INSIGHTS

Detailing the Five-Step Framework for Revenue from Contracts with Customers (Topic 606)

August 2017

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Accounting • Tax • Advisory

Revenue from Contracts with Customers (Topic 606)
The Five-Step Framework

Executive Summary

In May 2014, the Financial Accounting Standards Board (FASB) issued new accounting guidance related to revenue recognition in *Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606)*, including subsequent amendments thereto (collectively, the "Update", "Topic 606", the "new standard", or the "new guidance"). This Update will soon be effective and replaces virtually all existing revenue recognition guidance within U.S. GAAP, and also affects the accounting for certain transfers of nonfinancial assets to non-customers[1]. For some entities, particularly those in industries that currently apply industry-specific accounting standards, the new revenue standard may significantly change the recognition of revenue, as well as the recognition of contract assets and liabilities related thereto. All entities will be impacted by the new standard, which means every entity will need to understand how its requirements will impact them. In addition, all entities must obtain an understanding in regard to the type of information that will need to be aggregated for accounting decision-making and financial statement disclosure purposes. Consequently, entities may need to incorporate mechanisms into their revenue-related processes (both operationally and for accounting) to facilitate the aggregation of this information.

In place of transaction specific guidance under existing U.S. GAAP, the Update establishes an underlying **core principle** under which an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Ultimately, an entity will recognize revenue when or as **control of a good or service is transferred** to the respective customer. Transfer of control is a significant concept that must be considered when evaluating any revenue transaction and determines whether and when a contract will qualify for revenue recognition.

The Update creates the five-step framework (referred to as the "Five-Step Framework") listed below, which entities will be required to apply in order to achieve the core principle described above:

Step 1: Identify the contract(s) with a customer

Step 2: Identify the performance obligations in the contract

Step 3: Determine the transaction price

[1] The new accounting guidance for disposal transactions with non-customers that involve certain nonfinancial assets will be covered in a subsequent publication.

Step 4: Allocate the transaction price to the performance obligations in the contract

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

This Five-Step Framework is to be applied consistently to contracts with similar characteristics once those agreements have passed the basic criteria (see STEP 1 below) to be within the scope of ***Topic 606***. A contract (as defined by the new standard) can be **written, verbal, or implied by customary business practice, as long as it creates enforceable rights and obligations**.

Each of the steps in the Five-Step Framework can impact the amount and the timing of revenue recognized. The potential impacts can vary significantly among entities and industries. As a result, standard setters and regulators, such as the SEC, have repeatedly called for financial statement preparers to engage in dialogue about their implementation of ***Topic 606*** with stakeholders, including their independent accountants.

The effective dates of ***Topic 606*** are shown in the following table:

<table>
<tr><th rowspan="2">Reporting Period</th><th colspan="2">Effective For Periods Beginning After</th><th rowspan="2">Early Application Permitted?</th></tr>
<tr><th>Public Business Entities{1}</th><th>All Other Entities</th></tr>
<tr><td>Annual</td><td rowspan="2">December 15, 2017</td><td>December 15, 2018</td><td rowspan="2">Yes, but only for reporting periods beginning after December 15, 2016</td></tr>
<tr><td>Interim</td><td>December 15, 2019</td></tr>
<tr><td colspan="4">{1} Includes (a) a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market; and (b) an employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission.</td></tr>
<tr><td colspan="4"><u>Transition Methods Available</u>

Full Retrospective Application: Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients). The new standard would be applied retrospectively to each prior reporting period presented with the cumulative effect of the change recorded in retained earnings as of the first day of the first period presented.

Modified Retrospective Application: The new standard is applied to all existing uncompleted contracts[2] as of the effective date or adoption date, as applicable, and to all future contracts. Under this transition method, an entity will recognize the cumulative effect of initially applying Topic 606 as an adjustment to the opening balance of retained earnings in the year of adoption. Revenue in periods presented in the financial statements before that date is reported under guidance in effect before the effective (or adoption) date (i.e. Topic 605 or other legacy U.S. GAAP).</td></tr>
</table>

[2] Per ***ASC 606-10-65-1c***, a completed contract is a contract for which all (or substantially all) of the revenue was recognized in accordance with legacy generally accepted accounting principles (GAAP) for revenue recognition in effect prior to the date ***Topic 606*** was initially adopted.

Background

On May 28, 2014, the FASB issued *Accounting Standards Update 2014-09, Revenue from Contracts with Customers (**Topic 606**)* ("ASU 2014-09) on revenue recognition that **(1)** replaces virtually all existing guidance for revenue recognition and **(2)** supersedes industry-specific guidance under current U.S. GAAP. The FASB and the International Accounting Standards Board (IASB) worked together to develop the new guidance. The IASB's standard was issued as IFRS 15.

Since the release of ASU 2014-09, the FASB has issued several amendments to the new standard, as shown in in **Exhibit 1** below:

ASU 2015-14 ***Deferral of the Effective Date of ASU 2014-09.*** Defers the original effective date of for all entities by one year, but leaves in place the original early adoption date.	**ASU 2016-04** ***Recognition of Breakage for Certain Prepaid Store-Value Products.*** Provides a narrow scope exception to the guidance in **ASC 405-20** to require that breakage for liabilities in the scope of that guidance be accounted for consistent with the breakage guidance in ***Topic 606***.
ASU 2016-08 ***Principal vs. Agent Considerations.*** Clarifies the implementation guidance on principal versus agent considerations, and among other matters addresses: 1) Determining the appropriate unit of account under the revenue standard's principal-versus-agent guidance 2) Applying the indicators of whether an entity is a principal or an agent in accordance with the revenue standard's **control principle**	**2016-10** ***Identifying Performance Obligations and Licensing.*** Clarifies but retains the related principles for these two aspects of ***Topic 606***.
ASU 2016-11 Rescission *of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting (SEC Update).*	**ASU 2016-12** ***Narrow Scope Improvements and Practical Expedients.*** Clarifies, rather than changes, the new revenue standard's core revenue recognition principles. Topics covered in this ASU include the following: 1) Collectibility; 2) Presentation of sales tax and other similar taxes collected from customers; 3) Noncash consideration; 4) Contract modifications and completed contracts at transition; and 5) Technical correction on disclosure of the effect of change in accounting principle when using the full retrospective transition method
ASU 2016-20 Technical *Corrections and Improvements to Topic 606, Revenue from Contracts with Customers.* Amendments in this ASU are of a similar nature to the items typically addressed in the Technical Corrections and Improvements project, which are clarifications and corrections to the codification, and are not expected to have a significant effect on accounting practice.	

In addition to the core principle and the Five-Step Framework, which are discussed in more detail below, the Update contains many practical expedients that may be elected during transition and/or as part of accounting policy decision making after adoption. See **Appendix A** regarding the practical expedients available under the new standard. In addition, ***Topic 606*** includes significantly increased disclosure requirements.

Overview of the Main Provisions

The core principle established under ***Topic 606*** is applicable to all contracts with customers. However, not all transactions or contracts are subject to the guidance under ***Topic 606***. Before application of the Five-Step Framework, entities must first determine whether the transaction or contract falls within its scope. Determining whether a contract with a customer falls within the scope of the new guidance requires analysis of both the contract and the customer. It also requires determination of whether an identified contract with a customer has been specifically excluded from the scope of the new guidance. See **Exhibit 2** below for an excerpt from the guidance describing contracts that are not within the scope of ***Topic 606***.

Exhibit 2: Contracts with Customers that are NOT in the Scope of *Topic 606*

606-10-15-2 An entity shall apply the guidance in this Topic to all **contracts** with **customers**, except the following:

a. Lease contracts within the scope of Topic 842, Leases.[3]
b. Insurance contracts within the scope of Topic 944, Financial Services— Insurance.
c. Financial instruments and other contractual rights or obligations within the scope of the following Topics:
   1. Topic 310, Receivables
   2. Topic 320, Investments—Debt Securities[4]
   2a. Topic 321, Investments—Equity Securities[4]
   3. Topic 323, Investments—Equity Method and Joint Ventures
   4. Topic 325, Investments—Other
   5. Topic 405, Liabilities
   6. Topic 470, Debt
   7. Topic 815, Derivatives and Hedging
   8. Topic 825, Financial Instruments
   9. Topic 860, Transfers and Servicing.
d. Guarantees (other than product or service warranties) within the scope of Topic 460, Guarantees.
e. Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Topic would not apply to a contract between two oil companies that agree to an exchange of oil to fulfill demand from their customers in different specified locations on a timely basis. Topic 845 on nonmonetary transactions may apply to nonmonetary exchanges that are not within the scope of this Topic.

Contracts Partially Within the Scope of the New Revenue Standard

Some contracts may be partially within the scope of ***Topic 606*** and partially within the scope of the topics listed in **Exhibit 2** above. In those instances, the entity would first apply the guidance from the other topics if they specify how to separate and/or initially measure the part(s) of the contract not within the scope of the new revenue standard. The amount initially measured in accordance with the guidance from those other topics[5] would be excluded from the transaction price. The remaining

[3] Lease contracts within the scope of Topic 840 (prior to the effective date of Topic 842) are excluded from the scope of ***Topic 606***.
[4] ASU 2016-01 amends Topic 320 and adds Topic 321. Prior to ASU 2016-01 being effective, Topic 320 applies to both debt and equity securities.
[5] See ***ASC 606-10-15-4***.

transaction price would then be allocated to the remaining parts of the contract that are within the scope of ***Topic 606***. However, if the other topics do not specify how to separate and/or initially measure the parts of the contract not in-scope, then the entity would apply the guidance in ***Topic 606*** to separate and/or initially measure them.

The Five-Step Framework

Each step in the Five-Step Framework involves concepts and considerations which can significantly impact recognition of revenue under the Update. While this publication will not attempt to explore each of these concepts and considerations in depth, it will identify them in connection with each step. Pursuant to ***Topic 606***, a contract is defined as:

> *A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law.* ***Contracts can be written, oral, or implied by an entity's customary business practices****. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.*

Authors' Note: *There are a number of key concepts and definitions in* ***Topic 606*** *that are integral to understanding and applying the new revenue guidance. Some of the more relevant concepts in the context of the Five-Step Framework are discussed in* ***Appendix B*** *to this publication. It is strongly recommended that readers review and understand those concepts in* ***Appendix B*** *prior to reading* ***Topic 606****.*

STEP 1: IDENTIFY THE CONTRACT(S) WITH A CUSTOMER

In order for an in-scope agreement with a customer to be accounted as a contract under ***Topic 606***, all of the criteria listed below must be met. An entity will perform STEP 1 at contract inception, and will not reassess the following criteria unless there is *an indication of a significant change in facts and circumstances*[6].

a. The parties to the contract have approved the contract and are committed to performing their respective obligations.

b. Each party's rights regarding the goods or services to be transferred can be identified.

c. The payment terms for the goods or services to be transferred are identifiable.

d. The contract has commercial substance (that is, the risk, timing, and/or amount of the entity's future cash flows are expected to change as a result of the contract).

[6] Notwithstanding, a significant deterioration in a customer's ability to pay the promised consideration would require an entity to reassess the collectability criterion in e. (see ***ASC 606-10-25-5***).

e. It is probable the seller will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

Authors' Note: *The contract price can be different than the amount of consideration to which the entity expects to be entitled in exchange for the promised goods or services. For example, the amount an entity expects to be entitled could differ from the contract price because of price concessions or a customer's right to return a product.*

Further, the amount stipulated in a contract may not represent the amount to which an entity is currently entitled. By way of example, a contract could stipulate the maximum number of units to be delivered and/or the maximum dollar amount of purchases the customer can make over the contract term. However, the customer must place individual orders for goods under that contract. Each individual order would presumably represent a separate performance obligation of the entity. Accordingly, the amount to which an entity expects to be entitled currently is the consideration it expects to receive from the customer in exchange for the satisfaction of each respective performance obligation (i.e. transfer of control of the promised good to the customer). Collectability is discussed further in the following paragraphs of this section of the publication. See STEP 2 regarding identification of performance obligations and STEP 4 with respect to allocating the transaction price thereto.

For the purpose of applying the new revenue standard, a contract would not exist if the contract is wholly unperformed and each party has a unilateral enforceable right to terminate[7]. Wholly unperformed means that no goods or services have been transferred to the customer and the entity has not received or is not entitled to receive any consideration in exchange for goods or services.

Assessing Collectability

The following excerpt from ***ASC 606-10-25-1(e)*** specifically addresses the "collectability criterion" in e. above:

> *In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession.*

The collectability criterion is a necessary condition for identifying a contract with a customer, and is indicative of whether a substantive transaction has occurred. An entity must use judgment when assessing the collectability criterion and, when making this assessment, would consider (among other things) facts and circumstances relevant to the transaction, qualitative characteristics about the customer, credit risk (including factors that mitigate such risk), and customary business practices[8]. Importantly, it should be noted that an entity need not assess the collectability of the consideration for all goods and services in the contract. This assessment should be made in the context of the consideration to which the entity expects to be entitled for the goods and services that will be transferred by the entity to its customer. Further, an entity would not necessarily assess collectability based on a customer's ability and intent to pay the entire amount of consideration for the duration of the contract.

[7] See ***ASC 606-10-25-4***.
[8] See ***ASC 606-10-55-3A*** through ***55-3C***.

An example of a factor that could mitigate or limit an entity's exposure to credit risk would be a contractual provision that requires a customer to make payment in advance of receiving a promised good or service. The ability of an entity to stop transferring goods or services to a customer if such customer fails to make payment would also limit an entity's exposure to credit risk. The prospect of the repossession of an asset, however, is not a factor that would mitigate or limit an entity's exposure to credit risk. **A significant deterioration in a customer's ability to pay the consideration after contract inception would require an entity to reassess the collectability of contracts with such customer.**

In assessing the collectability criterion, it should be underscored that the collectible amount is the amount *to which the entity will be entitled*. Frequently that may be an amount less than the stated amount of consideration in the contract, but the criterion may still be met. Differences between the amount stated in the contract and the amount the entity expects to be entitled can arise from forms of variable consideration (discussed in STEP 3 below) including, but not limited to, price concessions that the entity may offer to a customer. Such price concessions may even be offered after the performance obligation is satisfied[9].

Combinations of Contracts

Entities will combine two or more contracts that are entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract upon meeting one or more of the following criteria[10]:

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

b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation (discussed in STEP 2 below).

Contracts Not Meeting the STEP 1 Criteria

If an agreement does not meet the criteria for identifying a contract (STEP 1), it would generally not be eligible for revenue recognition under ***Topic 606***, and an entity would not perform the remainder of the Five-Step Framework. If, however, a reporting entity were to receive consideration from a customer in a situation involving a contract that does not meet the aforementioned criteria, the entity would recognize the consideration as a liability until one or more of the following has occurred[11]:

a. The entity has no remaining obligation to transfer goods or services and has received substantially all of the related consideration.

b. The contract has been terminated and the consideration received is nonrefundable.

c. The entity has **(i)** transferred control of the goods or services to which the consideration relates; **(ii)** ceased transferring goods or services to the customer (if applicable) and has no further obligation to transfer additional assets; and **(iii)** the consideration received is nonrefundable.

[9] See Example 3 in ***ASC 606-10-55-102*** through ***55-105***.
[10] See ***ASC 606-10-25-9***.
[11] See ***ASC 606-10-25-7***.

STEP 2: IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

Topic 606 defines a performance obligation as a **promise in a contract with a customer** to transfer to the customer either:

a. A good or service (or a bundle thereof) that is distinct; or

b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Authors' Note: *An entity identifies the performance obligation(s) in the contract in STEP 2 and must obtain a thorough understanding of the nature of each performance obligation identified. With this information, an entity will assess whether a performance obligation is able to be recognized over time or, if not, at a point in time (see STEP 5). Further, the distinctness of goods or services will impact both* ***(i)*** *the allocation of the transaction price performed in STEP 4; and* ***(ii)*** *principal versus agent considerations. Principal versus agent considerations will be covered in a future National Accounting & Auditing publication.*

In order to have a performance obligation, there must be a promise. A contract will usually explicitly state the promise to the customer (i.e. a promised good or service). However, a contract may also include promises that are **implied** by an entity's customary business practices, published policies, or specific statements. Accordingly, performance obligations could be explicitly stated or implied, if such implied promises create a valid expectation of the customer that the entity will transfer a good or service. See **Exhibit 3** below for examples of promised goods or services.

Exhibit 3: Examples of Promised Goods or Services

606-10-25-18 Depending on the **contract**, promised goods or services may include, but are not limited to, the following:

a. Sale of goods produced by an entity (for example, inventory of a manufacturer)
b. Resale of goods purchased by an entity (for example, merchandise of a retailer)
c. Resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal, as described in paragraphs 606-10-55-36 through 55-40)
d. Performing a contractually agreed-upon task (or tasks) for a **customer**
e. Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides
f. Providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party, as described in paragraphs 606-10-55-36 through 55-40)[12]
g. Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
h. Constructing, manufacturing, or developing an asset on behalf of a customer
i. Granting licenses (see paragraphs 606-10-55-54 through 55-65)
j. Granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs 606-10-55-41 through 55-45).

A key take-away from the definition of a performance obligation is that a promise in a contract with a customer must be distinct. A promise to transfer a non-distinct good or service does not meet the definition of a performance obligation. It is not possible to perform the later step of allocating the transaction price (STEP 4) to a good or service that is ***not*** distinct. Accordingly, an entity will need to combine a promise to transfer a non-distinct good or service with other such promises until it identifies a bundle of goods and/or services that meets both of the criteria for being distinct (those criteria are discussed later on in this section). It may be possible that an entity will need to combine all of the goods and services within a particular contract before the bundle meets the criteria to be considered distinct.

Alternatively, some contracts contain a promise to make multiple deliveries of a similar good or service over time. ***Topic 606*** defines these agreements as a series, which consists of the transfer of *distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer*. A hotel management contract could be an example of a series of distinct goods or services[13] (as it would provide for the daily provision of distinct services over the term of the arrangement). A series has the same pattern of transfer to the customer if:[14]

[12] Principal versus agent considerations will be covered in a future publication.
[13] See Example 12A in ***ASC 606-10-55-157B*** through ***55-157E***.
[14] See ***ASC 606-10-25-15***.

a. each distinct good or service would meet the criteria to be a performance obligation over time; and

b. the same method would be used to measure the entity's progress toward satisfaction of the performance obligation.

The Boards included the concept of a series because, without it, the entity would be required to identify multiple distinct goods or services, allocate the transaction price to each of the resulting performance obligations on a standalone selling price basis, and then recognize revenue when each of those performance obligations are satisfied. In order to qualify as a series, each good or service must meet the requirements to be considered transferred over time (instead of at a point in time, as discussed in STEP 5 below). A series also requires that the same method would be used to measure progress toward satisfying the performance obligation to transfer each good or service to the customer.

As discussed above, in order to be identified as a performance obligation, a promise must be for the transfer of a distinct good or service, a distinct bundle, or a series of distinct goods and/or services. Both of the below criteria must be met[15] in order for a good or service, bundle, or series to be distinct.

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

Goods or Services That Are Capable of Being Distinct (First Criterion to Be Distinct)

This first criterion is met if the good or service could be held by a customer in a way that generates economic benefits[16]. Some goods or services may provide benefits to a customer on their own, while others may provide benefits to a customer only in conjunction with other readily available resources. With respect to the latter, other readily available resources may or may not have been obtained concurrently with the good or service, and could have been obtained by the customer either from the entity or another provider.

Author's Note: *Some goods or services may provide benefits to a customer only in conjunction with other readily available resources. In those transactions, an entity must evaluate whether the customer can obtain those resources separately from the good or service. To determine this an entity would assess whether:*
(i) *Such resources are regularly sold separately by the entity or another party; and/or*
(ii) *Whether the customer already obtained those resources from the entity or through other transactions or events.*

[15] See ***ASC 606-10-25-19***.
[16] The good or service could be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits (see ***ASC 606-10-25-20***).

Goods or Services That Are Distinct In the Context of the Contract (Second Criterion to Be Distinct)

The objective of the second criterion is to determine whether an entity has a performance obligation to transfer each of the goods or services individually or as a combined item with each individual good or service being an input thereto. The second criterion is therefore necessary to prevent confusion when there is more than one promise made in contracts with a customer. The following list includes examples of factors that would indicate the second criterion is met (i.e. whether the promises in the contract are separately identifiable)[17]:

a. The entity **does not provide a significant service of integrating the good or service** with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted. In other words, the entity is not using the individual good or service as an input to produce or deliver the combined output specified by the customer.
b. The good or service **does not significantly modify or customize** another good or service promised in the contract.
c. The good or service **is not highly dependent on, nor highly interrelated** with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.

The following are several examples found in the implementation guidance of the new standard of how to apply the criteria for determining whether a promise is distinct:

- Example 10 involving a general contractor - see ***ASC 606-10-55-136*** through ***55-140***
- Cases A and B within Example 11 involving a software developer - see ***ASC 606-10-55-141*** through ***55-150***
- Cases A, B, and C within Example 12 involving a manufacturer - see ***ASC 606-10-55-151*** through ***55-157***

Shipping and Handling Activities

In situations in which shipping and handling activities are performed, and they are not immaterial in the context of the contract with the customer[18], the identification of those activities as a performance obligation would be based on whether they were performed before or after the customer obtains control of the good being shipped. If the shipping and handling activities are performed before the customer obtains control of the good (see STEP 5), then they are not a promised service to the customer and they would therefore represent fulfillment activities. On the other hand, shipping and handling activities that occur after control of the related good transfers to the customer are a promised service requiring a portion of the transaction price to be allocated thereto. An entity, however, may make an accounting policy election to account for shipping and handling activities that occur after control of

[17] These examples were derived from ***ASC 606-10-25-21***.
[18] See ***ASC 606-10-25-16A*** and ***25-16B***.

the related good transfers as fulfillment activities (please refer to **Appendix A** regarding practical expedients).

STEP 3: DETERMINE THE TRANSACTION PRICE

In STEP 3, the entity considers the terms of the contract and its customary business practices to determine the amount of fixed and/or variable consideration to which an entity ***expects to be entitled*** in exchange for transferring the promised goods or services. The consideration to which an entity expects to be entitled should be measured in contemplation of fixed consideration, variable consideration, the existence of a significant financing component, non-cash consideration and consideration payable to the customer[19]. Further, an entity would exclude amounts collected on behalf of the customer such as sales tax. For other taxes that are levied on an entity but are collected from the customer (e.g. valued-added tax), the entity may make an accounting policy election to also exclude such taxes when measuring the transaction price[20].

> ***Authors' Note:*** *Measuring the amount of consideration to which the entity expects to be entitled is a key aspect of the Five-Step Framework. Many factors can affect the amount of consideration to which an entity expects to be entitled. Such factors include* ***(i)*** *volume based rebates;* ***(ii)*** *rights of return;* ***(iii)*** *variable consideration;* ***(iv)*** *non-cash consideration; and* ***(v)*** *any amounts paid or payable to the customer. As further described in the "Variable Consideration" paragraph in this section, application considerations of the new guidance to situations involving variable consideration include a prohibition of future revenue reversal, determination of any cumulative catch-up adjustments and whether there are any significant financing components.*

It is important to note that the transaction price is determined for the entire contract, which will subsequently be allocated to the identified performance obligations in STEP 4. **Further, the Boards intentionally used the words "expects to be entitled" to distinguish the transaction price from the estimated amount to be collected.** In other words and as previously discussed in connection with the collectability criterion[21] in STEP 1, customary business practice may indicate that the entity expects to be entitled to an amount less than the stated contract price. This might be the case when, for example, the entity has a history of offering price concessions. The transaction price would be measured in contemplation of expected price concessions and could be less than the estimated amount to be collected[22].

Variable Consideration[23]

Consideration may be variable in nature due to a broad range of reasons (including customary business practices). Variable consideration must be estimated by the entity to arrive at the contract's transaction price. Further, an entity will apply constraints to that estimate such that a significant reversal of cumulative revenue recognized is not probable. Estimates of variable consideration and the

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[19] See ***ASC 606-10-32-3***.
[20] See ***ASC 606-10-32-2A***.
[21] See **ASC 606-10-25-1(e)**.
[22] In the case of an expected price concession that results in a transaction price being lower than the amount recognized in trade receivables, the entity would recognize the difference as a contract liability representing the expected price concession.
[23] See ***ASC 606-10-32-5*** through ***32-9***.

constraint thereon would occur at contract inception and, as discussed further in this section, is reassessed at each reporting date. See **EXHIBIT 4** below for a description from the guidance of factors that make consideration variable.

Exhibit 4: Variable Consideration Factors

606-10-32-6 An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration also can vary if an entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

606-10-32-7 The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer this offer may be referred to as a discount, rebate, refund, or credit.
b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

To estimate the portion of the transaction price that represents variable consideration, entities are required to use one of two methods: **(1)** **expected value** from the sum of probability weighted values in a range; or **(2)** **the most likely amount**. The **most likely amount** is the appropriate method when the outcome is binary, such as a performance bonus for which the entity will either receive all or none. The method selected by an entity must be consistently applied throughout the respective contract, and should be applied to the same types of variable consideration in similar contracts. The most appropriate method should be selected given the facts and circumstances specific to a contract. Therefore, different methods could be used for different types of variable consideration.

After estimating the amount of variable consideration in the contract, the entity would constrain[24] the estimate. Only the amount for which it is probable that a significant reversal of cumulative revenue recognized will not occur once the uncertainty is resolved can be included in the transaction price. The following list, which was abstracted from ***ASC 606-10-32-12***, contains examples of factors that could increase the likelihood of a significant reversal of revenue:

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

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[24] See ***ASC 606-10-32-11*** through ***32-13***.

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

The transaction price is reassessed at the end of each reporting period. Consequently, a portion of the estimate previously constrained (i.e. excluded from the transaction price) may be added to the transaction price when reassessing the transaction price and once the entity has concluded that a significant reversal is not probable. See Example 8 (involving a construction company) at ***ASC 606-10-55-129*** through ***55-133,*** in which after reassessment, the entity records a cumulative catch-up adjustment to revenue when it becomes probable that a significant reversal will not occur.

Additionally, consider Example 40 in ***ASC 606-10-55-291*** through ***55-294***, which describes a volume based rebate feature in a contract with a customer. At inception, the entity determines the customer will meet the volume requirement to qualify for the rebate, and therefore incorporates the rebate in the calculation of the transaction price (i.e. the transaction price is computed net of the rebate), even though the customer has not yet earned the rebate when the entity begins delivering units sold. The result is that a receivable is recorded for the stated contract price per unit for units delivered, but the revenue recognized is limited to the transaction price per unit (which is net of the rebate), and a refund liability is recorded for the difference between the receivable and the revenue recognized.

Right of return is another example of why the amount expected to be entitled is less than the stated contract price. In Example 22 in ***ASC 606-10-55-202*** through ***55-207***, the entity estimates the number of units that will be returned and reduces the amount of total consideration expected to be received by the per unit contract price for those units. The result is that upon transfer of the units sold, revenue is only recognized for the number of units expected to not be returned, and a refund liability is recorded for the difference between the stated contract consideration and the estimated transaction price of the contract.

Significant Financing Component[25]

There could be a timing difference between when an entity transfers a good or service to a customer and when the entity receives the consideration from the customer. When a customer pays the consideration in arrears (i.e. at some point after having received the good or service), the entity has provided a form of financing to the customer. If a customer instead pays for a good or service in advance (i.e. makes a prepayment), the customer has provided a form of financing to the entity. If the timing of payment provides the customer or the entity with a **significant benefit of financing**, the entity must adjust the transaction price to account for the time value of money.

[25] See ***ASC 606-10-32-15*** through ***32-20***.

Authors' Note: *A financing component would not be significant **(a)** if the customer, at its discretion, paid for the goods or services in advance; **(b)** in situations involving a substantial amount of variable consideration whose variability is based on the occurrence/nonoccurrence of a future event not within the customer's or the entity's control (e.g. sales-based royalties); **OR** **(c)** the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference.*[26]

The objective of this adjustment, which would be made at contract inception and would not be updated subsequently for factors such as changes in interest rates or customer credit risk[27], is for an entity to adjust the transaction price such that the amount of revenue ultimately recognized reflects the price the customer would have paid absent the significant financing component (i.e. as if the customer had paid in cash at the time of transfer). In other words, the transaction price would be adjusted such that it reflects the consideration to which the entity expects to be entitled in exchange for the goods or services without consideration of the financing component. At contract inception, the entity would also consider the credit characteristics of the party (could be the entity or the customer) receiving the financing when determining an appropriate discount rate. After contract inception, the entity would not update the discount rate for changes in circumstances that impact the level of credit risk associated with the customer or changes in market rates.

It should be noted that this accounting treatment only applies to financing components that are **significant** (as discussed below). Further, a practical expedient is available under which an entity could elect to forgo incorporating a significant financing component into the measurement of the amount of promised consideration if the duration between the transfer of a promised good or service and when the customer pays is one year or less, and provided that the entity discloses that fact[28].

An entity would identify a financing component and determine whether it is significant to the contract by considering all relevant facts and circumstances, including[29]:

a. Differences (if any) between the promised amount of consideration and the cash selling price of the promised goods or services
b. The combined effect of the **(1)** expected length of time between the transfer and the payment by the customer; and **(2)** interest rates prevailing in the relevant market.

The new revenue standard provides specific factors that, if present, would result in an entity concluding that a contract does not have a significant financing component[30]. **For example, a contract would not have a significant financing component if the entity collects cash from the customer that exceeds the cash selling price for the purpose of mitigating its credit risk with respect to that customer.**

Income Statement Presentation

[26] See ***ASC 606-10-32-17***.
[27] See ***ASC 606-10-32-19***.
[28] See ***ASC 606-10-50***.
[29] See ***ASC 606-10-32-16***.
[30] See ***ASC 606-10-32-17***.

The effects of the financing component should be classified as either interest income or interest expense. In addition, these amounts must be presented separately from revenue from contracts with customers in the income statement or statement of activities, and would only be recognized if a contract receivable or contract liability is also recognized on the balance sheet.

Noncash Consideration

Noncash consideration included in the promised consideration should be measured at fair value in determining the transaction price. If the fair value of the noncash consideration cannot be reasonably estimated, the entity can measure the consideration indirectly by reference to the standalone selling price of the performance obligation. Subsequent changes in the fair value of the noncash consideration that are due to the form of such consideration (i.e. change in the fair value of a share issued as consideration) are excluded from the transaction price, and are therefore not subsequently reassessed as variable consideration. **The same is not true for variability that is tied to the entity's performance under the contract.** If a customer contributes goods or services to facilitate the entity's fulfillment of the contract, the entity should assess whether it obtains control of the goods or services and if so, account for such contributions as noncash consideration received from the customer.[31]

Consideration Payable to a Customer

Consideration paid or payable to a customer should be accounted for as a reduction in the transaction price (and thus a reduction of revenue), unless it is in exchange for goods or services transferred from the customer to the entity. In that case, it would be accounted for in the same way the entity accounts for other purchases from vendors. Any consideration paid to a customer in excess of the fair value of the goods or services received by the entity in exchange should be treated by the entity as a reduction of the transaction price. **If the fair value of the goods or services purchased from the customer cannot be reasonably estimated, the entire amount of the consideration paid to the customer would be treated as a reduction of the transaction price.**[32] If accounted for as a reduction of revenue, consideration payable to a customer will be recognized in an entity's income statement (or statement of activities) at the later of: **(a)** when the entity recognizes revenue for the transfer of the related goods or services; and **(b)** the entity implicitly or explicitly promises to the pay the consideration[33].

STEP 4: ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS IN THE CONTRACT.

In STEP 4, the transaction price determined in STEP 3 is allocated to the performance obligations identified in STEP 2. The objective of this allocation is to establish the foundation from which the core principle of the new revenue standard will ultimately be achieved in STEP 5. STEP 4 is the point in the framework where an entity determines the potential revenue (by allocating the transaction price) that is expected be recognized for each distinct good or service the entity is obligated to transfer to the customer.

[31] See ***ASC 606-10-32-21*** through ***32-24***.
[32] See ***ASC 606-10-32-25*** through ***32-27***.
[33] See ***ASC 606-10-32-27***.

Authors' Note: *Allocation of the transaction price to the performance obligations identified is an important part of the Five-Step Framework, as the amount allocated to each performance obligation is ultimately what an entity expects to recognize as revenue when each respective performance obligation is satisfied (as determined in STEP 5). As discussed in the following paragraphs of this section, complexity can arise in situations in which stand-alone selling price information is not observable.*

Generally, the transaction price is allocated at contract inception to performance obligations in proportion to their stand-alone selling prices (i.e. based on the relative stand-alone selling price of each distinct good or service). Subsequently, changes in the transaction price should be allocated to performance obligations based on the same relative basis as they had been at contract inception. In other words, allocations of subsequent changes in transaction price should not reflect changes in relative stand-alone selling prices that occurred after contract inception. **The entity should not presume that the price stated in the contract for an individual performance obligation is the stand-alone selling price.** The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. If the stand-alone selling price is not directly observable, however, the entity will need to estimate it based on available information. Those estimates must maximize the use of observable inputs and be based on methodologies that are applied consistently to similar transactions.

See **Exhibit 5** below for examples of suitable estimation methods that may be used when estimated stand-alone selling prices. It may be necessary to use a combination of estimation methods.

Exhibit 5: Methods for estimating the stand-alone selling price of a performance obligation

606-10-32-34 Suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:

a. Adjusted market assessment approach—An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
b. Expected cost plus a margin approach—An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
c. Residual approach—An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:
    1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).
    2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

Authors' Note: A combination of methods may be needed to estimate standalone selling prices in certain situations. An example of such a situation could be when two of the three distinct promises for the delivery of goods in a contract have highly variable stand-alone selling prices[34]. In that situation, an entity could combine available methods by using a residual approach to determine the aggregate portion of the transaction price for the two distinct promises with highly variable stand-alone selling prices. Then, the entity could use the adjusted market assessment approach to determine the relative stand-alone selling prices and allocate the residual transaction price to the two distinct promises with highly variable stand-alone selling prices accordingly.

Exceptions to the Relative Standalone Selling Price Method

As stated above, the transaction price should generally be allocated to performance obligations based on relative standalone selling prices. Accordingly, an entity should apply the relative standalone selling price method by default, with deviations from that method being an exception pursuant to the new revenue standard. There are exceptions, however, applicable to certain situations involving discounts and variable consideration.

Allocation of Discounts

Discounts should be allocated to performance obligations proportionately based on relative standalone selling prices, unless there is observable evidence that the discount relates only to certain performance obligations in the contract (i.e. the discount does not relate to all of the performance obligations). The new guidance provides the following criteria, all of which must be met, in order for a discount to be allocated specifically to one or more, but not all, of the performance obligations in the contract:[35] **(a)** the entity regularly sells each distinct good, service, or bundle thereof on a standalone basis; **(b)** the entity regularly sells bundles of some of those distinct goods or services in the contract at a discount to their standalone selling prices; and **(c)** the discount attributable to each such bundle is substantially the same as the discount in the contract and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation to which the entire discount in the contract belongs.

Drawing on Example 34 in the implementation guidance[36]:

- Online Retailer enters into a contract to sell three distinct products (Products A, B and C) to Customer for $2,000. The contract also includes a discount of $500, and the transaction price is therefore $1,500.
- Online Retailer individually offers to its customers Product A for $1,000, Product B for $650 and Product C for $850. Accordingly, those offer prices represent the relative standalone selling prices for each of the products.
- Online Retailer regularly offers Products A and B as a bundle to customers for $1,150, (a $500 discount).
- Online Retailer is scheduled to deliver Products A and B in July 20XY and Product C in August 20XY.

[34] See ***ASC 606-10-32-35***.
[35] See ***ASC 606-10-32-37***.
[36] See ***ASC 606-10-55-259*** through ***55-269***.

By default, Online Retailer would generally allocate the discount to Products A, B and C based on relative standalone selling prices. However[37]: **(a)** Online Retailer regularly sells Products A, B and C (each of which is a distinct good) on a standalone basis; **(b)** Online Retailer regularly sells Products A and B as a bundle at a discount; and **(c)** the $500 discount in the contract is the same[38] as the discount Online Retailer regularly offers other customers when selling them Product A and B as a bundle. Pursuant to the measurement guidance in the new revenue standard, there is observable evidence that the entire discount does not relate all of the performance obligations in the contract. Therefore, Online Retailer would allocate the $500 discount in the contract with Customer to Products A and B, resulting in the $1,500 transaction price being allocated as follows: **(i)** $1,150 to Products A and B ($1,650 less $500 discount); and **(ii)** $850 to Product C.

If Products A and B were delivered at different points in time, the entire discount would be allocated to each product based on their relative standalone price (but only considering the relative standalone prices of Products A and B). In other words, $697 would be allocated to Product A and $453 would be allocated to Product B for a total of $1,150.

Variable Consideration

Variable consideration should be allocated to performance obligations based on relative standalone selling prices, unless certain criteria are met. Similar to discounts, an entity will assess whether certain criteria are met that would indicate that the variable consideration is attributable to fewer than all of the performance obligations in a contract. The allocation of variable consideration to specific performance obligations in this manner adds a layer of difficulty to the inherent complexity of measuring variable consideration.

The new standard provides the following criteria, both of which must be met, in order for variable consideration to be allocated specifically to one or more, but not all, of the performance obligations in the contract:[39]

a. The terms that create the variability relate specifically to either the entity's efforts to satisfy the performance obligation or an outcome from the satisfaction of the performance obligation; and

b. The outcome of the resulting allocation is such that the portion of the transaction price attributed to each respective performance obligation reflects the consideration to which the entity is expects to be entitled.

STEP 5: RECOGNIZE REVENUE WHEN (OR AS) THE ENTITY SATISFIES A PERFORMANCE OBLIGATION

STEP 5 is the culmination of the Five-Step Framework and involves the assessment of whether a promised good or service has been transferred to the customer. This transfer occurs at the time the customer obtains control of the good or service. When evaluating whether a customer has obtained control, an

[37] See ***ASC 606-10-32-37*** for the applicable criteria used in this example.
[38] While identical for purposes of this example, the guidance in ***ASC 606-10-32-37*** would require the discount offered to Customer in this example to be *substantially the same* as the discount Online Retailer offers on the Product A and B bundle it regularly sells.
[39] See ***ASC 606-10-32-40***.

entity must also consider whether it has any repurchase rights or obligations (i.e. call right, agreement to repurchase, etc.)[40].

In the context of the new standard, **control** is described in the below excerpt from the guidance. Understanding this definition is a prerequisite to performing STEP 5.

> *Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.*[41]

Authors' Note: *In STEP 5, an entity determines whether a performance obligation is satisfied over a period of time or at a point in time. This determination is crucial as it will directly affect how an entity recognizes revenue. The focus of this section of the publication is on determining whether a performance obligation is satisfied over time or at a point in time. An entity's revenue recognition approach, which depends on when and how a performance obligation is satisfied, is summarized in this section of the publication.* A future publication will provide an expanded discussion on the actual recognition of revenue after the first four Steps have been met.

The entity must determine whether the performance obligation is satisfied (through transfer of control of the good or service to the customer) over time. If a performance obligation is not satisfied over time, an entity would conclude that it is satisfied at a point in time. **This determination is made at contract inception.**

[40] See ***ASC 606-10-25-26***. Repurchase rights will be covered in a future publication covering disposal transactions with non-customers involving certain nonfinancial assets.
[41] See ***ASC 606-10-25-25***.

Performance Obligations Satisfied Over Time

Any one of the following three criteria must be met for a performance obligation to be satisfied over time[42]:

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

Implementation Guidance (***ASC 606-10-55-5*** and ***55-6***)

Contracts for routine or recurring services (i.e. maintenance or cleaning) would generally meet this criterion. Some contracts, however, would not meet this criterion because a customer would not benefit until the entity's performance is complete. When assessing whether a customer simultaneously receives and consumes the benefits provided by an entity's performance, the entity should consider all relevant facts and circumstances such as the terms in the contract, how the good or service will be transferred, and the basic characteristics of the good or service.

Whether a customer simultaneously receives and consumes the benefits of an entity's performance may not always be readily determinable. In those instances, the entity would make a hypothetical assessment in evaluating whether a performance obligation meets this criterion. That hypothetical assessment involves considering whether another entity would need to substantially re-perform the work completed to date in order to fulfill the remaining performance obligation. **If another entity would not need to substantially re-perform such work, the entity would conclude that the performance obligation is satisfied over time.** To illustrate this hypothetical assessment, consider the following example derived from paragraph B126 in the Basis of Conclusions for ASU 2014-09 involving a freight logistics contract:

- Customer contracted with Logistics Provider to deliver freight from the shipping point ("Point A") to its warehouse ("Point C").
- Logistics Provider transported the freight to a half-way point between Point A and Point C ("Point B").

In assessing this criterion, Logistics Provider would consider the hypothetical scenario in which Customer used another provider to transport the freight from Point B to Point C, and whether that other provider would have to substantially re-perform the work completed to date (i.e. transport of freight from Point A to Point B). In this hypothetical situation, another provider would not have to re-perform any of the completed work in order to fulfill the performance obligation of delivering the freight to Point C. Accordingly, the customer benefits as the logistics provider performs and, therefore, this performance obligation is satisfied over time.

Actual and/practical restrictions would have no bearing on such a hypothetical assessment. This is demonstrated by the fact that, when making such an assessment, an entity would **(a)** disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from fulfilling the remaining performance obligation; and **(b)** presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.

[42] See ***ASC 606-10-25-27***.

Implementation Guidance (***ASC 606-10-55-7***)

By way of example, a construction contract in which an entity is building on land owned by the customer would generally meet this criterion if the customer controls the related work in process. The basis for this criterion is consistent with the rationale for using the percentage-of-completion method for revenue recognition under current U.S. GAAP (see paragraph B130 in the Basis of Conclusions for ASU 2014-09).

While this criterion appears to be straightforward, there could be performance obligations for which it may be unclear as to whether the work in process is controlled by the customer. The third criterion below is intended to address those situations.

c. The entity's performance does not create an asset with an alternative use to the entity ***and*** the entity has an enforceable right to payment for performance completed to date. This criterion has the following two parts, both of which must be satisfied in order for this criterion to be met: **(i)** the "no alternative use" part; and **(ii)** the "enforceable payment right" part. While the "no alternative use" part is generally assessed only at contract inception (see below), the "enforceable payment right" part must be satisfied on an on-going basis.

(i) Performance Does Not Create an Alternative Use - Implementation Guidance (***ASC 606-10-55-8*** to ***55-10***)

An entity would reassess "no alternative use" part of the criterion after contract inception only if there is a contract modification that substantively changes the performance obligation. An asset would not have an alternative use if either: [43]

- *The entity is contractually restricted from readily directing the asset for another use during the creation or enhancement of that asset.* The possibility of the contract being terminated would not indicate that the entity is not able to readily direct the asset for an alternative use, and the restriction(s) must be substantive.

  OR

- *The entity is limited practically from readily directing the asset in its completed state for another use.* A practical limitation would be the incurrence of a significant economic loss in order for the entity to redirect the asset for an alternative use. Examples of practical limitations include unique design specifications and geography (i.e. located in a remote location).

(ii) Entity Has an Enforceable Right to Payment - Implementation Guidance (***ASC 606-10-55-11*** to ***55-15***)

The "enforceable payment right" part[44] of the criterion **must be satisfied at any time during the contract term**, and is an entity's enforceable right to payment for performance completed to date if the contract is terminated for reasons other than the entity's failure to perform as promised. When determining whether it has an enforceable right to receive payment in the context of the relevant contractual terms, an entity would consider applicable laws and customary business practices. Further, the amount to which the entity is entitled in the event of cancellation (for reasons other than the entity's non-performance) must approximate the selling price of the goods or services transferred to date.

[43] See ***ASC 606-10-25-28***.
[44] See ***ASC 606-10-25-28***

Measuring Progress

A performance obligation satisfied over time requires the measurement of the progress toward its complete satisfaction. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised, and as a result, recognize revenue over time in an amount equal to the portion of the transaction price that is commensurate with the progress measured. Measuring the progress toward complete satisfaction of a performance obligation can be performed using either output methods or input methods. A detailed description of the use of input and output methods is provided in the implementation guidance of the standard at ***ASC 606-10-55-16*** through ***55-21***[45]. The method chosen should be the one that most faithfully depicts the transfer of control of the goods or services promised. Output methods are based on direct measurements of value to the customer. Input methods are based on the inputs used in satisfying the obligation, such as hours expended or costs incurred.

If an entity is not able to reasonably estimate the progress toward complete satisfaction of the performance obligation, then it cannot recognize the revenue over time. However, in some circumstances, an entity may not be able to reasonably measure the outcome of a performance obligation, but it expects to recover its costs incurred to satisfy the performance obligation. In that situation, an entity can recognize revenue up to the extent of costs incurred until such time that it can measure the outcome of the performance obligation.

Performance Obligations Satisfied at a Point in Time

If a performance obligation is not satisfied over time, it is satisfied at a point in time, and revenue in the amount of the transaction price allocated to that obligation is only recognized when control of the good or service is transferred. In addition, the ***ASC 606-10-25-30***[45] standard provides indicators, which are not meant to be all-inclusive, of the transfer of control.

Contract Assets & Liabilities[46]

Performance under a contract between an entity and its customer create **contract assets** or **contract liabilities**. The Other Presentation Matters section of ***Topic 606*** describes the requirements to record contract assets and contract liabilities. The standard does not prohibit the use of alternative descriptions of these terms, provided sufficient information is given to distinguish receivables from contract assets.

Contract Assets

The new revenue standard defines a contract asset (commonly referred to as *unbilled revenue* or *unbilled receivables* prior to the Update):[47]

[45] A future publication will provide an expanded discussion regarding: **(1)** output and input methods for measuring progress toward the complete satisfaction of a performance obligation over time; and **(2)** the evaluation of when to recognize revenue associated with performance obligations satisfied at a point in time.
[46] See ***ASC 606-10-45-1*** through ***45-5***.

An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

Integral to understanding the definition of a contract asset, is the ability to distinguish between contract assets and receivables. Receivables represent an *unconditional* right to receive consideration. By way of example, an entity would recognize a contract asset in a situation in which a performance condition has been satisfied but the entity will not have the unconditional right to the related consideration until it satisfies another performance obligation[48]. Once an entity has the unconditional right to receive consideration, the related contract asset (if any) would be re-characterized to a receivable.

Contract assets should be presented separately from amounts presented as receivables. Contract assets should be assessed for impairment, and such impairments should be measured, presented, and disclosed in accordance with Topic 310. ***Topic 606*** requires impairments on receivables and contract assets arising from contracts with customers to be presented separately from impairment losses from other contracts.

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[47] This definition has been taken from the ***ASC 606-10-20 Glossary***.
[48] See Example 39 beginning at ***ASC 606-10-55-287***.

Contract Liabilities

Contract liabilities (commonly referred to as *deferred revenue* or *unearned revenue* prior to the ASU) arise and should be recorded when a customer pays consideration, or the entity has an unconditional right to payment before transferring control of the performance obligation (i.e. cash received in advance).

Disclosures

The ASU includes new comprehensive disclosure requirements that are expected to provide users of financial statements with detailed information on an entity's contracts with customers. The enhanced disclosure requirements will provide more information that enables users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

Generally, entities will disclose quantitative and qualitative information about:

- Contracts with customers;
- Significant judgments and changes in judgments made in applying the revenue recognition guidance to contracts with customers; and
- Assets recognized from the costs to obtain or fulfill a contract with a customer.[49]

In satisfying the requirements to disclose information about contracts with customers, entities will need to sufficiently disaggregate revenue into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. Private companies may elect a much simplified disaggregation presentation.

Other subject matters for required disclosures related to contracts with customers include information about contract balances, information about performance obligations and how they are satisfied, and the transaction price allocated to the remaining performance obligations. Private companies may elect to not provide the disclosures about the transaction price allocated to remaining performance obligations.

Disclosures about significant judgments in the application of the revenue recognition guidance include determining the timing of satisfaction of performance obligations, and determining the transaction price and the amounts allocated to performance obligations. Private companies may elect much simplified presentations of these items.

[49] The requirements for disclosure about contract assets and liabilities are described in Topic 340 (ASC 340-40-25-1 through 25-5)

Appendix A

Practical Expedients

There are many practical expedients within ASU 2014-09 and the related subsequent ASUs that may be elected during transition and/or as part of accounting policy decision making after adoption. The table below summarizes them. Disclosure is generally required concerning practical expedients elected. ASU 2016-20 renamed certain practical expedients to be called "optional exemptions," carrying with them their own disclosure requirements that were updated by ASU 2016-20.

Practical Expedient Area	Description
Transition methods: ***ASC 606-10-65-1***	When adopting using the full retrospective method, specific practical expedients may be elected to facilitate presentation of comparative periods, completed contracts, contract modifications, and disclosure requirements. Any of these expedients elected should be applied consistently to all of an entity's contracts.
Disclosure: ***ASC 606-10-50-14*** & ***50-14a to 50-14b*** as amended by ASU 2016-20.	An entity need not disclose the information in paragraph 606-10-50-13, which requires information about remaining performance obligations, for a performance obligation if either of the following conditions is met: a. The performance obligation is part of a contract that has an original expected duration of one year or less. b. The entity recognizes revenue from the satisfaction of the performance obligation in accordance with paragraph 606-10-55-18 (disclosure about the satisfaction of performance obligations over time). An entity need not disclose the information in paragraph 606-10- 50-13 (see above) for variable consideration for which either of the following conditions is met: a. The variable consideration is a sales-based or usage-based royalty promised in exchange for a license of intellectual property accounted for in accordance with paragraphs 606-10-55-65 through 55-65B. b. The variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b), for which the criteria in paragraph 606-10-32-40 have been met. These disclosure exemptions may not be applied to fixed consideration. Electing these optional exemptions will trigger specific disclosures outlined in ASC 606-10-50-15 as amended by ASU 2016-20.
Significant Financing Component: **ASC 606-10-32-18**	If the duration between transfer or the performance obligation and when the customer pays is one year or less, an entity does not need to adjust the promised amount of Consideration for the effects of a significant financing component.
Sales Taxes: ***ASC 606-10-32-2A***	An entity may elect to exclude from its transaction price any amounts collected from customers for all sales (and other similar) taxes.
Costs to Obtain a Contract: ***ASC 340-40-25-4***	An entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.
Shipping and Handling: ***ASC 606-10-25-18B***	An entity may elect to account for shipping and handling activities that occur after control of the related good transfers as fulfillment activities instead of assessing such activities as performance obligations.

Portfolio Approach: ***ASC 606-10-10-4***	An entity may apply ***Topic 606*** to a portfolio of contracts (or performance obligations) with similar characteristics if it reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio.
Right to Invoice: ***ASC 606-10-55-18***	For performance obligations satisfied over time, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.

Appendix B

Key Definitions

Understanding and becoming fluent in the important concepts outlined in ***Topic 606*** is integral to understanding and applying the new revenue standard. A sound understanding of these concepts will also be important in accounting for transactions that are only partially within the scope of the new revenue standard.

Contract[50]
A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. ***Contracts can be written, oral, or implied by an entity's customary business practices****. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.* An entity will apply the guidance in ***Topic 606*** to transactions within its scope only when a contract with a customer meets all of the criteria in STEP 1 of the Five-Step Framework. There is one limited exception as further described earlier sections of this publication.

Customer[51]
A party that has contracted with an entity to obtain goods or services that are ***an output of the entity's ordinary activities*** *in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.* For example, Clothing Manufacturer, whose sole operations are to manufacture and sell garments to wholesalers, enters into a contract to sell its manufactured garments to a reseller of those garments ("Distributor"). Distributor would likely be a customer in that contract because the contract is for Clothing Manufacturer to sell garments to the Distributor, and those garments are an output of the entity's ordinary activities.

[50] Excerpt from ***ASC 606-10-25-2***.
[51] Excerpt from ***ASC 606-10-15-3***.

Subsequently, Clothing Manufacturer sells forklifts to Distributor. Distributor would likely **not** be a customer in this transaction because the forklifts are not an output of the entity's ordinary activities.

The key take away is that a reporting entity will identify customers by assessing the goods and/or services being transferred in relation to its own operations and major revenue generating activities.

Control[52]

Control of a promised good or service (that is, an asset) is the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. The components that make up the description of control are explained as follows:

- ***a.*** *Ability—A customer must have the present right to direct the use of, and obtain substantially all of the remaining benefits from, an asset for an entity to recognize revenue.*
- ***b.*** *Direct the use of—A customer's ability to direct the use of an asset refers to the customer's right to deploy that asset in its activities, to allow another entity to deploy that asset in its activities, or to restrict another entity from deploying that asset.*
- ***c.*** *Obtain the benefits from—The customer must have the ability to obtain substantially all of the remaining benefits from an asset for the customer to obtain control of it. Conceptually, the benefits from a good or service are potential cash flows (either an increase in cash inflows or a decrease in cash outflows). A customer can obtain the benefits directly or indirectly in many ways, such as by using, consuming, disposing of, selling, exchanging, pledging, or holding an asset.*

Transfer of the control of a good or service may be determined from the perspective of the transferring entity or the customer, but should be assessed primarily from the perspective of the customer.

Transaction Price[53]

The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both. However, the transaction price would exclude estimates of variable consideration that are constrained.

The transaction price is ultimately the amount allocated to the entity's performance obligations, and will be recognized as revenue when (or as) those performance obligations are satisfied.

[52] Excerpt from **BC120** in the ***Basis of Conclusions*** for ***ASU 2014-09***.
[53] Based on the ***ASC 606-10-20 Glossary***, and ***ASC 606-10*** paragraphs ***32-1*** and ***32-2***.

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