Revenue recognition

Executive summary

US GAAP

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New revenue challenges

The application of Topic 606 (revenue) is not a simple exercise – it requires significant judgment, estimation and disclosures. Changes in business practices and the economic environment continue to create new challenges to the accounting for revenue.

In response to these challenges, companies evaluate and may need to revisit a number of estimates and judgments to account for their revenue arrangements and related costs. Companies may also apply certain aspects of the guidance that they had not, or had less frequently, applied in the past.

Questions continue to arise as companies enter into new or modified revenue arrangements or respond to a changing economic environment. The interpretation of the principles in Topic 606 continues to be informed by evolving practice issues and regulator views.

Our purpose in this Executive Summary is to highlight the guidance in Topic 606 related to its scope, the five-step revenue model, certain implementation guidance and the presentation and disclosure of revenue. We also highlight the contract costs guidance in Subtopic 340-40 and the derecognition of nonfinancial assets guidance in Subtopic 610-20.

Our related Handbook, Revenue recognition, provides an in-depth understanding of Topic 606 and Subtopics 340-40 and 610-20 by answering the questions that we are encountering in practice and providing examples to explain key concepts.

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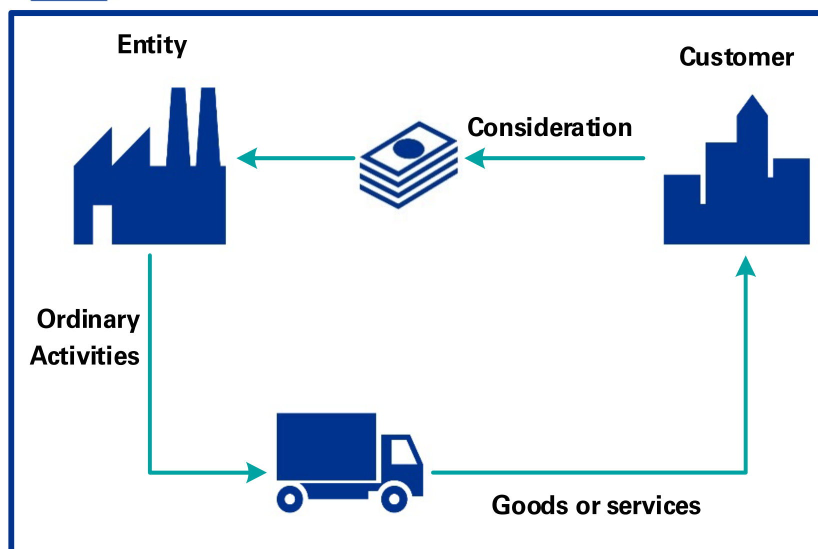
Scope

Topic 606 applies to contracts to deliver goods or services to a customer. A 'customer' is 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.

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



In addition, Topic 606 applies to all contracts with customers unless the customer contract is specifically in the scope of other guidance – e.g. Topic 944 (insurance), Topic 460 (guarantees).

A contract can be partially in the scope of Topic 606 and partially in the scope of other guidance. Because Topic 606 is residual guidance, if another Topic or Subtopic specifies how to separate or measure one or more parts of a contract, then the entity first applies that separation or measurement guidance. Any separated elements of a contract that are not in the scope of that other Topic may be in the scope of Topic 606.

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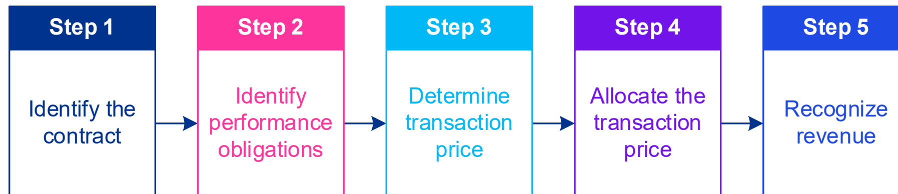
The five-step revenue model

Topic 606 includes the following five-step revenue model.



In the first step of the five-step revenue model, an entity identifies the contract with the customer. Next, in Step 2, the entity identifies the performance obligations (i.e. the units of account for recognizing revenue) in that contract. Then, the entity allocates the transaction price determined in Step 3 to the identified performance obligations in Step 4 and recognizes revenue when it satisfies a performance obligation in Step 5.

Step 1: Identify the contract

A contract with a customer is accounted for under the revenue model when the contract is legally enforceable and all of the following criteria are met:

- the contract has commercial substance;
- rights to goods or services can be identified;
- payment terms can be identified;
- it is probable that the entity will collect the consideration to which it expects to be entitled; and
- the contract is approved and the parties are committed to their obligations.

If the criteria are not met, any consideration received from the customer is generally recognized as a deposit (liability).

Contracts can be written, oral or implied by an entity's customary business practices, but must be enforceable by law. This may require legal analysis on a jurisdictional level to determine when a contract exists and the terms of that contract's enforceability.

A contract does not exist if each party has a unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party.

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Step 2: Identify the performance obligations

Performance obligations are the unit of account under Topic 606 and generally represent the distinct goods or services that are promised to the customer. Performance obligations do not have to be legally enforceable; they exist if the customer has a reasonable expectation that the good or service will be provided. A promise can be implied by customary business practices, policies or statements.

Identifying a contract's performance obligations involves two major tasks:

- identifying the contract's promised goods or services; and
- determining how those promised goods or services are grouped into performance obligations.

Promises that transfer goods or services to the customer are separated into performance obligations, and are accounted for separately if they are both (1) capable of being distinct and (2) distinct in the context of the contract. If both criteria are not met, the good or service is bundled into a single performance obligation with other goods or services that together meet the criteria for being distinct. If the distinct goods or services are substantially the same and have the same pattern of transfer to the customer over time, they are combined into a single performance obligation (a 'series').

Promises that do not transfer a good or service are accounted for as an administrative task or set-up activity.

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 goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. some sales taxes. It includes not only fixed cash consideration but also several other types of consideration and adjustments as follows.

Variable consideration (and the constraint)
Estimated at contract inception and updated at each reporting date for any changes in circumstances. The amount of estimated variable consideration included in the transaction price is the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. Estimating variable consideration is a significant judgment for many entities.

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Significant financing component

May exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.

Consideration payable to a customer

Represents a reduction of the transaction price unless it is a payment for distinct goods or services the entity receives from the customer.

Noncash consideration (received from a customer)

Measured at fair value at contract inception.

When determining the transaction price, an entity uses the legally enforceable contract term. It does not take into consideration the possibility of a contract being cancelled, renewed or modified.

Step 4: Allocate the transaction price

The transaction price is allocated at contract inception to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. Observable stand-alone prices are used when they are available. If not available, an entity is required to estimate the price using other techniques that maximize the use of observable inputs – even if the entity never sells the promised good or service separately. A contractually stated price or list price is not presumed to be the stand-alone selling price of that good or service.

If the transaction price changes (e.g. a change in estimate for variable consideration after contract inception), the entity allocates those changes on the same basis as it allocated the original estimate of the transaction price.

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Step 5: Recognize revenue

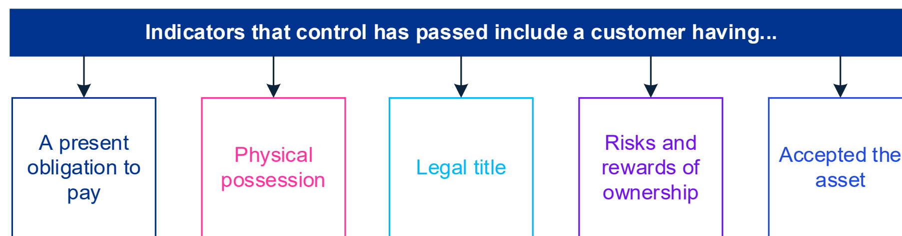
An entity recognizes revenue when it satisfies its obligation by transferring control of the good or service to the customer. Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods or services – or prevent others from doing so.

To identify when control of a good or service transfers to the customer, an entity first determines whether a performance obligation meets one of the following criteria to recognize revenue over time:

- the customer simultaneously receives and consumes the benefits as the entity performs;
- the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- 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.

If control transfers **over time**, an entity selects a method to measure progress that is consistent with the objective of depicting its performance and applies that method to recognize revenue.

If none of the over-time criteria are met, revenue for the performance obligation is recognized at the **point in time** that the customer obtains control of the goods or services.



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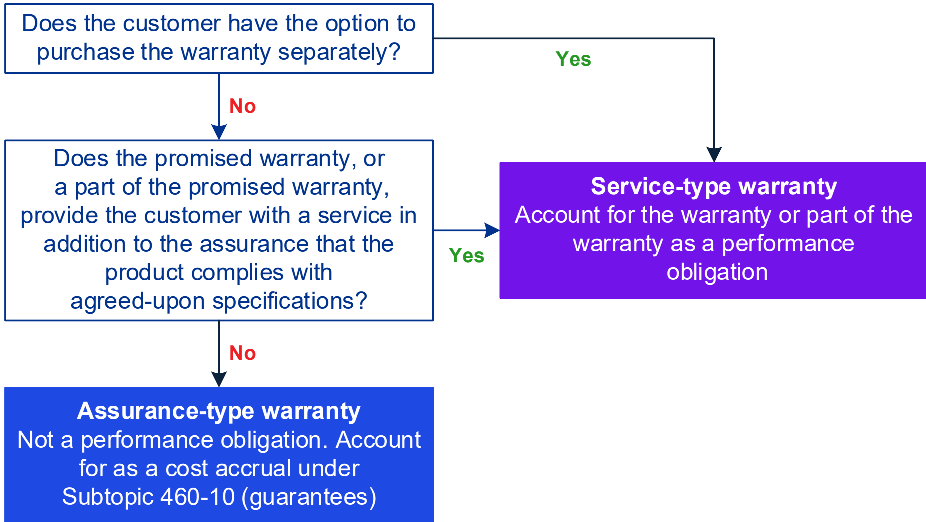
Implementation guidance

Warranties

The accounting for a warranty depends on whether it is a performance obligation under the contract. If it is, Topic 606 applies in the same way as for all other performance obligations. The following diagram summarizes the process for determining the appropriate accounting.



For a service-type warranty, revenue is recognized as the services are provided. For an assurance-type warranty, the cost is accrued at the time the good is transferred.

Customer options

A customer option to purchase additional goods and services is accounted for as a performance obligation only if it represents a material right.

A material right exists if:

- the customer is only able to obtain the option by entering into the sale agreement; and
- the option provides the customer with the ability to obtain the additional goods or services at a discount that is incremental to a discount typically given to that class of customer.

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When a customer option represents a material right, revenue is allocated to it and deferred until (1) those future goods or services are transferred or (2) the option expires.

If the option is not a material right, it is considered a marketing offer that is accounted for separately.

Licensing of intellectual property (IP)

A license of IP establishes a customer's rights to that IP and the licensor's obligations to provide those rights.

How a licensor recognizes revenue from a licensing transaction depends on the nature of the license. However, before assessing the nature of a license, an entity determines whether a transaction actually contains a license and whether it is distinct from the other goods or services promised in the contract.

For a distinct license, Topic 606 includes a framework for assessing whether the nature of the IP subject to the license is functional or symbolic, which factors into whether the pattern of revenue recognition for the license is point in time or over time.

Functional IP	Symbolic IP
Definition	
The customer derives a substantial portion of the overall benefit from the IP's stand-alone functionality.	The IP does not have significant stand-alone functionality, and substantially all of the customer's benefit is derived from its association with the licensor's ongoing activities.
Examples	
Software, biological compounds, films and television shows	Brands, trade names and franchise rights
Revenue recognition	
Generally at the point in time that control of the license transfers to the customer	Generally over the license period using a measure of progress that reflects the licensor's progress toward completion of its performance obligation

A customer may be required to pay a sales- or usage-based royalty when licensing IP. There is an exception to the general revenue model

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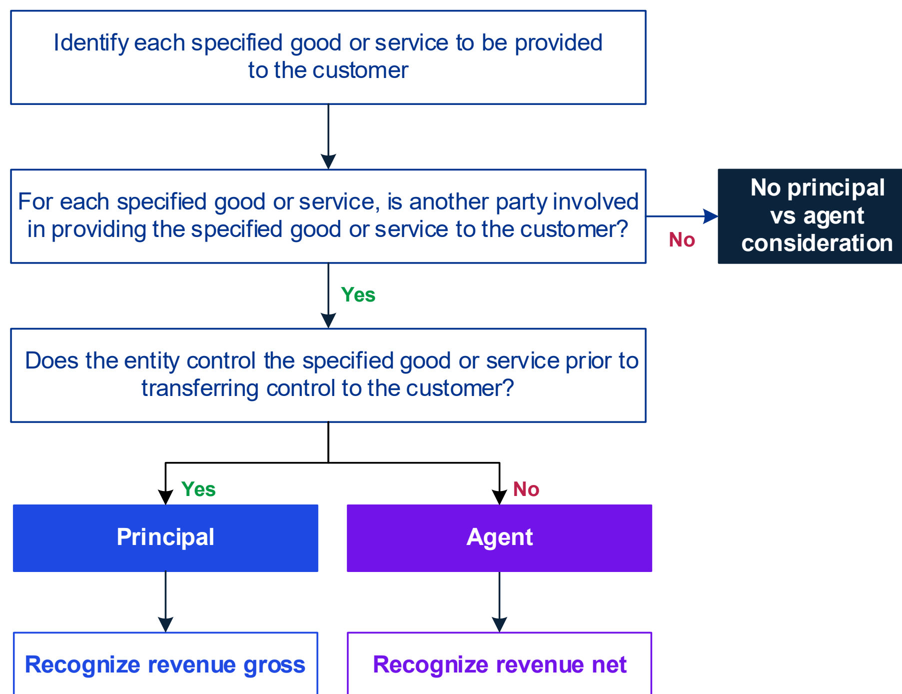
on variable consideration related to these royalties, which results in recognizing them as revenue at the later of:

- when the sales or usage occurs; and
- the satisfaction or partial satisfaction of the performance obligation to which the royalty has been allocated.

Principal vs agent

The following diagram illustrates how to apply the principal vs agent guidance in Topic 606.



Indicators that an entity has obtained control of a good or service before it is transferred to the customer are:

- having primary responsibility to provide the specified goods or services;
- assuming inventory risk; and
- having discretion to establish prices for the specified goods or services.

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Contract modifications

The contract modification guidance in Topic 606 applies when the parties approve a change in the scope or price of a contract and requires an entity to account for approved modifications either on a:

- **cumulative catch-up basis**, when the additional goods or services are not distinct; or
- **prospective basis**, when the additional goods or services are distinct.

If any additional distinct goods or services are not priced at their stand-alone selling prices, the remaining transaction price is required to be reallocated to all unsatisfied performance obligations, including those from the original contract.

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Contract costs

Subtopic 340-40 provides guidance on the following costs related to a contract with a customer in the scope of Topic 606:

- incremental costs to obtain a contract; and
- costs incurred in fulfilling a contract that are not in the scope of other guidance.

Incremental costs to obtain a contract with a customer (e.g. sales commissions) are required to be capitalized if an entity expects to recover those costs – unless the amortization period, which may include anticipated contracts or renewals, is less than 12 months.

The fulfillment cost guidance only applies when the costs are not in the scope of other guidance. Examples of fulfillment costs in the scope of other guidance include inventory, intangibles and property, plant and equipment. Fulfillment costs not in the scope of other guidance are capitalized if they:

- relate directly to an existing contract or specific anticipated contract;
- generate or enhance resources that will be used to satisfy performance obligations in the future; and
- are expected to be recovered.

Capitalization is required when these criteria are met.

An entity amortizes the assets recognized for the costs to obtain and fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the assets relate.

Capitalized contract costs are subject to an impairment analysis.

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Presentation and disclosure

Presentation

For each contract with a customer, an entity presents a contract asset, contract liability and/or a receivable on the balance sheet, if applicable. Contract assets and contract liabilities for a single contract are presented on a net basis at the contract level.

Disclosure

Topic 606 contains both qualitative and quantitative disclosure requirements for annual and interim periods. The disclosure requirements are designed to provide financial statement users with sufficient information to understand the nature, amount, timing and uncertainty of revenue, certain costs and cash flows arising from contracts with customers.

Topic 606 requires disclosures about all of the following.

- General information
- Remaining transaction price
- Disaggregation of revenue
- Significant judgments
- Contract balances
- Costs to obtain or fulfill a contract
- Performance obligations
- Practical expedients and policy elections

Reduced disclosures are available for many nonpublic entities.

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Derecognition of nonfinancial assets

Subtopic 610-20 provides a single model for recognizing a gain or loss on the transfer of nonfinancial assets and in-substance nonfinancial assets to noncustomers. Transfers of such assets are within its scope unless other guidance takes precedence. The following table summarizes transactions that are in scope and when they are subject to other guidance.

In-scope items include…		
Nonfinancial assets	Transfer of an interest in a subsidiary, including partial sales	In-substance nonfinancial assets
…unless the…		
• counterparty is a customer and the transaction is in the scope of Topic 606; • asset or subsidiary is (or is a part of) a business; • asset is transferred in a sale-leaseback transaction; or • transaction is in the scope of other guidance.		

The following table summarizes key incremental guidance in Subtopic 610-20.

Topic	Key consideration
Topic 606 vs Topic 810 (consolidation)	An entity first considers under Topic 810 whether it loses a controlling financial interest (or never obtains a controlling financial interest) in the entity that holds the transferred assets. If it does, next it applies the principles of Topic 606 to determine the gain/loss.
Unit of account	A distinct nonfinancial asset is the unit of account even if the form of the transaction is the transfer of interests in a legal entity.
Retained NCI (partial sales)	A retained noncontrolling interest (NCI) is measured at fair value and factored into the gain or loss on derecognition, which results in a 100% gain/loss on derecognition in a partial sale.

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