MFA PERSPECTIVE

Revenue From Contracts With Customers

The FASB and IASB's converged standard on revenue recognition is a historic change that establishes a global model for virtually all industries in U.S. GAAP, including those that previously followed industry-specific guidance. Even though effective dates for the standard are not until 2017, the work toward proper implementation needs to begin now. As such, gaining an understanding of when you will be impacted is critically important, as is having an understanding of the core concepts. This MFA Perspective outlines the new, five-step revenue recognition model in detail.

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Introduction

In 2014, the FASB issued its landmark standard, Revenue from Contracts with Customers.[1] It is generally converged with equivalent new IFRS guidance and sets out a single and comprehensive framework for revenue recognition. It takes effect in 2018 for public companies and in 2019 for all other companies, and addresses virtually all industries in U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. For many entities, the timing and pattern of revenue recognition will change. In some areas, the changes will be very significant and will require careful planning.

The new standard also introduces an overall disclosure objective together with significantly enhanced disclosure requirements for revenue recognition. In practice, even if the timing and pattern of revenue recognition does not change, it is possible that new and/or modified processes will be needed in order to comply with the expanded disclosure requirements.

Recent Updates

Subsequent to issuing new accounting standards for revenue recognition, the FASB and IASB formed the Joint Transition Resource Group for Revenue Recognition (TRG). The goals of the TRG are to inform the Boards about potential implementation issues and to assist stakeholders in understanding specific aspects of the new guidance. As a result of TRG deliberations, the FASB has made the following updates to Topic 606:

- Accounting Standards Update (ASU) 2015-14, Deferral of the Effective Date
- ASU 2016-08, Principal versus Agent Considerations (Reporting Revenue Gross versus Net)
- ASU 2016-10, Identifying Performance Obligations and Licensing
- ASU 2016-12, Narrow Scope Improvements and Practical Expedients

This newsletter has been updated through August 2016 to reflect changes to the standard made by the subsequent ASUs.[2] Please refer to Appendix 2 for a summary of significant changes since the last publication date.

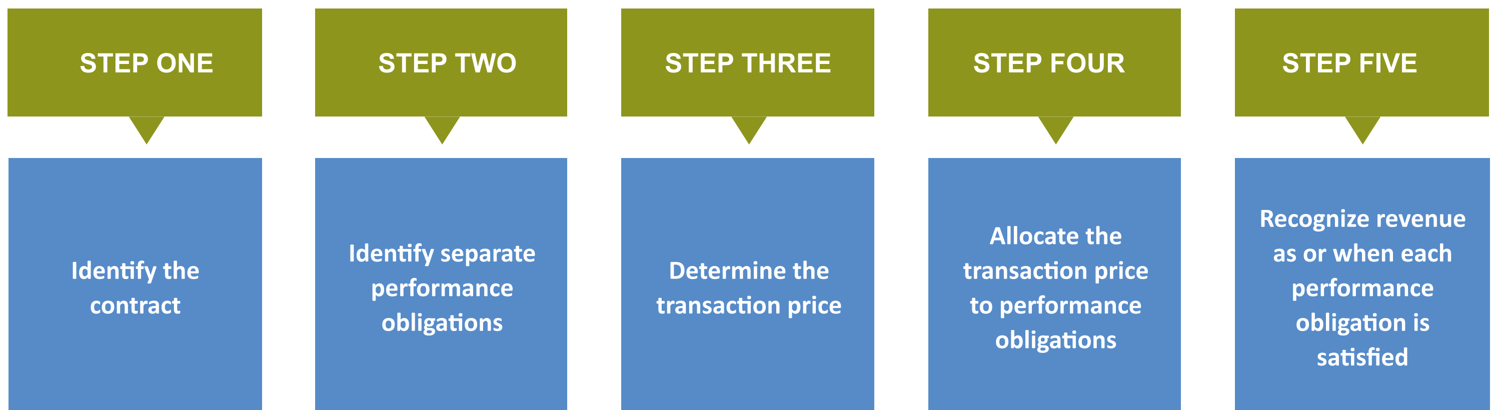
Background

The FASB's joint project with the IASB to develop a new accounting standard for revenue recognition dates back over a decade. The U.S. and international standard setters had noted inconsistencies and weaknesses in each of their respective accounting standards. In IFRS, there was significant diversity in practice because existing standards contained limited guidance for a range of significant topics, such as accounting for contracts with multiple elements; should these be accounted for as one overall obligation, or as a series of separate (albeit related) obligations? Under U.S. GAAP, concepts for revenue recognition had been supplemented with a broad range of industry specific guidance, which had resulted in economically similar transactions being accounted for differently.

Both the FASB and the IASB also noted that existing disclosure requirements were inadequate, as they often resulted in insufficient information for users of financial statements to understand the sources of revenue, and the key judgments and estimates that had been made in its recognition. The information disclosed was also often 'boilerplate' and uninformative.

The new standard establishes a single, comprehensive framework which sets out how much revenue is to be recognized, and when. The core principle is that a vendor should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the vendor expects to be entitled in exchange for those goods or services.

Revenue will now be recognized by a vendor when control over the goods or services is transferred to the customer. The application of the core principle is carried out in five steps:



The first step is to identify the contract(s) with the customer. Whatever the form, a contract creates legally enforceable rights and obligations between a vendor and its customer.

After identifying the contract(s) with the customer, a vendor separates the contract into what are termed 'performance obligations'. A performance obligation is a promise by a vendor to transfer goods or services to a customer. Each performance obligation is 'distinct', being either a good or service from which the customer can benefit on its own (or in combination with other readily available goods and services); or two or more goods and services (such as the supply of construction material and labor) that are combined if, in reality, they represent one overall performance obligation.

In the third and fourth steps, a vendor determines the transaction price of the entire contract and then allocates the transaction price among the different performance obligations that have been identified.

In the fifth step, a vendor assesses when it satisfies each performance obligation (which may be at a point in time, or over time) and recognizes revenue. The principle is based on the point at which the customer obtains control of the good or service.

Scope

Topic 606 applies to all contracts with customers, except for:

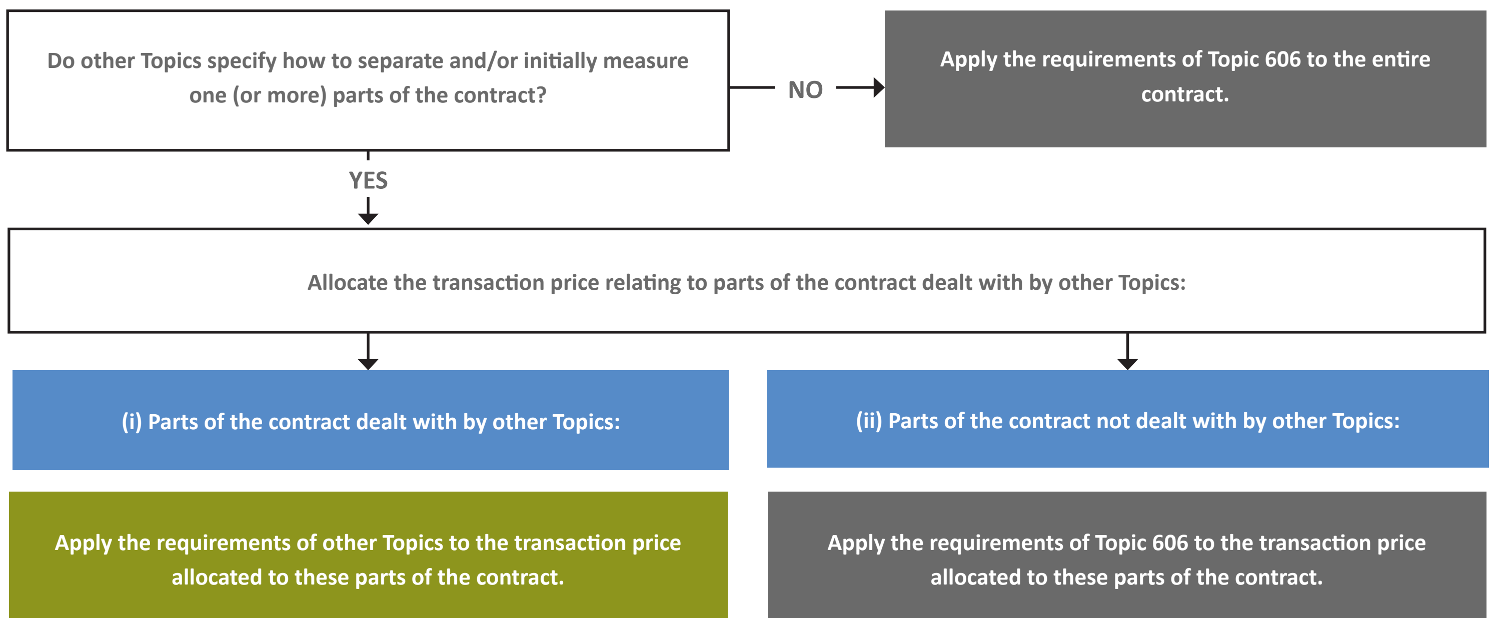
- Lease contracts within the scope of Topic 840 Leases;
- Insurance contracts within the scope of Topic 944 Insurance;
- Financial instruments and other contractual rights and obligations within the scope of Topic 310, Receivables, Topic 320, Investments—Debt and Equity Securities, Topic 323, Investments—Equity Method and Joint Ventures, Topic 325, Investments—Other, Topic 405, Liabilities, Topic 460, Guarantees (except certain warranties), Topic 470, Debt, Topic 815, Derivatives and Hedging, Topic 825, Financial Instruments and Topic 860, Transfers and Servicing.

Revenue is derived from contracts entered into by a vendor for the sale of goods or services, arising from its ordinary activities, to a customer. Its recognition is linked to changes in a vendor's assets and liabilities; this can be in the form of cash inflows or increases in receivable balances, or decreases in a liability that represents deferred revenue. All changes in those assets and liabilities are recognized in profit or loss, other than those relating to transactions with owners (for example, shareholders) in their capacity as such.

The existing requirements of other Topics for the recognition of a gain or loss on the transfer of some non-financial assets that are not an output of a vendor's ordinary activities (such as property, plant and equipment and intangible assets) have been amended so that they are consistent with the requirements in Topic 606 .

In addition, the new standard does not apply to non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. An example is a contract between two oil companies that agree to exchange oil in different locations in order to fulfill demand from their customers.

A contract may be partially within the scope of Topic 606 and partially within the scope of other Topics. In this situation an entity takes the approach summarized in the following diagram:



More specifically, if one or more other Topics specify how to separate and/or measure the parts of a contract that they address, then entities should apply the separation and measurement guidance in those other Topics to determine the portion of the transaction price that is excluded from the new revenue standard. If other Topics do not address how to separate and or measure the parts of the contract that they address, then Topic 606's guidance for separating and measuring parts of the contract (as described below) should be used to determine the portion subject to other U.S. GAAP vs. the portion subject to the new revenue standard.

However, a vendor is required to assess whether, instead of a transaction being a sale, the counterparty to a contract shares the risks and benefits that result from an activity or process (such as developing an asset). If so, the counterparty is not a customer, and the transaction falls outside of the scope of Topic 606. Special care may also be needed in assessing transactions with related parties, as their relationship with the vendor may be more complex than those with third parties.

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The FASB has a separate project[3] (in three phases) on its agenda to clarify the definition of a "business," as distinguished from an "asset." That distinction has important implications in U.S. GAAP today, and it will also impact whether sales of certain items are within the scope of the new revenue standard, which addresses nonfinancial asset sales. Sales of businesses are generally addressed by Topic 810 Consolidation (except for businesses that are in-substance real estate), and will continue to be in the scope of Topic 810 after the adoption of the new revenue standard.

The 'Five Step' approach

1. Step One - Identify the contract

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Topic 606 is applied to contracts with customers that meet all of the following five criteria:

- The contract has been approved in writing, orally, or in accordance with other customary business practices and the parties are committed to perform their obligations in the contract;
- Each party's rights and obligations regarding the goods or services to be transferred can be identified;
- The payment terms for the goods or services to be transferred can be identified;
- The contract has commercial substance (i.e., the risk, timing or amount of the vendor's future cash flows is expected to change as a result of the contract); and
- It is probable that the consideration for the exchange of the goods or services that the vendor is entitled to will be collected. For the purposes of this criterion, only the customer's ability and intention to pay amounts when they become due are considered.

In assessing collectibility, a vendor should consider the extent to which the customer has both the ability and the intention to pay substantially all of the consideration promised in exchange for the goods or services that will be transferred to the customer. In other words, an expectation of collecting all of the consideration promised in the contract is not required, only the consideration related to goods or services that will be transferred to the customer. An entity should consider its exposure to credit risk and its ability to mitigate that credit risk as part of this assessment, for example the ability to discontinue providing service in the third month of a 12 month contract.

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This requirement is similar to SAB 104, under which collectability must be reasonably assured in order to recognize revenue.

The focus will often be on the price included in the contract between a vendor and its customer. However, it is possible that the amount of consideration that the vendor ultimately expects to be entitled to will be less, because the vendor expects to offer a price concession (or discount). In these cases, the assessment of the customer's ability and intention to pay is made against the lower amount.

EXAMPLE

A vendor sells 1,000 units of a product to a customer in return for a contractually agreed amount of CU 1 million. This is the vendor's first sale to a customer in the geographic region, and the region is experiencing significant financial difficulty. The vendor believes that economic conditions will improve in the future, and that by establishing a trading relationship now with the customer, sales volumes in the future will be enhanced. However, for this first contract, the vendor does not expect that the customer will be able to pay the full amount of the contractually agreed price.

Consequently, the vendor determines that it expects to offer a 50% discount to its customer. Having considered the customer's intention and ability to pay, taking into account the current poor economic conditions, it is concluded that it is probable that the estimated amount of CU 500,000 will be collected. If the other four criteria set out above are met, the contract for the sale of 1,000 units in return for estimated (and therefore variable) consideration of CU 500,000 is accounted for in accordance with Topic 606.

A contract with a customer might not meet all of the five criteria set out above. For those contracts, if the vendor receives consideration from the customer, the amount received is recognized as revenue only when one of the following applies:

(i) The vendor has no remaining contractual obligations to transfer goods or services and all, or substantially all, of the consideration has been received and is non-refundable.

(ii) The contract has been terminated and the consideration received is non-refundable.

(iii) 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 non-refundable.

In addition, contracts with customers that do not meet the five criteria are assessed on a continuous basis to determine whether these criteria are subsequently met. In contrast, if a contract does meet the five criteria, it is only reassessed if there is an indication of a significant change in facts or circumstances. For example, this might arise if a customer's ability to pay consideration deteriorates significantly, such that the customer no longer has the ability to pay when amounts are due. The result would be that revenue and a related asset balance (often a receivable) would be recorded up to the point at which the deterioration occurred, with no revenue being recorded after that point.

1.1 Combination of contracts

Two or more contracts that are entered into at (or near) the same time, and with the same customer or related parties, are accounted for as if they were a single contract, provided at least one of the following criteria is met:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration in one contract depends on the price or performance of the other contract.
- The goods or services that are promised in the contracts (or some of the goods or services) represent a single performance obligation.

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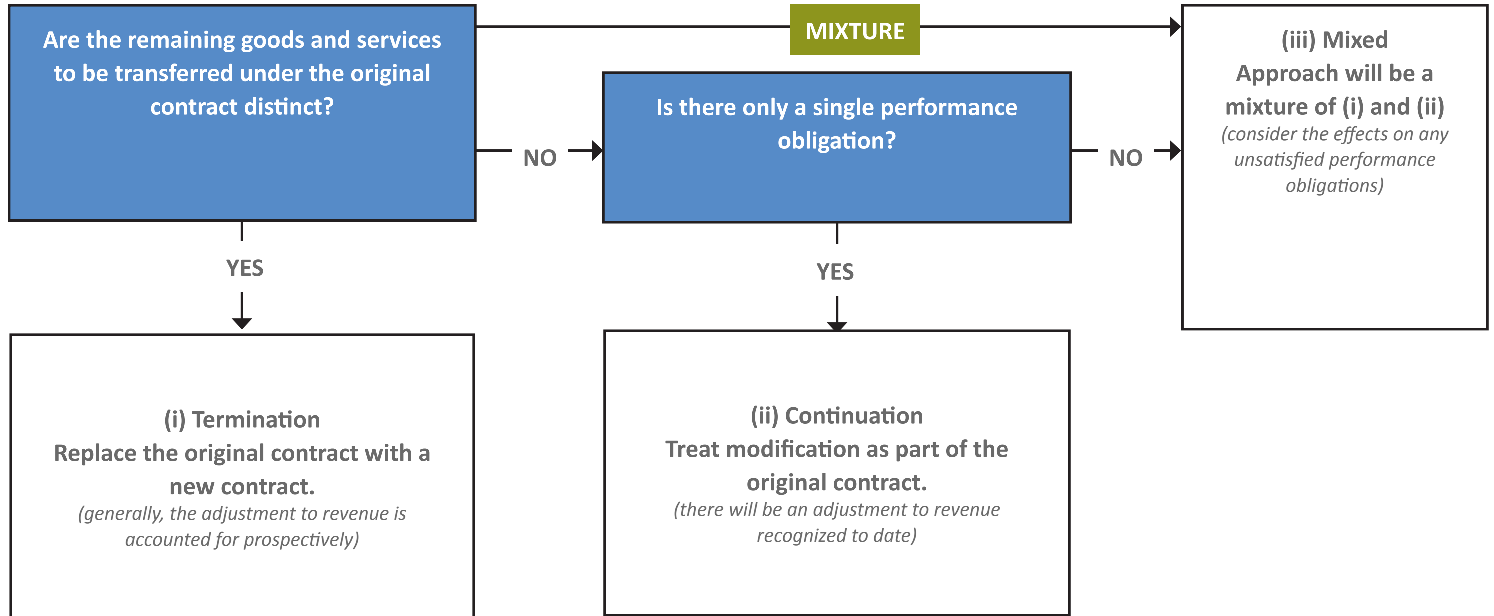
The requirement to potentially combine contracts which are entered into with two or more separate parties that are related to each other has been included because there may be interdependencies between or among those contracts. In some cases, a careful analysis may be required to ensure that all related parties of the customer are considered.

1.2 Contract modifications

A contract modification is a change in the scope and/or price of a contract that is approved by the parties to that contract. This might be referred to as a change order, variation, and/or an amendment. Consistent with the provisions of Topic 606, adjustments are only made for a contract modification when either new enforceable rights and obligations are created, or existing ones are changed.

A contract modification is accounted for as a separate (and additional) contract only if:

- The scope of the contract changes due to the addition of promised goods or services that are distinct; and
- The price of the contract increases by an amount of consideration that reflects the vendor's standalone selling price of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract.



When a contract modification is not accounted for as a separate (and additional) contract, the vendor identifies the goods or services that have not yet been transferred. This will be comprised of the remaining goods or services from the original contract, and any new goods or services arising from the contract modification. The approach which is then followed is illustrated by the following diagram:

EXAMPLE – SALE OF A PRODUCT

A vendor enters into a contract with a customer to sell 200 units of a product for CU 16,000 (CU 80 per unit). These are to be supplied evenly to the customer over a four month period (50 units per month) and control over each unit passes to the customer on delivery.

After 150 units have been delivered, the contract is modified to require the delivery of an additional 50 units. At the point at which the contract is modified, the standalone selling price of one unit of the product has declined to CU 75.

In accordance with the requirements of Topic 606, the additional units to be delivered are distinct. Consequently, the subsequent accounting will depend on whether the sales price for the additional units reflects the standalone selling price at the date of contract modification (CU 75).

Scenario A – the price of each of the additional units is CU 75

The selling price of the additional units is the standalone price at the date of contract modification. Consequently, the additional units are accounted for as being sold under a new and separate contract from the units to be delivered under the terms of the original contract.

The vendor recognizes revenue of CU 80 per unit for the remaining 50 units specified in the original contract, and CU 75 per unit for the 50 units that are added as a result of the contract modification.

Scenario B – the price of each of the additional units is CU 65, including a CU 10 discount for poor service

When the contract modification for the additional 50 units was being negotiated, the vendor agreed to a price reduction of CU 10 for each of the additional units, to compensate the customer for poor service. Some of the first 50 units that had been delivered were faulty and the vendor had been slow in rectifying the position.

At the point of contract modification, the vendor recognizes the CU 10 per unit discount as an immediate reduction in revenue of CU 500. This is because the discount relates to units that have already been delivered to the customer; the contractually-modified price of CU 65 for units that are to be sold in future does not mean that the CU 10 discount is attributed to them for accounting purposes.

The selling price of the additional units is therefore the standalone selling price (CU 75) at the date of contract modification. Consequently, the additional units are accounted for as being sold under a new and separate contract from the units to be delivered under the terms of the original contract.

This means that, as in scenario A, the vendor recognizes revenue of CU 80 per unit for the remaining 50 units specified in the original contract, and CU 75 per unit for the 50 units that are added as a result of the contract modification.

Scenario C – the price of each of the additional units is CU 60

The selling price of the additional units is not the standalone price at the date of contract modification. Consequently, for accounting purposes, the original contract is considered to be terminated at the point of contract modification. The remaining units to be sold that were covered by the original contract, together with the additional units from the contract modification, are accounted for as being sold under a new contract.

The amount of revenue recognized for each of the units is a weighted average price of CU 70. This is calculated as ((50* CU 80) + (50* CU 60)) / 100.

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Careful consideration will be needed when determining the appropriate accounting approach in circumstances in which a contract is modified, and the selling price reflects both compensation for poor quality goods or services that have already been supplied to the customer, and a selling price for the additional goods or services that does not represent the standalone selling price at the date of contract modification.

2. Step Two - Identify separate performance obligations in the contract

Having identified the contract in step one, a vendor is then required to identify the performance obligations(s) contained in the contract. A performance obligation is a promise to a customer to transfer:

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

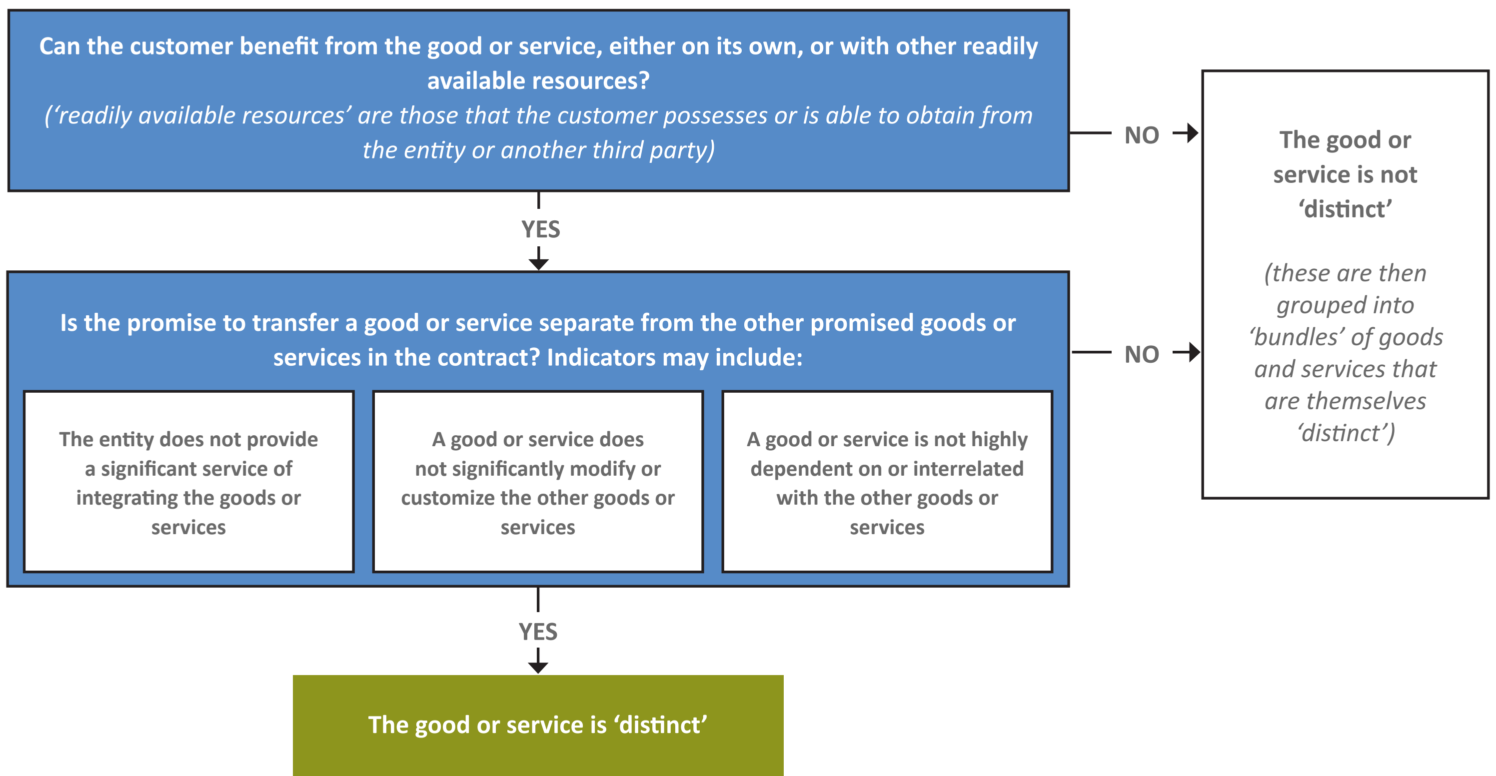
A series of distinct goods or services has the same pattern of transfer to the customer if two criteria are met:

(i) Each distinct good or service in the series is a performance obligation satisfied over time; and

(ii) The same method would be used to measure the vendor's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Examples of promised goods or services, which may or may not be distinct, include the sale of goods, performing an agreed-upon task, standing ready to provide goods or services (e.g., unspecified software updates), arranging for another party to transfer goods or services, constructing an asset on behalf of a customer, granting licenses, and granting certain options to purchase additional goods or services.

Consequently, it is necessary to identify whether a good or service is distinct. The approach to be followed is illustrated in the following diagram:



The two criteria that need to be met in order for a good or service to be distinct are set out in more detail below:

Criterion 1

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 (i.e., the good or service is capable of being distinct).

A customer can benefit from a good or service if the good or service can be used, consumed, or sold (other than for scrap value), or it can be held in a way that generates economic benefits. A customer may benefit from some goods or services on their own, while for others a customer may only be able to obtain benefits from them in conjunction with other readily available resources.

A readily available resource is either a good or service that is sold separately (either by the vendor or another vendor), or a resource that the customer has already obtained from the vendor (this includes goods or services that the vendor has already transferred to the customer under the contract) or from other transactions or events.

If the vendor regularly sells a good or service separately, this indicates that a customer can benefit from it (either on its own, or in conjunction with other resources).

Criterion 2

The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract).

In order to determine whether the vendor's promise to transfer a good or service is separately identifiable from other promised goods or services in the contract, a vendor needs to apply judgment and consider all relevant facts and circumstances. The objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each good or service individually, or instead, to transfer a combined item to which the promised good and services are inputs. Factors that indicate that a vendor's promise to transfer two or more goods or services to the customer are not separately identifiable include:

- The vendor provides a significant service of integrating the goods or services with other goods or services promised in the contract as a bundle which represents a combined output or outputs for which the customer has contracted (i.e., the vendor is using the good or service as an input to produce the combined output specified by the customer);
- One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, another good or service promised in the contract; and
- The goods or services are highly interdependent or highly interrelated. That is, each of the goods or services is significantly affected by one or more of the other promised goods or services in the contract.

When assessing whether a promised good or service is distinct, an entity is not required to identify promised goods or services that are immaterial in the context of the contract. However, customer options to purchase additional goods or services which represent a material right should not be designated as immaterial in the context of the contract. The entity would apply the guidance in paragraphs 606-10-55-42 through 55-43 to determine whether an option gives rise to a material right.

In addition, an entity is permitted to account for shipping and handling activities as fulfillment costs rather than as additional promised services in certain circumstances. Specifically, if shipping and handling activities are performed after a customer obtains control of the good, then the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good (shipping and handling activities performed before the transfer of control are always considered fulfillment activities). Otherwise, they should be evaluated as potential performance obligations. This is an accounting policy election to be applied consistently to similar types of transactions, and related accounting policy disclosures apply. If elected, those shipping and handling activities would not be identified as separate performance obligations and no revenue would be allocated to them.

2.1 Combining a good or service with other promised goods or services

If a good or service is not distinct, the vendor is required to combine that good or service with other promised goods or services until a bundle of goods or services that is distinct can be identified. This may result, in some cases, in a vendor accounting for all the goods or services promised in a contract as a single performance obligation.

2.2 Oral and implied obligations

Goods or services that are to be transferred to a customer are normally specified in a contract. However, a contract may also include promises that are implied by a vendor's customary business practices, published policies, or specific statements if those promises create a valid expectation of the customer that the vendor will transfer a good or service to the customer. Accordingly, a contract includes those promises which are written, oral, or implied by a vendor's customary business practices (provided in all cases that the arrangements are enforceable).

Consequently, the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly promised in that contract.

Performance obligations do not include activities that a vendor must perform in order to fulfill a contract, unless the vendor transfers a good or service to the customer as those activities occur. For example, a service provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed; therefore these setup activities are not performance obligations of the contract.

EXAMPLES – DETERMINING WHETHER GOODS AND SERVICES ARE DISTINCT

Construction contract

A building contractor (the vendor) enters into a contract to build a new office block for a customer. The vendor is responsible for the entire project, including procuring the construction materials, project management and associated services. The project involves site clearance, foundations, construction, piping and wiring, equipment installation and finishing.

Although the goods or services to be supplied are capable of being distinct (because the customer could, for example, benefit from them on their own by using, consuming or selling the goods or services, and could purchase them from other suppliers), they are not distinct in the context of the vendor's contract with its customer. This is because the vendor provides a significant service of integrating all of the inputs into the combined output (the new office block) which it has contracted to deliver to its customer.

Software – scenario A

A vendor enters into a contract with a customer to supply a license for a standard 'off the shelf' software package, to install the software, and to provide unspecified software updates and technical support for a period of two years. The vendor sells the license and technical support separately, and the installation service is routinely provided by a number of other unrelated vendors. The software will remain functional without the software updates and technical support.

Since the software is delivered separately from the other goods or services, can be installed by a different third party vendor, and remains functional without the software updates and technical support, it is concluded that the customer can benefit from each of the goods or services either on their own or together with other goods or services that are readily available. In addition, each of the promises to transfer goods or services is separately identifiable; because the installation service does not significantly modify or customize the software, the installation and software are separate outputs promised by the vendor, and not one overall combined output.

The following four distinct goods or services are identified:

- The software license;
- Installation service;
- Software updates;
- Technical support.

Software – scenario B

The vendor's contract with its customer is the same as in scenario A, except that as part of the installation service the software is to be substantially customized in order to add significant new functionality to enable the software to interface with other software already being used by the customer. The customized installation service can be provided by a number of unrelated vendors.

In this case, although the installation service could be provided by other entities, the analysis required by Topic 606 indicates that within the context of its contract with the customer, the promise to transfer the license is not separately identifiable from the customized installation service. This is because the license and the customized installation are inputs to produce a combined output, i.e., a functional and integrated software system. However, the software updates and technical support are separately identifiable.

The following three distinct goods or services are identified:

- Software license and customized installation service;
- Software updates;
- Technical support.

Software – scenario C

The vendor's contract with its customer is the same as in scenario B, except that the vendor is the only supplier that is capable of carrying out the customized installation service; and the software updates and technical support are essential to ensure that the software continues to operate satisfactorily, and the customer's employees continue to be able to operate the related IT systems. No other entity is capable of providing the software updates or the technical support.

In this case, the analysis indicates that in the context of its contract with the customer, all of the promises are combined to provide a single service, which is the only distinct performance obligation.

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The identification of each of the distinct goods or services in the scenarios above may require a detailed analysis of contractual terms. Contracts for different combinations of software and services may require considerable judgment to determine whether each of the components is a distinct good or service, or whether they must be combined instead.

Each distinct good or service will then be analyzed separately to determine the amount of revenue to be allocated, and the timing of recognition. The approach required by Topic 606 may bring substantial changes to the pattern and timing of software revenue recognition in comparison with current practice under Topic 985, which only allows entities to allocate arrangement consideration to delivered elements in a multiple element arrangement if vendor-specific objective evidence of fair value (VSOE) has been established for undelivered elements.

Outside of software, the requirement in Topic 606 to estimate a standalone sales price is similar, though not identical, to existing guidance in Subtopic 605-25 on multiple-element arrangements.

2.3 Customer options for additional goods or services

Customer options to acquire additional goods or services (either free of charge or at a discount) come in many forms, including sales incentives, customer award credits (or points), contract renewal options, or other discounts on future goods or services. Such customer options give rise to a performance obligation in the contract when the option provides a material right to the customer that it would not receive without entering into the contract. In those cases, the vendor is required to allocate a portion of the transaction price that relates to those future goods or services and recognize that portion as revenue only when those future goods or services are transferred to the customer (or when the option expires).

The allocation is based on the relative standalone selling prices of the goods or services and, if the prices of the future potential goods or services are not observable, they are estimated. This estimate takes into account any discount that the customer would receive without exercising the option together with the likelihood that the option will be exercised.

EXAMPLE

A retailer sells a pair of jeans for CU 100 and also provides the customer a 40% off coupon for any purchases of up to CU 100 in the next 30 days. The retailer also intends to offer a 10% discount on all sales in the next 30 days as part of a seasonal promotion. The 10% discount cannot be used in conjunction with the 40% coupon.

The coupon that the customer obtained as part of its initial purchase represents a material right because it is incremental to the standard 10% discount that all customers receive. Similarly, the measurement of the material right is based on the incremental 30%, rather than the entire 40%. It is treated as a separate performance obligation, adjusted for the portion of customers who will use it. The calculation of the standalone sales price would be: CU 50 average expected purchase price of additional goods * 30% incremental discount * 80% of expected coupon redemptions = CU 12.

As such, the initial CU 100 sale of jeans would require an allocation of the transaction price as follows: Jeans – CU 89 (CU 100/CU 112 * CU 100) and Coupon – CU 11 (CU 12/CU 112 * CU 100). The CU 11 allocated to the coupon would be recognized either upon its redemption or expiration.

2.4 Renewal options

A renewal option gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. If a renewal option provides a customer with a material right, then the option is considered a separate performance obligation, and the effect can be to defer the recognition of revenue to future periods as noted previously.

Topic 606 includes criteria to distinguish renewal options from other options to acquire additional goods or services:

- The additional goods or services are similar to the original goods or services in the contract (i.e., a vendor continues to provide what it was already providing). Consequently, it is more intuitive to view the goods or services underlying such options as part of the initial contract.
- The additional goods or services are provided in accordance with the terms of the original contract. Consequently, the vendor's position is restricted because it cannot change those terms and conditions and, in particular, it cannot change the pricing of the additional goods or services beyond the parameters specified in the original contract.

Topic 606 also includes a practical alternative to estimate the standalone selling price of the option, by allowing entities to include the optional goods or services that it expects to provide (and corresponding expected customer consideration) in the initial measurement of the transaction price. This practical alternative acknowledges that for some entities it may be simpler to account for renewal options within a single contract, rather than as a contract with a series of options.

2.5 Sale with a right of return

A right of return enables a customer to receive:

- A full or partial refund of any consideration paid.
- A credit that can be applied against amounts owed or that will be owed to the vendor.
- Another product in exchange.
- Any combination of the above.

A right of return may be given for various reasons (e.g., dissatisfaction with the product). In practice, a right of return is usually attached to the sale of goods, but can also be attached to the transfer of some services that are provided by the vendor subject to refunds.

When a vendor transfers products with a right of return, revenue is recognized only to the extent that the vendor expects to be entitled to it. To determine the amount of consideration to which it expects to be entitled, a vendor:

- Applies the guidance regarding constraining estimates of variable consideration in Step 3; and
- Considers the nature of the products expected to be returned.

A refund liability (rather than revenue) is recognized for any consideration received to which the vendor does not expect to be entitled (that is, which relates to goods that it expects to be returned). An asset is also recognized for the vendor's right to recover the goods

from customers on settling the refund liability. The asset is measured by reference to the former carrying amount of the good less any expected costs to recover those products (including potential decreases in the value of the good). The asset is presented separately from the refund liability (offsetting is not permitted). If the value is less than the amount recorded in inventory, the carrying amount of inventory is reduced with a corresponding adjustment to cost of goods sold.

In subsequent periods the vendor updates:

- Its assessment(s) of amounts to which it expects to be entitled in exchange for the transferred products.
- The measurement of the refund liability with a corresponding adjustment to revenue for changes in expectations about the amount of refunds.
- The measurement of the asset with a corresponding adjustment to cost of sales, together with any impairment.

EXAMPLE

On January 1, 20X4, a retailer sells 100 identical goods to different customers, at a sales price of CU 100 (total CU 10,000). The cost of each good is CU 60. Revenue is recognized at the point at which a customer buys one of the goods, and customers have a right to return the good for a period of 30 days from the original purchase, in return for a full refund.

The right of return gives rise to variable consideration (see Step 3). Based on substantial historical experience with the good, and on future expectations, the vendor estimates that three of the goods will be returned. The amount and quality of evidence available means that the vendor is able to conclude that it is probable that there will not be a significant reversal of revenue if it recognizes revenue attributable to the 97 goods that it does not expect to be returned.

On January 1, 20X4, the vendor recognizes revenue of CU 9,700 (CU 100 x 97) together with a refund liability of CU 300 (CU 100 x 3). A right to recover the inventory to be returned of CU 180 (CU 60 x 3) is recorded, because the vendor concludes that the goods that it expects to be returned will be capable of being sold for at least that amount. The recovery asset is essentially a reclassification from inventory.

MFA INSIGHT

The effect of the accounting requirements is that a sale is not recognized for the three goods that are expected to be returned. Since the customers that have purchased these goods are expected to return them to the vendor, the consideration paid is deemed variable consideration, which is not recognized until it is probable of not being reversed.

In some cases, the vendor may conclude that the goods it expects to be returned will either not be capable of being sold to other customers, or will need to be sold for an amount below their original cost. In such cases, in addition to recording a refund liability, a charge will be made to profit or loss for the write down in the carrying amount of the related asset.

2.6 Principal vs. agent

When a third party is involved in providing goods or services to a customer, the vendor is required to determine whether the nature of its promise is a performance obligation to:

- Provide the specified goods or services itself (principal); or
- Arrange for a third party to provide those goods or services (agent).

A vendor acting as principal controls a good or service before the vendor transfers the good or service to the customer. A vendor that qualifies as a principal may satisfy a performance obligation by itself or engage another party (for example, a subcontractor) to satisfy some or all of a performance obligation on its behalf. When a vendor, in its role as a principal, satisfies a performance obligation, it recognizes revenue at the gross amount.

The obligation of an agent is to arrange for the provision of goods or services by another third party. When a vendor is an agent, and satisfies a performance obligation, it recognizes revenue as the amount of any fee or commission to which it expects to be entitled.

A vendor's fee or commission might be the net amount of consideration that the vendor retains after paying the third party the consideration received in exchange for the goods or services to be provided by that party.

An entity must determine whether it is a principal or an agent for each distinct good or service (or a distinct bundle of goods or services) to be provided to the customer. If a contract with a customer includes more than one distinct good or service, an entity could be a principal for some and an agent for others. As part of this assessment – determining whether the entity provides a distinct good or service (principal) or merely arranges for a third party to do so (agent) – the entity should assess whether it controls each good or service before it is transferred to the customer. That is, an entity can only be a principal if it controls the good or service beforehand. However, the vendor is not necessarily acting as a principal if the vendor obtains legal title to a product only momentarily before legal title is transferred to a customer.

The standard provides the following indicators as to when the vendor controls the specified good or service before transferring it to the customer, and therefore is considered a principal:

- The entity is primarily responsible for fulfilling the promise to provide a good or service;
- The entity has inventory risk before the good or service is transferred;
- The entity has discretion in establishing prices.

MFA INSIGHT

Under current guidance, in practice it has sometimes been difficult to identify which party is acting as principal and which as agent. We expect those judgments to continue to be challenging when accounting in accordance with Topic 606, which reflects the complexity of certain transactions, and the way in which they are undertaken. For example, transactions involving virtual goods and services are often executed in milliseconds and involve multiple counterparties. Consequently, control over a virtual good may, in some cases, transfer almost instantaneously.

It is likely that significant focus will need to be placed on the precise contractual terms of the arrangements, in order to determine the nature of the promises made (that is, what each party is providing) and the consideration payable to each party. This links to the first of the five steps in Topic 606, which is to identify the contract, including the goods or services to be transferred and the payment terms. In addition, because the new guidance focuses on the concept of control rather than risk and rewards, the conclusion of whether an entity is the principal in an arrangement or an agent may change under the new guidance.

3. Step Three - Determine the transaction price of the contract

The transaction price is the amount of consideration that a vendor expects to be entitled to in exchange for the goods or services. This will often be the amount specified in the contract. However, the vendor is also required to consider its customary business practices (e.g., price concessions) and, adjust the expected amount of consideration if these indicate that a lower amount will be accepted.

Although a number of estimates about the future may need to be made when determining the transaction price, these are based on the goods and services to be transferred in accordance with the existing contract. They do not take into account expectations about whether the contract will be cancelled, renewed or modified.

The vendor also needs to consider the effects of the following:

- Variable consideration;
- Constraining estimates of variable consideration;
- The existence of a significant financing component in the contract;
- Non-cash consideration; and
- Consideration payable to a customer.

The standard provides an accounting policy election whereby an entity may exclude from the measurement of transaction price all taxes assessed by a taxing authority related to the specific transaction and which are collected from the customer. Examples include sales, use, value added, and some excise taxes. That is, such amounts would be presented "net" under this option. Otherwise, an entity must analyze each jurisdiction in which it operates to determine whether such amounts should be included or excluded from the transaction price under Topic 606.

3.1 Variable consideration

Instead of the amount of consideration specified in a contract being fixed, the amount receivable by a vendor may vary. In other cases, the consideration may be a combination of fixed and variable amounts.

Variable consideration can arise for a wide range of reasons, including discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. Any potential variation in the amount that a vendor will receive in return for its performance must be considered.

To identify variable consideration, entities will need to look beyond the contract's explicit terms. Variability in the amount of consideration may arise if the customer has a valid expectation arising from a vendor's customary business practices, published policies or specific statements that the vendor will accept an amount of consideration that is less than the price stated in the contract. For example, a manufacturer of retail goods might expect to offer a retailer a discount (or additional discount) from that specified in a contract for goods, to enable the retailer to sell the goods to its own customers at a discount and therefore to increase sales volumes.

When variable consideration exists in a contract, a vendor estimates the amount of consideration to which it is entitled in exchange for the transfer of the promised goods or services. There are two possible methods which can be used, which are required to be applied consistently throughout the term of each contract:

- ***Expected value method***
  The sum of probability weighted amounts in a range of possible outcomes. This may be an appropriate approach if the vendor has a large number of contracts which have similar characteristics, or if a contract may result in a large number of potential outcomes, such as a fee calculated based on the market price of assets under management.
- ***Most likely amount***
  The single most likely amount from a range of possible outcomes. This may be an appropriate approach if a contract has only two possible outcomes, such as a performance bonus which will or will not be received.

The approach which is chosen is not intended to be a free choice. Rather, the selected method should be the one that is expected to provide a better prediction of the amount of consideration to which a vendor expects to be entitled.

The estimated amount of variable consideration is updated at each reporting date to reflect the position at that date, and any changes in circumstances since the last reporting date, until the uncertainty is resolved. See below regarding the constraint of variable consideration.

MFA INSIGHT

The requirement to estimate variable consideration represents a significant change to U.S. GAAP. Under the new standard, there is no "fixed or determinable" concept. This change reflects the new standard's principle that revenue should more closely depict the transfer of control. That is, the standard accepts more uncertainty in the measurement of revenue compared to prior U.S. GAAP to more closely reflect a vendor's performance.

Further, when a discount is offered between the date of supply of goods or services and the payment date, it may be difficult to determine whether a vendor has offered a price concession, or has chosen to accept the risk of the customer defaulting on the contractually agreed amount of consideration. In the development of Topic 606, it was noted that this judgment is already required in current U.S. GAAP and it was decided not to include detailed requirements in Topic 606 for making the distinction between a price concession and an impairment.

EXAMPLES

Variable consideration – expected value method

On January 1, 20X4, a vendor enters into a contract with a customer to build an item of specialized equipment, for delivery on March 31, 20X4. The amount of consideration specified in the contract is CU 2 million, but that amount will be increased or decreased by CU 10,000 for each day that the actual delivery date is either before or after March 31, 20X4.

In determining the transaction price, the vendor considers the approach that will better predict the amount of consideration that it will ultimately be entitled to, and determines that the expected value method is the appropriate approach. This is because there is a range of possible outcomes.

Variable consideration – most likely amount

A vendor enters into a contract with a customer to construct a building for CU 1 million. The terms of the contract include a penalty of CU 100,000 if the building has not been completed by a specified date.

In determining the transaction price, the vendor considers the approach that will better predict the amount of consideration that it will ultimately be entitled to, and determines that the most likely amount method is the appropriate approach. This is because there are only two possible outcomes; either the penalty will be applied or it will not.

3.2 Constraining estimates of variable consideration

Estimates introduce a degree of uncertainty into the amount of revenue that a vendor expects to earn. In order to avoid overly optimistic estimates being included in revenue, followed by a subsequent downward adjustment to actual amounts earned (i.e., a reversal of previously recognized revenue), Topic 606 includes a constraint on the amount of variable revenue that can be recognized.

The effect of the constraint is that the estimated transaction price can only include an amount of variable consideration if it is probable that there will not be a subsequent significant reversal in the amount of revenue recognized at the point at which uncertainty over the amount of variable consideration is resolved. As noted above, the position may change at each reporting date as more information becomes available and there is greater certainty about the expected amount of consideration.

MFA INSIGHT

The term “probable” is used consistent with its meaning in Topic 450, Contingencies, i.e., “the future event or events are likely to occur.”

The use of judgment and consideration of all facts and circumstances is required when assessing the potential for such a reversal and, includes the likelihood of a change in the estimate of variable consideration and the amount of the possible revenue reversal. Factors that indicate a significant revenue reversal may result from including an estimate of variable consideration in the transaction price include:

- The consideration is highly susceptible to factors outside the vendor’s influence, including:
  - Volatility in a market;
  - The judgment or actions of third parties (e.g., when the amount of variable consideration varies based on the customer’s subsequent sales of a good or service);
  - Weather conditions; and
  - A high risk of obsolescence of the promised good or service.
- The uncertainty regarding the amount of variable consideration is not expected to be resolved for a long period of time.
- The vendor’s experience (or other evidence) with similar types of contracts is limited or it has limited predictive value.
- The vendor 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.
- The contract has a large number and broad range of possible variable consideration amounts.

EXAMPLE

The example, and two scenarios, set out below illustrate the interaction between variable consideration and its related constraint.

On January 1, 20X4, a vendor sells 1,000 identical goods to a distributor, which sells them to its own customers. The vendor's selling price is CU 100 per unit, and payment is due from the distributor to the vendor when the distributor sells each of the goods to its own customers. Typically, those subsequent sales take place 90 days after the goods have been obtained by the distributor. Control of the goods transfers to the distributor on January 1, 20X4. (See discussion in Step 5 for consideration around to when control has transferred to a customer.)

The vendor expects that it will subsequently grant a price concession (a discount), so that the distributor can offer its own customers a discount and increase sales volumes. Consequently, the consideration in the contract is variable.

Scenario 1 – the vendor's estimate of variable consideration is not constrained

The vendor has substantial past experience of selling the goods and, historically, has granted a subsequent price concession of approximately 20% of the original sales price. Current market conditions indicate that a similar reduction in price will be applied to the contract entered into on January 1, 20X4.

The vendor considers the approach which will better predict the amount of consideration to which it will be entitled, and concludes that the expected value method should be used. Under this method, the estimated transaction price is CU 80,000 (CU 80 x 1,000 units).

In addition, the vendor considers the requirements for constraining the estimate of variable consideration to determine whether the transaction price can be the estimated amount of CU 80,000. In this scenario, the vendor determines that it has significant previous experience with the particular good and that current market information supports the estimate. In addition, despite there being some uncertainty (because the vendor will only receive payment when the distributor sells the goods to its own customers), this will be resolved in a relatively short time period.

Consequently, the vendor recognizes revenue of CU 80,000 on January 1, 20X4, the date on which control of the goods passes to the distributor.

Scenario 2 – the vendor's estimate of variable consideration is constrained

Although the vendor has experience selling similar goods, these goods (including the goods being sold in this transaction) have a high risk of obsolescence and the ultimate pricing is very volatile. Historically, the vendor has offered subsequent price concessions of 20-60% from the sales price for similar goods, and current market information indicates that a range of 15-50% might apply to the current transaction.

The vendor considers the approach which will better predict the amount of consideration to which it will be entitled, and concludes that the expected value method should be used. Under this method, it is estimated that a 40% price concession will apply, meaning that the estimated transaction price is CU 60,000 (CU 60 x 1,000 units).

In addition, the vendor considers the requirements for constraining the estimate of variable consideration. This is in order to determine whether the transaction price can be the estimated amount of CU 60,000. In this scenario, the vendor determines that the ultimate amount of consideration is highly variable and susceptible to factors outside its control, and that there is a wide range of possible price concessions that will need to be offered to the distributor. Consequently, the vendor cannot use its estimate of CU 60,000 because it is unable to conclude that it is probable that there will not be a significant reversal in the cumulative amount of revenue that has been recognized.

Although historic information shows that price concessions of 20-60% have been given in the past, current market information indicates that a price concession of 15-50% will be needed for the current transaction. The vendor has carried out an analysis of past prices and can demonstrate that they were consistent with the current market information that was available at that time. Consequently, it is concluded that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur if a transaction price of CU 50,000 is used.

Consequently, the vendor recognizes revenue of CU 50,000 on January 1, 20X4, and reassesses its estimates of the transaction price at each subsequent reporting date until the uncertainty has been resolved.

MFA INSIGHT

In scenario 2 above, although the uncertainties resulted in a restriction over the amount of revenue that was recognized when the goods were supplied to the distributor, there was still sufficient evidence to support the immediate recognition of a portion of the estimated transaction price. For those entities in the early stages of their operations, in particular those operating in relatively new sectors, it is possible that the constraint over estimates of variable consideration will result in no revenue being recognized on the date on which control over goods passes to a customer, with recognition being postponed until a later date. Because of the requirement for reassessment at each reporting date, this may result in a gradual subsequent recognition of revenue.

In addition, there are specific requirements for revenue relating to sales- or usage-based royalties that are promised in return for a license of intellectual property. In those cases, revenue is recognized when (or as) the later of the following events takes place:

(i) The subsequent sale or usage occurs.

(ii) The performance obligation to which some or all of the sale- or usage-based royalty has been allocated has been satisfied (in whole or in part).

The treatment of sales-based royalties for intellectual property might lead to a change in the timing of revenue recognition for some transactions—see sections 5.8 and 5.9.

3.3 The existence of a significant financing component in the contract

The timing of payments specified in a contract may be different from the timing of recognition of the related revenue (and, consequently, the timing of transfer of control of the related goods or services to the customer). If the timing of payments specified in the contract provides the customer or the vendor with a significant benefit of financing the transfer of goods or services, the transaction price is adjusted to reflect this financing component of the contract.

MFA INSIGHT

Again, it is necessary to consider factors beyond the documented contractual terms. A significant financing component may exist regardless of whether a financing component is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

This new requirement may bring a significant change in practice for some entities. Under existing guidance, consideration has not always been given to whether a schedule of payments gives rise to a financing arrangement.

As a practical expedient, adjustments for the effects of a significant financing component are not required if the vendor expects at contract inception that the period between the point at which the vendor recognizes revenue for the transfer of the goods or services, and the date of payment from the customer, will be one year or less.

The new guidance brings a significant change in practice, because although some entities have previously adjusted for a financing component when payment is received after the supply of goods or services, adjustments have not typically been made by a vendor when payment is received in advance. In addition, for those arrangements where customers pay in arrears, there may be a change in practice.

The objective of including adjustments for significant financing components is to reflect the amount that would have been paid if the customer had paid for the goods or services at the point at which they are supplied (that is, when control transfers to the customer). Otherwise, excluding the effects of financing could result in two economically similar transactions giving rise to substantially different amounts of revenue.

For example, a vendor may require a customer to pay in advance for a long-term construction contract because the vendor requires funds in order to obtain materials to carry out the contract. In the absence of such an advance payment, the vendor would typically need to borrow the funds from a bank (or other financial institution). If the vendor obtained financing from the bank, the vendor would need to pay finance charges and would likely pass those costs to the customer by way of a higher transaction price. However, the fair value of goods and services transferred to the customer would be the same. It is only the party providing the financing to the vendor that

changes. Consequently, the vendor's revenue should not vary depending on whether the vendor receives financing from the customer or from a third party.

Factors to consider in assessing whether a contract contains a significant financing component include:

- The difference, if any, between the amount of consideration and the cash selling price of the goods or services;
- The combined effect of:
  - The expected length of time between the point at which the vendor transfers the goods or services to the customer, and the point at which the customer pays for those goods or services, and
  - The prevailing interest rates in the relevant market.

When the existence of a significant financing component is identified, the applicable interest rate will not always be the rate which is implied by the contractual terms for the sales transaction. In addition to considering any difference between the amount of consideration and the cash selling price of the goods or services, the interest rate that would apply to a particular borrowing arrangement needs to be considered, i.e., it would reflect the credit characteristics of the party receiving the financing as well as current interest rates.

EXAMPLE

A vendor (a construction company) enters into a contract with a customer to supply a new building. Control over the completed building will pass to the customer in two years (the vendor's performance obligation will be satisfied at a point in time—see Section 5). The contract contains two payment options. Either the customer can pay CU 5 million in two years when it obtains control of the building, or the customer can pay CU 4 million at inception of the contract.

The customer decides to pay CU 4 million at inception.

The vendor concludes that because of the significant period of time between the date of payment by the customer and the transfer of the asset (the completed building) to the customer, together with the effect of prevailing market rates of interest, that there is a significant financing component.

The interest rate implicit in the transaction is 11.8%. However, because the vendor is effectively borrowing from its customer, the vendor is also required to consider its own incremental borrowing rate which is determined to be 6%.

The accounting entries required are as follows:

Contract inception:		
	CU '000	CU '000
Cash	4,000	
Contract liability		4,000
Recognition of a contract liability for the payment in advance		
Over the two year construction period:		
Interest expense	494	
Contract liability		494
Accretion of the contract liability at a rate of 6%		
At the date of transfer of the asset (the building) to the customer:		
Contract liability	4,494	
Revenue		4,494

MFA INSIGHT

For the purposes of identifying whether there is a significant financing component, the comparison made is between the timing of payment and the timing of transfer (of control) of the related goods or services. Therefore, a long term contract (e.g., 10 years) may not contain a significant financing component if the timing of payments and the transfer of control coincide throughout the term.

In some cases, although there may be a difference between the timing of the goods or services and payment, this is not regarded as giving rise to a significant financing component. This is the case in any of the following circumstances:

- A customer has paid in advance and maintains discretion over when the good or service is transferred (such as a prepaid phone card);
- A substantial amount of consideration payable by the customer is variable, and the amount or timing of that consideration will be determined by future events that are not substantially within the control of either the vendor or the customer (such as a sales-based royalty);
- The timing of payment in comparison with the timing of supply of goods or services is for a reason other than financing (such as to provide the customer with protection that the vendor has or will adequately complete its obligations – such as post completion remedial work on a building).

The discount rate used is the rate that would apply to a separate financing transaction between the vendor and the customer at contract inception. It needs to reflect the credit characteristics of the party receiving financing, as well as any collateral or security provided by that party (which might include assets transferred in the contract). The discount rate may be capable of being determined by identifying the rate that discounts the nominal amount of consideration to the cash selling price of the good or service. However, the discount rate will not necessarily be the same as the implied rate that would be derived by using the timing of the amount(s) payable by the customer and the timing of the transfer of the related goods or services to the customer.

After contract inception, the discount rate is not updated for changes in interest rates or other circumstances (including a change in the customer's credit risk).

The effects of a financing component are presented separately from revenue in the statement of comprehensive income. Interest income or interest expense is only recognized by a vendor to the extent that a related contract asset/receivable or contract liability (such as deferred revenue) is recognized.

3.4 Non-cash consideration

In some cases, a customer might pay for goods or services in a form other than cash. For example, a customer might issue shares to the vendor.

When determining the transaction price, the vendor should measure the non-cash consideration at its fair value at contract inception. Subsequent changes in the fair value of noncash consideration based on the form of the consideration (e.g., a change in the quoted market price of a share received as consideration) are not included in the transaction price. In contrast, subsequent changes in the fair value due to reasons other than the form of consideration (e.g., a change in the exercise price of a share option resulting from the entity's performance) are subject to the guidance on variable consideration within the standard. If it is not possible to measure the fair value of the non-cash consideration, then the vendor is required to estimate it by using the stand-alone selling prices of the goods or services subject to the contract.

A customer might contribute goods or services (for example, a customer for a construction contract might contribute materials, equipment or labor). In those circumstances, the vendor is required to assess whether it obtains control of the contributed goods or services. If so, they are accounted for as non-cash consideration.

3.5 Consideration payable to a customer

Consideration payable to a customer includes cash amounts that a vendor pays, or expects to pay, to a customer (or to other parties that purchase the vendor's goods or services from the customer), credits or other items such as coupons or vouchers that can be applied against amounts owed to the vendor. Alternatively, the payment to the customer may be in return for the supply of goods or services.

Consideration payable to a customer is accounted for as a reduction of the transaction price (and hence, a reduction of revenue), unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the vendor.

A vendor might sell goods or services to a customer and at the same time purchase goods or services from the same customer. If the amount of consideration payable to the customer exceeds the fair value of a distinct good or service that the vendor receives in exchange, the difference is accounted for as a reduction in the vendor's transaction price.

If a vendor cannot reasonably estimate the fair value of a good or service received from the customer, then the full amount of the consideration payable to the customer is deducted from the vendor's own transaction price (and hence revenue).

When the consideration payable to a customer is treated as a reduction of the transaction price the reduction of revenue is recognized when (or as) the later of either of the following occurs:

(i) The vendor recognizes revenue for the transfer of the related goods or services to the customer.

(ii) The vendor pays, or promises to pay, the consideration, even if the payment is conditional on a future event. Such a promise may be implied by the vendor's customary business practices.

A key point is that any amount paid by a vendor to its customer will be accounted for as a reduction in revenue, unless that payment is in return for a distinct good or service.

EXAMPLE

A vendor that manufactures retail goods enters into a contract to sell goods to a customer (a large supermarket group) for a period of one year. The customer is required to purchase at least CU 20 million of goods during the year.

The contract requires the customer to make changes to the shelving and display cabinets at the stores from which the retail goods will be sold. On the date on which the contract is entered into, the vendor makes a non-refundable payment of CU 2 million to the customer to compensate for the related costs.

The payment by the vendor to its customer does not result in it obtaining any distinct good or service. Although the shelving and display cabinets will be used by the customer to sell the retail goods, the vendor does not obtain control of any rights to those shelves or display cabinets.

Consequently, the CU 2 million payment is accounted for as a 10% reduction in the transaction price when the vendor recognizes revenue for the transfer of retail goods. To achieve this, the CU 2 million payment is recorded as an asset and is amortized as a reduction in revenue as the related sales of retails goods are recorded.

4. Step Four - Allocate the transaction price to the performance obligations

The amount allocated to each separate performance obligation reflects the consideration to which a vendor expects to be entitled in exchange for transferring the related goods or services to the customer. The starting point for the allocation is the standalone selling price of each performance obligation.

4.1 Allocating the transaction price based on the standalone selling price

At contract inception a vendor is required to determine the standalone selling price of the good or service underlying each performance obligation and then allocate the transaction price proportionately based on these standalone selling prices. The 'standalone selling price' is the price at which a vendor would sell a good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service sold in similar circumstances and to similar customers. Although a contractually stated price or a list price for a good or service may represent the standalone selling price, this is not presumed to be the case.

When a standalone selling price is not directly observable, it is estimated. The objective is to determine the amount of consideration that When a standalone selling price is not directly observable, it is estimated. The objective is to determine the amount of consideration to which the vendor expects to be entitled in return for the good or service. This is achieved by using all available information including market conditions, vendor-specific factors and information about the customer or class of customers. In all cases, the use of observable inputs is required to be maximized to the extent possible.

Approaches that might be used include:

- ***Adjusted market assessment***
  Estimating the price that a customer in the particular market would be prepared to pay, which might include referring to prices charged by the vendor's competitors for similar goods or services, and adjusting those prices as necessary to reflect the vendor's costs and margins.
- ***Expected cost plus margin***
  Estimating the expected costs of satisfying a performance obligation and adding an appropriate margin.
- ***Residual***
  Deducting observable standalone selling prices that are available for other goods or services to be supplied from the total contract price. However, the use of this approach is restricted to those goods or services for which there is a wide range of selling prices (meaning that these cannot be observed from past transactions or other observable evidence), or in circumstances in which the selling price is uncertain because no selling price has been set for the good or service and it has not previously been sold on a standalone basis.

4.2 Allocation of variable consideration

Variable consideration may be attributable either to the entire contract, or to specific part(s) of the contract, such as:

- One or more, but not all, performance obligations. For example, a bonus may be contingent on the vendor transferring a good or service within a specified period of time.
- One or more, but not all, of the distinct goods or services of a single performance obligation. This would apply if, for example, the consideration promised for the second year of a two-year maintenance service will increase based on movements in a consumer price index.

A variable amount of consideration (and subsequent changes to that amount) is allocated entirely to a performance obligation (or a distinct good or service that forms part of a single performance obligation to transfer a series of distinct goods or services that are substantially the same) if both:

- The terms of a variable payment relate specifically to the vendor'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); and
- The allocation of the variable amount in its entirety to a performance obligation or distinct good or service is consistent with the objective that the transaction price is allocated to each performance obligation in order to reflect the consideration to which the vendor expects to be entitled in exchange for the good or service.

EXAMPLE

A vendor enters into a contract with a customer for two licenses of intellectual property (licenses A and B). It is determined that each license represents a separate performance obligation, which is satisfied at a point in time (the transfer of each of the licenses to the customer). The standalone selling prices of the licenses are CU 1,200 (license A) and CU 1,500 (license B).

Scenario A

The prices included in the contract are as follows:

- License A: a fixed amount of CU 1,200, payable 30 days from the transfer of the license to the customer.
- License B: a royalty payment of 5% of the selling price of the customer's future sales of products that use license B.

The vendor estimates that the amount of sales-based royalties that it will receive in respect of license B will be approximately CU 1,500.

The vendor then determines the allocation of the transaction price to each of the two licenses. It is concluded that the allocation should be as follows:

- License A: CU 1,200
- License B: the variable royalty payment

This allocation is made because both of the following conditions apply:

- The variable payment relates solely to the transfer of license B (the subsequent royalty payments); and
- The fixed amount of license A, and the estimated amount of sales-based royalties for license B, are equivalent to their standalone selling prices.

Although revenue will be recognized for license A on its transfer to the customer, no revenue will be recognized when license B is transferred to the customer. Instead, revenue attributable to license B will be recognized when the subsequent sales of the customer's products that use license B take place—see sections 5.8 and 5.9.

In contrast, the allocation of variable consideration is different if the prices included in a contract do not reflect standalone selling prices.

Scenario B

Assume the same example as above, except that the prices included in the contract are:

- License A: a fixed amount of CU 450.
- License B: a royalty payment of 7.5% of the selling price of the customer's future sales of products that use license B.

The vendor estimates that the amount of sales-based royalties that it will receive in respect of license B will be approximately CU 2,250.

In this case, although the variable payments relate solely to the transfer of license B (the subsequent royalty payments), allocating the variable consideration only to license B would be inappropriate. This is because allocating CU 450 to license A and CU 2,250 to license B would not reflect a reasonable allocation based on the standalone selling prices of those two licenses. Instead, the fixed amount receivable in respect of license A is allocated to the two licenses on the basis of their standalone selling prices. This allocation is calculated as:

- License A: (1,200 / 2,700) x CU 450 CU 200
- License B : (1,500 / 2,700) x CU 450 CU 250

The royalty income will be allocated to licenses A and B on a relative standalone selling price basis and recognized when the related product sales take place in the future (see Sections 5.8 and 5.9). Although contractually the royalty income relates to the transfer of license B, the allocation of the fixed selling price of license A and the estimate of sales-based royalties to be generated by license B is disproportionate in comparison with the standalone selling prices of the two licenses. This means that, in effect, some of the income to be generated by license B in fact relates to the sale of license A.

4.3 Allocating discounts

A discount exists if the sum of the standalone selling prices of the goods or services in the contract exceeds the consideration payable by the customer. After allocating variable consideration (Section 4.2), a discount is allocated on a proportionate basis to all performance obligations in the contract, unless there is observable evidence that the discount is attributable to only some performance obligations in a contract. This might be the case if a contract is for the supply of three goods, and two of these are frequently sold together at a discount from the total of the two standalone selling prices, which is substantially the same as the discount in the contract.

EXAMPLE

A vendor sells three products (A, B and C) to a customer for CU 100. Each product will be transferred to the customer at a different time. Product A is regularly sold separately for CU 50; products B and C are not sold separately, and their estimated standalone selling prices are CU 25 and CU 75 respectively.

There is no evidence that suggests the discount of CU 50 relates entirely to one, or a group of two, of the products being sold. Consequently the discount is allocated proportionately to the three products:

A	(100 x (50/150))	CU 33
B	(100 x (25/150))	CU 17
C	(100 x (75/150))	CU 50

If a discount is allocated entirely to only some of the performance obligations in the contract, the discount is allocated before applying the residual approach to estimate the standalone selling price of any remaining performance obligation.

EXAMPLE

Assume the same fact pattern as above, except that products B and C are regularly sold together for consideration of CU 50, the total amount payable by the customer is 90 and product A is regularly sold for amounts between CU 35 and CU 50. Because the vendor has evidence that a discount of CU 50 is regularly applied to products B and C, the selling price attributed to those products is determined first with a residual amount being attributed to product A.

Consequently, revenue will be attributed to each product as follows:

A	(90-50)	CU 40
B	(50 x (25/100))	CU 12.5
C	(50 x (75/100))	CU 37.5

It should be noted that the residual approach resulted in an amount being attributed to product A that is within the range of prices at which it is regularly sold. If, for example, product A was never sold for less than CU 50, then the residual approach illustrated above would not be appropriate. Instead, the standalone selling prices for each separate product would be estimated and the discount allocated on a relative standalone selling price basis.

MFA INSIGHT

It is common for vendors in the retail sector to ‘bundle’ a number of different goods together and sell them at a discount. Although the approach set out in Topic 606 appears straightforward, care will be required to ensure that discounts are allocated on an appropriate basis. Historically, when using a residual approach, some entities may not previously have considered the range of prices at which each good within a bundle has historically been sold separately.

4.4 Changes in the transaction price after contract inception

For certain contracts, the transaction price is not fixed. Consequently, after contract inception, the resolution of uncertain events or changes in circumstances can result in a variation of the amount to which the vendor expects to be entitled in return for goods or services.

Any changes in the transaction price subsequent to contract inception are allocated to the performance obligations on the same basis as at contract inception. Amounts that are allocated to performance obligation(s) which have already been satisfied are recognized as revenue (or as a reduction of revenue if necessary) in the period in which the transaction price changes. This approach ensures that changes in estimates of variable consideration that are included in (or excluded from) the transaction price will be allocated to the performance obligation(s) to which the variable consideration relates.

A change in the transaction price is allocated entirely to one or more distinct goods or services only if the criteria for allocation of variable consideration to performance obligations are met. These are that:

- The terms of a variable payment relate specifically to the satisfaction of a performance obligation or to distinct goods or services; and
- The allocation meets the objective that the amount allocated to each performance obligation or distinct good or service reflects the amount to which the vendor expects to be entitled in exchange for transferring the goods or services to the customer.

Changes in standalone selling prices after contract inception are not considered when determining the reallocation of the transaction price.

Some changes in the transaction price occur after a contract modification (as opposed to changes that result from a contract modification—see Section 1). In those circumstances, a vendor allocates the change in the transaction price in whichever of the following ays is applicable:

- The change in the transaction price is allocated 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 termination of the original contract and the establishment of a new contract.
- In all other cases, the change in the transaction price is allocated to the performance obligations in the modified contract (i.e., the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

5. Step Five – Recognize revenue when each performance obligation is satisfied

Revenue is recognized when (or as) goods or services are transferred to a customer. A vendor satisfies each of its performance obligations (that is, it fulfills its promises to the customer) by transferring control of the promised good or service underlying that performance obligation to the customer.

MFA INSIGHT

In many cases, existing requirements for revenue recognition are based on an assessment of whether the risks and rewards of ownership of a good or service have been transferred to a customer. The application of the control principle to all types of transactions for providing goods or services is one of the primary changes in Topic 606 compared with current practice. Under the control model, an analysis of risks and rewards is only one of a number of factors to be considered. This may lead to a change in the timing of revenue recognition in certain industries.

Control in the context of Topic 606 is the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. It includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. Indicators that control has passed include that the customer has:

- A present obligation to pay;
- Physical possession of the asset(s);
- Legal title;
- Risks and rewards of ownership;
- Accepted the asset(s).

The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly, such as by:

- Using the asset to produce goods or provide services (including public services);
- Using the asset to enhance the value of other assets;
- Using the asset to settle liabilities or reduce expenses;
- Selling or exchanging the asset;
- Pledging the asset to secure a loan;
- Holding the asset.

When evaluating whether a customer obtains control of an asset, a vendor considers any agreement to repurchase the asset transferred to the customer, or a component of that asset.

For each performance obligation, a vendor determines at contract inception whether control of that good or service is transferred over time or at a point in time. If it is determined that a vendor does not satisfy a performance obligation over time, the performance obligation is deemed to be satisfied at a point in time.

5.1 Performance obligations satisfied over time

A vendor satisfies a performance obligation and recognizes revenue over time when one of the following three criteria is met:

(i) The customer simultaneously receives and consumes the economic benefits provided by the vendor's performance.
(ii) The vendor creates or enhances an asset controlled by the customer.
(iii) The vendor's performance does not create an asset for which the vendor has an alternative use, and the vendor has an enforceable right to payment for performance completed to date.

(i) The customer simultaneously receives and consumes the economic benefits provided by the vendor's performance

This criterion applies primarily to certain contracts for services, and in some cases it will be straightforward to identify that it has been met. For example, for routine or recurring services (such as cleaning services) it will be clear that there is simultaneous receipt by the customer of the benefits of the vendor's performance. The concept of control of an asset applies, because services are viewed as being an asset (if only momentarily) when they are received and used.

For other performance obligations, it may be less straightforward to identify whether there is simultaneous receipt and consumption of the benefits from the vendor's performance. In these cases, a key test is whether, to complete the remaining performance obligations, another vendor would need to substantially re-perform the work the vendor has completed to date. If another vendor would not need to do so, then it is considered that the customer is simultaneously receiving and consuming the economic benefits arising from the vendor's performance.

In determining whether another entity would need substantially to reperform the work completed to date, the vendor is required to:

- Disregard any contractual or practical barriers to the transfer of the remaining performance obligations to another entity; and
- Presume that any replacement vendor would not benefit from an asset that the vendor currently controls (such as a work in progress balance) if the performance obligation was transferred to another entity.

(ii) The vendor creates or enhances an asset controlled by the customer

This criterion is most likely to be relevant when an asset is being constructed on the customer's premises. The asset being sold by the vendor could be tangible or intangible (for example, a building that is being constructed on land owned by the customer, or customized software that is being written into a customer's existing IT infrastructure).

(iii) The vendor's performance does not create an asset for which the vendor has an alternative use, and the vendor has an enforceable right to payment for performance completed to date

This two-step criterion may be relevant to entities in the construction and real estate sector, and also applies when a specialized asset is to be constructed that can only be used by the customer. It may also apply when an asset is to be constructed to a customer's specification.

5.2 Alternative use

A vendor does not have an alternative use for an asset if the vendor is unable, either contractually or practically, to direct the asset (which may be a partially completed asset) for another use during the creation or enhancement of that asset. The assessment is made at contract inception, and takes into account the characteristics of the asset that will ultimately be transferred. It is not updated unless there is a modification to the contract that results in a substantive change to the vendor's performance obligation(s).

The contractual 'alternative use' restriction applies if the vendor would expect the customer to enforce its rights to the promised asset if the vendor sought to direct the asset for another use. However, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the vendor could transfer to the customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract. This might apply when the asset being sold is mass produced, and it would be straightforward for one item to be sold and another substituted. This would apply even if each of the items produced (for example, a car) could be specified individually by each customer from a range of optional extras, because it is straightforward for another car to be produced with the same options.

A vendor does not have a practical alternative use for an asset if the vendor would incur significant economic losses to direct the asset for another use, for example,

- Incurring significant costs to rework the asset, or
- Only being able to sell the asset at a significant loss.

This may occur in some manufacturing contracts where the basic design of the asset is the same across all contracts, yet the customization is substantial and therefore to redirect a nearly completed asset to another customer would require significant rework.

A vendor does not consider the possibility of a contract termination in assessing whether the vendor is able to redirect the asset to another customer.

5.3 Enforceable right to payment for performance completed to date

The right to payment for performance completed to date must be enforceable by the vendor in all circumstances, other than where the contract is terminated due to the vendor's failure to carry out its obligations. In assessing that enforceability a vendor considers the terms of the contract as well as any laws or regulations that relate to the contract. The enforceable amount must at least compensate the vendor for performance completed to date (i.e., an amount that approximates the selling price of the goods or services transferred to date), even if the customer has a right of termination.

A vendor must always be entitled to compensation for recovery of costs that it has incurred plus either of the following amounts:

(i) A proportion of the expected profit margin under the contract, reasonably reflecting the extent of the vendor's performance under the contract before termination by the customer or another third party.
(ii) A reasonable return on the vendor's cost of capital for similar contracts (that is, the vendor's typical operating margin in similar contracts or transactions) if the contract specific margin is higher than the return the vendor usually generates from similar contracts.

A vendor's right to payment for performance completed to date does not need to be a present unconditional right to payment. In many cases, a vendor will have that right only at an agreed-upon milestone or upon complete satisfaction of the performance obligation, and not throughout the contract term. However, in the event of contract termination, the vendor must always be entitled to payment for performance completed to date.

A customer might terminate (or take steps to terminate) a contract without having the right to do so (this includes when a customer fails to perform its obligations as promised). In those circumstances, the contract (or other laws) might entitle the vendor to continue to carry out its obligations set out in the contract and require the customer to pay the consideration promised in exchange for those goods or services. This would result in the vendor having a right to payment for performance completed to date because the vendor has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations which include paying the promised consideration. If the vendor is capable of forcing completion of its own and its customer's contractual obligations (including payment in accordance with the original contractual terms), it is not necessary to satisfy other conditions for the right to payment for performance completed to date.

In assessing the existence and enforceability of a right to payment, a vendor considers whether:

- Legislation, legal precedent or administrative practice gives the vendor a right to payment for performance to date even though that right is not specified in the contract.
- A court (or other relevant legal precedent) has previously decided that similar rights to payment for performance to date in similar contracts have no binding legal effect.
- Its own customary business practices of choosing not to enforce a right to payment have caused that right to be unenforceable in that legal environment. If the vendor concludes that the right would still be enforceable, the vendor would have a right to payment for performance to date notwithstanding that the vendor has previously chosen, and may in the case being analyzed choose, to waive that right.

For example, some real estate contracts may result in an asset that cannot (under the terms of the contract) be readily redirected to another customer (that is, the vendor's performance does not create an asset for which the vendor has an alternative use because it is unable to sell the unit specified in the contract to any other party). In those cases, the focus will be on whether the contract requires the

customer to pay for performance to date in all circumstances other than vendor default; if that right exists then revenue will typically be recognized over time. However, other real estate contracts that do not create an asset with an alternative use to the vendor may not require the customer to pay for performance to date, with either a deposit being forfeited or penalties being payable which represent only the vendor's loss of profit. For those contracts, a vendor will recognize the sale on completion (at a point in time).

5.4 Measuring progress toward complete satisfaction of a performance obligation

For each performance obligation that is satisfied over time, revenue is recognized by measuring progress towards completion of that performance obligation each reporting period. This is achieved based on either:

(i) *Output methods*
These include appraisals of results, milestones reached, units produced and units delivered; or

(ii) *Input methods*
These include resources consumed, labor hours expended, costs incurred, time lapsed or machine hours used.

For each separate performance obligation, the same input or output method of assessing progress to date is required to be used. The same method is also required to be applied consistently to similar performance obligations and in similar circumstances.

Output methods result in revenue being recognized based on direct measurement of the value of goods or services transferred to date in comparison with the remaining goods or services to be provided under the contract. When evaluating whether to apply an output method, consideration is given to whether the output selected would reflect the vendor's performance toward complete satisfaction of its performance obligation(s). An output method would not reflect the vendor's performance if the output selected fails to measure a material amount of goods or services (for example, work in progress or finished goods) which are controlled by the customer.

As a practical expedient, if the amount of a vendor's right to consideration from a customer corresponds directly with the value to the customer of the vendor's performance completed to date (e.g., a service contract in which a vendor bills a fixed amount for each hour of service provided), the vendor recognizes revenue at the amount to which the vendor has the right to invoice.

When the information that is required to apply an output method is not observable, or is not available without undue cost, it may be necessary to use an input measurement method.

Input methods result in revenue being recognized based on the vendor's efforts or inputs towards the satisfaction of a performance obligation. When the vendor's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for a vendor to recognize revenue on a straight-line basis.

A drawback of input methods is that there may not be a direct relationship between the vendor's inputs and the transfer of goods or services to a customer. Therefore, when using a cost-based input method, an adjustment to the measure of progress may be required if certain costs incurred do not contribute to the vendor's progress in satisfying its performance obligation(s). This would be the case when costs incurred are attributable to significant inefficiencies in the vendor's performance which were not reflected in the price of the contract. In addition, certain costs may not be proportionate to the vendor's progress in satisfying a performance obligation, and Topic 606 then requires an adjustment to be made to the amount of profit recognized to date. For example if, as part of a contract to refurbish a building, a vendor needs to purchase new elevators from a third party, the vendor will recognize revenue when control of the elevators is transferred to the customer, but will recognize no incremental profit. This is because arranging the delivery of the elevators to the customer's premises does not result in any progress being made towards the refurbishment of the building.

In some cases, a vendor may not be able reasonably to measure the outcome of a performance obligation, but may expect to recover the costs incurred in satisfying that performance obligation (e.g., in the early stages of a contract). In these circumstances, the vendor recognizes revenue only to the extent of the costs incurred to date, until such time that it can reasonably measure the outcome of the performance obligation. This guidance is similar to the current practice when a vendor cannot estimate the costs in a long term contract and applies the zero margin method.

5.5 Revenue recognition at a point in time

If a performance obligation is not satisfied over time, a vendor satisfies the performance obligation at a point in time. A vendor considers indicators of the transfer of control, which include the following:

(i) The vendor has a present right to payment for the asset. If the customer is obliged to pay for the asset, this indicates that the customer may have the ability to obtain substantially all of the remaining benefits from the asset.
(ii) The customer has legal title to the asset. Legal title may indicate that the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from an asset or to restrict the access of other entities to those benefits. If a vendor retains legal title over an asset solely as protection against the customer's failure to pay, this is a protective right and does not preclude a customer from obtaining control of that asset.
(iii) The customer has physical possession of an asset. This may indicate that the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset; for example, consignment stock or bill and hold arrangements may result in physical possession but not control, or vice-versa.
(iv) Significant risks and rewards of ownership. When evaluating whether the customer has the risks and rewards of ownership of an asset, a vendor considers any risks that may give rise to a performance obligation in addition to the performance obligation to transfer the asset. For example, a vendor may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
(v) Acceptance of the asset. The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.

5.6 Customers' unexercised rights

Customers' unexercised rights refer to instances where there is breakage in a contract, such as when a customer does not exercise all its contractual rights from the contract to receive goods or services in the future. Common examples of customers' unexercised rights include coupons for discounts on future purchases and non-refundable tickets.

When a vendor expects to be entitled to a breakage amount in a contract liability (i.e., because a customer has paid in advance), the vendor recognizes the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. When the vendor does not expect to be entitled to a breakage amount, any breakage is recognized as revenue when the likelihood of the customer exercising its remaining rights becomes remote.

MFA INSIGHT

Depending on a company's current policy to account for breakage not governed by ASU 2016-04, Recognition of Breakage for Certain Prepaid Stored-Value Products, Topic 606 may require a change. See FAQ 5 in Appendix 1.

5.7 Non-refundable upfront fees

A vendor may charge a customer a non-refundable upfront fee at (or near) contract inception, which may be related to an activity that the vendor is required to undertake at (or near) contract inception to fulfill the contract (for example, joining fees in health club memberships). The vendor is required to determine whether the fee relates to the transfer of a promised good or service, in order to identify the performance obligations within the contracts.

When the non-refundable upfront fee is not related to a performance obligation but to setup activities or other administrative tasks, the non-refundable upfront fee is accounted for as an advance payment for future goods or services and is therefore only recognized as revenue when those future goods or services are provided. The revenue recognition period would extend beyond the initial contractual period if the vendor grants the customer a renewal option that provides the customer with material right as described in Section 2.

MFA INSIGHT

In practice, non-refundable upfront fees typically relate primarily to setup activities, instead of to a performance obligation, and thus will be deferred.

5.8 Licensing

A license establishes a customer's rights over the intellectual property of a vendor, such as:

- Software[4] and technology;
- Media and entertainment (e.g., motion pictures);
- Franchises;
- Patents, trademarks, and copyrights.

A contract to transfer (provide) a license to a customer may include performance obligations in addition to the promised license. Those obligations may be specified in the contract or implied by the vendor's customary business practices, published policies or specific statements.

When the license is not distinct from other goods or services to be provided in accordance with the contract, the license and other goods or services are accounted for together as a single performance obligation; the nature of the license (functional or symbolic, as discussed below) is one consideration in determining whether the combined performance obligation is satisfied at a point in time or over time, and how to best measure progress toward completion if recognized over time. This would be the case, for example, when the license forms a component of a tangible good and is integral to the good's functionality (e.g., software embedded in a smartphone), or it is a license that the customer can benefit from only in conjunction with a related service (e.g., an online service that enables a customer to access content through granting a license).

When the license is distinct from other promised goods or services in the contract, the license is a separate performance obligation. Revenue is then recognized either at a point in time, or over time, depending on whether the nature of the vendor's promise in transferring the license to the customer is to provide that customer with either:

- A right to access the vendor's intellectual property throughout the license period (i.e., the vendor continues to be involved with its intellectual property); or
- A right to use the vendor's intellectual property as it exists at the point in time the license is granted.

To determine whether the vendor's promise represents a right to access the vendor's intellectual property or a right to use the vendor's intellectual property, a vendor should consider the nature of the intellectual property itself by categorizing the underlying license as either functional or symbolic.

A functional license has significant standalone functionality because it can be used as is for performing a specific task, or be aired or played. A functional license represents a right to use the intellectual property as it exists at a point in time; the customer's ability to derive substantial benefit from the license is not dependent upon the seller supporting or maintaining the intellectual property during the license period (although post-contract support and when-and-if-available updates may be provided as one or more separate performance obligations). A functional license is generally satisfied at the point in time the customer is able to use and benefit from the license. Examples of a functional license include software, biological compounds or drug formulas, and completed media content.

A symbolic license does not have significant standalone functionality. It represents a promise to both (a) grant the customer rights to use and benefit from the intellectual property and (b) support or maintain the intellectual property during the license period (or over the remaining economic life, if shorter). This type of license is satisfied over time because the customer simultaneously receives and consumes the benefit as the entity performs its obligation to provide access. Examples of a symbolic license include brands, team or trade names, logos, and franchise rights.

EXAMPLE

A vendor grants a franchise license to a customer, which provides the right to use the vendor's trade name and sell its products for a period of 10 years. During this period, the vendor will undertake activities that will affect the franchise license, including analyzing changes in customer preferences, implementing product improvements and undertaking marketing campaigns.

The nature of the vendor's promise to its customer is to provide access to the vendor's intellectual property throughout the license period, i.e., a symbolic license. Consequently, the performance obligation is satisfied over time.

In addition, if a license grants a right to use the vendor's intellectual property as it exists at a point in time, but the functionality of the intellectual property is expected to substantively change during the license period due to activities of the vendor that do not represent a separate promised good or service, and the customer is contractually or practically required to use the updated intellectual property to continue to derive a benefit from it, then the license grants a right to access the entity's intellectual property and is considered a symbolic license, which is accounted for over time. As such, an appropriate method would be selected to measure the vendor's progress toward complete satisfaction of its performance obligation to provide access to the intellectual property.

Regardless of whether revenue is recognized at a point in time or over time, an entity cannot recognize revenue for a license of intellectual property before control of the license is transferred to the customer, defined as when the vendor provides or otherwise makes available a copy of the intellectual property to the customer, and the beginning of the period during which the customer is able to use and benefit from its right to access or use the intellectual property. This means that, if the vendor provides (or otherwise makes available) to the customer an access code that is necessary to enable the customer to access or use licensed software, the vendor would not recognize revenue until the access code has been made available, even though the license period could have started at an earlier date. In addition, an entity would not recognize revenue from a license renewal earlier than the beginning of the renewal period.

EXAMPLE

A vendor (a music record label) licenses a specified recording of a Beethoven symphony to a customer for a period of two years. The customer has the right to use the recording in all types of advertising campaigns (including television, radio and online media) in a specified country. The contract is non-cancellable and the customer is required to pay CU 10,000 per month.

The nature of the vendor's promise to its customer is to provide a right to use the recording in its condition at the start of the license period, i.e., a functional license. Consequently, the customer's rights to the intellectual property are static and the vendor's performance obligation is satisfied at a point in time.

The vendor recognizes all of the revenue (adjusted for a significant financing component, if appropriate) at the point at which the customer is able to use, and obtain substantially all the benefits, of the licensed intellectual property.

When determining the type of license that has been granted (functional intellectual property or symbolic intellectual property), contractual provisions that require an entity to transfer control of additional goods or services should be distinguished from provisions that define the attributes of a single license, such as restrictions of time, geography, or use. This is because these restrictions define the attributes of the promised license, rather than define whether the vendor satisfies its performance obligation at a point in time or over time.

A promise to defend a patent is not a performance obligation because it protects the value of the vendor's intellectual property and provides the customer with assurance that the license transferred meets the related contractual specifications.

5.9 Sales-based or usage-based royalties

As an exception to the principle requiring entities to estimate variable consideration, a sales-based or usage-based royalty for a license of intellectual property is only recognized as revenue when (or as) the later of the following (i.e., the "royalty constraint"):

- The subsequent sale or usage occurs; and
- The performance obligation to which some or all of the sales- or usage-based royalty has been allocated has been satisfied (or partially satisfied).

In this context, an entity should not split a sales-based or usage-based royalty into a portion subject to the royalty constraint and a portion that is not subject to that guidance. In other words, a royalty is either subject to the royalty constraint, or it is not. The constraint applies whenever the predominant item to which the royalty relates is a license. For example, a license may be the predominant item to which the royalty relates when the entity reasonably expects that its customer places significantly more value on the license (e.g., a movie) rather than other related goods and services (e.g., movie memorabilia and advertising).

MFA INSIGHT

For purposes of their own revenue recognition, vendors who sell licenses will need to ensure they have a process in place to determine when the customer's subsequent sales or usages occur.

5.10 Consignment arrangements

A vendor may deliver a product to another party, such as a dealer or retailer, for sale to end customers. In these circumstances, the vendor is required to assess whether the other party has obtained control of the product. If the other party has not obtained control, the product may be held in a consignment arrangement. A vendor does not recognize revenue on delivery of a product to another party which is held on consignment.

The following are indicators of a consignment arrangement:

- The product is controlled by the vendor until a specified event occurs (e.g., sale of the product to a customer of the dealer or retailer, or until a specified period expires);
- The vendor is able to require the return of the product or transfer the product to a third party (e.g., transfer to another dealer or retailer); and
- The dealer or retailer does not have an unconditional obligation to pay for the product. However, there might be a requirement for a deposit to be paid.

5.11 Bill-and-hold arrangements

Bill-and-hold arrangements involve the vendor invoicing a customer for a product but, instead of delivering it to the customer, the vendor retains physical possession with the product being shipped or delivered to the customer at a later date. A customer might request this type of arrangement if, for example, it does not have sufficient space of its own to accommodate the product.

In determining the point at which it is appropriate to recognize revenue from a sale of the product, the vendor applies the same control criteria as for any other sale (or performance obligation) to be recognized at a point in time. In addition, all of the following criteria are required to be met:

- The reason for the bill and hold arrangement must be substantive;
- The product must be identified separately as belonging to the customer;
- The product must currently be ready for physical transfer to the customer;
- The vendor cannot have the ability to use the product, or to direct it to another customer.

When a vendor recognizes revenue for the sale of an asset on a bill-and-hold basis, it is also required to consider whether there are any remaining performance obligations (e.g., for custodial services) to which a portion of the transaction price needs to be allocated.

MFA INSIGHT

While many bill and hold arrangements may be accounted for consistent with current guidance, some contracts may be accounted for differently. See FAQ 6 in Appendix 1.

5.12 Customer acceptance

If a customer accepts an asset, this may indicate that control over the asset has passed to the customer. However, contractual arrangements typically include clauses which enable the customer to require the vendor to take action if the asset does not meet its contractually agreed upon specifications, and might allow the customer to cancel the contract.

If a vendor can demonstrate that an asset that has been transferred to a customer meets the contractually agreed upon specifications, then customer acceptance is considered to be a formality that is not taken into account when determining whether control over the asset has passed to the customer. This might apply if the sale is subject to an asset meeting certain size and weight specifications; the vendor would be able to confirm whether these had been met. However, if revenue is recognized in advance of receiving customer acceptance, the vendor is required to consider whether there are any other performance obligations that have not yet been fulfilled, such as equipment installation.

If the vendor is not able to determine that the asset that has been transferred to the customer meets the contractually agreed upon specifications, then control over the asset does not transfer to the customer until the vendor has received the customer's acceptance. In addition, if products are delivered to a customer for trial purposes, and the customer has no commitment to pay any consideration until the trial period has ended, control of the asset does not pass to the customer until the earlier of the point at which the customer accepts the asset or the trial period ends.

6. Other issues

6.1 Contract costs

A distinction is made between incremental costs incurred in obtaining a contract, and costs incurred to fulfill a contract.

Incremental costs of obtaining a contract

Incremental costs are those costs incurred in obtaining a contract that would not have been incurred had that individual contract not been obtained. This guidance is restrictive, as any ongoing costs of operating the business will be expensed as incurred. The only exception is when costs are explicitly charged to a customer regardless of whether a contract is obtained. For all others, only costs such as a sales commission that is only paid if a specified contract is obtained are incremental; the new standard requires that these are recognized as an asset and then amortized on a basis that reflects the transfer of goods or services to the customer.

As a practical expedient, incremental costs of acquiring a contract can be recognized as an immediate expense if the amortization period would have been one year or less.

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Under current guidance, some entities expense the incremental costs of obtaining a contract as they are incurred. For those entities, Topic 606 may represent a substantial change because those costs are required to be capitalized, subject to the one-year practical expedient mentioned above. This may require a systems change to track and record items that were previously written off.

At the first meeting of the TRG in July 2014, a question was raised about the period over which an asset arising from contract acquisition costs would be amortized. In particular, should this include a contract extension or renewal period when the extension or renewal is at the option of the customer? It was noted that this period should be taken into account if the vendor expects that the customer will extend or renew the contract, and that the asset relates to goods or services that would be transferred to the customer during the extension or renewal period.

Costs to fulfill a contract

In contrast with the incremental costs of obtaining a contract, which fall wholly within its scope, the new standard's requirements apply only to costs to fulfill a contract which do not fall within the scope of another Topic (for example, Topic 330—Inventory or Topic 360—Property, Plant and Equipment). For those costs which do fall within the scope of the new standard, the threshold for identifying costs to fulfill a contract is lower than the 'incremental' threshold for costs in obtaining a contract. Examples include direct labor and materials, whereas general and administrative costs must be expensed. However, there are still restrictions and all of the following criteria need to be met:

- The costs relate directly to a contract or to an anticipated contract that can specifically be identified;
- The costs generate or enhance resources of the vendor that will be used to satisfy performance obligations in future; and
- The costs are expected to be recovered through future sales.

6.2 Warranties

Topic 606 distinguishes between two types of warranties:

- Warranties that provide a customer with the assurance that the product will function as intended because it complies with agreed-upon specifications. These warranties are accounted for in accordance with the guidance on product warranties in Subtopic 460-10 on guarantees.
- Warranties that provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. These 'additional service' warranties are accounted for as a performance obligation and allocated a portion of the transaction price in accordance with the principles of Topic 606.

In assessing whether a contract contains a service in addition to the assurance that the product complies with agreed-upon specifications, a vendor considers factors such as:

- Whether the warranty is required by law;
- The length of the warranty coverage period;
- The nature of the tasks that the vendor promises to perform.

If a customer does not have the option of purchasing a warranty separately, it is accounted for in accordance with Subtopic 460-10 unless part or all of that warranty provides the customer with a service in addition to an assurance that the good or services complies with agreed-upon specifications.

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In some cases, careful consideration will be needed to determine whether a warranty goes beyond providing assurance that a product will comply with agreed-upon specifications, which would require recording a separate performance obligation. For example, in some jurisdictions car manufacturers include a warranty period which goes well beyond the period required by law, which is used as a marketing tool to enhance sales.

6.3 Repurchase agreements

A repurchase agreement arises when a vendor sells an asset to a customer and is either required, or has an option, to repurchase the asset. The asset could be the same one that was originally sold to the customer, one which is substantially the same, or another (larger) asset of which the asset originally sold is a component.

When a vendor has an obligation or right to repurchase the asset, the customer is limited in its ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Therefore the customer does not obtain control of the asset. This means that the vendor does not recognize revenue from a sale and instead, depending on the contractual terms, the transaction is accounted for either as a lease or as a financing arrangement.

In determining whether a contract with a repurchase agreement gives rise to a lease or a financing arrangement, the vendor compares the repurchase price of the asset with its original selling price, taking into account the effects of the time value of money. When the repurchase price is lower than the original selling price of the asset the agreement is accounted for as lease in accordance with Topic 840—Leases[5]. If the repurchase price is greater than or equal to the original selling price of the asset then the contract gives rise to a financing arrangement; the vendor recognizes a financial liability for any consideration received from the customer and continues to recognize the asset.

When a vendor has an obligation to repurchase the asset at the customer's request (the customer has a put option) the accounting will depend on the relationship between the repurchase price of the asset and the original selling price of the asset.

When the repurchase price of the asset is lower than the original selling price of the asset, the vendor considers whether the customer has a significant economic incentive to exercise its right. If this is the case, the customer does not obtain control of the asset, and the agreement is accounted for as a lease (unless the contract is part of a sale and leaseback transaction, in which case the contract is accounted for as a financing arrangement).

However, if the customer does not have a significant economic incentive to exercise its option, the customer obtains control of the asset and vendor records a sale of the product with a right of return. This accounting also applies if the repurchase price is equal to or greater than the original selling price, but less than or equal to the expected market value.

Conversely, if the repurchase price of the asset is equal to or greater than the original selling price and more than the expected market value of the asset at the date of exercise of the customer's put option, then the customer does not obtain control of the asset and the contract is instead accounted for as a financing arrangement.

7. Presentation

In its statement of financial position, a vendor is required separately to present contract assets, contract liabilities and receivables due from customers. Alternative descriptions are permitted to be used for these line items.

When a vendor transfers control over goods or services to a customer before the customer pays consideration, the vendor presents the contract as either a contract asset or a receivable. A contract asset is a vendor's right to consideration in exchange for goods or services that the vendor has transferred to a customer, when that right is conditional on the vendor's future performance such as the delivery of an additional good or service. A receivable is a vendor's unconditional right to consideration, and is accounted for in accordance with Topic 310—Receivables.

When a customer pays consideration in advance, or an amount of consideration is due contractually before a vendor performs by transferring a good or service, the vendor presents the amount received in advance as a contract liability.

On the income statement, a vendor will present or disclose revenue from contracts with customers separately from the vendor's other sources of revenue, such as rental income.

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As noted in Appendix 1, there are currently no indications that Regulation S-X 5-03 will be amended in light of the new revenue standard. As such, SEC registrants are expected to continue complying with the requirement to separately present items that represent 10% or more of income, e.g., different types of products and services.

8. Disclosures

Topic 606 includes an overall disclosure objective, which is for the disclosures to include sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. This is accompanied by comprehensive disclosure requirements about a vendor's:

- Contracts with customers;
- Significant judgments, and changes in the judgments, made in applying Topic 606 to those contracts; and
- Assets recognized in respect of costs of obtaining contracts, and in fulfilling contracts.

Topic 606 notes specifically that consideration is to be given to the level of detail that is necessary to satisfy the disclosure objective, and to the emphasis to be placed on each disclosure requirement. The purpose is to ensure that the information that users will find useful is not obscured by a large amount of insignificant detail, with items with sufficiently different characteristics being disaggregated and presented separately.

9. Effective Date and Transition

Public business entities[6] will adopt the standard for annual reporting periods beginning after December 15, 2017, including interim periods within that year. Therefore, a calendar year-end public entity would reflect the new standard in its first quarter ended March 31, 2018, each subsequent quarter, and also in the year ended December 31, 2018. Early adoption is permitted only as of annual reporting periods beginning after December 15, 2016, including interim periods within that year.

All other entities will adopt the standard for annual reporting periods beginning after December 15, 2018, and interim periods within annual reporting periods beginning after December 15, 2019. Therefore, a calendar year-end nonpublic entity would first apply the new standard for the year ended December 31, 2019. If it also prepares interim financial statements, the new standard would first take affect for those interim periods in 2020. Early adoption is permitted as of either:

- An annual reporting period beginning after December 15, 2016, including interim periods within that year, or
- An annual reporting period beginning after December 15, 2016 and interim periods within annual reporting periods beginning one year after the annual period in which an entity first applies the new standard.

For both public and nonpublic entities, a full retrospective approach is available, under which entities may avail themselves of certain practical expedients. If a retrospective approach is not applied, then entities will use a cumulative effect approach. More specifically:

1. A full retrospective approach would apply the default method of adopting new accounting standards in Topic 250. Each prior period presented would follow the guidance in paragraphs 250-10-45-5 through 45-10.
2. Similarly, a retrospective approach can be used in conjunction with up to three forms of practical relief. That is, entities can choose to use one, two or all three of the following accommodations:
   (i) Contracts that begin and end in the same annual reporting period would not need to be restated under the new revenue recognition standard.
   (ii) Entities may use hindsight in accounting for contracts that contain variable consideration. That is, entities are allowed to use the final transaction price at the date the contract was actually completed, rather than estimating the variable consideration at inception.
   (iii) Entities are not required to disclose the amount of a contract's transaction price that was allocated to the remaining performance obligations or an explanation of when those obligations are expected to be recognized as revenue for reporting periods presented before the date of adoption.

For purposes of applying the practical expedients above, the term "completed contract" is one in which all (or substantially all) of the revenue was recognized in accordance with guidance that is in effect before the date of initial application.

Under the cumulative effect approach, an entity would apply the new revenue standard only to contracts that are incomplete under legacy U.S. GAAP at the date of initial application (e.g., January 1, 2018 for a calendar year-end public company) and recognize the cumulative effect of the new standard as an adjustment to the opening balance of retained earnings. That is, prior years would not be restated. However, additional disclosures would be required to enable users of the financial statements to understand the impact of adopting the new standard in the current year compared to prior years that are presented under legacy U.S. GAAP.

The standard provides an additional practical expedient whereby an entity electing either the full or modified retrospective method of transition is permitted to reflect the aggregate effect of all prior period modifications (using hindsight) when 1) identifying satisfied and unsatisfied performance obligations, 2) determining the transaction price, and 3) allocating the transaction price to satisfied and unsatisfied obligations. The aggregate approach would be in lieu of separately accounting for individual modifications in each prior period.

Topic 606 also provides an exception whereby an entity does not need to disclose the effect on the current period of retrospectively adopting the new revenue standard. However, entities are still required to disclose the impact on prior years.

Companies may want to carefully consider the method of adoption they select, specifically those with long term contracts that are in progress when Topic 606 is adopted.

EXAMPLE:

A vendor has a single four year contract which runs from January 1, 2015 to December 31, 2018. The total consideration receivable is fixed at CU 2,000,000. Under current U.S. GAAP, it is being recognized evenly over that four year period at CU 500,000 per annum.

Under Topic 606, revenue would have been recognized at CU 1,100,000 in 2014 and CU 300,000 for each of the succeeding three years.

Under each of the transition options, the effect would be (amounts in CU):

					3 yr total:
	2015	**2016**	**2017**	**2018**	**2016-2018**
Existing U.S. GAAP	500	500	500	500	1,500
Topic 606 **Retrospective (no practical expedients)**					
Revenue		300	300	300	900
Opening equity adjustment		600			600
Cumulative effect adjustment					
Revenue		500	500	300	1,300
Opening Equity adjustment				200	200

The retrospective equity adjustment of 600 is calculated as the difference at January 1, 2016 between the cumulative amount of revenue recognized in accordance with existing U.S. GAAP (CU 500) and the amount that would have been recognized in accordance with Topic 606 (CU 1,100).

The cumulative effect adjustment of 200 is calculated as the difference at January 1, 2018 between the cumulative amount of revenue recognized in accordance with existing U.S. GAAP (CU 1,500) and the amount that would have been recognized in accordance with Topic 606 (CU 1,700).

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Appendix 1 - Frequently Asked Questions - SEC Registrants

Q1: ***Can an SEC registrant early adopt ASU 2014-09?***

A1: In limited circumstances. For a public business entity, the amendments in the update are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. The U.S. standard allows early adoption as of the original effective date, which was for periods beginning after December 15, 2016. Adoption prior to that date is not permitted under U.S. GAAP. However, foreign private issuers (FPIs) that report under IFRS as issued by the IASB are allowed to early adopt. Otherwise, IFRS 15 applies to annual reporting periods beginning on or after January 1, 2018.

Q2: ***Is there any accommodation in the transition rules if a company's status changes from "private" to "public" in 2018? For example, what happens if a private company conducts an IPO, is acquired by an SEC registrant under Regulation S-X 3-05 Financial statements of businesses acquired or to be acquired, or becomes an equity method investee of a public company in 2018?***

A2: No. Currently, in each of the situations noted above, a "private" company would meet the definition of a public business entity for purposes of an SEC filing that includes its financial statements. The same is true for situations in which an SEC registrant records its share of an equity method investee's income or loss, when the investee is otherwise privately-held. That is, the investee would need to prepare its financial statements as if it was public in order to meet the needs of its public investor. As such, the "private" company would be considered public and required to adopt the standard one year earlier than entities that are not public. However, the SEC staff is aware of these situations and is considering what guidance, if any, might be appropriate.

Q3: ***Are any disclosures required prior to adoption of the new revenue standard?***

A3: Yes. SEC registrants should continue to make disclosures under Staff Accounting Bulletin No. 74 (codified in SAB Topic 11-M) in their interim and annual filings. SAB 74 addresses disclosure of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period. An example of such disclosure to be made in the initial reporting periods following the issuance of ASU 2014-09 might be as follows:

> In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. In March 2016, the FASB issued ASU 2016-08 which further clarifies the guidance on the principal versus agent considerations within ASU 2014-09. In April 2016, the FASB issued ASU 2016-10 to expand the guidance on identifying performance obligations and licensing within ASU 2014-09. In May 2016, the FASB issued ASU 2016-12 to improve revenue recognition in the areas of collectability, presentation of sales tax and other similar taxes collected from customers, noncash consideration, contract modifications and completed contracts at transition. This update also amends the disclosure requirements within ASU 2014-09 for entities that retrospectively apply the guidance.
>
> The standard is effective for annual periods beginning after December 15, 2017, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). We plan to adopt ASU 2014-09 using a full retrospective approach in 2018 and continue to evaluate the impact of its adoption on our consolidated financial statements.

The SEC staff has indicated that it expects these disclosures to evolve over time as companies begin to better understand how the standard will impact their financial statements. As encouraged by SAB 74, registrants should also consider making disclosure of the potential impact of other significant matters that may result from the adoption of the standard (e.g., technical violations of debt covenants or planned changes in business practices). The method of transition should also be disclosed as soon as one is elected, which will likely vary across entities.

Q4: ***Must SEC registrants recast all periods reflected in the 5-year Summary of Selected Financial Data in accordance with the new revenue standard?***

A4: No. The Division of Corporation Finance's Financial Reporting Manual states that registrants that select a full retrospective approach are not required to apply the new revenue standard when reporting selected financial data to periods prior to those presented in its retroactively-adjusted financial statements. That is, a company would be required to reflect the accounting change in selected financial data only for the three years for which it presents full financial statements elsewhere in the filing. Companies will be required to provide the disclosures required by Instruction 2 to S-K Item 301 regarding comparability of the data presented.

Q5: ***Will an entity's accounting for breakage change as a result of the new revenue standard?***

A5: Maybe. The SEC staff currently accepts three approaches for recognizing breakage: (1) upon vendor's legal release from its obligations, for example, at expiration, (2) at the point redemption becomes remote, or (3) in proportion to redemption activity.[7] The selection of a breakage model is an accounting policy election.

The new revenue standard does not permit the first approach based on legal release. Further, an accounting policy election between the two remaining approaches is not available. Rather, if an entity expects to be entitled to breakage, then it is required to recognize the breakage as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, breakage is recognized as revenue when the likelihood of the customer exercising its remaining rights becomes remote. Further, when assessing breakage, entities are required to apply the guidance on constraining variable consideration, which ensures that the entity's obligation to stand ready to provide future goods and services is not understated. As such, entities may or may not (1) be required to change the way they account for breakage and/or (2) experience a change in the timing of when breakage is recognized.

However, companies must continue to comply with any applicable escheatment laws. Amounts subject to escheatment laws must be remitted to the government and should not be recognized as revenue under the breakage guidance in the new standard.

In addition, ASU 2016-04, Recognition of Breakage for Certain Prepaid Stored-Value Products provides guidance on accounting for the derecognition of financial liabilities related to unused prepaid gift cards and other stored-value products. Although these liabilities are not within the scope of the new revenue recognition guidance, ASU 2016-04 requires breakage on prepaid stored-value products to be recognized consistent with the breakage model in the new revenue recognition guidance. For additional information, refer to our Insight on the ASU, here.

Q6: ***Is the accounting for bill-and-hold arrangements expected to change under the new standard compared to the SEC staff's current guidance?***

A6: Generally, no. The SEC staff may revise or rescind its bill-and-hold criteria when it reconsiders SAB 104 (see below). Although the new standard's bill-and-hold guidance is slightly less prescriptive than the current SEC staff guidance, the concepts are similar. However, if this SEC staff guidance is rescinded, the accounting for bill-and-hold arrangements may change in certain circumstances. For example, there might be rare situations where revenue is recognized earlier compared to current U.S. GAAP for bill-and-hold arrangements because there is no longer a requirement for the vendor to have a fixed delivery schedule from the customer in order to recognize revenue, nor is the customer required to have been the party that initiated the bill and hold arrangement. However, in all cases, entities must apply the basic five-step model for recognizing revenue in addition to meeting the specific criteria for bill and hold arrangements. Further, agreements that lack a fixed delivery schedule or that the customer did not initiate, may in fact lack a substantive business purposes. If the arrangement lacks substance, revenue recognition on a bill and hold basis would be precluded.

Q7: ***Will the SEC staff rescind SAB No. 104?***

A7: This is still uncertain. The SEC staff is aware that much of the guidance in SAB 104 will likely need to be revisited or rescinded in light of the new standard. However, the staff has not announced what its specific intentions are.

Q8: ***Does the new revenue standard change the SEC's rule to separately present items of revenue that represent 10% or more of total income, e.g., different types of product and service revenue?***

A8: No. There is no indication that Rule 5-03, Income Statements of Regulation S-X will be amended as a result of the new standard.

Q9: ***Are there any internal control implications related to adopting and implementing the new revenue standard?***

A9: Yes. The SEC staff has indicated that public companies should ensure they have the appropriate controls in place with respect to implementing new accounting standards, including the new revenue recognition standard. This is prior and in addition to any internal control changes related to revenue recognition after adoption.

Appendix 2 - Summary of Significant Changes

This newsletter was last published in September 2014. The following is a list of significant changes since that publication date:

1. Step One – Identify the contract

Incorporated clarifications to the collectibility assessment and the new criterion to clarify when revenue would be recognized for a contract that fails to meet the criteria in Step 1 (ASU 2016-12).

2. Step Two – Identify separate performance obligations in the contract

Incorporated clarifications to criterion 2 (whether a good or service is separately identifiable from other promises in the contract) (ASU 2016-10).

2.6 Principal vs. agent

Incorporated clarifications to the principal versus agent evaluation (ASU 2016-08).

3. Step Three – Determine the transaction price of the contract

Added discussion of the accounting policy election to exclude amounts collected from customers for all sales (and other similar) taxes from the transaction price (ASU 2016-12).

3.4 Non-cash consideration

Added clarification that the measurement date for noncash consideration is contract inception, and that the variable consideration guidance applies only to variability resulting from reasons other than the form of the consideration (ASU 2016-12).

4.2 Allocation of variable consideration and 4.3 Allocating discounts

The order of these sections has been reversed to reflect that variable consideration must be allocated to performance obligations prior to the allocation of discounts (TRG Agenda Paper #31).

5.8 Licensing

Incorporated clarifications to the guidance on licenses (ASU 2016-10).

5.9 Sales-based or usage-based royalties

Incorporated clarifications to the guidance on sales-based or usage-based royalties (ASU 2016-10).

9. Effective Date and Transition

Updated to reflect the effective date deferral (ASU 2015-14). Incorporated clarifications, practical expedient, and disclosure exception (ASU 2016-12).

Appendix 1 – Frequently Asked Questions – SEC Registrants

Updated to reflect various changes and communications from the SEC staff.

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[1] *ASU 2014-09*

[2] *An additional ASU related to the new revenue standard containing certain technical corrections and improvements is anticipated in the fall of 2016. Constituents should monitor the FASB website for further developments.*

[3] *In June 2016, the FASB issued an exposure draft entitled "Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20)" that would further amend the guidance on the transfer of non-financial assets that are not an output of the entity's ordinary activities included in ASU 2014-09. This exposure draft represents phase 2 of the FASB's broader project to clarify the definition of a business.*

[4] *Software subject to a hosting arrangement that does not meet the criteria in paragraph 985-20-15-5 is not considered a license of intellectual property in this context.*

[5] *In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). This standard holistically amends the guidance on accounting for leases, and will be effective for public companies in 2019 and for all other companies in 2020. For more information on the new leasing standard, see our previous Insight on Leases.*

[6] *A "public entity" is one that meets the definition of a "public business entity" in the ASC Master Glossary, as defined in ASU 2013-12. Under ASU 2014-09, "not-for-profit" entities that have issued (or are conduit bond obligors for) certain securities will apply the same effective date as public business entities. Employee benefit plans that file or furnish financial statements with the SEC are also considered public. All other entities are considered "non-public" under the new revenue recognition standard.*

[7] *See remarks of Pamela R. Schlosser before the 2005 AICPA National Conference on Current SEC and PCAOB Developments*

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