fee and a \$5 million variable fee that is in the scope of the sales- or usage-based royalty exception because it is contingent on Manufacturer’s subsequent sales. TechCo would recognize the \$15 million fixed fee when control of the license transfers to Manufacturer. TechCo would recognize the \$5 million contingent fee in the period sales exceed the cumulative target. The accounting would not be impacted by the likelihood that

Manufacturer will reach the cumulative target because the payment is in the scope of the sales- or usage-based royalty exception, which requires recognition in the period the uncertainty is resolved (that is, when the sales occur).

9.8.3 *Minimum royalties or other fixed fee components*

The sales- or usage-based royalty exception does not apply to fees that are fixed and are not contingent upon future sales or usage. Some arrangements include both a fixed fee and a fee that is a sales- or usage-based royalty. Any fixed, noncontingent fees, including any minimum royalty payments or minimum guarantees, are not subject to the sales- or usage-based royalty exception.

A fixed fee in exchange for a license that is a right to use IP is recognized at the point in time control of the license transfers. Thus, if a contract includes a sales-based royalty with a minimum royalty guarantee that is binding and not contingent on the occurrence or non-occurrence of a future event, the minimum (fixed fee) would be recognized as revenue when control of the license transfers. Royalties in excess of the minimum would be recognized in the period the sales occur.

A fixed fee in exchange for a license that is a right to access IP is recognized over time. We believe there could be multiple acceptable approaches for recognizing revenue when a license that is a right to access IP includes a sales- or usage-based royalty and a minimum royalty guarantee. Examples of acceptable approaches include:

- Recognize revenue as the royalties occur if the licensor expects the total royalties to exceed the minimum guarantee and the royalties due each period correspond directly with the value to the customer of the entity's performance (that is, recognizing royalties as they occur is an appropriate measure of progress using the right to invoice practical expedient discussed in RR 6.4.1.1).
- Estimate the total transaction price (including fixed and variable consideration) that will be earned over the term of the license. Recognize revenue using an appropriate measure of progress; however, the sales- or usage-based royalty exception must continue to be applied to the cumulative revenue recognized.
- Recognize the minimum guarantee (fixed consideration) using an appropriate measure of progress, and recognize royalties only when cumulative royalties exceed the minimum guarantee.

The selection of an approach could require judgment and should consider the nature and terms of the specific arrangement. Refer to US Revenue TRG Memo No. [58](#) and the related meeting minutes in Revenue TRG Memo No. [60](#) for further discussion of this topic.

Example 9-12 illustrates the accounting for an arrangement with a guaranteed minimum royalty.

EXAMPLE 9-12

Sales- or usage-based royalties – minimum guarantee

TechCo licenses IP to Manufacturer that Manufacturer will utilize in products it sells to its customers over a five-year license period. TechCo will receive a royalty based on Manufacturer's sales during the license period. The contract states that the minimum royalty payment in each year is \$1 million. TechCo expects actual royalties to significantly exceed the \$1 million minimum each year.

TechCo concludes that the license is a right to use IP. There are no other promises included in the contract and control of the license transfers on January 1, 20x0. There is not a significant financing component in the arrangement.

When should TechCo recognize revenue from the arrangement?

Analysis

The minimum royalty of \$5 million (\$1 million x five years) is a fixed fee. Since the license is a right to use IP, subject to point-in-time revenue recognition, TechCo would recognize the \$5 million fixed fee on January 1, 20x0 when control of the license transfers to Manufacturer. TechCo would apply the sales- or usage-based royalty exception guidance for the royalty and recognize the royalties earned in excess of \$1 million each year in the period sales occur. The fact that actual royalties are expected to significantly exceed the minimum does not impact the accounting conclusion.

9.8.4 Distinguishing usage-based royalties from additional rights

Many license arrangements include a variable fee linked to usage of the IP. It may not be clear, particularly for software licenses, whether this fee is a usage-based royalty or a fee received in exchange for the purchase of additional rights by the customer. If a licensor is entitled to additional consideration based on the usage of IP to which the customer already has rights, without providing any additional or incremental rights, the fee is generally a usage-based royalty. In contrast, if a licensor provides additional or incremental rights that the customer did not previously control for an incremental fee, the customer is likely exercising an option to acquire additional rights.

Judgment might be required to distinguish between a usage-based royalty (a form of variable consideration) and an option to acquire additional goods or services. A usage-based royalty is recognized when the usage occurs or the performance obligation is satisfied, whichever is later. The usage-based royalty may need to be disclosed in the period recognized pursuant to the requirements to disclose revenue recognized in the reporting period from performance obligations satisfied in previous periods (refer to RR 12.3.3.3). Fees received when an option to acquire additional rights is exercised are recognized when the additional rights are transferred; however, at contract inception, management would need to assess whether the option provides a material right (refer to RR 7). If so, a portion of the transaction price would be allocated to the option and deferred until the option is exercised or expires.

Example 9-13 and Example 9-14 illustrate the assessment of whether variable fees represent a usage-based royalty or an option to acquire additional rights.

EXAMPLE 9-13

Variable fees – usage-based royalty

SoftwareCo licenses software to a customer that will be used by the customer to process transactions. The license permits the customer to grant an unlimited number of users access to the software for no additional fee. The contract consideration includes a fixed upfront fee and a variable fee for each transaction processed using the software.

How should SoftwareCo account for the variable fee?

Analysis

SoftwareCo should account for the variable fee as a usage-based royalty. The incremental fees SoftwareCo receives are based on the usage of the software rights previously transferred to the customer. There are no additional rights transferred to the customer; therefore, SoftwareCo should recognize the usage-based royalty in the period the usage occurs.

EXAMPLE 9-14**Variable fees – option to acquire additional rights**

On January 1, 20X7, SoftwareCo licenses to a customer the right to use its software for five years for a fixed price of \$1 million for 1,000 users (or “seats”). \$1,000 per user is the current standalone selling price for the software. The contract also provides that the customer can add additional users during the term of the contract at a price of \$800 per user. Management has concluded that each “seat” is a separate performance obligation and in substance the customer obtains an additional right when a new user is added.

On January 1, 20X8, Customer adds 20 users and pays SoftwareCo an additional \$16,000.

How should SoftwareCo account for the variable fee?

Analysis

The variable fee in this arrangement is an option to purchase additional rights to use the software because the rights for the additional users are incremental to the rights transferred to the customer on January 1, 20x7. SoftwareCo will need to assess whether the option provides a material right and if so, allocate a portion of the \$1 million transaction price to the option. The amount allocated to the option would be deferred until the option is exercised or expires. In this fact pattern, the discounted pricing of \$800 per user compared to the current pricing of \$1,000 per user may indicate that the option provides a material right if the customer would not have received the discount without entering into the current contract.

SoftwareCo would recognize the \$16,000 fee for the additional rights when it transfers control of the additional licenses. SoftwareCo would also recognize amounts allocated to the related material right, if any, at the time the right is exercised.

Chapter 10:

Principal versus agent considerations

10.1 Chapter overview

Some arrangements involve two or more unrelated parties that contribute to providing a specified good or service to a customer. Management will need to determine, in these instances, whether the entity has promised to provide the specified good or service itself (as a principal) or to arrange for those specified goods or services to be provided by another party (as an agent). This determination often requires judgment and different conclusions can significantly impact the amount and timing of revenue recognition.

Examples of arrangements that frequently require this assessment include internet advertising, internet sales, sales of virtual goods and mobile applications/games, consignment sales, sales through a travel or ticket agency, sales where subcontractors fulfill some or all of the contractual obligations, and sales of services provided by a third-party service provider.

This chapter discusses principal versus agent considerations and related practical application issues, including accounting for shipping and handling fees, out-of-pocket reimbursements, and amounts collected from a customer to be remitted to a third party.

Entities that issue “points” under customer loyalty programs that are satisfied by other parties also need to assess whether they are the principal or an agent for transfer and redemption of the points. Refer to RR 7.2.5 for further discussion of the accounting for customer loyalty points.

10.2 Assessing whether an entity is the principal or an agent

The principal is the entity that has promised to provide goods or services to its customers. An agent arranges for goods or services to be provided by the principal to an end customer. An agent normally receives a commission or fee for these activities. An agent will, in some cases, deduct the amount it is owed from the gross consideration received from the end customer and remit a net amount to the principal.

The revenue standard provides guidance for determining whether an entity is the principal or an agent. Management should first identify the specified goods or services being provided to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) that will be transferred to the customer. An entity is the principal in a transaction if it obtains control of the specified goods or services before they are transferred to the customer. An entity is an agent if it does not control the specified goods or services before they are transferred to the customer.

Determining whether an entity is the principal or an agent is not a policy choice. It should be based on an assessment of whether the entity obtains control of the specified goods or services based on the facts and circumstances of each arrangement.

The revenue standard includes indicators that an entity controls a specified good or service before it is transferred to the customer to help entities apply the concept of control to the principal versus agent assessment. The entity’s control needs to be substantive. For example, obtaining legal title of a product only momentarily before it is transferred to the customer does not necessarily indicate that the entity is the principal.

Management needs to determine whether the entity is a principal or agent separately for each specified good or service promised to a customer. In contracts with multiple distinct goods or services, the entity could be the principal for some goods or services and an agent for others.

The revenue standard describes examples of how an entity that is a principal could control a good or service before it is transferred to the customer.

ASC 606-10-55-37A and IFRS 15.B35A

When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

- a. A good or another asset from the other party that it then transfers to the customer.
- b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.
- c. A good or service from the other party that it then combines with other goods or services in providing the specific good or service to the customer. For example, if an entity provides a significant service of integrating the goods or services... provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or services is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

This guidance is intended to clarify how an entity could obtain control in different arrangements, including service arrangements. It also explains that if the entity combines goods or services into a combined output (that is, a single performance obligation) that is transferred to the customer, the entity is the principal for that combined output. Management should assess whether goods or services are inputs into a combined output based on the guidance for determining whether goods or services are distinct from other promises in a contract. Refer to RR 3.4.2 for discussion of this guidance.

10.2.1 Accounting implications

The difference in the amount and timing of revenue recognized can be significant depending on the conclusion of whether an entity is the principal in a transaction or an agent. This conclusion determines whether the entity recognizes revenue on a “gross” or “net” basis.

The principal recognizes as revenue the “gross” amount paid by the customer for the specified good or service. The principal records a corresponding expense for the commission or fee it has to pay any agent in addition to the direct costs of satisfying the contract.

An agent records as revenue the commission or fee earned for facilitating the transfer of the specified goods or services (the “net” amount retained). In other words, it records as revenue the net consideration it retains after paying the principal for the specified goods or services that were provided to the customer.

The timing of revenue recognition can also differ depending on whether the entity is the principal or an agent. Once an entity identifies its promises in a contract and determines whether it is a principal or an agent for those promises, it recognizes revenue when (or as) the performance obligations are satisfied. It is therefore critical to identify the promise in the contract in order to determine when that promise is satisfied, and, therefore, the timing of revenue recognition.

An agent might satisfy its performance obligation (facilitating the transfer of specified goods or services) before the end customer receives the specified good or service from the principal in some situations. For example, an agent that promises to arrange for a sale between a vendor and the vendor's customers in exchange for a commission will generally recognize its commission as revenue at the time the sale is completed (that is, when the agency service is provided). In contrast, the vendor will not recognize revenue until it transfers control of the underlying goods or services to the end customer.

10.2.2 Indicators that an entity is the principal

Determining whether an entity is the principal or an agent in an arrangement can require significant judgment. Management should first obtain an understanding of the relationships and contractual arrangements between the various parties. This includes identifying the specified good or service being provided to the end customer and the nature of the entity's promise.

It is not always clear whether the entity obtains control of the specified good or service. The revenue standard provides indicators to help management make this assessment.

ASC 606-10-55-39 and IFRS 15.B37

Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal...) include, but are not limited to, the following:

- a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.
- b. The entity has inventory risk before the specified good or service has been transferred to a customer, or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits [itself [IFRS]] to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.
- c. The entity has discretion in establishing the prices for the specified goods or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

Management needs to apply judgment when assessing the indicators. No single indicator is determinative or weighted more heavily than other indicators, although some indicators may provide stronger evidence than others, depending on the circumstances. Physical receipt of cash on a net or gross basis, however, is not an indicator of which party is the principal in an arrangement.

These indicators, in the context of the principal versus agent analysis, are not intended to “override” the control transfer assessment that an entity makes in accordance with ASC 606-10-25-30 [IFRS 15, paragraph 38]; instead, they provide further guidance to help management assess whether the entity obtains control of a good or service. We expect that management would generally reach consistent conclusions based on applying the definition of control and applying the indicators.

10.2.2.1 *Primary responsibility for fulfilling the contract*

The terms of the agreement and other information communicated to the customer (for example, marketing materials) often provide evidence of which party is primarily responsible for fulfilling the obligations in the contract. Management should consider who the customer views as primarily responsible for fulfilling the contract, including which entity will be providing customer support, resolving customer complaints, and accepting responsibility for the quality or suitability of the product or service.

Multiple parties in an arrangement could share responsibility for fulfillment in some circumstances. For example, one party could be responsible for providing the underlying good or service while another party is responsible for the acceptability of the good or service. This indicator might provide less persuasive evidence in these instances. Management should consider the overall principle of control and the other indicators to make its assessment in those cases.

10.2.2.2 *Inventory risk*

Inventory risk exists when the entity bears the risk of loss due to factors such as physical damage, decline in value, or obsolescence either before the specified good or service has been transferred to the customer or upon return. An entity’s risk is reduced if it has the ability to return unsold products to the supplier. Noncancellable purchase commitments and certain types of guarantees may expose an entity to inventory risk if the entity bears the risk of not being able to monetize the inventory.

Inventory risk might exist even if no physical product is sold. For example, an entity might have inventory risk in a service arrangement if it is committed to pay the service provider even if the entity is unable to identify a customer to purchase the service.

Taking physical possession of a product and bearing risk of loss for a period of time does not, on its own, result in an entity being the principal. The entity needs to have control of the product before it is transferred to the customer to be the principal.

On the other hand, it is not a requirement for an entity to have inventory risk to conclude it takes control of a product. For example, an entity that sells a product to a customer may instruct a supplier to ship the product directly to the customer (“dropship” the product) and as a result, the entity does not take physical possession and may never have substantive inventory risk related to the product. This fact, on its own, would not prevent the entity from concluding it controls the product before it is transferred to the customer. However, the entity would have to support its conclusion based on the definition of control and the other indicators.

10.2.2.3 *Discretion in establishing pricing*

Discretion in establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of the good or service and obtain substantially all of the remaining benefits. Earning a fixed percentage of the consideration for each sale might indicate that an entity is an agent, as a fixed percentage limits the benefit an entity can receive from the transaction.

In some cases, an entity could have some flexibility in setting prices and still be considered an agent. For example, agents often have the ability to provide discounts to end customer (and effectively forgo a portion of their fee or commission) in order to incentivize purchases of the principal's good or service.

Sometimes, an entity allows another entity (such as a reseller) to sell its product or services for a range of prices instead of a single set price. The reseller has some ability to set prices (within the range), but this does not necessarily indicate that the reseller is the principal in the transaction with the end customer. If the range of prices that an intermediary can charge is narrow, this could indicate that the intermediary is an agent because the benefit it can derive from selling the goods or services is limited. If the range of prices is broad, this may indicate that the intermediary is the principal in the sale to the end customers. In those cases, the intermediary (as opposed to the end customer) would be the entity's customer, and the entity should recognize revenue equal to the sales price to the intermediary when control transfers to the intermediary. Management should take into account all of the indicators in this assessment, some of which could still support a conclusion that the entity is the principal in the sale to the end customer.

10.2.3 *Examples of the principal versus agent assessment*

Example 10-1, Example 10-2, Example 10-3, and Example 10-4 illustrate analysis of whether an entity is the principal or agent in various arrangements. These concepts are also illustrated in Examples 45-48A of the revenue standard (ASC 606-10-55-317 through ASC 606-10-55-334F and IFRS 15.IE231 through IFRS 15.IE248F).

EXAMPLE 10-1

Principal versus agent – entity is an agent

WebCo operates a website that sells books. WebCo enters into a contract with Bookstore to sell Bookstore's books on line. WebCo's website facilitates payments between Bookstore and the customer. The sales price is established by Bookstore and WebCo earns a commission equal to 5% of the sales price. Bookstore ships the books directly to the customer; however, the customer returns the books to WebCo if they are dissatisfied. WebCo has the right to return books to Bookstore without penalty if they are returned by the customer.

Is WebCo the principal or agent for the sale of books to the customer?

Analysis

WebCo is acting as the agent of Bookstore and should recognize commission revenue for the sales made on Bookstore's behalf; that is, it should recognize revenue on a net basis. The specified good or service in this arrangement is a book purchased by the customer. WebCo does not control the books before they are transferred to the customer. WebCo does not have the ability to direct the use of the

goods transferred to customers and does not control Bookstore's inventory of goods. WebCo is also not responsible for the fulfillment of orders and does not have discretion in establishing prices of the books. Although customers return books to WebCo, WebCo has the right to return the books to Bookstore and therefore does not have substantive inventory risk. The indicators therefore support that WebCo is not the principal for the sale of Bookstore's books.

WebCo should recognize commission revenue when it satisfies its promise to facilitate a sale (that is, when the books are purchased by a customer).

EXAMPLE 10-2

Principal versus agent – entity is the principal

TravelCo negotiates with major airlines to obtain access to airline tickets at reduced rates and sells the tickets to its customers through its website. TravelCo contracts with the airlines to buy a specific number of tickets at agreed-upon rates and must pay for those tickets regardless of whether it is able to resell them. Customers visiting TravelCo's website search TravelCo's available tickets. TravelCo has discretion in establishing the prices for the tickets it sells to its customers.

TravelCo is responsible for delivering the ticket to the customer. TravelCo will also assist the customer in resolving complaints with the service provided by the airlines. The airline is responsible for fulfilling all other obligations associated with the ticket, including the air travel and related services (that is, the flight), and remedies for service dissatisfaction.

Is TravelCo the principal or agent for the sale of airline tickets to customers?

Analysis

TravelCo is the principal and should recognize revenue for the gross fee charged to customers. The specified good or service is a ticket that provides a customer with the right to fly on the selected flight (or another flight if the selected one is changed or cancelled). TravelCo controls the ticket prior to transfer of the ticket to the customer. TravelCo has the ability to direct the use of the ticket and obtains the remaining benefits from the ticket by reselling the ticket or using the ticket itself. TravelCo also has inventory risk before the ticket is transferred to the customer and discretion in establishing the price of the ticket. The indicators therefore support that TravelCo is the principal.

EXAMPLE 10-3

Principal versus agent – significant integration service

CloudCo provides its customers with a package of cloud services, including access to a software-as-a-service (SaaS) platform owned and operated by a third party. CloudCo contracts directly with the third party for the right to access the SaaS platform as part of its service offering to its customers. CloudCo determines that it is providing a significant service of integrating the various services into a combined package to meet the customer's specifications. Therefore, access to the SaaS platform and the related services performed by CloudCo are not separately identifiable and the contract contains a single performance obligation.

Is CloudCo the principal or agent for the package of cloud services?

Analysis

CloudCo is the principal and should recognize revenue for the gross fee charged to customers. Access to the SaaS platform is an input into the package of cloud services (the specified good or service). CloudCo obtains control of the inputs, including access to the SaaS platform, and directs their use to create the combined output for which the customer has contracted.

The conclusion could differ if CloudCo determines that access to the SaaS platform and the related services performed by CloudCo are each distinct (and therefore, separate performance obligations). In that case, CloudCo would determine whether it is the principal or agent separately for each distinct good or service.

EXAMPLE 10-4**Principal versus agent – multiple specified goods or services**

SoftwareCo provides payroll processing services to customers under a service arrangement. SoftwareCo also offers consulting services to the customer related to the customer's payroll and compensation processes. SoftwareCo has concluded that the payroll processing services and consulting services are distinct.

The consulting services are performed by a third party, ConsultCo. ConsultCo determines the pricing of the consulting services and coordinates directly with the customer to determine the timing and scope of work. SoftwareCo occasionally assists customers in resolving complaints about the consulting services; however, ConsultCo is responsible for meeting customer specifications, including providing any refunds or reperforming work, as needed.

The customer pays SoftwareCo a monthly service fee for the payroll processing services. SoftwareCo also collects the fee for the consulting services, retains 10% of the fee paid, and remits the remaining amount to ConsultCo. Any losses resulting from overruns in the consulting services are fully absorbed by ConsultCo.

Is SoftwareCo the principal or agent for the payroll processing services and consulting services?

Analysis

There are two specified services in the arrangement: payroll processing services and consulting services. SoftwareCo must assess whether it is the principal or agent separately for each specified service. SoftwareCo concludes it is the principal for the payroll processing services and is an agent for the consulting services.

SoftwareCo controls the payroll processing services before the services are transferred to the customer because it performs the services itself and no other party is involved in providing those services to the customer.

SoftwareCo does not control the consulting services before the services are transferred to the customer because it is not directing ConsultCo to perform on its behalf. SoftwareCo is not primarily responsible for fulfillment because SoftwareCo is not responsible for providing the services or meeting customer specifications. SoftwareCo also does not have inventory risk or discretion in establishing prices for the

consulting services. The indicators therefore support that SoftwareCo is not the principal for the consulting services.

10.2.4 Estimating gross revenue as a principal

As discussed in RR 10.2.1, an entity that is a principal will typically recognize as revenue the amount paid by the customer for the specified good or service. If the arrangement includes an intermediary (an agent) that has pricing discretion, there could be instances when the principal is not aware of the price charged to the customer. For example, an entity and a sales agent may agree that the agent will pay the entity a fixed amount per good or service sold regardless of the price charged by the agent to the customer. In this situation, judgment may be required to determine the principal's transaction price.

ASC 606 does not include specific guidance to address this situation. However, the FASB noted in its basis for conclusions (BC38 of ASU 2016-08) that if the price charged by an intermediary to the customer is unknown, and not expected to be resolved, the unknown amount does not meet the definition of variable consideration and should not be included in the transaction price. Thus, the entity should not estimate the price charged to the customer by the intermediary and should instead recognize revenue for only the amount paid by the intermediary for the good or service.

IFRS 15 also does not include specific guidance on this topic. In its basis for conclusions (BC385Z), the IASB noted that the entity that is a principal should apply judgment and determine the transaction price based on the relevant facts and circumstances. It is therefore possible that under IFRS a different amount of revenue could be recognized compared with the amount recognized under US GAAP.

10.3 Shipping and handling fees

Entities that sell products often deliver them via third-party shipping service providers. Entities sometimes charge customers a separate fee for shipping and handling costs, or shipping and handling might be included in the price of the product. Separate fees may be a direct reimbursement of costs paid to the third-party, or they could include a profit element.

Management needs to consider whether the entity is the principal for the shipping service or is an agent arranging for the shipping service to be provided to the customer when control of the goods transfers at shipping point. Management could conclude that the entity is the principal for both the sale of the goods and the shipping service, or that it is the principal for the sale of the goods, but an agent for the service of shipping those goods.

Question 10-1 addresses the principal versus agent considerations when a US GAAP reporter elects to account for shipping and handling activities as a fulfillment cost.

Question 10-1

Does a US GAAP reporter need to assess whether it is the principal or agent for shipping and handling if it elects to account for shipping and handling activities as a fulfillment cost?

PwC response

No. We believe a US GAAP reporter that elects to account for shipping and handling activities as a fulfillment cost does not need to separately assess whether it is the principal or agent for those

activities. Entities applying the election will include any fee received for shipping and handling as part of the transaction price and recognize revenue when control of the good transfers. Refer to RR 3.6.4 for further discussion of this policy election.

Example 10-5 illustrates an assessment of whether an entity is the principal for shipping and handling activities.

EXAMPLE 10-5

Principal versus agent – shipping and handling

ToyCo operates retail stores and a website where customers can purchase toys. Customers that make online purchases can choose to pick their order up at the retail store for no additional cost or have the order delivered to their home for a fee. Toys can be delivered via standard delivery or overnight delivery with a specified delivery company. The customer is charged for the cost of the delivery (as established by the delivery company) and given a tracking number so it can track the status of the delivery and contact the delivery company with any questions or concerns.

Control of the toys transfers to the customer when the order leaves the warehouse. ToyCo has not elected to account for shipping and handling activities as a fulfillment cost under US GAAP. ToyCo concludes that shipping the toys is a promise in the contract and a distinct service.

Should ToyCo recognize the shipping fees it charges to its customers gross (as revenue and expense) or net of the amount paid to the shipping provider?

Analysis

ToyCo should recognize revenue for the shipping fees net of the amount paid to the shipping provider. ToyCo is an agent for the delivery company as it is merely arranging the shipping services on behalf of its customer and does not control the shipping service.

ToyCo is not responsible for shipping the toys and has no inventory risk or discretion in establishing prices for the shipping service. The indicators therefore support that ToyCo is not the principal for the shipping services.

10.4 Out-of-pocket expenses and other cost reimbursements

Expenses are often incurred by service providers while performing work for their customers. These can include costs for travel, meals, accommodations, and miscellaneous supplies. It is common in service arrangements for the parties to agree that the customer will reimburse the service provider for some or all of the out-of-pocket expenses. Alternatively, such expenses may be incorporated into the price of the service instead of being charged separately.

Out-of-pocket expenses often relate to activities that do not transfer a good or service to the customer. For example, a service provider that is entitled to reimbursement for employee travel costs would generally account for the travel costs as costs to fulfill the contract with the customer. Reimbursements would be included in the transaction price for the contract.

Management should consider the principal versus agent guidance if a customer reimburses the vendor for a good or service transferred to the customer as part of a contract (for example, reimbursement of subcontractor services). Management should first identify the specified good or service to be provided to the customer. This includes assessing whether the goods or services are inputs into a combined output that the entity transfers to the customer.

For example, a service provider may subcontract a portion of the service it provides to customers and agree with the customer to be reimbursed for the subcontracted services (sometimes referred to as a "pass-through" cost). The service provider would be an agent with regard to the subcontracted services if it does not control the subcontracted services before they are transferred to the customer. In this case, the service provider would recognize revenue from the reimbursement net of the amount it pays to the subcontractor. The service provider would be the principal if it controls the subcontracted services by directing the subcontractor to perform on its behalf or combining the subcontracted services with its own services to create a combined output. If the service provider is the principal, the reimbursement would be included in the transaction price and allocated to the separate performance obligations in the contract.

10.5 Amounts from customers remitted to a third party

Entities often collect amounts from customers that must be remitted to a third party (for example, collecting and remitting taxes to a governmental agency). Taxes collected from customers could include sales, use, value-added, and some excise taxes. Amounts collected on behalf of third parties, such as certain sales taxes, are not included in the transaction price as they are collected from the customer on behalf of the government. The entity is the agent for the government in these situations.

Taxes that are based on production, rather than sales, are typically imposed on the seller, not the customer. An entity that is obligated to pay taxes based on its production is the principal for those taxes, and therefore recognizes the tax as an operating expense, with no effect on revenue.

Management needs to assess each type of tax, on a jurisdiction-by-jurisdiction basis, to conclude whether to net these amounts against revenue or to recognize them as an operating expense. The intent of the tax, as written into the tax legislation in the particular jurisdiction, should also be considered.

The name of the tax (for example, sales tax or excise tax) is not always determinative when assessing whether the entity is the principal or the agent for the tax. Whether or not the customer knows the amount of tax also does not necessarily impact the analysis. Management needs to look to the underlying characteristics of the tax and the tax laws in the relevant jurisdiction to determine whether the entity is primarily obligated to pay the tax or whether the tax is levied on the customer. This could be a significant undertaking for some entities, particularly those that operate in numerous jurisdictions with different tax regimes.

Indicators that taxes are the responsibility of the entity and therefore should be recorded as an expense (as opposed to a reduction of transaction price) include but are not limited to:

- The triggering event to pay the tax is the production or the importation of goods. Conversely, when the triggering event is the sale to a customer, this might indicate that the entity is collecting the tax on behalf of a governmental entity.

- The tax is based on the number of units or on the physical quantity (for example, number of cigarettes or volume of alcoholic content) produced by the entity rather than the selling price to customers.
- The tax is due on accumulated earnings during a period of time as opposed to each individual sale transaction.
- The entity cannot claim a refund of the tax in the event the related inventory is not sold or the customer fails to pay for the goods or services being sold.
- The entity has no legal or constructive obligation to change prices in order to reflect taxes. Conversely, when the tax is clearly separate from the selling price and a change in the tax would result in an equivalent change in the amount passed through to the customer, this might indicate that the entity is collecting the tax on behalf of the government.

The above indicators should be considered along with the intended purpose of the tax, as written into the tax legislation in the particular jurisdiction. The existence (or nonexistence) of one of the above indicators may not be determinative on its own.

Example 10-6 and Example 10-7 illustrate the assessment of whether a tax should be presented as an expense or a reduction of transaction price.

EXAMPLE 10-6

Presentation of taxes – entity is principal for the tax

SpiritsCo is a global producer and distributor of branded alcoholic spirits. SpiritsCo pays an excise duty based on the value as well as the volume of products that leave a bonded warehouse. The movement of products from the bonded warehouse for customs clearance is the triggering event of the obligation to pay excise duty. In case a customer fails to make payment or if products are not sold, SpiritsCo cannot claim a refund of the excise duty it has paid.

SpiritsCo has no legal or constructive obligation to reflect any change of the rate of excise duty in the selling price of products. An increase in the rate of excise duty can lead SpiritsCo to increase its selling price, but such increases are a commercial decision and would not be automatic. The tax is not separately presented on the invoice.

How should SpiritsCo account for the excise duty?

Analysis

SpiritsCo is the principal for the excise duty as the triggering event is the movement of products (as opposed to sales to customers), SpiritsCo makes a decision whether to adjust the selling price of products to pass the tax on to the customer, and SpiritsCo cannot claim a refund in case of a customer's failure to pay. SpiritsCo should therefore recognize the excise duty as an expense as opposed to a reduction of transaction price.

EXAMPLE 10-7**Presentation of taxes – tax is collected on behalf of a governmental entity**

Manufacturer sells widgets to customers in various jurisdictions. In a particular jurisdiction, Manufacturer pays a sales tax calculated based on the number of widgets sold. The triggering event of the obligation is each individual sale to a customer. The tax is separately identified on the invoice to the customer and any increase in the tax rate would result in an equivalent increase of the tax charged to the customer. Manufacturer receives a refund of the tax if the receivables are not collected.

How should Manufacturer account for the excise duty?

Analysis

Manufacturer is likely collecting the sales tax as an agent on behalf of a governmental agency. The triggering event is sales to customers, the tax is separately charged to customers, and Manufacturer receives a refund if the receivables are not collected. Manufacturer should therefore exclude the sales tax collected from customers from the transaction price, and no expense would be recognized for the tax. The collection and payment of the tax would only impact balance sheet accounts.

10.5.1 Presentation of taxes collected from customers (US GAAP)

In accordance with ASC 606-10-32-2A, US GAAP reporters may present, as an accounting policy election, amounts collected from customers for sales and other taxes net of the related amounts remitted. If presented on a net basis, such amounts would be excluded from the determination of the transaction price in the revenue standard. An entity that makes this election should comply with the general requirements for disclosures of accounting policies. Entities that do not make this election should evaluate each type of tax as described in RR 10.5.

Excerpt from ASC 606-10-32-2A

An entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process shall be excluded from the scope of the election. An entity that makes this election shall exclude from the transaction price all taxes in the scope of the election and shall comply with the applicable accounting policy guidance, including the disclosure requirements.

Chapter 11:

Contract costs

11.1 Chapter overview

Entities sometimes incur costs to obtain a contract that otherwise would not have been incurred. Entities also may incur costs to fulfill a contract before a good or service is provided to a customer. The revenue standard provides guidance on costs to obtain and fulfill a contract that should be recognized as assets. Costs that are recognized as assets are amortized over the period that the related goods or services transfer to the customer, and are periodically reviewed for impairment.

Question 11-1 addresses whether an entity can apply the portfolio approach to account for contract costs.

Question 11-1

Can an entity apply the portfolio approach to account for contract costs?

PwC response

Yes. Management may apply the portfolio approach to account for costs related to contracts with similar characteristics, similar to other aspects of the revenue standard. We believe the portfolio approach is permitted under both IFRS and US GAAP even though, for US GAAP reporters, the portfolio approach guidance is contained in ASC 606 and the contract cost guidance is contained in ASC 340-40. The portfolio approach is permitted if the entity reasonably expects that the effect of applying the guidance to the portfolio would not differ materially from applying the guidance to each contract or performance obligation individually.

11.2 Incremental costs of obtaining a contract

Entities sometimes incur costs to obtain a contract with a customer, such as selling and marketing costs, bid and proposal costs, sales commissions, and legal fees. Costs to obtain a customer do not include payments to customers; refer to RR 4.6 for discussion of payments to customers.

Excerpt from ASC 340-40-25-1 and IFRS 15.91

An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

Only incremental costs should be recognized as assets. Incremental costs of obtaining a contract are those costs that the entity would not have incurred if the contract had not been obtained (for example, sales commissions). Bid, proposal, and selling and marketing costs (including advertising costs), as well as legal costs incurred in connection with the pursuit of the contract, are not incremental, as the entity would have incurred those costs even if it did not obtain the contract. Fixed salaries of employees are also not incremental because those salaries are paid regardless of whether a sale is made.

An entity could make payments to multiple individuals for the same contract that all qualify as incremental costs. For example, if an entity pays a sales commission to the salesperson, manager, and regional manager upon obtaining a new contract, all of the payments would be incremental costs.

The timing of a payment does not on its own determine whether the costs are incremental; however, management should consider whether the payment is contingent upon factors other than obtaining a contract. For example, a bonus payment that is calculated based on obtaining contracts is similar to a commission, but if the bonus is also based on the individual's overall performance in relation to non-sales-related goals, it is likely not an incremental cost. Similarly, a payment that is contingent upon an employee providing future service in addition to obtaining a new contract would generally not be considered an incremental cost to obtain a contract. Assessing whether a payment has a substantive future service requirement may require judgment. Refer to US Revenue TRG Memo No. 57 and the related meeting minutes in Revenue TRG Memo No. 60 for further discussion of costs that are incremental.

Costs of obtaining a contract that are not incremental should be expensed as incurred unless those costs are explicitly chargeable to the customer, even if the contract is not obtained. Amounts that relate to a contract that are explicitly chargeable to a customer are a receivable if an entity's right to reimbursement is unconditional.

Incremental costs of obtaining a contract with a customer are recognized as assets if they are recoverable. Expensing these costs as they are incurred is not permitted unless they qualify for the practical expedient discussed at RR 11.2.2.

The revenue standard does not address the timing for recognizing a liability for costs to obtain a contract. Management should therefore refer to the applicable liability guidance (for example, ASC 405, *Liabilities*, or IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*) to first determine if the entity has incurred a liability and then apply the revenue standard to determine whether the related costs should be capitalized or expensed. Refer to Revenue TRG Memo No. 23 and the related meeting minutes in Revenue TRG Memo No. 25 for further discussion of this topic.

In some cases, incremental costs may relate to multiple contracts. For example, many sales commission plans are designed to pay commissions based on cumulative thresholds. The fact that the costs relate to multiple contracts does not preclude the costs from qualifying as incremental costs to obtain a contract. Management should apply judgment to determine a reasonable approach to allocate costs to the related contracts in these instances. Refer to Revenue TRG Memo No. 23, US Revenue TRG Memo No. 57, and the related meeting minutes in Revenue TRG Memo No. 25 and Revenue TRG Memo 60, respectively, for further discussion of this topic.

Question 11-2 addresses whether fringe benefits represent incremental costs to obtain a contract.

Question 11-2

Do fringe benefits (for example, payroll taxes) related to commission payments represent incremental costs to obtain a contract?

PwC response

Yes, if the fringe benefits would not have been incurred if the contract had not been obtained. Fringe benefits that are incremental costs and recoverable (refer to RR 11.2.1) are required to be capitalized, unless they qualify for the practical expedient discussed at RR 11.2.2. Refer to Revenue TRG Memo No. 23 and the related meeting minutes in Revenue TRG Memo No. 25 for further discussion of this topic.

Question 11-3 addresses the accounting for incremental costs to obtain contract renewals or modifications.

Question 11-3

Should incremental costs to obtain contract renewals or modifications be capitalized?

PwC response

Yes, if the costs to obtain contract renewals or modification are incremental and recoverable. An example is a commission paid to a sales agent when a customer renews a contract. Management should not, however, record an asset in anticipation of contract renewals or modifications if the entity has not yet incurred a liability related to the costs. Refer to Revenue TRG Memo No. 23 and the related meeting minutes in Revenue TRG Memo No. 25 for further discussion of this topic.

Question 11-4 addresses whether a sales commission should be capitalized if it is subject to clawback.

Question 11-4

Should a sales commission be capitalized if it is subject to clawback in the event the customer fails to pay the contract consideration?

PwC response

Yes, assuming management has concluded that the parties are committed to perform their respective obligations and collection is probable, which are requirements for identifying a contract (refer to RR 2.6.1). Management should reassess whether a valid contract exists if circumstances change after contract inception and assess the contract asset for impairment. Refer to Revenue TRG Memo No. 23 and the related meeting minutes in Revenue TRG Memo No. 25 for further discussion of this topic.

11.2.1 Assessing recoverability

Management should assess recoverability of the incremental costs of obtaining a contract either on a contract-by-contract basis, or for a group of contracts if those costs are associated with the group of contracts. Management may be able to support the recoverability of costs for a particular contract based on its experience with other transactions if those transactions are similar in nature.

Management should consider, as part of its recoverability assessment, estimates of expected consideration from potential renewals and extensions. This should include both consideration received but not yet recognized as revenue and consideration the entity is expected to receive in the future. Variable consideration that is constrained for revenue recognition purposes should also be included in assessing recoverability. Costs that are not expected to be recoverable should be expensed as incurred. See RR 11.4.2 for additional discussion of impairment.

11.2.2 Practical expedient

There is a practical expedient that permits an entity to expense the costs to obtain a contract as incurred when the expected amortization period is one year or less. Anticipated contract renewals, amendments, and follow-on contracts with the same customer are required to be considered (to the

extent the costs relate to those goods or services) when determining whether the period of benefit, and therefore the period of amortization, is one year or less. These factors might result in an amortization period that is beyond one year, in which case the practical expedient is not available.

Question 11-5 addresses whether the practical expedient can be applied to an individual contract.

Question 11-5

Can an entity elect whether to apply the practical expedient to each individual contract or is it required to apply the election consistently to all similar contracts?

PwC response

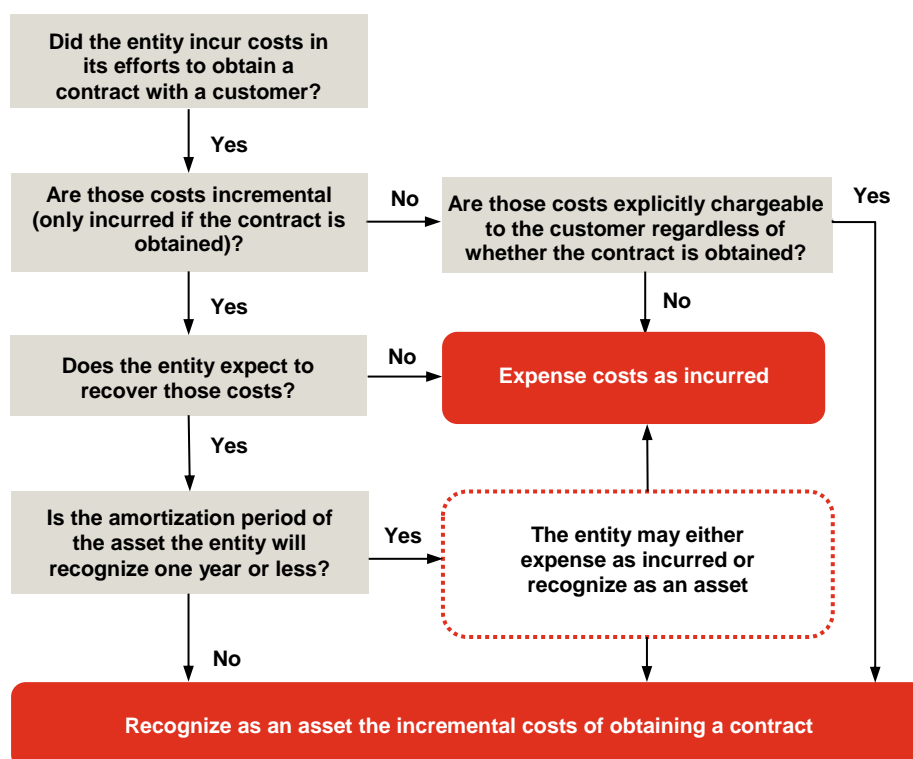
The practical expedient is an accounting policy election that should be applied consistently to similar contracts.

11.2.3 Recognition model overview and examples

Figure 11-1 summarizes the accounting for incremental costs to obtain a contract.

Figure 11-1

Costs to obtain a contract overview



Example 11-1, Example 11-2, Example 11-3, Example 11-4, and Example 11-5 illustrate the accounting for incremental costs to obtain a contract. These concepts are also illustrated in Examples 36 and 37 of the revenue standard (ASC 606-10-55-281 through ASC 606-10-55-282 and IFRS 15.IE191 through IFRS 15.IE196).

EXAMPLE 11-1

Incremental costs of obtaining a contract — practical expedient

A salesperson for ProductCo earns a 5% commission on a contract that was signed in January. ProductCo will deliver the purchased products throughout the year. The contract is not expected to be renewed the following year. ProductCo expects to recover this cost.

How should ProductCo account for the commission?

Analysis

ProductCo can either recognize the commission payment as an asset or expense the cost as incurred under the practical expedient. The commission is a cost to obtain a contract that would not have been incurred had the contract not been obtained. Since ProductCo expects to recover this cost, it can recognize the cost as an asset and amortize it as revenue is recognized during the year. The commission payment can also be expensed as incurred because the amortization period of the asset is one year or less.

The practical expedient would not be available; however, if management expects the contract to be renewed such that products will be delivered over a period longer than one year, as the amortization period of the asset would also be longer than one year.

EXAMPLE 11-2

Incremental costs of obtaining a contract — construction industry

ConstructionCo incurs costs in connection with winning a successful bid on a contract to build a bridge. The costs were incurred during the proposal and contract negotiations, and include the initial bridge design.

How should ConstructionCo account for the costs?

Analysis

ConstructionCo should expense the costs incurred during the proposal and contract negotiations as incurred. The costs are not incremental because they would have been incurred even if the contract was not obtained. The costs incurred during contract negotiations could be recognized as an asset if they are explicitly chargeable to the customer regardless of whether the contract is obtained.

Even though the costs incurred for the initial design of the bridge are not incremental costs to obtain a contract, some of the costs might be costs to fulfill a contract and recognized as an asset under that guidance (refer to RR 11.3).

EXAMPLE 11-3**Incremental costs of obtaining a contract — telecommunications industry**

Telecom sells wireless mobile phone and other telecom service plans from a retail store. Sales agents employed at the store signed 120 customers to two-year service contracts in a particular month. Telecom pays its sales agents commissions for the sale of service contracts in addition to their salaries. Salaries paid to sales agents during the month were \$12,000, and commissions paid were \$2,400. The retail store also incurred \$2,000 in advertising costs during the month.

How should Telecom account for the costs?

Analysis

The only costs that qualify as incremental costs of obtaining a contract are the commissions paid to the sales agents. The commissions are costs to obtain a contract that Telecom would not have incurred if it had not obtained the contracts. Telecom should record an asset for the costs, assuming they are recoverable.

All other costs are expensed as incurred. The sales agents' salaries and the advertising expenses are expenses Telecom would have incurred whether or not it obtained the customer contracts.

EXAMPLE 11-4**Incremental costs of obtaining a contract — bonus based on a revenue target**

TechCo's vice president of sales receives a quarterly bonus based on meeting a specified revenue target that is established at the beginning of each quarter. TechCo's revenue includes revenue from both new contracts initiated during the quarter and contracts entered into in prior quarters.

Is the bonus an incremental cost to obtain a contract?

Analysis

No. The revenue target is impacted by more than obtaining new contracts. As such, the payment would not be an incremental cost to obtain the contract.

If the revenue target was based on obtaining new contracts, the substance of the payment would be the same as a sales commission. If this were the case, the bonus might be an incremental cost.

EXAMPLE 11-5**Incremental costs of obtaining a contract — payment requires future service**

Employee A, an internal salesperson employed by ProductCo, earns a 5% commission on a new contract obtained in January 20x1. The commission plan requires Employee A to continue providing employee service through the end of 20x2 to receive the commission payment.

Is the payment an incremental cost to obtain a contract?

Analysis

No. Employee A has to provide future service to receive the payment; therefore, the payment is contingent upon factors other than obtaining new contracts. ProductCo would recognize the expense over the service period based on the relevant standard (ASC 710, *Compensation*, and IAS 19, *Employee Benefits*).

11.3 Costs to fulfill a contract

Entities often incur costs to fulfill their obligations under a contract once it is obtained, but before transferring goods or services to the customer. Some costs could also be incurred in anticipation of winning a contract. The guidance in the revenue standard for costs to fulfill a contract only applies to those costs not addressed by other standards. For example, inventory costs would be covered under ASC 330, *Inventory*. Costs that are required to be expensed in accordance with other standards cannot be recognized as an asset under the revenue standard. Fulfillment costs not addressed by other standards qualify for capitalization if the following criteria are met.

Excerpt from ASC 340-40-25-5 and IFRS 15.95

- a. The costs relate directly to a contract or an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under the renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).
- b. The costs generate or enhance resources of the entity that will be used in satisfying (or continuing to satisfy) performance obligations in the future.
- c. The costs are expected to be recovered.

Fulfillment costs that meet all three of the above criteria are required to be recognized as an asset; expensing the costs as they are incurred is not permitted.

Costs that relate directly to a contract include the following.

Excerpt from ASC 340-40-25-7 and IFRS 15.97

- a. Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer)
- b. Direct materials (for example, supplies used in providing the promised services to a customer)
- c. Allocation of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract)

- d. Costs that are explicitly chargeable to the customer under the contract [and [IFRS]]
- e. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

Judgment is needed to determine the costs that should be recognized as assets in some situations. Some of the costs listed above (for example, direct labor and materials) are straightforward and easy to identify. However, determining costs that should be allocated to a contract could be more challenging.

Certain costs might relate directly to a contract, but neither generate nor enhance resources of an entity, nor relate to the satisfaction of future performance obligations.

Excerpt from ASC 340-40-25-8 and IFRS 15.98

An entity shall recognize the following costs as expenses when incurred:

- a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract...)
- b. Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract
- c. Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)
- d. Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

It can be difficult in some situations to determine whether incurred costs relate to satisfied performance obligations or to obligations still remaining. Costs that relate to satisfied or partially satisfied performance obligations are expensed as incurred. This is the case even if the related revenue has not been recognized (for example, because it is variable consideration that has been constrained). Costs cannot be deferred solely to match costs with revenue, nor can they be deferred to normalize profit margins. An entity should expense all incurred costs if it is unable to distinguish between those that relate to past performance and those that relate to future performance.

Costs to fulfill a contract are only recognized as an asset if they are recoverable, similar to costs to obtain a contract. Refer to RR 11.2.1 for further discussion of assessing recoverability.

Question 11-6 addresses whether costs to fulfill a contract can be deferred to achieve a consistent profit margin.

Question 11-6

Contractor utilizes an output method (engineering surveys) to measure progress of construction services for which control transfers over time. In the first reporting period, Contractor determines that 35% of the contract has been completed based on the engineering survey and accordingly, recognizes revenue equal to 35% of the estimated transaction price. In the same period, Contractor incurs 45% of the estimated total costs to fulfill the contract. Can Contractor defer a portion of the costs incurred to achieve a consistent profit margin throughout the contract?

PwC response

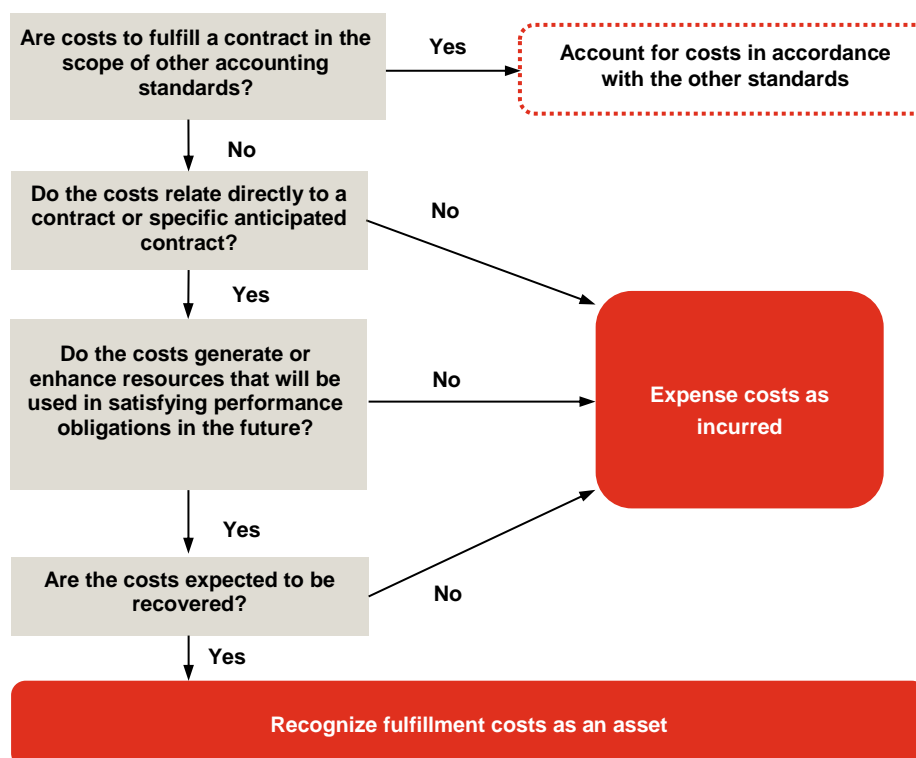
No. Costs cannot be deferred solely to match costs with revenue or to achieve a consistent profit margin throughout the contract. Only costs to fulfill the contract that are capitalizable under other standards or meet the criteria for capitalization in the revenue standard (refer to RR 11.3.1) should be capitalized. The use of an output method to measure progress can result in different period to period profit margins unlike an input method based on costs incurred; however, the total profit margin on the contract will be the same under either method. The IFRIC discussed a similar example in its IFRIC Agenda Decision, *Costs to fulfil a contract*, issued in June 2019.

11.3.1 Recognition model overview

Figure 11-2 summarizes accounting for costs to fulfill a contract.

Figure 11-2

Recognition model overview



11.3.2 *Learning curve costs*

Learning curve costs are costs an entity incurs to provide a service or produce an item in early periods before it has gained experience with the process. Over time, the entity typically becomes more efficient at performing a task or manufacturing a good when done repeatedly and no longer incurs learning curve costs for that task or good. Such costs usually consist of labor, overhead, rework, or other special costs that must be incurred to complete the contract other than research and development costs.

Judgment is required to determine the accounting for learning curve costs. Learning curve costs incurred for a single performance obligation that is satisfied over time are recognized in cost of sales, but they may need to be considered in the measurement of progress toward satisfying a performance obligation, depending on the nature of the cost. For example, an entity applying a cost-to-cost measure of progress might recognize more revenue in earlier periods due to the higher costs incurred earlier in the contract.

Learning curve costs incurred for a performance obligation satisfied at a point in time should be assessed to determine if they are addressed by other standards (such as inventory). Learning curve costs not addressed by other standards are unlikely to meet the criteria for capitalization under the revenue standard, as such costs generally do not relate to future performance obligations. For example, an entity may promise to transfer multiple units under a contract in which each unit is a separate performance obligation satisfied at a point in time. The costs to produce each unit would be accounted for under inventory guidance and recognized in cost of sales when control of the inventory transfers. As a result, the margin on each individual unit could differ if the costs to produce units earlier in the contract are greater than the costs to produce units later in the contract.

11.3.3 *Set-up and mobilization costs*

Set-up and mobilization costs are direct costs typically incurred at a contract's inception to enable an entity to fulfill its obligations under the contract. For example, outsourcing entities often incur costs relating to the design, migration, and testing of data centers when preparing to provide service under a new contract. Set-up costs may include labor, overhead, or other specific costs. Some of these costs might be addressed under other standards, such as property, plant, and equipment. Management should first assess whether costs are addressed by other standards and if so, apply that guidance.

Mobilization costs are a type of set-up cost incurred to move equipment or resources to prepare to provide the goods or services in an arrangement. Costs incurred to move newly acquired equipment to its intended location could meet the definition of the cost of an asset under property, plant, and equipment guidance. Costs incurred subsequently to move equipment for a future contract that meet the criteria in RR 11.3 are costs to fulfill a contract and therefore assessed to determine if they qualify to be recognized as an asset.

Certain pre-production costs related to long-term supply arrangements are addressed by specific guidance in US GAAP (i.e., ASC 340-10, *Other Assets and Deferred Costs—Overall*). As such, costs in the scope of ASC 340-10 should be assessed under that guidance to determine whether they should be capitalized or expensed. Management may need to apply judgment in assessing the guidance that applies to pre-production costs (for example, ASC 340-10, ASC 340-40, *Other Assets and Deferred Costs—Contracts With Customers*, ASC 730, *Research and Development*). Refer to PPE 1.5.2 for a discussion of ASC 340-10 and RR 3.6.1 for further discussion of pre-production activities.

Example 11-6 illustrates the accounting for set-up costs. This concept is also illustrated in Example 37 of the revenue standard (ASC 340-40-55-5 through ASC 340-40-55-9 and IFRS 15.IE192 through IFRS 15.IE196).

EXAMPLE 11-6

Set-up costs — technology industry

TechCo enters into a contract with a customer to track and monitor payment activities for a five-year period. A prepayment is required from the customer at contract inception. TechCo incurs costs at the outset of the contract consisting of uploading data and payment information from existing systems. The ongoing tracking and monitoring is automated after customer set up. There are no refund rights in the contract.

How should TechCo account for the set-up costs?

Analysis

TechCo should recognize the set-up costs incurred at the outset of the contract as an asset since they (1) relate directly to the contract, (2) enhance the resources of the company to perform under the contract, and relate to future performance, and (3) are expected to be recovered.

An asset would be recognized and amortized on a systematic basis consistent with the pattern of transfer of the tracking and monitoring services to the customer. The prepayment from the customer should be included in the transaction price and allocated to the performance obligations in the contract (that is, the tracking and monitoring services).

11.3.4 Abnormal costs

Abnormal costs are fulfillment costs that are incurred from excessive resources, wasted or spoiled materials, and unproductive labor costs (that is, costs not otherwise anticipated in the contract price). Such costs may arise due to delays, changes in project scope, or other factors. They differ from learning curve costs, which are typically reflected in the price of the contract. Abnormal costs should be expensed as incurred, as illustrated in Example 11-7.

EXAMPLE 11-7

Costs to fulfill a contract — construction industry

Construction Co enters into a contract with a customer to build an office building. Construction Co incurs directly related mobilization costs to bring heavy equipment to the location of the site. During the build phase of the contract, Construction Co incurs direct costs related to supplies, equipment, material, and labor. Construction Co also incurs some abnormal costs related to wasted materials that were purchased in connection with the contract. Construction Co expects to recover all incurred costs under the contract.

How should Construction Co account for the costs?

Analysis

Construction Co should recognize an asset for the mobilization costs as these costs (1) relate directly to the contract, (2) enhance the resources of the entity to perform under the contract and relate to satisfying a future performance obligation, and (3) are expected to be recovered.

The direct costs incurred during the build phase are accounted for in accordance with other standards if those costs are in the scope of those standards. Certain supplies and materials, for example, might be capitalized in accordance with inventory guidance. The equipment might be capitalized in accordance with property, plant, and equipment guidance. Any other direct costs associated with the contract that relate to satisfying performance obligations in the future and are expected to be recovered are recognized as an asset.

Construction Co should expense the abnormal costs as incurred.

11.4 Amortization and impairment

The revenue standard provides guidance on the subsequent accounting for contract cost assets, including amortization and periodic assessment of the asset for impairment.

11.4.1 Amortization of contract cost assets

The asset recognized from capitalizing the costs to obtain or fulfill a contract is amortized on a systematic basis consistent with the pattern of the transfer of the goods or services to which the asset relates. Judgment may be required to determine the goods or services to which the asset relates. Capitalized costs might relate to an entire contract, or could relate only to specific performance obligations within a contract.

Capitalized costs could also relate to anticipated contracts, such as renewals. An asset recognized for contract costs should be amortized over a period longer than the initial contract term if management anticipates a customer will renew a contract and the costs also relate to goods or services that are expected to be transferred during renewal periods. An appropriate amortization period could be the average customer life or a shorter period, depending on the facts and circumstances. For example, a period shorter than the average customer life may be appropriate if the average customer life is longer than the life cycle of the related goods or services. Judgment will be required to determine the appropriate amortization period, similar to other tangible and intangible assets.

The amortization period should not include anticipated renewals if the entity also incurs a similar cost for renewals. In that situation, the costs incurred to obtain the initial contract do not relate to the subsequent contract renewal. Assessing whether costs incurred for contract renewals are “commensurate with” costs incurred for the initial contract could require judgment. For example, entities often pay a higher sales commission for initial contracts as compared to renewal contracts. The assessment of whether the renewal commission is commensurate with the initial commission should not be based on the level of effort required to obtain the initial and renewal contracts. Instead, it should generally be based on whether the initial and renewal commissions are reasonably proportional to the respective contract values. Refer to US Revenue TRG Memo No. [57](#) and the related meeting minutes in Revenue TRG Memo No. [60](#) for further discussion of this topic.

Management should apply an amortization method that is consistent with the pattern of transfer of goods or services to the customer. An asset related to an obligation satisfied over time should be amortized using a method consistent with the method used to measure progress and recognize revenue (that is, an input or output method). Straight-line amortization may be appropriate if goods or services are transferred to the customer ratably throughout the contract, but not if the goods or services do not transfer ratably.

An entity should update the amortization of a contract asset if there is a significant change in the expected pattern of transfer of the goods or services to which the asset relates. Such a change is accounted for as a change in accounting estimate.

Question 11-7 addresses how entities should classify the amortization of capitalized costs.

Question 11-7

How should entities classify the amortization of capitalized costs to obtain a contract?

PwC response

Whether costs are capitalized or expensed generally does not impact classification. For example, if similar types of costs are presented as sales and marketing costs, then the amortization of the capitalized asset would also typically be presented as sales and marketing.

Example 11-8, Example 11-9, Example 11-10, Example 11-11, and Example 11-12 illustrate the amortization of contract cost assets.

EXAMPLE 11-8

Amortization of contract cost assets — renewal periods without additional commission

Telecom sells prepaid wireless services to a customer. The customer purchases up to 1,000 minutes of voice services and any unused minutes expire at the end of the month. The customer can purchase an additional 1,000 minutes of voice services at the end of the month or once all the voice minutes are used. Telecom pays commissions to sales agents for initial sales of prepaid wireless services, but does not pay a commission for subsequent renewals. Telecom concludes the commission payment is an incremental cost of obtaining the contract and recognizes an asset.

The contract is a one-month contract and Telecom expects the customer, based on the customer's demographics (for example, geography, type of plan, and age), to renew for 16 additional months.

What period should Telecom use to amortize the commission costs?

Analysis

Telecom should amortize the costs to obtain the contract over 17 months in this example (the initial contract term and expected renewal periods). Management needs to use judgment to determine the period that the entity expects to provide services to the customer, including expected renewals, and amortize the asset over that period. In this fact pattern, Telecom cannot expense the commission payment under the practical expedient because the amortization period is greater than one year.

EXAMPLE 11-9**Amortization of contract cost assets — renewal periods with separate commission**

Telecom sells prepaid wireless services to a customer. The customer purchases up to 1,000 minutes of voice services and any unused minutes expire at the end of the month. The customer can purchase an additional 1,000 minutes of voice services at the end of the month or once all the voice minutes are used. Telecom pays commissions to sales agents for initial sales of prepaid wireless services and renewals. Telecom concludes the commission payment is an incremental cost of obtaining the contract and recognizes an asset.

What period should Telecom use to amortize the commission costs?

Analysis

Telecom should assess whether the commission paid on the initial contract relates only to the goods or services provided under the initial contract or to both the initial and renewal periods. If Telecom concludes the renewal commission is commensurate with the commission paid on the initial contract, this would indicate that the initial commission relates only to the initial contract and should be amortized over the initial contract period (unless Telecom elects to apply the practical expedient). The renewal commission would be amortized over the related renewal period.

EXAMPLE 11-10**Amortization of contract cost assets —amortization method**

ConstructionCo enters into a construction contract to build an oil refinery. ConstructionCo concludes that its performance creates an asset that the customer controls and that control is transferred over time. ConstructionCo also concludes that “cost-to-cost” is a reasonable method for measuring its progress toward satisfying its performance obligation.

ConstructionCo pays commissions totaling \$100,000 to its sales agent for securing the oil refinery contract. ConstructionCo concludes that the commission is an incremental cost of obtaining the contract and recognizes an asset. As of the end of the first year, ConstructionCo estimates its performance is 50% complete and recognizes 50% of the transaction price as revenue.

How much of the contract asset should be amortized as of the end of the first year?

Analysis

The pattern of amortization should be consistent with the method ConstructionCo uses to measure progress toward satisfying its performance obligation for recognizing revenue. ConstructionCo should amortize 50%, or \$50,000, of the commission costs as of the end of the first year.

EXAMPLE 11-11**Amortization of contract cost assets — multiple performance obligations**

EquipCo enters into a contract with a customer to sell a piece of industrial equipment for \$75,000 and provide two years of maintenance services for the equipment for \$25,000. EquipCo concludes that the promises to transfer equipment and perform maintenance are distinct and, therefore, represent

separate performance obligations. The contract price represents standalone selling price of the equipment and services.

EquipCo recognizes revenue for the sale of equipment when control of the asset transfers to the customer upon delivery. Revenue from the maintenance services is recognized ratably over two years consistent with the period during which the customer receives and consumes the maintenance services.

EquipCo pays a single commission of \$10,000 to its sales agent equal to 10% of the total contract price of \$100,000. EquipCo concludes that the commission is an incremental cost of obtaining the contract and recognizes an asset. Assume EquipCo does not expect the customer to renew the maintenance services.

What pattern of amortization should EquipCo use for the capitalized costs?

Analysis

EquipCo should use a reasonable method to amortize the asset consistent with the transfer of the goods or services. One acceptable approach would be to allocate the contract asset to each performance obligation based on relative standalone selling prices, similar to the allocation of transaction price. Applying this approach, EquipCo would allocate \$7,500 of the total commission to the equipment and the remaining \$2,500 to the maintenance services. The commission allocated to the equipment would be expensed upon transfer of control the equipment and the commission allocated to the services would be amortized over time consistent with the transfer of the maintenance services.

Other approaches could be acceptable if they are consistent with the pattern of transfer of the goods or services related to the asset. It would not be acceptable to amortize the entire asset on a straight-line basis in this example if the asset relates to both the equipment and the services. EquipCo could also consider whether there is evidence that would support a conclusion that the contract asset relates only to one of the performance obligations in the contract.

EXAMPLE 11-12

Amortization of contract cost assets – renewal commissions are not commensurate with initial commissions

ServiceCo pays an internal sales employee a \$500 commission for selling an initial annual service contract to Customer A. ServiceCo will also pay a \$250 commission for each annual renewal. The services provided under the initial and renewal contracts are substantially the same and the annual fee is the same. ServiceCo expects Customer A to renew the contract. ServiceCo concludes that the \$500 commission is an incremental cost to obtain the contract and records an asset. ServiceCo also concludes that a five-year average customer life is an appropriate amortization period.

What pattern of amortization should ServiceCo use for the capitalized costs?

Analysis

The initial commission should be amortized over a period longer than the initial contract term because the renewal commission is not commensurate with the initial commission, indicating that a portion of

the initial commission relates to services provided during renewal periods. The asset should be amortized on a systematic basis that is consistent with the transfer of the related services. To comply with this objective, ServiceCo could amortize the initial \$500 commission over the average customer life of five years, or it could separate the initial commission of \$500 into two components and amortize \$250 over the initial annual contract term and the remaining \$250 over the average customer life of five years. Other approaches could be acceptable if they are consistent with the pattern of transfer of the services related to the asset.

11.4.2 ***Impairment of contract cost assets***

Assets recognized from the costs to obtain or fulfill a contract are subject to impairment testing. The impairment guidance should be applied in the following order:

- Impairment guidance for specific assets (for example, inventory)
- Impairment guidance for contract costs under the revenue standard
- Impairment guidance for asset groups or reporting units under US GAAP or cash-generating units under IFRS

Excerpt from ASC 340-40-35-3 and IFRS 15.101

An entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset... exceeds:

- a. The [remaining [IFRS]] amount of consideration that the entity expects to receive [in the future and that the entity has received but not yet recognized as revenue, [US GAAP]] in exchange for the goods or services to which the asset relates [(“the consideration”) [US GAAP]], less
- b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses...

The amount of consideration the entity expects to receive (and has received but not yet recognized as revenue) should be determined based on the transaction price and adjusted for the effects of the customer’s credit risk. Management should also consider expected contract renewals and extensions (with the same customer) in addition to any variable consideration that has not been included in the transaction price due to the constraint (refer to RR 4).

Previously recognized impairment losses cannot be reversed under US GAAP. Entities applying IFRS will reverse previously recognized impairment losses when the conditions that caused the impairment cease to exist. Any reversal should not result in the asset exceeding the amortized balance of the asset that would have been recognized if no impairment loss had been recognized.

Example 11-13 illustrates the impairment test for a contract cost asset.

EXAMPLE 11-13**Impairment of contract cost assets**

DataCo enters into a two-year contract with a customer to build a data center in exchange for consideration of \$1,000,000. DataCo incurs incremental costs to obtain the contract and costs to fulfill the contract that are recognized as assets and amortized over the expected period of benefit.

The economy subsequently deteriorates and the parties agree to renegotiate the pricing in the contract, resulting in a modification of the contract terms. The remaining amount of consideration to which DataCo expects to be entitled is \$650,000. The carrying value of the asset recognized for contract costs is \$600,000. An expected cost of \$150,000 would be required to complete the data center.

How should DataCo account for the asset after the contract modification?

Analysis

DataCo should recognize an impairment loss of \$100,000. The carrying value of the asset recognized for contract costs (\$600,000) exceeds the remaining amount of consideration to which the entity expects to be entitled less the costs that relate directly to providing the data center (\$650,000 less \$150,000). Therefore, an impairment loss of that amount is recognized.

This conclusion assumes that the entity previously recognized any necessary impairment loss for inventory or other assets related to the contract prior to recognizing an impairment loss under the revenue standard. Impairment of other assets could impact the remaining costs required to complete the data center.

11.5 Onerous contracts

Onerous contracts are those where the costs to fulfill a contract exceed the consideration expected to be received under the contract. The revenue standard does not provide guidance on the accounting for onerous contracts or onerous performance obligations. Both US GAAP and IFRS contain other applicable guidance on the accounting for onerous contracts, and those requirements should be used to identify and measure onerous contracts. As a result, companies reporting under US GAAP and IFRS may identify and measure liabilities and losses for onerous contracts differently.

11.5.1 Onerous contract guidance (US GAAP)

US GAAP reporters generally should not recognize a liability for anticipated losses on contracts prior to those losses being incurred unless required by specific guidance in US GAAP. The most common types of contracts for which US GAAP requires recording anticipated losses are construction-type and production-type contracts (refer to RR 11.5.2).

Other guidance in US GAAP that might permit or require the accrual of losses on uncompleted contracts include:

- Separately priced extended warranty and product maintenance contracts subject to ASC 605-20-25-6, which requires an entity to record an anticipated loss if the sum of expected costs to provide services under the contract exceed the related unearned revenue

- Firm purchase commitments for inventory subject to ASC 330-10, which may require an entity to recognize a loss based on an anticipated impairment of the inventory upon acquisition

11.5.2 Construction-type and production-type contracts (US GAAP)

Entities under US GAAP will apply ASC 605-35, *Revenue Recognition—Provision for Losses on Construction-Type and Production-Type Contracts*, to identify and measure provisions for losses on contracts subject to its scope. An entity should not apply the guidance in ASC 605-35 to contracts other than those explicitly within its scope (refer to RR 11.5.3). That is, they should not apply the guidance to other contract types by analogy.

11.5.3 Contracts in the scope of ASC 605-35 (US GAAP)

ASC 605-35 provides a definition of contracts that are within scope of the guidance.

ASC 605-35-15-2

The guidance in this Subtopic applies to:

- a. The performance of contracts for which specifications are provided by the customer for the construction of facilities or the production of goods or the provision of related services. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design, engineering, procurement, and construction management. Contracts covered by this Subtopic are binding agreements between buyers and sellers in which the seller agrees, for compensation, to perform a service to the buyer's specifications. Specifications imposed on the buyer by a third party (for example, a government or regulatory agency or a financial institution) or by conditions in the marketplace are deemed to be buyer's specifications.

ASC 605-35 provides a list of example contracts that are within its scope.

- Construction contracts, such as general building, heavy earth moving, roads, bridges, building mechanicals (HVAC)
- Shipbuilding
- Design, development, and manufacture or modification of complex aerospace or electronic equipment to a buyer's specification and related services
- Construction consulting and construction management
- Architectural or engineering design services
- Software or a software system requiring significant production, modification, or customization of software

The term "complex," as used in ASC 605-35-15-3(c), is not defined and is subject to interpretation. We generally believe that aerospace or electronic equipment, or other manufactured equipment that must meet the unique specifications of a particular application, are within the scope of ASC 605-35. For example, commercial aircraft components that are highly engineered to meet strict tolerances would

generally be considered complex and within the scope of ASC 605-35. Similarly, complex industrial equipment (for example, turbines, generators, specially engineered industrial pumps) designed for a specific customer application and use would likely be within the scope of ASC 605-35. Conversely, manufactured products that are fabricated essentially to “stock” specifications, even if highly engineered and complex devices or “made to order,” would generally not be within the scope of ASC 605-35.

In addition to specifically excluding contracts subject to other specialized GAAP, ASC 605-35 also provides a list of example contracts not within its scope, including:

- Standard manufactured goods
- Supply contracts for homogeneous goods from continuing production over time
- Service contracts of health clubs, correspondence schools, and similar consumer-oriented entities
- Magazine subscriptions

11.5.3.1 Recognizing a loss under ASC 605-35 (US GAAP)

An entity recognizes a loss for construction-type and production-type contracts when the current estimate of total costs at completion of the contract exceeds the total consideration the entity expects to receive. The entire expected loss should be recorded in the period it becomes evident. Management should estimate total consideration by applying the principles in the revenue standard for determining and allocating the transaction price. However, the estimate of total consideration should be adjusted to exclude any constraint on variable consideration in accordance with ASC 605-35-25-46A and adjusted to reflect the customer’s credit risk. Estimated contract costs should include costs that relate directly to the contract, as provided in ASC 340-40, including direct labor, direct materials, and allocations of certain overhead costs. Other factors to consider in estimating contract losses include variable consideration (for example, bonuses or penalties), nonreimbursable costs on cost-plus contracts, and change orders that are accounted for as contract modifications (refer to RR 2.9) in accordance with ASC 606.

The lowest level required for determining loss provisions for construction-type and production-type contracts is the contract level, after considering the guidance on combining contracts in the revenue standard (refer to RR 2.8). However, the guidance permits an accounting policy election to determine the provision for losses at the performance obligation level. Management should apply this election consistently to similar types of contracts.

Example 11-14 illustrates the loss provision guidance in US GAAP.

EXAMPLE 11-14

Loss contracts – construction contract

Manufacturer enters into a contract to manufacture three specialized construction vehicles over a five-year period. Management concludes the contract is in the scope of ASC 605-35 because of the complex and specialized nature of the machines. At contract inception, Manufacturer anticipates the contract will be profitable. However, in the third year of the contract, due to an unexpected increase in production costs, Manufacturer anticipates the contract will generate a loss overall.

Should Manufacturer record a liability in year three to recognize the anticipated loss on the contract?

Analysis

Yes. Manufacturer is required to record the anticipated loss in the period the loss becomes evident because the contract is in the scope of ASC 605-35.

Question 11-8 addresses how to apply the guidance on contract loss provisions to a contract with components both in the scope and out of the scope of ASC 605-35.

Question 11-8

Manufacturer enters into a contract with a customer that has components in and some components out of the scope of ASC 605-35. Should Manufacturer apply the guidance on contract loss provisions to the contract as a whole?

PwC response

If Manufacturer elects to determine the provision for losses at the performance obligation level, we believe that Manufacturer should only apply the loss provision guidance to performance obligations that are in the scope of ASC 605-35. If Manufacturer elects to determine losses at the contract level, we believe it is appropriate to apply the loss provision guidance only to the portion of the contract that is in the scope of ASC 605-35. However, given the guidance refers to “contract,” as defined by the revenue standard, we believe other approaches may be acceptable, including applying the guidance to the contract as a whole. Entities should apply a consistent approach to similar contracts and provide appropriate disclosure, if material.

11.5.4 Onerous contract guidance (IFRS)

IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, provides guidance on identifying and measuring onerous contracts under IFRS and applies to all contracts in the scope of the revenue standard. An onerous contract exists when the unavoidable cost of meeting the obligations under a contract exceed the economic benefits to be received under that contract. IAS 37 does not define unavoidable cost. IAS 37 requires an entity to measure the liability for an onerous contract at the lower of the cost to exit or the cost to fulfill the remaining obligations under the contract. IFRS requires the determination of whether a loss exists to be performed at the contract level and does not include the same accounting election that exists under US GAAP to determine the provision for losses at the performance obligation level. IAS 37 also requires assets dedicated to a contract to be tested for impairment before a liability for an onerous contract is recognized.

Note about ongoing standard setting (IFRS)

As of the content cutoff date of this publication (August 31, 2019), the IASB has proposed to amend IAS 37 to specify that the costs of fulfilling a contract include both incremental costs and an allocation of other costs directly related to the contract. Financial statement preparers and other users of this publication are encouraged to monitor the status of the project.

Chapter 12:

Presentation and disclosure

12.1 Chapter overview

The revenue standard provides guidelines for presenting and disclosing revenue from contracts with customers, including revenue that is expected to be recognized. This chapter provides an overview of these requirements.

The revenue standard provides guidance on the presentation of contract assets and receivables, including how to distinguish between the two, and on the presentation of contract liabilities in the statement of financial position. The revenue standard also provides some guidance on the presentation of revenue and related items (for example, receivables impairment losses) in the statement of comprehensive income.

Detailed quantitative and qualitative disclosure requirements are included in the revenue standard that cover a range of topics, including significant judgments made when measuring and recognizing revenue. The disclosure requirements can be extensive and some will require significant judgment in application.

Practical expedients are available that permit entities to omit certain disclosures, but those expedients are limited. All disclosures required by the revenue standard are subject to materiality judgments. US GAAP requires more disclosure requirements in interim financial statements than IFRS, but allows reduced disclosure requirements for nonpublic entities reporting under US GAAP.

12.2 Presentation

The revenue standard provides guidance on presentation of assets and liabilities generated from contracts with customers.

ASC 606-10-45-1 and IFRS 15.105

When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.

12.2.1 Statement of financial position

An entity will recognize an asset or liability if one of the parties to a contract has performed before the other. For example, when an entity performs a service or transfers a good in advance of receiving consideration, the entity will recognize a contract asset or receivable in its statement of financial position. A contract liability is recognized if the entity receives consideration (or if it has the unconditional right to receive consideration) in advance of performance.

12.2.1.1 Contract assets and receivables

The revenue standard distinguishes between a contract asset and a receivable based on whether receipt of the consideration is conditional on something other than the passage of time.

Excerpt from ASC 606-10-45-3 and IFRS 15.107

A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for impairment in accordance with [ASC 310, *Receivables* [US GAAP] or IFRS 9, *Financial Instruments* [IFRS]].

Excerpt from ASC 606-10-45-4 and IFRS 15.108

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due.... An entity shall account for a receivable in accordance with [ASC 310 [US GAAP] or IFRS 9 [IFRS]].

The revenue standard requires that a contract asset be classified as a receivable when the entity's right to consideration is unconditional (that is, when payment is due only upon the passage of time). If an entity transfers control of goods or services to a customer before the customer pays consideration, the entity should record either a contract asset or a receivable depending on the nature of the entity's right to consideration for its performance. The point at which a contract asset becomes an account receivable may be earlier than the point at which an invoice is issued.

The distinction between a contract asset and a receivable is important because it provides relevant information about the risks related to the entity's rights in a contract, such as whether the entity only has credit risk or if there are other risks, such as performance risk, remaining. Additionally, as discussed in RR 12.2.1.4, contract assets and contract liabilities arising from the same contract are presented net as either a single net contract asset or single net contract liability for presentation purposes.

The revenue standard does not address impairment of contract assets or receivables. Other guidance exists for accounting for receivables (ASC 310, or ASC 326 once adopted for US GAAP reporters, and IFRS 9 for IFRS reporters), and entities should follow those standards when considering impairment.

Example 12-1 illustrates the distinction between a contract asset and a receivable. This concept is also illustrated in Examples 39 and 40 of the revenue standard (ASC 606-10-55-287 through ASC 606-10-55-294 and IFRS 15.IE201 through IFRS 15.IE208).

EXAMPLE 12-1**Distinguishing between a contract asset and a receivable**

Manufacturer enters into a contract to deliver two products to Customer (Products X and Y), which will be delivered at different points in time. Product X will be delivered before Product Y. Manufacturer has concluded that delivery of each product is a separate performance obligation and that control transfers to Customer upon delivery. No performance obligations remain after the delivery of Product Y. Customer is not required to pay for the products until one month after both are delivered. Assume for purposes of this example that no significant financing component exists.

How should Manufacturer reflect the transaction in the statement of financial position upon delivery of Product X?

Analysis

Manufacturer should record a contract asset and corresponding revenue upon satisfying the first performance obligation (delivery of Product X) based on the portion of the transaction price allocated to that performance obligation. A contract asset is recorded rather than a receivable because Manufacturer does not have an unconditional right to the contract consideration until both products are delivered. A receivable and the remaining revenue under the contract should be recorded upon delivery of Product Y, and the contract asset related to Product X should also be reclassified to a receivable. Manufacturer has an unconditional right to the consideration at that time since payment is due based only upon the passage of time.

12.2.1.2 Contract liabilities

An entity should recognize a contract liability if the customer's payment of consideration precedes the entity's performance (for example, by paying a deposit).

ASC 606-10-45-2 and IFRS 15.106

If a customer pays consideration or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

Example 12-2 illustrates when an entity should record a contract liability. This concept is also illustrated in Example 38 of the revenue standard (ASC 606-10-55-284 through ASC 606-10-55-286 and IFRS 15.IE198 through IFRS 15.IE200).

EXAMPLE 12-2

Recording a contract liability

Producer enters into a contract to deliver a product to Customer for \$5,000. Customer pays a deposit of \$2,000, with the remainder due upon delivery (assume delivery will occur three weeks later and a significant financing component does not exist). Revenue will be recognized upon delivery as that is when control of the product transfers to the customer.

How should Producer present the advance payment prior to delivery in the statement of financial position?

Analysis

The \$2,000 deposit was received in advance of delivery, so Producer should recognize a contract liability for that amount. The contract liability will be reversed and recognized as revenue (along with the \$3,000 remaining balance) upon delivery of the product.

12.2.1.3 *Timing of invoicing and performance*

The timing of when an entity satisfies its performance obligation and when it invoices its customer can affect the presentation of assets and liabilities on the statement of financial position. An unconditional right to receive consideration often arises after an entity transfers control of a good or service and invoices the customer, because receipt of payment is based only on the passage of time.

An entity could, however, have an unconditional right to consideration before it has satisfied a performance obligation. For example, an entity that enters into a noncancellable contract requiring advance payment could have an unconditional right to consideration before it performs under the contract. In other words, the right to invoice and collect from the customer is not contingent upon performance, even though the entity may have to refund all or a portion of the payment to the customer if it ultimately does not perform according to the contract. A receivable is recorded in these situations with a corresponding credit to a contract liability (which may be referred to as deferred revenue); however, revenue is not recognized until the entity has transferred control of the goods or services promised in the contract.

The fact that an entity has issued an invoice does not necessarily mean it has an unconditional right to consideration. An entity that invoices the customer cannot record a receivable unless it has concluded it has an unconditional right to consideration.

An entity could, on the other hand, have an unconditional right to consideration before it invoices its customer, in which case the entity should record an unbilled receivable. For example, this could occur if an entity has satisfied its performance obligations, but has not yet issued the invoice.

In certain contracts, including certain commodity arrangements, the transaction price varies based on future changes in the market price that occur after the entity has satisfied its performance obligations. An entity might conclude it has an unconditional right to consideration (and therefore, should recognize a receivable subject to the financial instruments guidance) before the variability arising from changes in the market price is resolved.

Example 12-3 and Example 12-4 illustrate the interaction between the timing of invoicing, performance, and recording a receivable. This concept is also illustrated in Example 38 of the revenue standard (ASC 606-10-55-284 through ASC 606-10-55-286 and IFRS 15.IE198 through IFRS 15.IE200).

EXAMPLE 12-3

Balance sheet presentation — recording a receivable

On January 1, Producer enters into a contract to deliver a product to Customer on March 31. The contract is noncancellable and requires Customer to make an advance payment of \$5,000 on January 31. Customer does not pay the consideration until March 1.

How should Producer reflect the transaction in the statement of financial position?

Analysis

On January 31, Producer should record a receivable as Producer has an unconditional right to consideration:

Dr. Receivable	\$5,000	
Cr. Contract liability		\$5,000

On March 1, upon receipt of the cash, Producer should record the following:

Dr. Cash	\$5,000	
Cr. Receivable		\$5,000

On March 31, upon satisfying the performance obligation, Producer should recognize revenue as follows:

Dr. Contract liability	\$5,000	
Cr. Revenue		\$5,000

Producer has an unconditional right to the consideration when the advance payment is due because the contract is noncancellable. As a result, Producer records a receivable on January 31.

Producer would not record a receivable on January 31 if the contract were cancellable because, in that case, it does not have an unconditional right to the consideration. Producer would instead record the cash receipt and a contract liability on the date the advance payment is received.

EXAMPLE 12-4**Balance sheet presentation — unbilled receivable**

On January 1, Producer enters into a contract to deliver a product to Customer. Producer delivers the product on March 31 and sends an invoice for \$5,000 to Customer on April 15. Customer pays the consideration on April 30. There are no other performance obligations in the contract.

How should Producer reflect the transaction in the statement of financial position?

Analysis

On March 31, upon satisfying the performance obligation, Producer would recognize revenue and record a receivable:

Dr. Receivable	\$5,000	
Cr. Revenue		\$5,000

On April 15, there would be no entry for Producer to record when it issues the invoice.

On April 30, upon receipt of the cash, Producer would record the following:

Dr. Cash	\$5,000	
Cr. Receivable		\$5,000

Producer has an unconditional right to the consideration after it delivers the product. As a result, Producer would record a receivable on March 31. The receivable is “unbilled” because Producer has not yet issued an invoice; however, the balance should be included with receivables (as opposed to contract assets) because it is an unconditional right to consideration.

12.2.1.4 Netting of contract assets and contract liabilities

Entities often enter into complex arrangements with their customers with payments due at different times throughout the arrangement. Entities sometimes receive consideration from their customers in advance of performance on a portion of the contract and, on another portion of the contract, perform in advance of receiving consideration. Contract assets and liabilities related to rights and obligations in a contract are interdependent and therefore are recorded net in the statement of financial position.

Question 12-1 addresses whether contract assets and liabilities can be presented net when they arise from different performance conditions.

Question 12-1

Should contract assets and liabilities be presented net even if they arise from different performance obligations in a contract?

PwC response

Yes. We believe a net contract asset or liability should be determined and presented at the contract level, not at the performance obligation level. Refer to Revenue TRG Memo No. 7 and the related meeting minutes in Revenue TRG Memo No. 11 for further discussion of this topic.

Question 12-2 addresses the presentation of contract assets and liabilities when contracts are combined and accounted for as a single contract.

Question 12-2

Should contract assets and liabilities be recorded net in the statement of financial position for contracts that are combined in accordance with the revenue standard? Or should they be presented separately?

PwC response

We believe when contracts are combined and accounted for as a single contract, the presentation guidance should be applied to the combined contract. Contract assets and liabilities should therefore be presented net as either a single contract asset or a contract liability. Refer to Revenue TRG Memo

No. 7 and the related meeting minutes in Revenue TRG Memo No. 11 for further discussion of this topic.

Entities should look to other standards on financial statement presentation to conclude if it is appropriate to net contract assets and contract liabilities if they arise from different contracts that are not combined in accordance with the revenue standard.

Question 12-3 addresses how an entity should present balance sheet accounts other than contract assets and contract liabilities that arise from a contract with a customer.

Question 12-3

How should an entity assess whether to present other balance sheet accounts resulting from accounting for contracts with customers on a net basis (other than contract assets and contract liabilities)?

PwC response

The revenue standard only specifically addresses the need to present contract assets and contract liabilities on a net basis. To determine whether it is appropriate to offset other balance sheet accounts (for example, accounts receivable against refund liabilities), management should assess the general guidance on balance sheet offsetting included in ASC 210-20 for US GAAP reporters and IAS 1 for IFRS reporters.

12.2.1.5 Presentation of contract assets and contract liabilities

The revenue standard does not specify whether an entity is required to present its contract assets and contract liabilities, or other balance sheet accounts related to contracts from customers (for example, refund liabilities), as separate line items in the statement of financial position. Entities should look to other standards on financial statement presentation to determine if separate presentation is necessary.

While the revenue standard uses the terms “contract asset” and “contract liability,” entities can use alternative descriptions in the statement of financial position (for example, deferred revenue). Certain industries, for example, have common terms that are used for these situations. Entities can use these alternative descriptions as long as they provide sufficient information to distinguish between those rights to consideration that are conditional (that is, contract assets) from those that are unconditional (that is, receivables).

Question 12-4 addresses whether to distinguish between the current and non-current portions of contract assets and contract liabilities.

Question 12-4

In a classified statement of financial position, should contract assets and contract liabilities be presented as current and non-current assets and liabilities?

PwC response

Yes. In a classified statement of financial position, entities should refer to the guidance in ASC 210 (US GAAP) or IAS 1 (IFRS) to distinguish between the current and non-current portions of contract assets and contract liabilities.

Question 12-5 addresses the presentation of a refund liability.

Question 12-5

An entity records a refund liability, which is an estimate of cash that will be refunded to customers that return products. Should this refund liability be presented as a contract liability for purposes of disclosure and netting with contract assets?

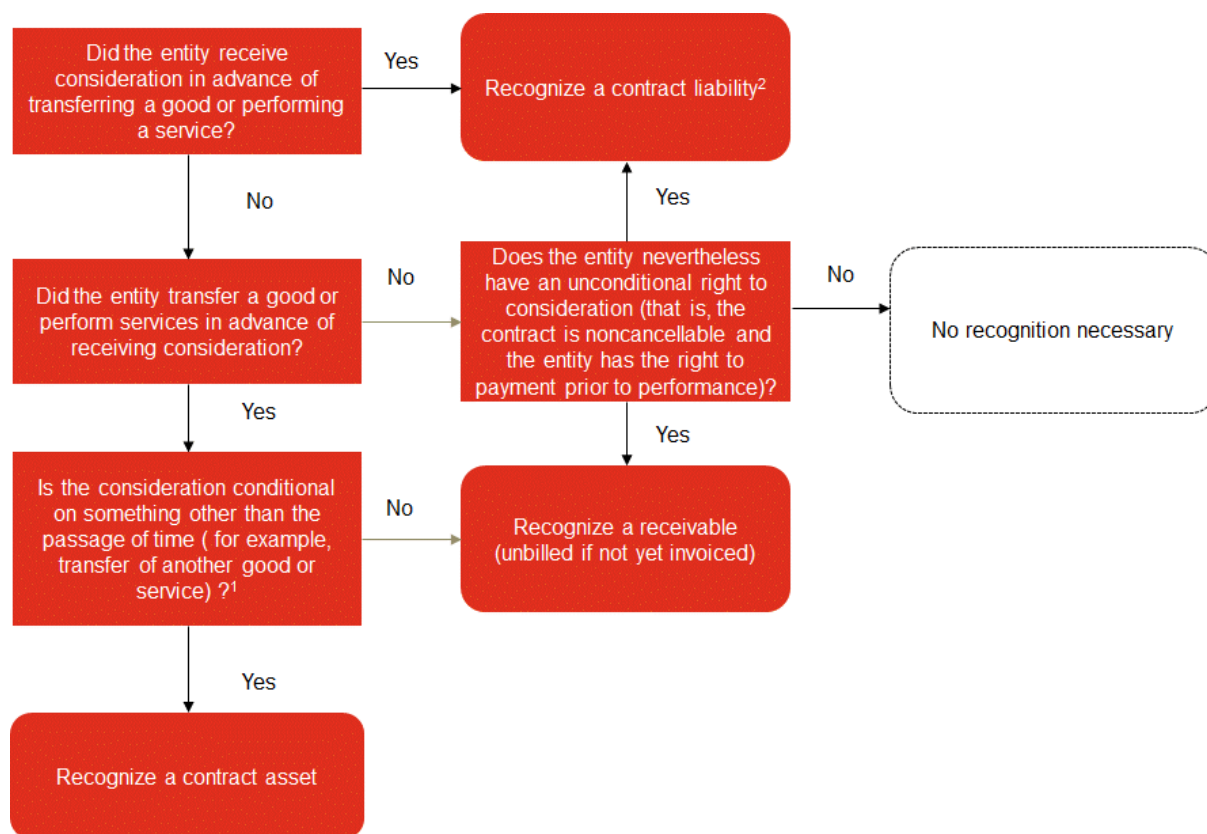
PwC response

No. The refund liability described above differs from a contract liability, which is an obligation to transfer goods or services. Therefore, the refund liability should not be included with contract liabilities for purposes of disclosure and netting with contract assets.

12.2.1.6 Recognition decision tree

Figure 12-1 illustrates the decision tree used to determine when to recognize a contract asset, receivable, or contract liability.

Figure 12-1
Recognition decision tree



¹An entity might conclude it has an unconditional right to consideration if the transaction price varies solely due to future changes in market price (for example, after the entity has already satisfied its performance obligations).

²If the customer can cancel the contract and receive a refund of the advance payment, the entity should generally exclude such amounts from contract liabilities and record a “customer deposit” or similar liability.

12.2.2 Statement of comprehensive income

The revenue standard requires entities to separately present or disclose revenue from contracts with customers from other sources of revenue. Other sources of revenue include, for example, revenue from interest, dividends, leases, etc. Interest income and interest expense recorded when a significant financing component exists (see RR 4.4) must be presented separately from revenue from contracts with customers in the statement of comprehensive income. An entity might present interest income as revenue in circumstances in which interest income arises from an entity’s ordinary activities.

Impairment losses from contracts with customers (for example, impairments of contract assets or receivables) are presented separately from impairment losses from other types of contracts, and are not recorded as a reduction of revenue. The measurement of the impairment loss is not addressed by the revenue standard. Entities should refer to other accounting standards addressing measurement and impairment of receivables for this guidance.

12.3 Disclosure

Entities must disclose certain qualitative and quantitative information so that financial statement users can understand the nature, amount, timing, and uncertainty of revenue and cash flows generated from their contracts with customers. These disclosures can be extensive, may be challenging to compile, and may require significant management judgment.

Excerpt from ASC 606-10-50-1 and IFRS 15.110

An entity shall disclose qualitative and quantitative information about all of the following:

- a. Its contracts with customers...
- b. The significant judgments, and changes in those judgments, made in applying [the revenue standard] to those contracts...
- c. Any asset recognized from the costs to obtain or fulfill a contract with a customer

Management should consider the level of detail necessary to meet the disclosure objective. For example, an entity should aggregate or disaggregate information, as appropriate, to provide clear and meaningful information to a financial statement user. The level of disaggregation is subject to judgment.

Management must also disclose the use of certain practical expedients. An entity that uses the practical expedient regarding the existence of a significant financing component (RR 4) or the practical expedient for expensing certain costs of obtaining a contract (RR 11), for example, must disclose that fact.

Disclosures are included for each period for which a statement of comprehensive income is presented and as of each reporting period for which a statement of financial position is presented. The requirements only apply to material items. Materiality judgments could affect whether certain disclosures are necessary or the extent of the information provided in the disclosure. Entities need not repeat disclosures if the information is already presented as required by other accounting standards.

Figure 12-2 summarizes the annual disclosure requirements.

Figure 12-2
Annual disclosure requirements

Disclosure type	Required information
Disaggregated revenue	Disaggregation of revenue into categories that show how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows
Reconciliation of contract balances	<ul style="list-style-type: none"> □ Opening and closing balances and revenue recognized during the period from changes in contract balances □ Qualitative and quantitative information about the significant changes in contract balances

Disclosure type	Required information
Performance obligations	<ul style="list-style-type: none"> □ Descriptive information about an entity's performance obligations □ Information about the transaction price allocated to remaining performance obligations and when revenue will be recognized □ Revenue recognized from performance obligations satisfied (or partially satisfied) in previous periods
Significant judgments	<ul style="list-style-type: none"> □ Method used to recognize revenue for performance obligations satisfied over time and why the method is appropriate □ Significant judgments related to transfer of control for performance obligations satisfied at a point in time □ Information about the methods, inputs, and assumptions used to determine and allocate transaction price
Costs to obtain or fulfill a contract	<ul style="list-style-type: none"> □ Judgments made to determine costs to obtain or fulfill a contract, and method of amortization □ Closing balances of assets and amount of amortization/impairment
Practical expedients	<p>Use of either of the following:</p> <ul style="list-style-type: none"> □ The practical expedient regarding the existence of a significant financing component; see RR 4.4.2 □ The practical expedient for expensing certain costs of obtaining a contract; see RR 11.2.2

Disclosure requirements are discussed in more detail below.

12.3.1 *Disaggregated revenue*

The revenue standard does not prescribe specific categories for disaggregation, but instead provides examples of categories that might be appropriate. An entity may need to disaggregate revenue by more than one type of category to meet the disclosure objective.

ASC 606-10-55-90 and IFRS 15.B88

When selecting the type of category (or categories) to use to disaggregate revenue, an entity [should [US GAAP]/shall [IFRS]] consider how information about the entity's revenue has been presented for other purposes, including all of the following:

- a. Disclosures presented outside the financial statements (for example, in earnings releases, annual reports, or investor presentations)
- b. Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments
- c. Other information that is similar to the types of information identified in (a) and (b) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.

ASC 606-10-55-91 and IFRS 15.B89

Examples of categories that might be appropriate include, but are not limited to, all of the following:

- a. Type of good or service (for example, major product lines)
- b. Geographical region (for example, country or region)
- c. Market or type of customer (for example, government and nongovernment customers)
- d. Type of contract (for example, fixed-price and time-and-materials contracts)
- e. Contract duration (for example, short-term and long-term contracts)
- f. Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)
- g. Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

Question 12-6 addresses the relationship between an entity's disaggregated revenue disclosures and segment disclosures.

Question 12-6

Will an entity's disaggregated revenue disclosure always be at the same level as its segment disclosures?

PwC response

No. The revenue standard requires entities to explain the relationship between the disaggregated revenue required by the revenue standard and the information required by the accounting standard on operating segments. Management should not assume the two disclosures will be disaggregated at the same level. More disaggregation might be needed in the revenue footnote, for example, because the operating segments standard permits aggregation in certain situations. The revenue standard does not have similar aggregation criteria. However, if management concludes that the disaggregation level is the same in both standards and segment revenue is measured on the same basis as the revenue standard, then the segment disclosure would not need to be repeated in the revenue footnote.

This disclosure is illustrated in Example 41 of the revenue standard (ASC 606-10-55-296 through ASC 606-10-55-297 and IFRS 15.IE210 through IFRS 15.IE211).

12.3.2 Reconciliation of contract balances

The purpose of these disclosures is to provide information about contract balances and the changes in those balances. The revenue standard provides for flexibility in how this information is presented from a formatting perspective (that is, it does not mandate a tabular presentation), but it does require certain items to be disclosed.

Excerpt from ASC 606-10-50-8 and IFRS 15.116

An entity shall disclose all of the following:

- a. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed
- b. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period

ASC 606-10-50-10 and IFRS 15.118

An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

- a. Changes due to business combinations
- b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained), or a contract modification
- c. Impairment of a contract asset
- d. A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable)
- e. A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability).

An entity should also explain how the timing of satisfaction of its performance obligations compares to the typical timing of payment and how that affects contract asset and liability balances. This information can be provided qualitatively.

12.3.3 Performance obligations

There are multiple quantitative and qualitative disclosures that entities are required to provide about their performance obligations.

12.3.3.1 Description of performance obligations

Entities must include information to help readers understand the nature of its performance obligations. These disclosures should not be “boilerplate” and should supplement the entity's revenue accounting policy disclosures.

ASC 606-10-50-12 and IFRS 15.119

An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:

- a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement
- b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained...)
- c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)
- d. Obligations for returns, refunds, and other similar obligations
- e. Types of warranties and related obligations.

12.3.3.2 Remaining performance obligations

The revenue standard requires disclosure of information about the transaction price allocated to remaining performance obligations and when revenue will be recognized related to these obligations. This could require judgment, as it might not always be clear when performance obligations will be satisfied, especially when performance can be affected by factors outside the entity's control. Entities should explain whether any amounts have been excluded from the transaction price and therefore excluded from the disclosure, such as variable consideration that has been constrained.

ASC 606-10-50-13 and IFRS 15.120

An entity shall disclose the following information about its remaining performance obligations:

- a. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period
- b. An explanation of when the entity expects to recognize as revenue the amount disclosed [in (a) above], which the entity shall disclose in either of the following ways:
 1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations
 2. By using qualitative information.

The revenue standard is not prescriptive regarding the format of disclosure. Therefore, management has discretion regarding the nature and extent of information needed to achieve the objective of the disclosure, which will depend on the entity's facts and circumstances. Examples 42 and 43 (ASC 606-10-55-298 through ASC 606-10-55-307 and IFRS 15.IE212 through IFRS 15.IE221) of the revenue

standard illustrate a quantitative and qualitative approach, respectively, to satisfying this disclosure requirement.

Entities can elect to omit disclosure of information about the transaction price allocated to remaining performance obligations and when revenue will be recognized when:

- the related contract has a duration of one year or less; or
- the entity recognizes revenue equal to what it has the right to invoice when that amount corresponds directly with the value to the customer of the entity's performance to date (refer to RR 6.4.1.1).

An entity that omits the disclosures should explain qualitatively what is being excluded.

US GAAP reporters may elect to omit this disclosure in two additional situations.

ASC 606-10-50-14A

An entity need not disclose the information in paragraph 606-10-50-13 for variable consideration in which either of the following conditions is met:

- a. The variable consideration is a sales-based or usage-based royalty promised in exchange for a license of intellectual property...
- b. The variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied distinct good or service that forms part of a single performance obligation...

For US GAAP reporters, the option to exclude from this disclosure revenue recognized using the “right to invoice” practical expedient and consideration meeting the conditions in ASC 606-10-50-14A only applies to variable consideration; that is, the entity would be required to disclose any fixed transaction price allocated to remaining performance obligations. US GAAP reporters that elect any of the permitted exemptions are required to disclose which exemptions have been applied, the nature of the performance obligations, the remaining duration, and a description of the variable consideration that has been excluded from their disclosures.

Question 12-7 addresses the disclosure of remaining performance obligations related to a master services agreement.

Question 12-7

An entity enters into a master services agreement (MSA) on March 31, 20x8 that includes the general terms and pricing for Product A and requires the customer to purchase a minimum of 1,000,000 units over a three-year term. The timing of purchases is not known until the customer submits purchase orders for a specified number of units. The pricing of units in excess of the minimum is not at a discount (that is, there is no material right). What should the entity include in its disclosure of remaining performance obligations as of March 31, 20x8?

PwC response

The transaction price related to the 1,000,000 unit minimum should be included in the disclosure of remaining performance obligations because the MSA commits the parties to the purchase and sale of

these units. The entity should not include in the disclosure the transaction price for any units in excess of the required minimum of 1,000,000 units, even if such orders are expected. The customer has not yet committed to the purchase of any units in excess of the minimum and therefore, these units are optional purchases.

12.3.3.3 *Revenue from previously satisfied performance obligations*

Entities must also disclose revenue recognized in the current period that did not result from current period performance.

ASC 606-10-50-12A and excerpt from IFRS 15.116

An entity shall disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).

This disclosure would include items such as changes in estimates of variable consideration, changes in estimates related to the measure of progress for performance obligations satisfied over time, and sales or usage-based royalties related to a license for which control transferred in a prior period.

12.3.4 *Significant judgments*

An entity must disclose its judgments, as well as changes in those judgments, that significantly impact the amount and timing of revenue from its contracts with customers.

ASC 606-10-50-18 and IFRS 15.124

For performance obligations that an entity satisfies over time, an entity shall disclose both of the following:

- a. The methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied)
- b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

ASC 606-10-50-19 and IFRS 15.125

For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when a customer obtains control of promised goods or services.

ASC 606-10-50-20 and IFRS 15.126

An entity shall disclose information about the methods, inputs, and assumptions used for all of the following:

- a. Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration
- b. Assessing whether an estimate of variable consideration is constrained

- c. Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)
- d. Measuring obligations for returns, refunds, and other similar obligations.

12.3.5 Costs to obtain or fulfill a contract

Entities must provide information about how assets are recognized from costs to obtain or fulfill a contract with a customer, and how the assets are subsequently amortized or impaired.

ASC 340-40-50-2 and IFRS 15.127

An entity shall describe both of the following:

- a. The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer...
- b. The method it uses to determine the amortization for each reporting period.

ASC 340-40-50-3 and IFRS 15.128

An entity shall disclose all of the following:

- a. The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer..., by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs)
- b. The amount of amortization and any impairment losses recognized in the reporting period.

12.3.6 Interim disclosure requirements

Interim financial reporting standards require entities to provide certain disclosures about revenue from contracts with customers in interim financial statements. Entities reporting under both US GAAP and IFRS must disclose disaggregated revenue information in interim financial statements; refer to RR 12.3.1. Interim reporting standards also require disclosure about significant changes in an entity's financial position, which includes changes relating to revenue.

Other interim disclosure requirements differ between US GAAP and IFRS, as described below.

12.3.6.1 Additional interim disclosures (US GAAP)

Public entities reporting under US GAAP must include many of the same disclosures in their interim financial statements that are required in annual financial statements.

Excerpt from ASC 270-10-50-1A

- a. A disaggregation of revenue for the period...
- b. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers (if not otherwise separately presented or disclosed)...

- c. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period...
- d. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price)...
- e. Information about the entity's remaining performance obligations as of the end of the reporting period

12.3.6.2 *Additional interim disclosures (IFRS)*

Entities that issue IFRS interim financial statements must also disclose impairment losses generated from assets arising from contracts with customers and the reversal of such an impairment loss.

12.3.7 *Nonpublic entity considerations (US GAAP)*

Certain exemptions are provided in the revenue standard to simplify the disclosure requirements for nonpublic entities that report under US GAAP. Such entities must follow the disclosure requirements described in RR 12.3.1 through RR 12.3.5 with some modifications. Figure 12-3 summarizes the modifications to the disclosure requirements for nonpublic entities.

Figure 12-3
Nonpublic entity disclosure considerations (US GAAP)

Disclosure type	Related information
Disaggregated revenue	<p>Nonpublic entities may elect to not apply the quantitative disaggregation of revenue disclosure guidance discussed in RR 12.3.1; however, if this election is made, the entity must at a minimum disclose:</p> <ul style="list-style-type: none"> □ Revenue disaggregated according to the timing of transfer of goods or services (for example, at a point in time and over time) □ Qualitative information about how economic factors (for example, type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows
Reconciliation of contract balances	<p>Nonpublic entities can elect to disclose only the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with its customers. The other disclosures described in RR 12.3.2 (contract assets and contract liabilities) are optional.</p>
Performance obligations	<p>Descriptive disclosures of an entity's performance obligations are required for nonpublic entities; however, disclosures regarding remaining unsatisfied or partially satisfied performance obligations are optional. Disclosures regarding revenue recognized from performance obligations satisfied (or partially satisfied) in previous periods are optional. See RR 12.3.3.</p>

Disclosure type	Related information
Significant judgments	<p>Nonpublic entities must disclose the following:</p> <ul style="list-style-type: none"> □ The methods used to recognize revenue (for example, a description of the input method or output method) for performance obligations satisfied over time □ The methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained <p>The other disclosures of significant judgments as described in RR 12.3.4 are optional.</p>
Costs to obtain or fulfill a contract	Disclosures of assets recognized from the costs to obtain or fulfill a contract with a customer described in RR 12.3.5 are optional.
Practical expedients	Disclosures on the use of practical expedients described in RR 12.3 are optional.
Interim financial statement disclosures	The interim financial statement disclosures described in RR 12.3.6 are optional.

Chapter 13:
Service concession
arrangements – US GAAP

13.1 Chapter overview

Service concession arrangements are increasingly prevalent as governments or public sector entities (“grantors”) look for ways to outsource public services that involve infrastructure that is costly to construct, maintain, or operate.

In a service concession arrangement, a grantor (a government or government agency) grants an operator (a private-sector entity) the right to operate and maintain the grantor’s infrastructure for a period of time. Typical forms of grantor infrastructure involved in service concession arrangements include airports, toll roads, bridges, hospitals, schools, prisons, and more. The infrastructure might already exist or the operator may also be engaged to construct the infrastructure as part of the concession arrangement. Other service concession arrangements may involve significant upgrades to existing infrastructure.

The grantor may pay the operator as the services are performed over the concession term or, often, the operator is given the right to charge the public to use the infrastructure (for example, tolls that are charged to drivers for use of a road or bridge). The grantor might also guarantee a minimum amount of user fees.

The accounting for service concession arrangements under US GAAP is governed by ASC 853, *Service Concession Arrangements*, and is significantly different from the accounting under IFRS pursuant to IFRIC 12, *Service Concession Arrangements*. While the definition of a service concession arrangement is generally consistent, there is a fundamental difference in recognition and measurement between the two standards that will often lead to different accounting outcomes. This chapter only addresses the US GAAP accounting for service concession arrangements. Refer to Chapter 34 of PwC’s IFRS Manual of Accounting for additional guidance on accounting for service concession arrangements under IFRS.

13.2 Scope of ASC 853

ASC 853-10-15-2 describes the scope of ASC 853, while ASC 853-10-15-3 includes the criteria to be a service concession arrangement.

ASC 853-10-15-2

The guidance in [ASC 853] applies to the accounting by operating entities of a service concession arrangement under which a public-sector entity grantor enters into a contract with an operating entity to operate the grantor’s infrastructure. The operating entity also may provide the construction, upgrading, or maintenance services of the grantor’s infrastructure.

ASC 853-10-15-3

A public-sector entity includes a governmental body or an entity to which the responsibility to provide public service has been delegated. In a service concession arrangement, both of the following conditions exist:

- (a) The grantor controls or has the ability to modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them, and at what price. (b) The grantor controls, through ownership, beneficial entitlement, or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement.

Inherent in the definition of a service concession arrangement is the premise that the arrangement involves both public infrastructure and the operation of that infrastructure by the private-sector operator. Although a typical service concession arrangement includes the provision of a public service, the scope of the standard is not focused on the nature of the services provided. The FASB observed in the basis for conclusions of the guidance that was ultimately codified in ASC 853 that a scope distinction based on the nature of the service would be overly subjective and therefore difficult to apply. Instead, ASC 853 focuses on the nature of the grantor (a public-sector entity), whether operation of infrastructure is involved, and whether the grantor controls the use and residual interest of the infrastructure.

If an entity is only providing a service or selling a good to a government entity, that arrangement would typically not be in the scope of ASC 853. For example, an arrangement to build a courthouse, to build (but not operate) a bridge, or to provide cleaning services at a government office building would not be a service concession arrangement. In contrast, constructing and operating a water treatment facility or a prison owned by a government entity typically would be a service concession arrangement in the scope of ASC 853 as long as the government entity controls the services and the infrastructure (as described in ASC 853-10-15-3).

13.2.1 *Control by the grantor*

In a service concession arrangement, the grantor controls or has the ability to modify or approve the services provided by the operator. Typically, the grantor maintains involvement in key areas to protect the public interest, such as determining the nature of the services, to whom they must be offered, the hours of operation of the infrastructure assets, and the fees the operator may charge for use of the infrastructure assets. Importantly, however, the guidance does not indicate the extent of, or how much, control is required to meet this first condition. Therefore, judgment may be required, which could involve considerations beyond the terms of the contract, such as the impact of laws and regulations applicable to the infrastructure and services to be provided.

13.2.2 *Residual interest in the infrastructure*

Under ASC 853-10-15-3(b), the grantor must control the residual interest in the infrastructure at the conclusion of a service concession arrangement. In certain arrangements, title to the infrastructure never transfers from the grantor to the operator; therefore, this condition is automatically met. However, this condition is also met if title reverts back to the grantor upon conclusion or termination of the arrangement. Conversely, if the operator controls the residual interest in the infrastructure and can unilaterally choose what to do with the assets at the end of the arrangement, the arrangement is not a service concession arrangement under ASC 853.

In some arrangements, rather than an automatic transfer or reversion of ownership to the grantor at the end of the term, the grantor will have an option to buy the infrastructure (a call option) from the operator. In this case, the grantor is generally deemed to control the residual interest in the infrastructure, even if the call option is only exercisable at the then-current fair value of the asset, because the operator cannot unilaterally choose to continue to operate the assets or sell them to a third party.

13.2.3 *Regulated operations*

Some regulated operations are similar to service concession arrangements in that pricing for the services is determined by a governmental entity. However, in regulated operations, the infrastructure

is typically controlled by the operator and is retained by the operator at the end of the arrangement. An arrangement that meets the scope criteria in ASC 980, *Regulated Operations*, is subject to that guidance and not the guidance in ASC 853.

13.3 *Recognition of revenue*

Generally, an arrangement to construct and/or operate assets on behalf of a grantor would be a revenue-generating arrangement with a customer. Accordingly, ASC 853 directs that an entity apply ASC 606, *Revenue from Contracts with Customers*.

13.3.1 *Identifying the contract and the customer*

Service concession arrangements typically involve multiple parties, including the grantor, the operator, and the users of the infrastructure. For example, the operator of an airport will have an agreement with the grantor but will also have relationships with the airlines, retail and food vendors, and travelers. Similarly, the operator of a toll road or bridge will have relationships with the grantor as well as drivers who pay tolls.

ASC 853 stipulates that the grantor (the governmental entity) is always the customer in a service concession arrangement. Because the scope only includes arrangements in which the grantor controls the infrastructure, the grantor has effectively hired the operator to construct and/or operate the assets on its behalf. Thus, the grantor is the customer in the arrangement even if the operator collects a portion of its fee from the users of the infrastructure (for example, airline gate fees or tolls from drivers).

A service concession arrangement often includes both construction and operation services, and the terms of these services may be governed by separate contracts. In many cases, separate contracts for construction and operation services will be combined for purposes of applying ASC 606 because one or more of the criteria for combining contracts (refer to RR 2.8) are met (for example, the contracts are negotiated as a package with a single commercial objective).

13.3.2 *Identifying performance obligations*

In many service concession arrangements, the operator constructs or renovates the infrastructure for the grantor and then operates the infrastructure after construction or renovation is complete. In such a scenario, the service concession arrangement contains multiple performance obligations, including both the construction or renovation of the infrastructure and the subsequent operation services.

There may also be other specified activities in the arrangement, such as specific improvements, additions or upgrades to the infrastructure assets, or major maintenance activities at various points during the arrangement. Judgment will be required to determine whether these additional specified activities are separate performance obligations or whether they should be combined with the construction or operation components of the arrangement. The assessment of whether goods or services are distinct is based on the principles in ASC 606 (refer to RR 3.4). ASC 853 does not provide additional interpretive guidance in this regard for service concession arrangements.

13.3.2.1 *Assessing whether major maintenance activities are distinct*

It is common for operators to agree to perform major maintenance activities related to the infrastructure during the term of a service concession arrangement. The operator should base its assessment of whether the major maintenance activities are distinct on the underlying principles of ASC 606; however, the following considerations may also be relevant:

- Are the major maintenance activities specified in the contract?
- Does the arrangement contain incremental consideration associated with the major maintenance?
- How significant is the cost of the major maintenance to the concession arrangement?
- How integral is major maintenance to the ongoing operation of the grantor's infrastructure?
- How frequently is major maintenance expected to be performed?

These factors are not an exhaustive list or individually determinative and should also not be used as a checklist. Refer to RR 3 for additional guidance on identifying performance obligations.

Example 13-1 illustrates the assessment of whether planned major maintenance should be accounted for as a separate performance obligation.

EXAMPLE 13-1

Assessing whether planned major maintenance is a separate performance obligation

OperatorCo enters into a service concession arrangement with State Government to construct and operate a toll road for a period of thirty years. The agreement specifies that OperatorCo will be responsible for:

- construction of the toll road,
- operation of the toll road during the operating period, and
- resurfacing the toll road every fifteen years during the operating period.

OperatorCo will collect tolls from users (drivers) and will remit a portion of the tolls to State Government. Given the significance of the resurfacing costs compared to the overall costs of operating and maintaining the toll road, OperatorCo will reduce the amount of tolls that would otherwise be remitted to the government by the costs of the resurfacing.

How many performance obligations are present in the service concession arrangement?

Analysis

Although judgment is required, OperatorCo would likely conclude that the arrangement contains three separate performance obligations: construction, operation, and resurfacing.

OperatorCo should assess whether the promises in the contract are distinct based on the criteria in ASC 606-10-25-14 through ASC 606-10-25-22 ("capable of being distinct" and "separately

identifiable”). The construction services are distinct because the customer can benefit from the services separately and the promise to perform those services is separately identifiable from other promises in the contract. Similarly, the operation services are distinct because the customer can benefit from the services separately and the promise to perform those services is separately identifiable from other promises in the contract.

The assessment of whether the resurfacing services are distinct requires judgment. In this fact pattern, the resurfacing services would likely be considered distinct because resurfacing does not occur frequently, the cost of resurfacing is significant compared to the overall costs, and OperatorCo effectively receives incremental consideration for resurfacing in the form of a reduction to the amount of tolls remitted to State Government. These factors indicate that the customer could benefit from the resurfacing services separate from the construction and operation services and that the resurfacing services are separately identifiable in the arrangement.

13.3.3 *Determining and allocating the transaction price*

In some service concession arrangements, the grantor pays fixed fees for the operation of the infrastructure assets at inception of the arrangement or as milestones are achieved. In others, the operator has the right to collect payment from the end users of the public services (for example, tolls) over the operating period. Both are considered payments from the customer (the grantor), although one is received directly and the other indirectly.

The operator should include both fixed and variable amounts when determining the transaction price. The amounts received from end users are variable consideration since they vary based on usage of the infrastructure. Those variable amounts will need to be estimated at inception of the arrangement for the entire term of the contract and included in the total transaction price, subject to the constraint on variable consideration; that is, such variable consideration is included in the transaction price only to the extent that a significant reversal in the cumulative amount of revenue recognized is not probable. The operator will need to update its estimate of variable consideration at each reporting date throughout the contract period. In some arrangements, the grantor guarantees a fixed minimum amount for the operator. Fixed minimums are not variable consideration and should be included in the transaction price in their entirety. See RR 4 for further discussion of estimating and constraining variable consideration.

The transaction price is allocated to the separate performance obligations in the arrangement based on their relative standalone selling prices. Variable consideration is generally allocated to all performance obligations in a contract based on their relative standalone selling prices. However, operators would allocate variable consideration to one or more, but not all, of the performance obligations in an arrangement if specific requirements are met (refer to RR 5.5.1). Changes in the estimate of transaction price (for example, changes in variable consideration) are allocated on the same basis used to allocate consideration at contract inception. Changes in the estimate of variable fees could therefore result in additional revenue being recognized related to the construction performance obligation well after construction is complete.

An operator might not be required to estimate future variable fees if the contract only includes a promise to provide operation services (that is, a single performance obligation). In that case, if the fees collected in a period are commensurate with the value of the services provided during the period, the operator could apply the “right to invoice” practical expedient to measure progress for the single performance obligation as described in RR 6.4.1.1. This would result in recognizing revenue each

period equal to the fees collected. If the operation services are determined to be a series of distinct goods or services (refer to RR 3.3.2), it may be appropriate to allocate variable consideration to individual distinct goods or services within the series (for example, individual time increments of performing a distinct service) if certain criteria are met (refer to RR 5.5.1.1), which would also provide relief from the requirement to estimate variable consideration at contract inception.

Refer to RR 4 and RR 5 for additional guidance on determining the transaction price and allocating consideration to performance obligations.

13.3.4 Recognizing revenue

As described in RR 13.3.3, the transaction price could include consideration received from the grantor and other parties (for example, end users of the infrastructure). Revenue from all sources is recognized as performance occurs based on the amount of the estimated transaction price allocated to the performance obligations being satisfied. For example, revenue recognized during the construction of the infrastructure might be based, at least in part, on an estimate of variable fees to be collected from end users in the future.

Revenue is often recognized in a service concession arrangement over time because (1) control of the infrastructure transfers as construction is performed and (2) control of the operations services transfers as the services are rendered. Operators will need to identify a measure of progress that best depicts the transfer of control of goods or services to the grantor. Refer to RR 6 for additional guidance on recognizing revenue and measures of progress.

13.3.5 Principal versus agent considerations

When multiple parties are involved in providing services to the grantor, the operator must consider whether it is the principal or agent for each distinct service. For example, an operator may utilize subcontractors to construct the grantor's infrastructure or perform some of the maintenance activities. Refer to RR 10 for additional guidance on determining if an entity is the principal or an agent in an arrangement.

13.3.6 Consideration payable to a customer

It is common in service concession arrangements for the operator to make a significant upfront payment to the grantor upon being awarded the concession contract, particularly if the infrastructure already exists. Since the grantor is considered the operator's customer in the arrangement, the upfront payment represents a payment to a customer. Consideration payable to a customer is recorded as a reduction of the transaction price and therefore, a reduction of revenue, unless the payment is in exchange for a distinct good or service. Securing the rights to a revenue contract, on its own, is not a good or service that is distinct from the underlying revenue contract.

In some arrangements, the operator makes ongoing payments to the grantor for the use of the infrastructure assets. These payments may be characterized as a "lease payment," "fee sharing," or some other type of remuneration. Any such payments are generally a reduction of the operator's revenue under the arrangement (unless they are made in exchange for a distinct good or service) because the grantor is the operator's customer. Use of the grantor's infrastructure as part of an arrangement in the scope of ASC 853 is not considered a lease (refer to RR 13.4).

Refer to RR 4.6 for additional guidance on accounting for consideration payable to a customer.

13.4 *Property, plant, and equipment*

ASC 853-10-25-2 provides guidance on accounting for the infrastructure assets used in a service concession arrangement.

ASC 853-10-25-2

The infrastructure that is the subject of a service concession arrangement within the scope of [ASC 853] shall not be recognized as property, plant and equipment of the operating entity. Service concession arrangements within the scope of [ASC 853] are not within the scope of Topic 842 on leases.

ASC 853-10-53-2 stipulates that the operator not recognize the infrastructure asset used in the arrangement as property, plant, and equipment. This is because the operator does not have control over the asset. Rather, the operator has a right to access the grantor's infrastructure in order to provide the services required by the arrangement. In some service concession arrangements, the operator may have title to the infrastructure assets during the contract term. Even in such cases, the operator should not capitalize those assets as property, plant, and equipment if they are part of the infrastructure controlled by the grantor.

If an operator is constructing infrastructure as part of a service concession arrangement, the related costs are typically expensed as incurred because (1) the operator is not creating an asset that it controls and (2) the costs relate to performance obligations that are satisfied or partially satisfied (the construction services). However, there may be circumstances when it is appropriate to capitalize certain costs to obtain or fulfill a contract. Refer to RR 11 for additional guidance on contract costs.

ASC 853 also stipulates that service concession arrangements are not leases because the operator does not control the use or disposition of the infrastructure and, thus, does not enjoy the exclusive benefit of the assets during the term of the arrangement.

An operator might acquire assets to be used in providing services to the grantor that are not part of the infrastructure. For example, an operator of a toll road may purchase a snow plow that will be used to clear the roads during the operation period. Operators often replace these assets multiple times over the course of the service concession arrangement. Assets that are not part of the infrastructure itself (such as the snow plow) that the operator may dispose of or replace at its discretion should be capitalized as property, plant, and equipment of the operator because they are controlled by the operator.

13.5 *Disclosure*

There are no specific disclosures required in ASC 853 for service concession arrangements. Entities should look to other standards for relevant disclosures related to the arrangement. For example, entities should provide the disclosures required by ASC 606 (refer to RR 12.3) for the portion of a service concession arrangement accounted for under ASC 606. Similarly, the disclosures required by ASC 360 (refer to FSP 8.6) should be provided if the entity has property, plant, and equipment not in the scope of ASC 853 (refer to RR 13.4).

Chapter 14:

Effective date and transition

14.1 Chapter overview

The revenue standard, as amended, is applicable for most entities in 2018. This chapter discusses the effective date and transition guidance, which can vary between entities reporting in accordance with IFRS and those reporting in accordance with US GAAP. There are different transition methods available to certain entities, and some entities are permitted to early adopt the revenue standard.

Adopting the revenue standard could be a significant undertaking and some entities may need to embed necessary changes into their systems and processes. Some practical expedients are provided to ease transition.

14.2 Effective date

Figure 14-1 summarizes the effective dates, as amended, for adopting the revenue standard.

Figure 14-1
Summary effective date chart

	IFRS	US GAAP
Public entities	Annual reporting periods beginning on or after January 1, 2018, including interim periods therein	Annual reporting periods beginning after December 15, 2017, including interim periods therein
Nonpublic entities	Annual reporting periods beginning on or after January 1, 2018, including interim periods therein	Annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019
Early adoption permitted?	Yes	Yes, but no earlier than for annual reporting periods beginning after December 15, 2016

14.2.1 IFRS reporters

Public and nonpublic entities that prepare IFRS financial statements will apply the revenue standard for annual reporting periods beginning on or after January 1, 2018 (subject to local regulatory endorsement). Calendar year-end entities will therefore first report in accordance with the revenue standard in their 2018 interim and annual financial statements. Early adoption is permitted (subject to local regulatory requirements), as long as it is disclosed.

14.2.2 US GAAP reporters

The effective date for entities that prepare US GAAP financial statements differs depending on whether they are public or nonpublic entities.

14.2.2.1 US GAAP – public entities

Public entities for US GAAP reporting purposes are entities that are any of the following:

- A public business entity (refer to the definition in ASC 606-10-20)
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- An employee benefit plan that files or furnishes financial statements to the SEC

Public entities will first apply the revenue standard for annual reporting periods beginning after December 15, 2017, including the interim periods therein (that is, January 1, 2018, for calendar year-end entities). Calendar year-end public entities therefore first reported in accordance with the revenue standard in their 2018 interim and annual financial statements. SEC registrants that qualify as emerging growth companies (EGCs) are permitted to follow the transition guidance for nonpublic entities discussed in RR 14.2.2.2.

Question 14-1 addresses whether an EGC is required to reflect adoption of the revenue standard in the supplementary quarterly financial data in its 2019 annual report.

Question 14-1

If an EGC elects to follow the transition guidance for nonpublic entities beginning on January 1, 2019 and for interim periods within annual periods beginning on January 1, 2020, is the EGC required to reflect adoption of the revenue standard in the supplementary quarterly financial data in its 2019 annual report?

PwC response

No. As noted in FRM Topic 11, an EGC would not be required to reflect adoption in the supplementary quarterly financial data in its 2019 annual report.

Question 14-2 addresses when an equity method investee of a calendar year-end SEC registrant is required to adopt the revenue standard.

Question 14-2

A calendar year-end SEC registrant has an equity method investment in a private company. The investment is considered “significant” under Regulation S-X Rule 1-02(w) and, as a result, the investor is required to include the investee’s financial information in its Form 10-K filing (under Regulation S-X Rule 3-09). When is the equity method investee required to adopt the revenue standard?

PwC response

For purposes of the registrant’s SEC filings, the equity method investee meets the definition of a “public business entity” because its financial information is included in a filing with the SEC. Although a public business entity was required to adopt the revenue standard in 2018, ASC 606-10-S65-1 states that the SEC would not object if entities adopt the new revenue standard according to the timeline

otherwise afforded private companies if they meet the definition of a public business entity solely due to the inclusion of their financial statements or financial information in another entity's SEC filing.

If an investee elects to adopt the new revenue standard according to the private company timeline, the investor's associate income or loss pickup under the equity method of accounting does not need to be adjusted to reflect adoption according to the public business entity timeline.

14.2.2.2 US GAAP – nonpublic entities

Nonpublic entities (that is, all entities other than public entities, as defined) have an additional year to comply with the revenue standard. Nonpublic entities are required to apply the revenue standard for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Calendar year-end entities will therefore first report revenue in accordance with the revenue standard in their 2019 annual financial statements and 2020 interim financial statements. Nonpublic entities can elect to apply the guidance earlier, but no earlier than the earliest permitted effective date for public entities. Any of the following dates are permitted:

- Annual reporting periods beginning after December 15, 2016, including interim periods therein
- Annual reporting periods beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017
- Annual reporting periods beginning after December 15, 2017, including interim periods therein
- Annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018
- Annual reporting periods beginning after December 15, 2018, including interim periods therein

14.3 Transition guidance

The revenue standard permits entities to apply one of two transition methods: retrospective or modified retrospective. Retrospective application requires applying the new guidance to each prior reporting period presented; however, entities can elect to apply certain practical expedients. Entities electing the modified retrospective transition approach would apply the new guidance only to contracts that are not completed at the adoption date and would not adjust prior reporting periods.

The modified retrospective transition approach is intended to be simpler than full retrospective application; however, there are still challenges associated with that approach, including additional disclosure requirements in the year of adoption. Entities should consider the needs of investors and other users of the financial statements when deciding which transition method to follow.

14.3.1 Completed contracts

Both transition methods refer to “completed contracts,” which is a term defined specifically for purposes of applying the transition guidance. The definition, however, differs between US GAAP and IFRS.

Excerpt from ASC 606-10-65-1-c-2

A completed contract is a contract for which all (or substantially all) of the revenue was recognized in accordance with revenue guidance that is in effect before the date of initial application.

Excerpt from IFRS 15.C2(b)

A completed contract is a contract for which the entity has transferred all of the goods or services identified in accordance with IAS 11 *Construction Contracts*, IAS 18 *Revenue* and related Interpretations.

The differences in the definitions will generally result in more contracts qualifying as “completed contracts” under IFRS 15 as compared to ASC 606. A “completed contract” under IFRS 15 would include a contract for which an entity has transferred all of the goods or services, but has not yet recognized all of the revenue (for example, due to uncertainties in the contract price). The contract would not qualify as a “completed contract” under ASC 606 unless substantially all of the related revenue has been recognized.

14.3.2 Retrospective application and practical expedients

Entities are permitted to adopt the revenue standard by restating all prior periods (that is, full retrospective adoption) following ASC 250, *Accounting Changes and Error Corrections* (US GAAP) or IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* (IFRS). Entities electing retrospective application are permitted to use any combination of several practical expedients, which differ in some respects between US GAAP and IFRS and are discussed further below.

Any of the expedients used must be applied consistently to all contracts in all reporting periods presented. Entities that choose to use any practical expedients must disclose that they have used the expedients and provide a qualitative assessment of the estimated effect of applying each expedient, to the extent reasonably possible.

14.3.2.1 US GAAP reporters

Entities that prepare US GAAP financial statements and adopt the revenue standard retrospectively are permitted to use any combination of the following practical expedients.

Excerpt from ASC 606-10-65-1-f

1. An entity need not restate contracts that begin and are completed within the same annual reporting period.
2. For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
3. For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.

4. For contracts that were modified before the beginning of the earliest reporting period presented... an entity need not retrospectively restate the contract for contract modifications... Instead, an entity shall reflect the aggregate effect of all contract modifications that occur before the beginning of the earliest period presented... when:
 - i. Identifying the satisfied and unsatisfied performance obligations
 - ii. Determining the transaction price
 - iii. Allocating the transaction price to the satisfied and unsatisfied performance obligations.

Disclosure of the impact of adopting the standard

US GAAP reporters adopting the revenue standard retrospectively must provide the relevant disclosures required by ASC 250, except for the disclosures required by ASC 250-10-50-1(b)(2). That is, entities do not have to disclose the effect of adopting the revenue standard in the current period (the period of adoption) on income from continuing operations, net income, each affected financial statement line item, and basic and diluted earnings per share. These disclosures are only required for the reporting periods that have been retrospectively adjusted.

Considerations for SEC registrants

SEC registrants are not required to apply the revenue standard to periods prior to those presented in their retroactively-adjusted financial statements for purposes of reporting the five-year selected financial data table. In other words, registrants are not required to recast the earliest two years in the table; however, they must disclose the basis of presentation and lack of comparability. Refer to FRM Topic 11 for further discussion of this and other reporting issues related to adoption of the revenue standard.

14.3.2.2 IFRS reporters

Entities that prepare IFRS financial statements and adopt the revenue standard retrospectively are permitted to use any combination of the following practical expedients.

Excerpt from IFRS 15.C5

- a. for completed contracts, an entity need not restate contracts that
 - (i) begin and end within the same annual reporting period; or
 - (ii) are completed contracts at the beginning of the earliest period presented.
- b. for completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
- c. for contracts that were modified before the beginning of the earliest period presented, an entity need not retrospectively restate the contract for those contract modifications.... Instead, an entity shall reflect the aggregate effect of all of the modifications that occur before the beginning of the earliest period presented when:

- (i) identifying the satisfied and unsatisfied performance obligations;
- (ii) determining the transaction price; and
- (iii) allocating the transaction price to the satisfied and unsatisfied performance obligations.
- d. for all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.

Disclosure of the impact of adopting the standard

IFRS reporters are required to disclose the effect of adopting the revenue standard on each financial statement line item and the effect on basic and diluted earnings per share (if applicable) for the immediately preceding reporting period (that is, the year prior to the date of initial application). Entities are not required, but are permitted, to present this information for the current or earlier comparative periods.

14.3.3 *Modified retrospective application and practical expedients*

Entities can elect to use a modified retrospective approach for transition to the revenue standard. Entities electing this approach will recognize the cumulative effect of initially applying the revenue standard as an adjustment to the opening balance of retained earnings (or other appropriate component of equity) in the period of initial application. Comparative prior year periods would not be adjusted. Calendar year-end companies, for example, would recognize the cumulative effect adjustment of applying the revenue standard in the opening balance of retained earnings as of January 1, 2018.

The modified retrospective transition approach allows an entity to avoid restating comparative years. US GAAP reporters that choose this approach must disclose the nature of and reason for the change in accounting principle. Additionally, both US GAAP and IFRS reporters must provide the following additional disclosures in the reporting period that includes the date of initial application (that is, reporting periods in the year of adoption):

- The amount by which each financial statement line item is affected in the current year as a result of applying the revenue standard (as compared to the previous revenue guidance)
- A qualitative explanation of the significant changes between the reported results under the revenue standard and the previous revenue guidance

These additional disclosures effectively require an entity to apply both the new revenue standard and the previous revenue guidance in the year of initial application. Several financial statement line items may be affected by the change and therefore require disclosure. Line items that could be affected, beyond revenue, gross margin, operating profit, and net income, include:

- Assets for costs to obtain or fulfill a contract to the extent that such costs were expensed under prior guidance but should now be capitalized (or conversely, had been capitalized under previous guidance but would no longer meet the criteria to be capitalized under the revenue standard)

- Employee compensation, including bonuses and share-based compensation, linked to revenue-related metrics, to the extent that the compensation charge determined in accordance with the relevant accounting standard and benefit plan terms would have been different if the previous revenue guidance had been applied
- Current and deferred tax balances, depending on the tax law

Entities must explain the extent of the effects of the change in revenue on all line items that are affected.

Practical expedients for modified retrospective application

Entities applying the modified retrospective approach can elect to apply the revenue standard only to contracts that are not completed as of the date of initial application (that is, they would ignore the effects of applying the revenue standard to contracts that were completed prior to the adoption date). Calendar year-end companies, for example, can elect to apply the new guidance only to contracts that are not completed as of January 1, 2018. Refer to RR 14.3.1 for discussion of the definition of “completed contract,” which differs between US GAAP and IFRS.

Entities applying the modified retrospective approach can also elect the practical expedient for contract modifications described in ASC 606-10-65-1-f(4) and IFRS 15.C5(c).

Entities that choose to use any practical expedients must disclose that they have used the expedients and provide a qualitative assessment of the estimated effect of applying each expedient, to the extent reasonably possible.

14.3.4 Contract modifications practical expedient illustrative example

Example 14-1 illustrates application of the contract modification practical expedient.

EXAMPLE 14-1

Contract modifications practical expedient

EquipmentCo enters into a contract with Customer in December 2011 to sell Product A for \$500,000 and a five-year service contract for \$10,000 a year. In January 2012, Customer takes control of the Product A and the service contract commences.

In 2015, EquipmentCo and Customer extend the service contract by an additional five years (for \$10,000 a year) and, at the same time, add an additional piece of equipment, Product B, for \$750,000. Product B will be delivered in 2020.

Does EquipmentCo have to apply the modification guidance in the revenue standard to this contract when it adopts the standard in 2018?

Analysis

EquipmentCo can choose to apply the contract modifications practical expedient when it adopts the revenue standard. If EquipmentCo applies the practical expedient, it would allocate the total transaction price (\$1,350,000) and allocate it to Product A, Product B, and the service contracts.

Revenue allocated to Product B and the remaining unperformed services would be recognized as they are transferred to the customer.

14.3.5 *Transition considerations for new revenue standard amendments*

Subsequent to issuing the revenue standard in May 2014, both boards issued amendments. The transition guidance for the amendments is detailed below.

14.3.5.1 *US GAAP reporters*

The amendments have the same effective date and transition requirements as the new revenue standard, which was effective for calendar year-end public companies in 2018. Nonpublic companies have an additional year to adopt the new standard.

14.3.5.2 *IFRS reporters*

Public and nonpublic entities should apply the amendments to the revenue standard retrospectively in accordance with IAS 8. Since IFRS reporters could have adopted the standard early, before the amendments were issued, the revenue standard provides additional details on transition considerations.

Excerpt from IFRS 15.C8A

In applying the amendments retrospectively, an entity shall apply the amendments as if they had been included in IFRS 15 at the date of initial application. Consequently, an entity does not apply the amendments to reporting periods or to contracts to which the requirements of IFRS 15 are not applied in accordance with paragraphs C2–C8. For example, if an entity applies IFRS 15 in accordance with paragraph C3(b) only to contracts that are not completed contracts at the date of initial application, the entity does not restate the completed contracts at the date of initial application of IFRS 15 for the effects of these amendments.

PwC's National Accounting Services Group

The Accounting Services Group (ASG) within the Firm's National Quality Organization leads the development of Firm perspectives and points of view used to inform the capital markets, regulators, and policy makers. ASG assesses and communicates the implications of technical and professional developments on the profession, clients, investors, and policy makers. The team consults on complex accounting and financial reporting matters in US GAAP and IFRS and works with clients to resolve issues raised in SEC comment letters. They work with the standard setting and regulatory processes through communications with the FASB, SEC, IASB, and others. The team provides market services, such as quarterly technical webcasts and external technical trainings, including our alumni events. The team is also responsible for sharing their expert knowledge on topics through internal and external presentations and by authoring various PwC publications.

In addition to working with the US market, the ASG team has a large global team that is involved in the development of IFRS.

The team of experienced Partners, Directors, and Managers helps develop talking points, perspectives, and presentations for when Senior Leadership interacts with the media, policy makers, academia, regulators, etc.

About PwC

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