Revenue Recognition Roadmap

A detailed roadmap to help you implement ASC Topic 606

Introduction

Purpose of the tool

To help the reader understand and implement the new revenue recognition standard

Objective of the new standard

- Establish a revenue recognition model for all contracts with customers to improve consistency across entities and industries

Core principle of the new standard

- An entity should recognize revenue to depict the transfer of goods or services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services

Updates

This PM tool reflects the following Accounting Standards Updates (ASUs):

- ASU 2014-09, Revenue from Contracts with Customers
- ASU 2015-14, Deferral of the Effective Date
- ASU 2016-08, Principal versus Agent Considerations
- ASU 2016-10, Identifying Performance Obligations and Licensing
- ASU 2016-12, Narrow-Scope Improvements and Practical Expedients
- ASU 2016-20, Technical Corrections and Improvements to Topic 606

Scope

Scope of new standard

Affects all entities that enter into contracts with customers to transfer goods or services

Exclusions (See ASC 606-10-15-2 for details)

- Lease contracts
- Insurance arrangements
- Financial instruments and certain other items
- Certain guarantees
- Certain nonmonetary exchanges

Implementation

‘Public business entities’, certain NFPs, and certain EBPs

- Effective for annual reporting periods beginning after Dec. 15, 2017, including interim periods within that reporting period
- Earlier application is permitted only as of annual reporting periods beginning after Dec. 15, 2016, including interim reporting periods within that reporting period

All other entities

- Effective for annual reporting periods beginning after Dec. 15, 2018, and interim periods within annual periods beginning after Dec. 15, 2019
- Earlier application is permitted as of an annual reporting period beginning after Dec. 15, 2016, and for interim reporting periods either within that reporting period or within the annual reporting period beginning one year after the annual reporting period of application

The new revenue recognition model

Step 1 — Identify the contract with the customer (pg. 6)

Step 2 — Identify the separate performance obligations in the contract (pg. 13)

Step 3 — Determine the transaction price (pg. 14)

Step 4 — Allocate the transaction price to separate performance obligations (pg. 22)

Step 5 — Recognize revenue when (or as) each performance obligation is satisfied (pg. 23)

"Step 6" — Consider balance sheet effects (pg. 28)

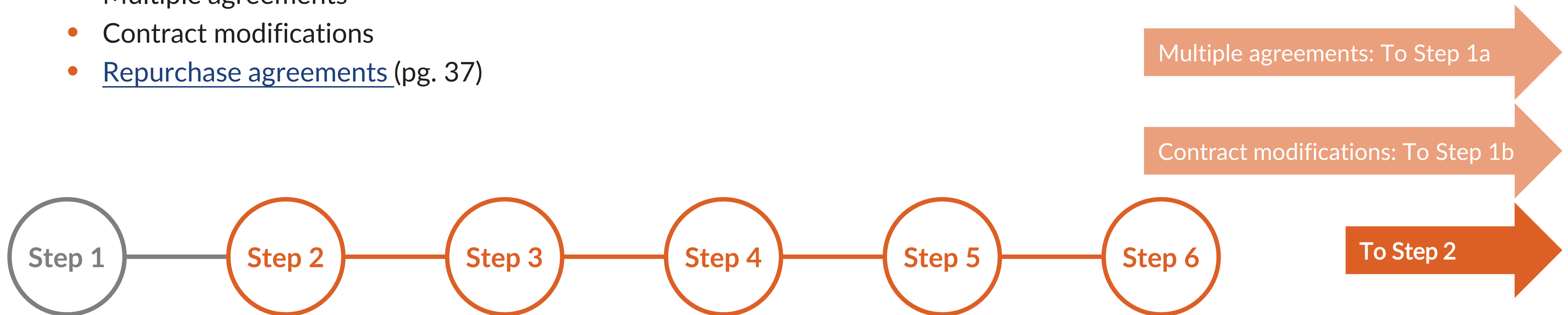
Step 1: Identify the contract with the customer

Account for a contract with the customer only when all of the following are met:

- Both parties have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform respective obligations.
- Each party's rights regarding the goods or services can be identified.
- Payment terms can be identified.
- Contract has commercial substance, i.e., the risk, timing, or amount of future cash flows are expected to change.
- It's probable that the entity will collect the consideration to which it is entitled in exchange for the goods or services.

Other items to consider in Step 1:

- Multiple agreements
- Contract modifications
- Repurchase agreements (pg. 37)

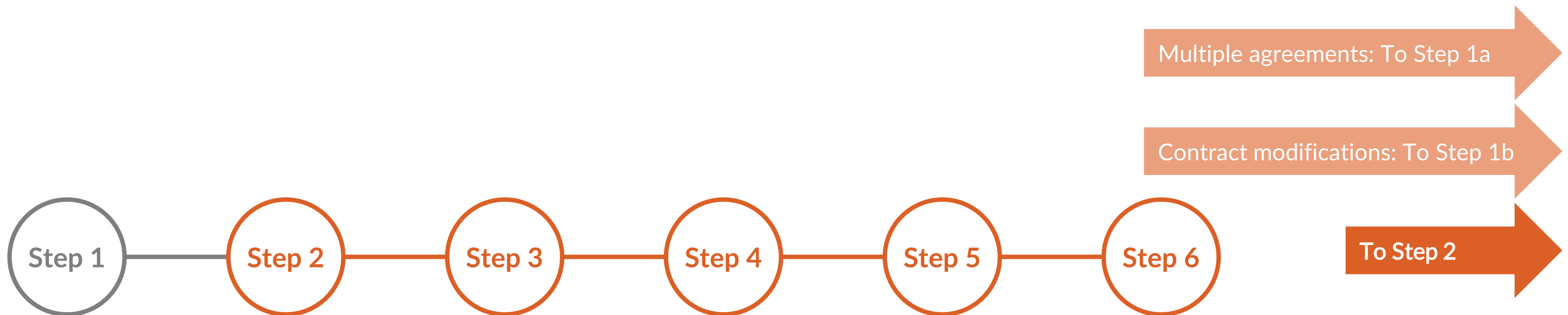


Step 1: Identify the contract with the customer (cont'd)

The portfolio approach:

Practical expedient to apply the guidance to a portfolio of contracts with similar characteristics if:

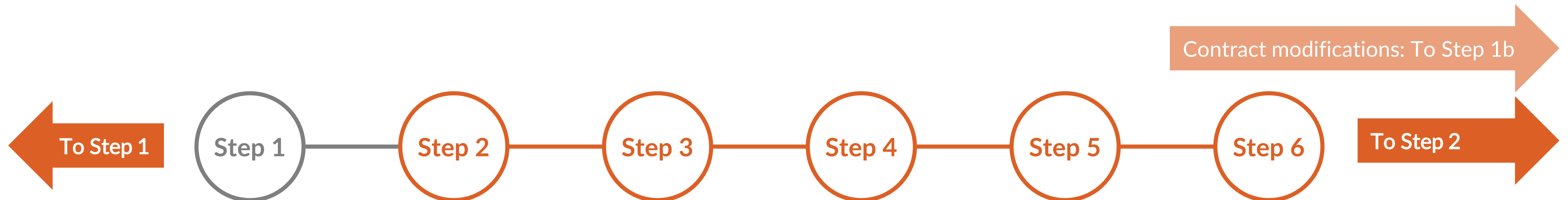
- An entity reasonably expects that the effects on the financial statements of applying the guidance to a portfolio vs. individual contracts would not be material.
- The estimates and assumptions used reflect the size and composition of the portfolio.



Step 1a: Multiple agreements

An entity combines two or more contracts and accounts for them as a single contract if they are entered into, at, or near the same time, with the same customer and/or related parties of the customer, and one or more of the following criteria are met:

- The contracts achieve a single commercial objective and are negotiated as a package.
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- The goods or services in the separate contracts represent a single performance obligation (pg. 13).



Combination of contracts flowchart

Step 1b: Contract modifications

A contract modification occurs when:

Both parties approve a change in the scope or price (or both); often described as a change order, variation, or an amendment.

Separate contract

A contract modification is treated as a separate contract if both of the following are true:

- The modification adds one or more distinct performance obligations to the contract.
- The price increases by an amount that reflects the stand-alone selling price of the additional distinct performance obligation(s).

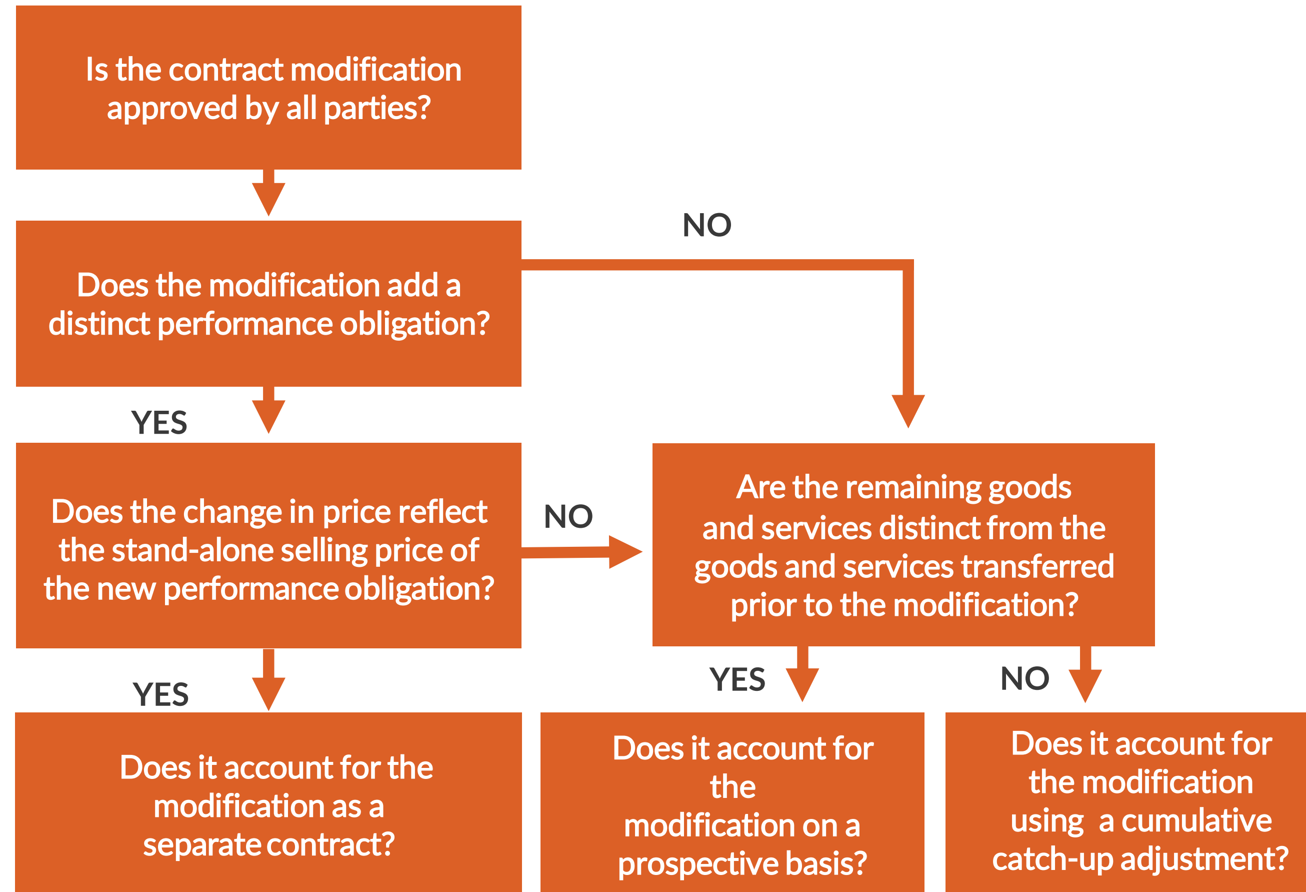
Step 1b: Contract modifications (cont'd)

Contract adjustment

If the conditions on the previous page are not met, the modification is accounted for as an adjustment to the original contract using whichever of the following methods is applicable, or in combination:

- Prospectively — If the new goods or services are distinct (pg. 13) from previously transferred goods and services, account for the modification as if it were a termination of the existing contract.
  - The remaining consideration in the original contract not yet recognized as revenue is combined with the additional consideration promised in the modification to create a new transaction price that is then allocated to all remaining performance obligations, i.e., those not yet completed in the original contract and any added through the modification.
- Cumulative catch-up adjustment — If the new goods or services are not distinct from previously transferred goods and services, the measure of progress toward satisfying the performance obligation is updated to reflect performance completed and performance that remains.

Contract modifications flowchart



Step 2: Identify the separate performance obligations in the contract

A performance obligation is:

A promise to transfer a distinct good or service, or a series of distinct goods or services that are substantially the same and have the same pattern of transfer, to a customer.

- Goods or services that are not distinct should be combined with other goods or services until the entity identifies a bundle of goods or services that is distinct.
- When multiple promises exist, such as multiple deliverables, management should determine whether they are distinct.

A good or service is distinct only if both of the below criteria are met:

- The customer can benefit from the good or service either on its own or together with other readily available resources
- The good or service is separately identifiable from other promises in the contract.

Other items to consider in Step 2:

- Licenses (pg. 35), customer options (pg. 41), warranties (pg. 43), nonrefundable upfront fees (pg. 45), and bill-and-hold arrangements (pg. 47)

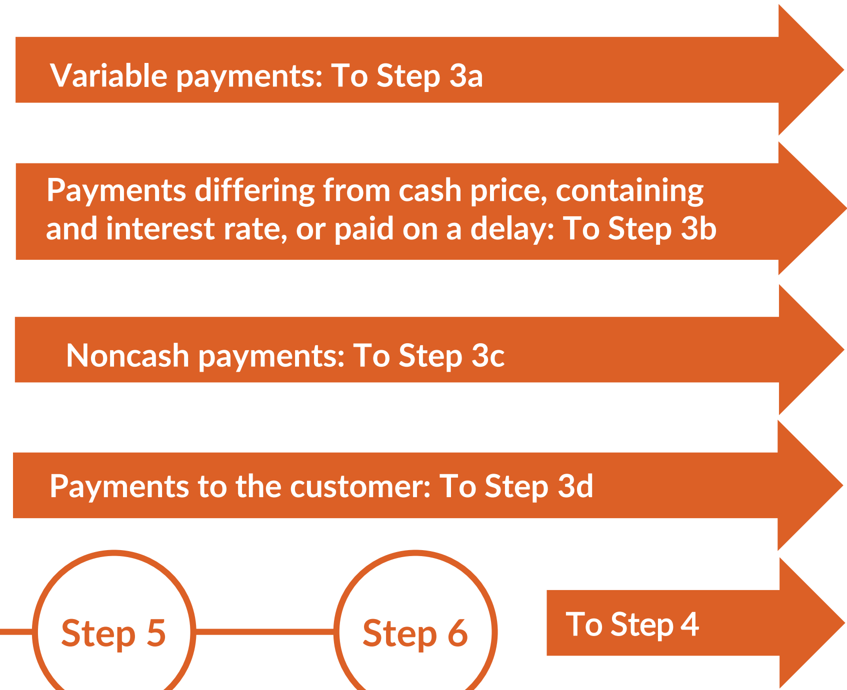
Step 3: Determine the transaction price

The transaction price is:

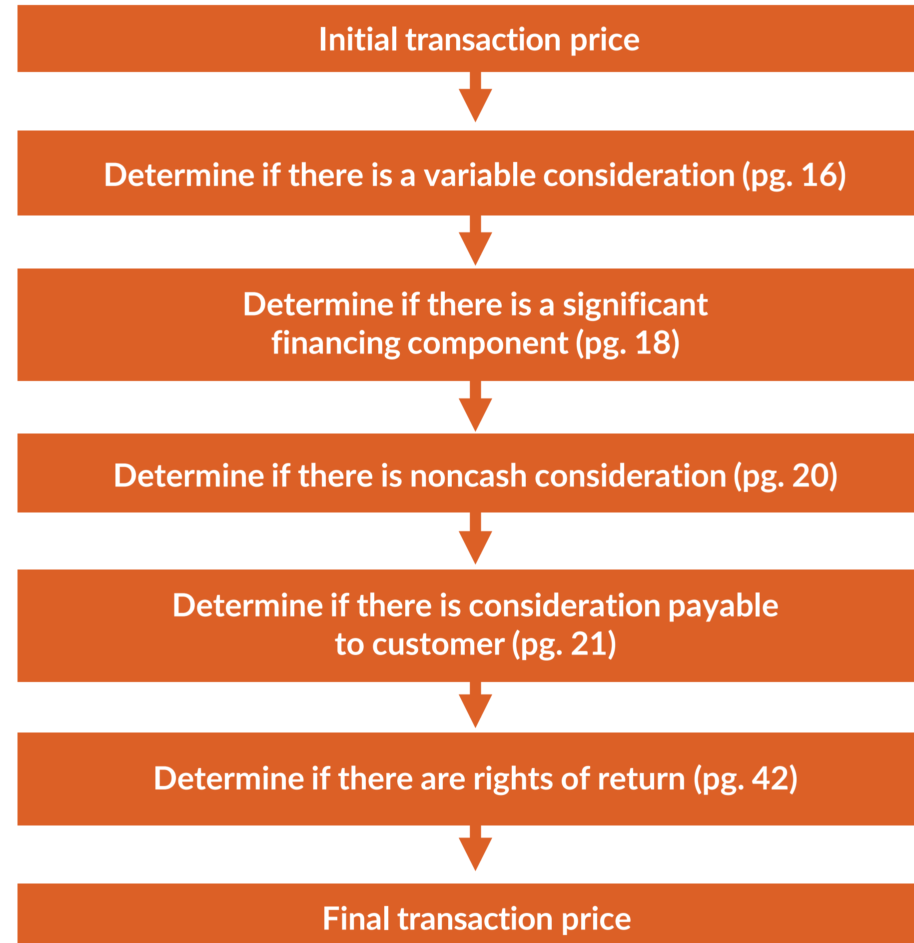
The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of a third-party (for example, some sales taxes).

If the arrangement involves any of the below, determining the transaction price becomes more complex:

- Variable payments
- Payments differing from cash price, containing an interest rate, or paid on a delay
- Noncash payments
- Payments to the customer
- Rights of return (pg. 42)



Determining the transaction price flowchart



Step 3a: Variable payments

Accounting for variable payments

Consideration can vary because of discounts, rebates, refunds, credits, etc. If consideration is variable, an entity estimates the amount of consideration to which it is entitled based on contract terms and all other available information. The method that best predicts the amount of consideration must be applied consistently throughout the contract, and the two available methods are:

- **Expected value** — sum of probability-weighted amounts in a range of possible consideration amounts
- **Most likely amount** — most likely amount in a range of possible consideration amounts, i.e., the single, most likely outcome

Constraint

Some or all of an amount of variable consideration should be included in the transaction price only to the extent that is probable that a significant reversal of the amount will not occur.

Step 3a: Variable payments (cont'd)

Exception

Sales-based or usage-based royalties promised in exchange for a license of intellectual property should be recognized when the later of the following events occurs:

- Subsequent sale or usage occurs.
- The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated, satisfied, or partially satisfied.

Step 3b: Payments differing from cash price, containing interest rate, or paid on a delay

The following factors should be considered and indicate a significant financing component:

- A difference between the amount of promised consideration and the cash selling price of the goods or services
- A difference between the time an entity transfers the goods/services to the customer and when the customer pays for those goods or services (> 1 year)
- The interest rate in the contract and prevailing interest rates in the relevant market

The following situations are NOT indicative of a significant financing component:

- The customer paid in advance, and the timing of the transfer of goods/servicers is at the discretion of the customer.
- A substantial amount of the consideration promised is variable, and the amount or timing of consideration varies due to the factors outside the control of the parties, e.g., a sales-based royalty.
- A difference between the promised consideration and the cash selling price arises for reasons other than the provision of finance to the customer or entity, e.g., protection against nonperformance.

Step 3b: Payments differing from cash price, containing interest rate, or paid on a delay (cont'd)

When a significant financing component has been identified:

- The consideration amount should be adjusted by a discount rate.
- The entity should present the effects of financing, i.e., interest income/expense, separately from the revenue from the contract.

Step 3c: Noncash consideration

To determine the transaction price when consideration is exchanged in a form other than cash:

Measure the estimated fair value of the noncash consideration at contract inception.

- If the fair value cannot be reasonably estimated, measure the noncash consideration indirectly by reference to the stand-alone selling price of the goods or services promised to the customer (or class of customer) in exchange for the consideration.

If a customer contributes goods or services, e.g., equipment or labor, to facilitate the fulfillment of the contract, consider whether the entity obtains control of those contributed goods or services.

- If control is obtained, the entity records the noncash consideration as revenue.

Step 3d: Payments to the customer

Payments to the customer:

- Can include cash, credits, or other items that an entity expects to pay to a customer, e.g., coupon or voucher.
- Reduce the transaction price, i.e., reduce revenue, unless the payment is made in exchange for a distinct good or service that the customer transfers to the entity.

An entity recognizes the reduction of revenue when the latter of either of the below events occurs:

- The entity recognizes revenue for the transfer of the related goods/services to the customer.
- The entity pays or promises to pay the consideration (even if payment is conditional).

Step 4: Allocate the transaction price to separate performance obligations

An allocation is made:

- At contract inception.
- Based on relative, stand-alone selling prices of the distinct goods or services.

If there is not a stand-alone selling price, an estimate is made; possible estimation methods include, but are not limited to:

- Adjusted market assessment approach
- Expected cost plus an appropriate margin
- Residual approach, in limited circumstances, e.g., the selling price is highly variable or uncertain

Discounts and variable consideration will typically be allocated proportionately to all of the performance obligations in the contract.

Step 5: Recognize revenue when (or as) each performance obligation is satisfied

Revenue should be recognized when (or as) a good or service is transferred to the customer, and the customer obtains control of that good or service.

Control of an asset means:

An entity is able to direct the use of and obtain substantially all of the remaining benefits from the asset; evaluation of control should consider any agreements to repurchase the asset.

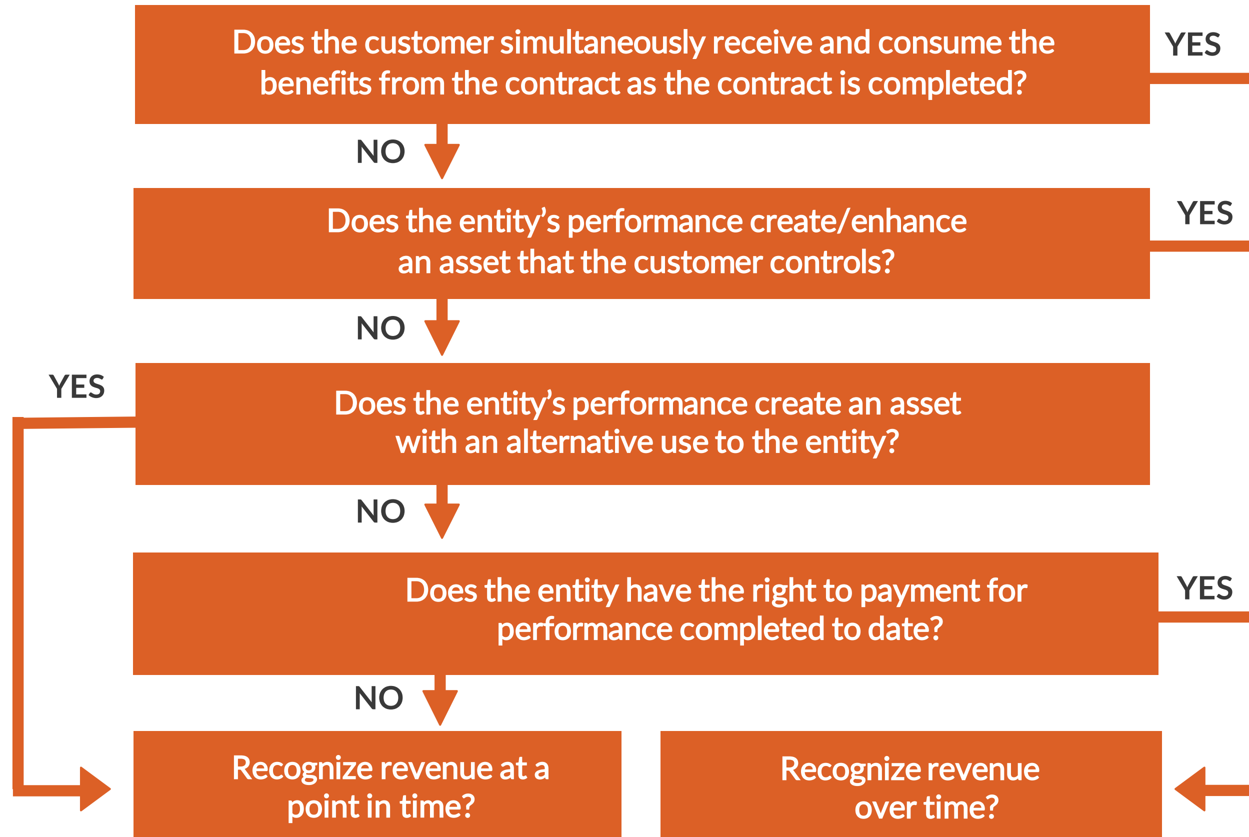
Management should determine at contract inception whether control of a good or service is transferred:

- Over time.
- At a point in time.

Other items to consider in Step 5

- Principal vs. agent (pg. 40)
- Consignment arrangements (pg. 46)
- Repurchase agreements (pg. 37)

Recognizing revenue flowchart



Step 5a: Recognize revenue over time

Performance obligations are satisfied over time if any of the following criteria is met:

- The customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs.
- The entity's performance creates or enhances an asset that the customer controls as it is created or enhanced.
- The entity’s performance does not create an asset with an alternative use to the entity, and the entity has a right to payment for performance completed to date.

Step 5a: Recognize revenue over time (cont'd)

Revenue should be recognized in a manner that depicts the transfer of control of the promised goods or services to the customer using output methods or input methods.

Output methods

Units produced or delivered, time elapsed, milestones reached, or surveys of performance completed, appraisals of results achieved

Input methods

Costs incurred, labor hours expended, time lapsed, or machine hours used

- Should exclude the effects of inputs that do not depict the transfer of control to the customer, e.g., significant inefficiency costs, materials delivered prior to installation

Step 5b: Recognize revenue at a point in time

Performance obligations satisfied at a point in time:

- Do not meet any of the criteria for revenue recognition over time.
- Result in revenue recognition at the point in time when control transfers.

When determining how to depict the transfer of control, consider the definition of control; the following are indicators:

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

“Step 6”: Consider balance sheet effects

Incremental costs of obtaining a contract with a customer:

- Are recognized as an asset.
- Include costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained, e.g., sales commissions.

Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained are recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained, e.g., salary of marketing personnel involved with contract proposal.

“Step 6”: Consider balance sheet effects (cont’d)

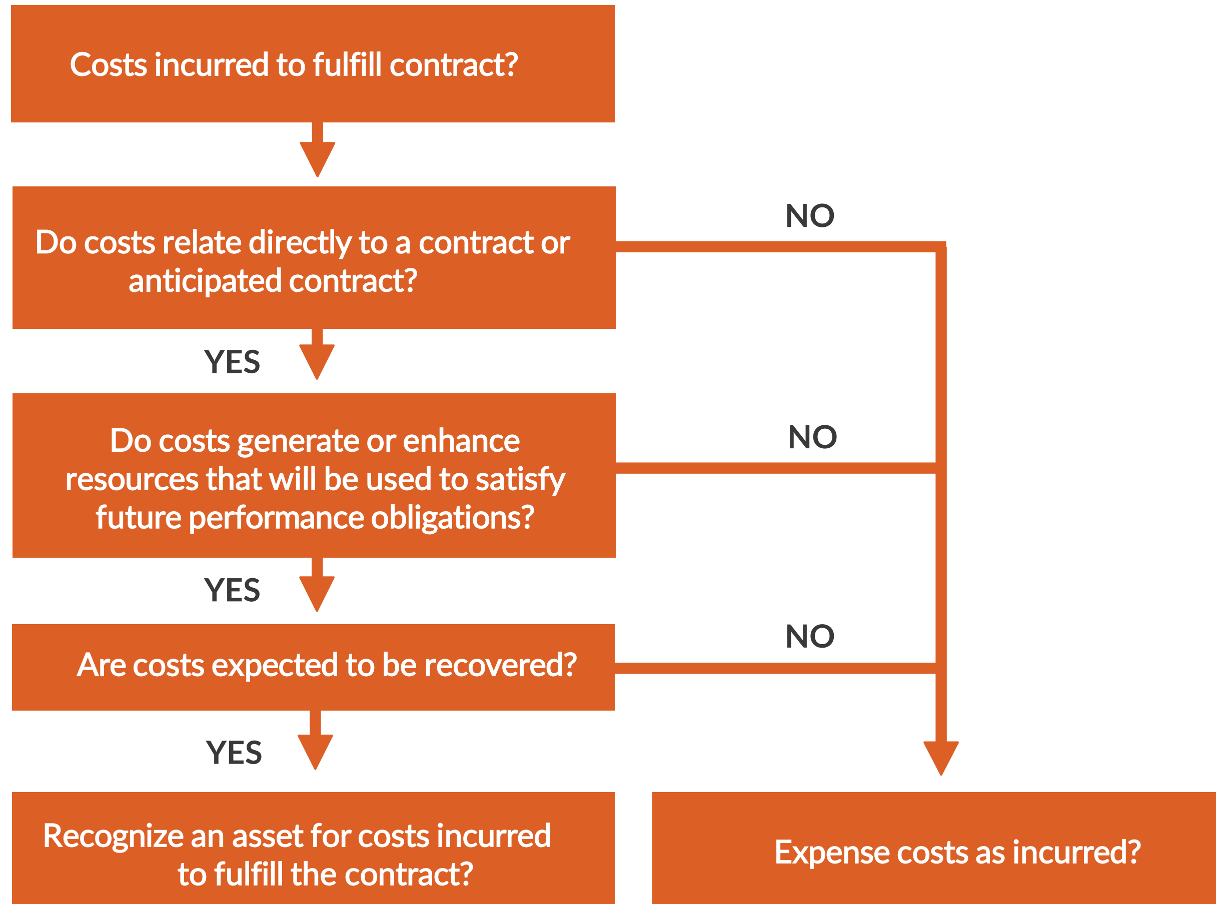
Costs incurred in fulfilling a contract with a customer

An entity shall recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria, e.g., costs of designing an asset to be transferred under a specific contract:

- Relate directly to a contract or anticipated contract that the entity can specifically identify
- Generate or enhance the entity’s resources that will be used to satisfy future performance obligations
- Are expected to be recovered

Management should consider whether costs to fulfill a contract should be accounted for in accordance with other ASC Topics — e.g., inventory, fixed assets, internal-use software — before applying this guidance.

Costs incurred to fulfill contract flowchart



“Step 6”: Consider balance sheet effects (cont’d)

An asset recognized for the costs to obtain or fulfill a contract will be amortized on a systematic basis as the goods or services to which the asset relates are transferred to the customer. The asset should also be assessed for impairment each reporting period.

- Practical expedient: If the amortization period of the asset related to the incremental costs would be one year or less, costs can be expensed as incurred.

“Step 6”: Consider balance sheet effects (cont’d)

A receivable is:

An entity’s right to consideration that is unconditional, i.e., only the passage of time is required before the payment of that consideration is due; this should include amounts that an entity has the right to bill for (even if not yet invoiced).

A contract asset is:

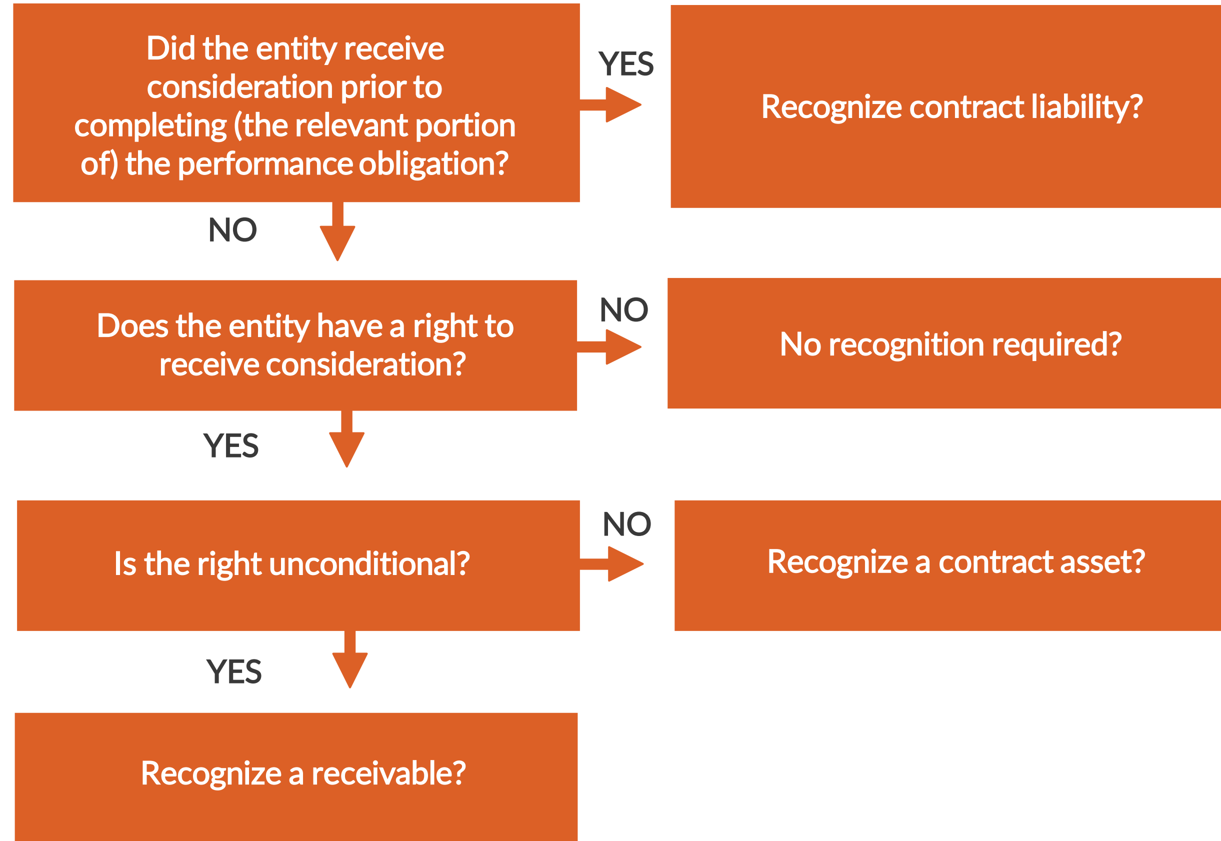
An entity’s right to consideration in exchange for goods or services that the entity has transferred to a customer.

- Should exclude amounts presented as a receivable
- Should be assessed for impairment

A contract liability is:

An entity’s obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

Balance sheet accounts flowchart



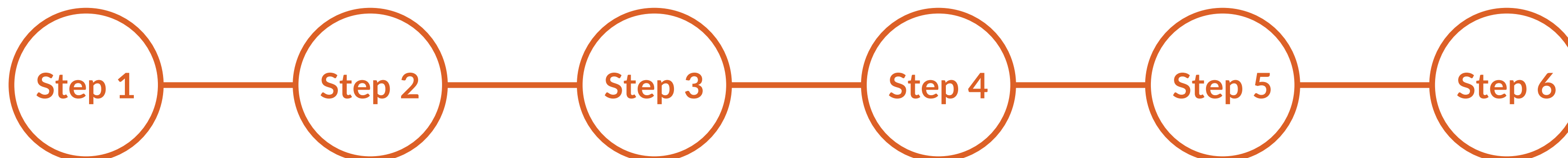
Other considerations (1 of 11)

Onerous contracts

Recognition and measurement guidance on a provision for losses for certain arrangements (that is, an onerous contract) continues to exist for the following arrangements:

- Separately Priced Extended Warranty and Product Maintenance Contracts
- Construction-Type and Production-Type Contracts
- Software
- Insurance
- Federal Government Contracts
- Continuing Care Retirement Communities
- Prepaid Health Care Services
- Long-Term Power Sales Contracts

For contracts that do not fall within the above types of arrangements, an accounting policy for handling onerous contracts with customers should be developed.

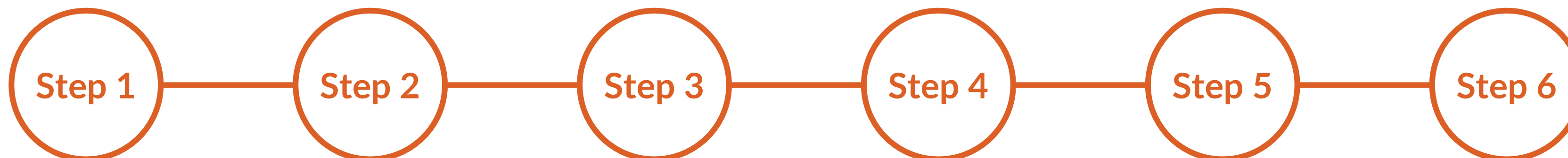


Other considerations (2 of 11)

Licenses:

Establish a customer's rights to intellectual property (IP) of an entity (e.g., software, music, media, franchises, patents, trademarks, copyrights)

- If a license is not distinct from other goods or services, combine with other goods or services in the contract as one performance obligation and recognize revenue when (or as) the performance obligation is satisfied.
- If a license is distinct, it creates a separate performance obligation that is satisfied either over time or at a point in time, depending on the type.
- Licenses to functional IP provide a right to use an entity's IP as it exists at the point in time when the license is granted, and this performance obligation is satisfied when the license period begins, unless two criteria are met (in which case, the performance obligation is satisfied as below).
- Licenses to symbolic IP provide a right to access an entity's IP as it exists over time; this performance obligation is satisfied as the entity fulfills its promises.



Licenses flowchart

Entity provides distinct IP rights to the customer?

Does the IP have significant stand-alone functionality?

NO → Symbolic IP with right to access (satisfied over time)

YES ↓

Is the functionality expected to substantially change during the license period due to activities of the entity that do not transfer a good or service to the customer?

NO → Functional IP with right to use (satisfied at a point in time)

YES ↓

Is the customer contractually or practically required to use the updated IP?

NO → Functional IP with right to use (satisfied at a point in time)

YES ↓

Functional IP with right to access (satisfied over time)

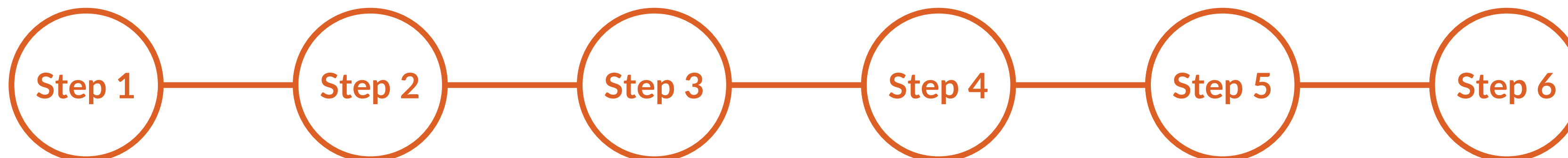
Other considerations (3 of 11)

Repurchase agreements are:

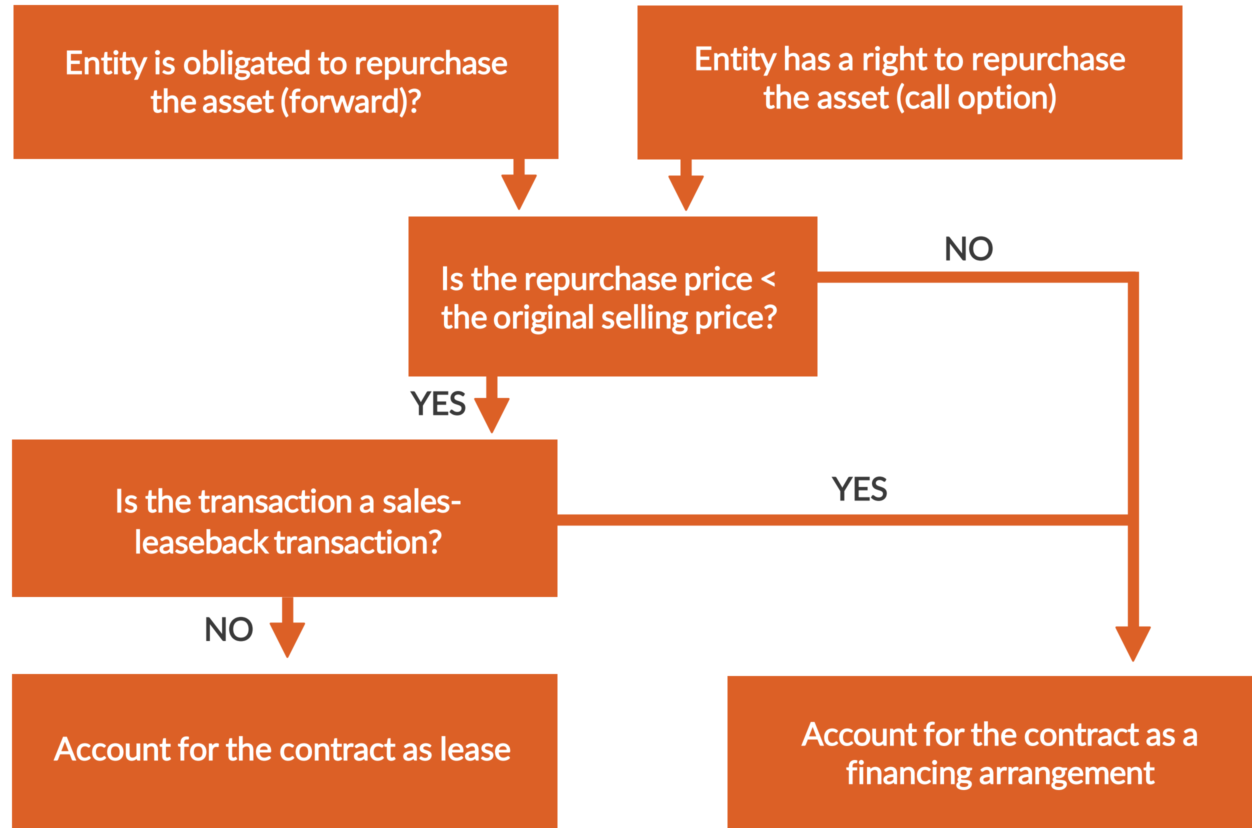
Contracts in which the entity sells an asset and also has the option to repurchase the asset. This could be the same asset originally sold, or a similar asset. Generally, there are three forms:

- An entity's obligation to repurchase the asset (a forward)
- An entity's right to repurchase the asset (a call option)
- An entity's obligation to repurchase the asset at the customer's request (put option)

Depending on the form, they are accounted for as leases, financing arrangements, or sales with the right of return.



Forwards and call options flowchart



Put options flowchart

Obligation to repurchase the asset at the request of the customer (put option)?

Is the repurchase price < the original selling price?

- NO → Is the repurchase price > expected market value of the asset?
  - YES → Account for the contract as a financing arrangement
  - NO → Does the customer have significant economic incentive to exercise the put option?
- YES → Does the customer have significant economic incentive to exercise the put option?

Does the customer have significant economic incentive to exercise the put option?

- NO → Account for transaction as though it were a sale with a right of return (pg.42)
- YES → Is the transaction a sales-leaseback transaction?

Is the transaction a sales-leaseback transaction?

- YES → Account for the contract as a financing arrangement
- NO → Account for the contract as a lease?

Other considerations (4 of 11)

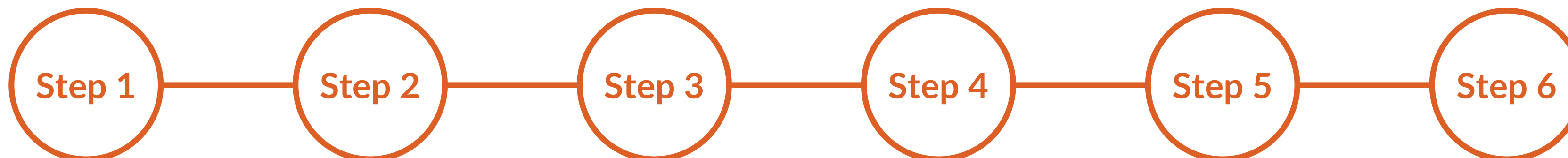
Principal vs. agent

Principal — The entity controls a specified good or service before the entity transfers the good or service to a customer. Recognize revenue on a gross basis.

Agent — The entity's performance obligation is to arrange for the provision of goods or services by another party before the good or service is transferred to the customer. Recognize revenue on a net basis (equal to the fee or commission received).

Indicators that an entity controls the specified good or service before the provision of the specified good or service to the customer (and is therefore a principal) include, but are not limited to, the following:

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service.
- The entity has inventory risk either before the specified good or service has been transferred to the customer or after control has been transferred, e.g., the sale is subject to rights of return.
- The entity has discretion in establishing the price for the specified good or service; establishing price may indicate that they entity has the ability to direct the use of that good or service and obtain the benefits.



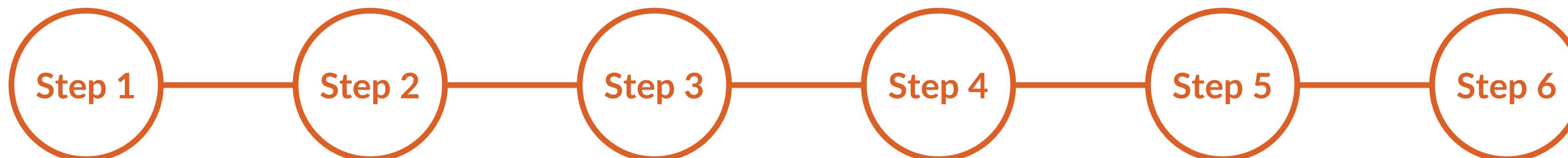
Other considerations (5 of 11)

Customer options for additional goods or services:

Occur when an entity grants a customer the option to acquire additional goods or services free of charge or at a discount, e.g., sales incentives, customer award credits/points, contract renewal options, discounts.

An option creates a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract.

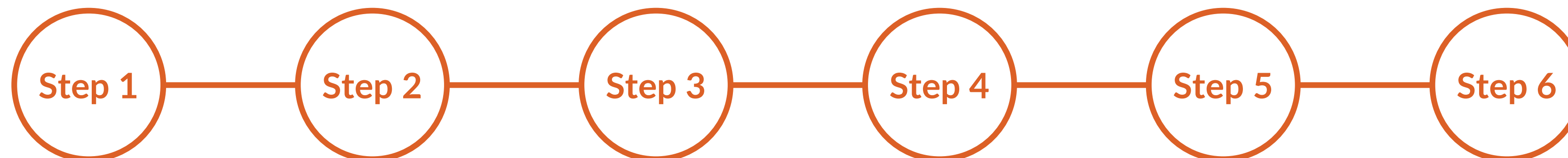
- The entity recognizes revenue when those future goods or services are transferred or when the option expires.
- As a practical expedient, the transaction price can be allocated to optional goods or services that are similar to the original goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration.



Other considerations (6 of 11)

If an entity sells goods with a right of return:

- Revenue should be recognized for the transferred products in the amount of consideration to which the entity expects to be entitled; therefore, revenue should not be recognized for the products expected to be returned.
- A refund liability is recognized for the amount an entity expects to pay customers.
- An asset (and corresponding adjustment to cost of sales) is recognized for its right to recover products from customers upon settling the refund liability.



Other considerations (7 of 11)

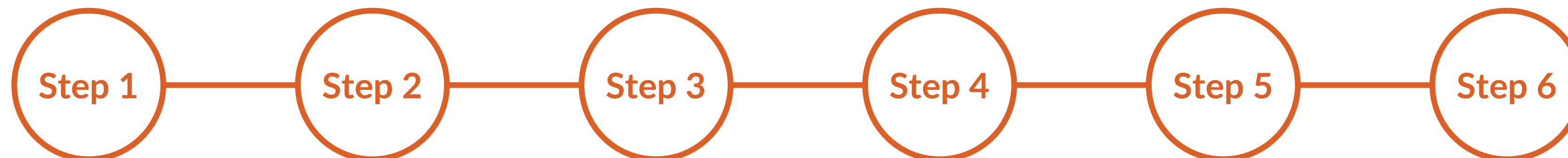
Warranties

If a customer has the option to purchase a warranty separately, the warranty is a distinct service.

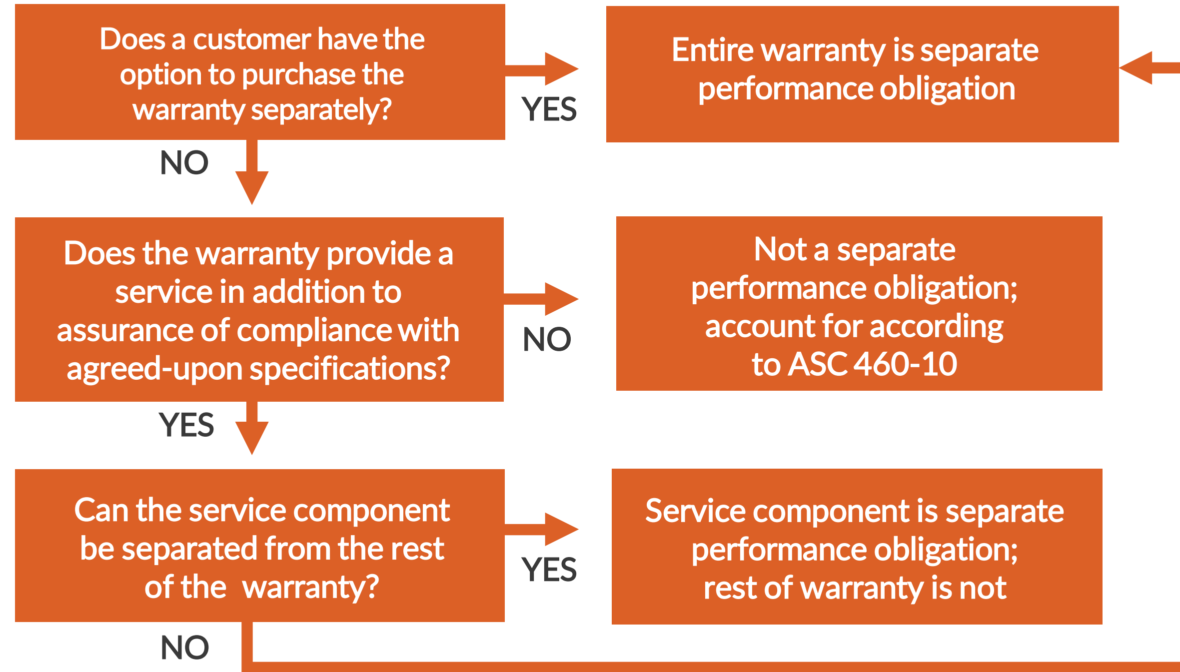
- Account for the warranty as a performance obligation and allocate a portion of the transaction price to it.

If a customer does not have the option to purchase a warranty separately, it is accounted for as a cost accrual unless the warranty is to provide the customer with a service in addition to assurance that the product complies with agreed-upon specifications.

- If the warranty provides the customer with a service, then it is a performance obligation to which consideration is allocated.
- If the entity is not able to separate the service from the rest of the warranty, then the entire warranty should be accounted for as a separate performance obligation.



Warranties flowchart



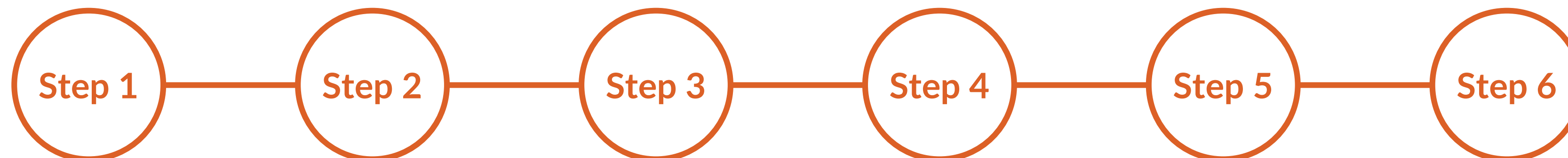
Other considerations (8 of 11)

Nonrefundable upfront fees

- Examples include set-up fees, activation fees, and joining fees
- If they relate to the transfer of a promised good or service, management should determine whether they represent a separate performance obligation

If the nonrefundable upfront fee is not a separate performance obligation:

- Recognize a contract liability that is derecognized (by recognizing revenue) when (or as) the performance obligation for the transfer of the goods or services is satisfied.
- Consider the guidance for costs incurred in fulfilling a contract with a customer (pg. 29).



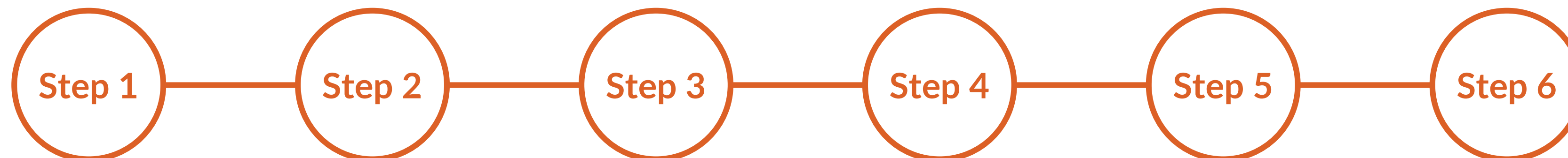
Other considerations (9 of 11)

Consignment arrangements

An entity should not recognize revenue upon delivery of a product to another party if the delivered product is held on consignment and the other party has not obtained control of the product. Management should assess when control is transferred.

Common characteristics of consignment arrangements include the following:

- The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.
- The entity is able to require the return of the product or transfer the product to a third party, e.g., another dealer.
- The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).



Other considerations (10 of 11)

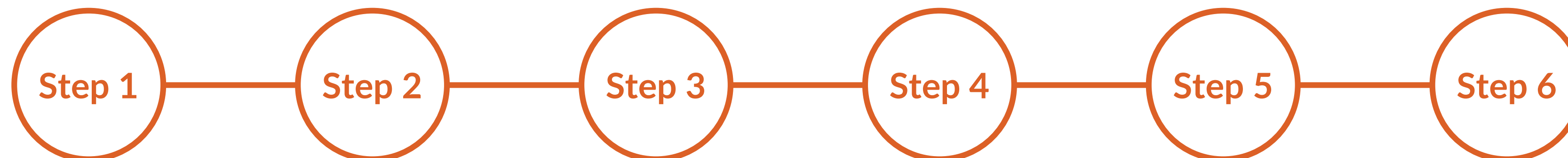
Bill-and-hold arrangements occur when:

An entity bills a customer for a product but retains physical possession of the product until a later date.

In addition to determining that the customer has obtained control of the product, all of the following requirements must be met to recognize revenue in a bill-and-hold arrangement:

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

If a bill-and-hold arrangement exists, an entity should consider whether it is providing custodial services that should be accounted for as a separate performance obligation.



Other considerations (11 of 11)

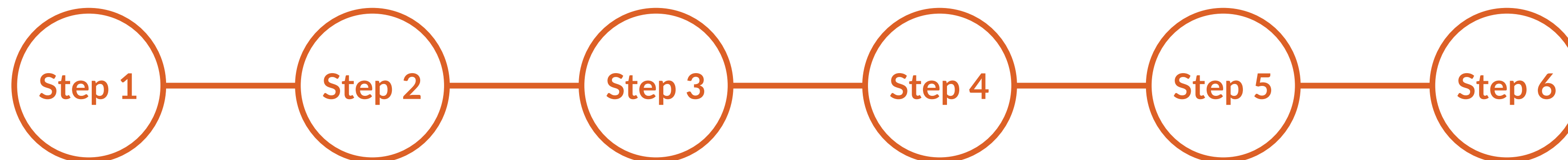
Bill-and-hold arrangements occur when:

A change in the timing of revenue recognition will likely impact all taxes including income tax, sales tax, excise tax, gross receipts tax, and value-added tax.

U.S. income tax has a separate set of rules to determine when revenue is recognized. If a change is made to revenue recognition for book purposes, one of the following three paths must be followed for tax purposes. An entity must choose which path to follow based on the facts of each particular change:

- The tax method **cannot follow** the new book method, and the entity must continue to track its old revenue recognition methodology for income tax purposes.
- The tax method **can follow** the new book method, and the entity must either apply to change its tax method with the IRS or retain and track its previous method.
- The tax method **must follow** the new book method, and the entity must apply to change its tax method with the IRS.

An entity should analyze the tax implications of each book change throughout the implementation process to ensure that adequate time exists to address both (a) the current and deferred tax implications and (b) any direct tax ramification of each change.



Overview of disclosure requirements

Objective

To disclose sufficient information for users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers:

- Consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. An entity should aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.
- Requirements are extensive, both qualitatively and quantitatively

Disclosure categories:

- Disaggregation of revenue
- Contract balances
- Performance obligations
- Assets recognized from the costs to obtain or fulfill contracts with customers
- Significant judgments and practical expedients