

reports in early 2003 that highlighted revenue recognition as an area prone to problems: (1) Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (Section 704 Report) and (2) Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Fortune 500 Report).

In developing the Section 704 Report, the SEC staff studied enforcement actions filed during the period July 31, 1997, through July 30, 2002. Improper revenue recognition was the area where the SEC brought the greatest number of enforcement actions during this period. The types of improprieties ranged from the improper timing of revenue recognition (e.g., improper recognition of revenue related to bill-and-hold sales and consignment sales) to fictitious revenue (e.g., falsification of sales documents, failure to consider side letter agreements) to improper valuation of revenue (e.g., failure to appropriately consider rights of return). Other revenue-related areas where the SEC brought a significant number of actions were nondisclosure of related party transactions and the accounting for nonmonetary and round-trip transactions.

The Fortune 500 Report resulted from the SEC Division of Corporation Finance's (Corp Fin's) review of all annual reports filed by Fortune 500 companies. This report provides insight into areas commonly questioned by Corp Fin during their reviews of annual reports. Revenue recognition accounting policy disclosures was an area frequently questioned by Corp Fin. In many cases, Corp Fin requested that companies significantly expand these disclosures. Industries where these requests were common included computer software, services, and hardware; communications equipment; capital goods; semiconductors; electronic instruments and controls; energy; pharmaceuticals; and retail. The revenue-related topics precipitating these requests included accounting for software, multiple-element (or multiple-deliverable) arrangements, rights of return, price protection features, requirements for installation of equipment, customer acceptance provisions, and various types of sales incentive programs.

Other studies since then have continued to show that revenue recognition issues cause more financial statement restatements than any other accounting topic. High-profile revenue restatements have reinforced the focus of regulators and the investing public on revenue recognition policy and disclosure.

While it is too early to assess whether the new standards for revenue recognition will result in less errors and restatements, several aspects of the new standards may in fact lead to fewer problems:

- The new guidance provides a single model for revenue recognition, reducing the chances that a reporting company will erroneously apply the wrong model.
- By articulating principles to apply to key decisions revenue recognition, the new guidance provides a better framework to help preparers of financial statements deal with questions and issues that are not specifically addressed in the standards.
- With less bright lines and more respect for judgments and estimates, companies may feel that the new standards better reflect the underlying economics of their business transaction, reducing the desire to push the envelope to justify different accounting than appears to be required.

Of course, it is also possible that the removal of bright lines and greater reliance on estimates and judgment will provide more room for those who would seek to abuse the revenue recognition standards. Regulators will no doubt be watching for signs of those not applying the new standards in good faith.

## APPLICATION AND IMPLEMENTATION GUIDANCE

The new standard was issued by the FASB and IASB in May 2014. The FASB and IASB immediately set up a group made up of experts on revenue recognition to discuss issues arising in implementation of the new standard. This group, called the FASB/IASB Joint Transition Resource Group for Revenue Recognition (TRG), met twice in 2014, four times in 2015, and twice in 2016. The TRG discussed over 65 issues at those meetings.<sup>1</sup>

Most of the discussions at the TRG revealed that TRG members worldwide:

- Consistently understood the principles in the new standard, and
- Believed that the standard provides sufficient guidance to resolve the issues raised.

Both the detailed issues papers discussed by the TRG and the minutes describing the discussions are publicly available.

In some instances, TRG discussions revealed areas where the standard was not as clear as the FASB and IASB had intended, or where application of the guidance appeared to be more difficult than the Boards had believed it would be. The FASB and IASB amended the standard to provide additional clarity or improve usability in a few areas.

The IFRS Interpretations Committee (IFRIC) has also discussed several issues related to implementation of the new standard. While the IFRIC does not intend to issue any interpretations, the documentation of those discussions is helpful in understanding how the standard should be applied. In addition, it is likely that the IASB will amend certain guidance outside of IFRS 15 to deal with issues raised as companies prepared to adopt the new standard.

The documents published by the FASB and IASB related to the new standard, all of which are publicly available, include:

### FASB

- ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*
- ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*
- ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*

<sup>1</sup> The TRG may hold additional meetings if additional issues are raised.

- ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Reporting Obligations and Licensing*
- ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*
- ASU No. 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*

## IASB

- IFRS 15, *Revenue from Contracts with Customers*
- *Effective Date of IFRS 15*
- *Clarifications to IFRS 15*
- IFRIC Update March 2018

## TRG (Summaries of Discussions)

- TRG Memo No. 5, *July 2014 Meeting—Summary of Issues Discussed and Next Steps*
- TRG Memo No. 11, *October 2014 Meeting—Summary of Issues Discussed and Next Steps*
- TRG Memo No. 25, *January 2015 Meeting—Summary of Issues Discussed and Next Steps*
- TRG Memo No. 34, *March 2015 Meeting—Summary of Issues Discussed and Next Steps*
- TRG Memo No. 44, *July 2015 Meeting—Summary of Issues Discussed and Next Steps*
- TRG Memo No. 49, *November 2015 Meeting—Summary of Issues Discussed and Next Steps*
- TRG Memo No. 55, *April 2016 Meeting—Summary of Issues Discussed and Next Steps*
- TRG Memo No. 60, *November 2016 Meeting—Summary of Issues Discussed and Next Steps*

## ABOUT THIS BOOK

Because the FASB and IASB issued converged standards, the discussion in this book is applicable under both U.S. GAAP and IFRS. References to the authoritative literature include both U.S. GAAP (Topic 606) and IFRS (IFRS 15) references. The few narrow differences between Topic 606 and IFRS 15 are identified in the discussion of the applicable topics.

### Organization

#### *Objectives and Framework*

Chapter 2, “Scope and Overview of Topic 606/IFRS 15,” explains the objectives and core principles of the new revenue recognition standards, and provides a high-level discussion of the five-step model that frames the guidance on deter-

mining the amount of revenue and the timing of revenue recognition. Chapter 2, “Scope and Overview of Topic 606/IFRS 15,” also discusses the scope of the new guidance.

Chapters 3-7 provide a detailed discussion of each of the five steps in the model, including implementation guidance in the standard, as well as guidance that has resulted from discussions of the TRG and the IFRIC.

#### *Related Matters*

Chapter 8, “Continuing Involvement,” discusses guidance in Topic 606/IFRS 15 on certain additional matters, including common contract terms such as warranties, rights of return, repurchase provisions, and options for additional goods and services.

Chapter 9, “Costs of Contracts with Customers,” addresses the guidance on costs of revenue transactions.

Chapter 10, “Presentation,” addresses matters of the presentation of revenue transactions in balance sheets and income statements, including discussion of whether to recognize transactions on a gross or net basis.

#### *Application to Common Arrangements*

Chapters 11-13 then explain how the model applies to common issues faced in the delivery of products, services, and intellectual property to customers. Explaining how the five steps apply to common transactions is intended to both provide practical guidance for readers and reinforce the understanding of the principles of the standard.

#### *Financial Reporting*

Chapter 14, “Disclosure,” addresses disclosures required by the new literature that go far beyond the disclosure requirements that currently exist. This chapter also discusses revenue disclosures required in SEC filings in areas other than the financial statements.

Finally, Chapter 15, “Transition,” discusses the transition to the new standard.

### Features

The discussion in this book generally does not include direct quotes from the authoritative guidance. Instead, the intent is to provide more of a “plain English” discussion of the principles and requirements. However, the book includes numerous cross-references to applicable paragraphs of Topic 606 and IFRS 15. These references are generally set-off in parentheses. References to U.S. GAAP include the applicable paragraph in the Accounting Standards Codification (ASC), which is the codified repository for authoritative U.S. GAAP. References to IFRS refer to the applicable paragraph of IFRS 15, as amended.

In some instances, the book also references the Basis for Conclusions of the standard. The Basis for Conclusions is not itself authoritative, but was published by the FASB and IASB to provide additional discussion and explanation as to

why they reached the decisions included in the standard. Because the Basis for Conclusions is not included in the Accounting Standards Codification, references to the Basis for Conclusions include the applicable paragraph from the Accounting Standards Update (generally, ASU 2014-09) that includes the discussion, as well as the applicable paragraph from the "BC" section of IFRS 15.

This book also references TRG discussion papers (e.g., TRG Memo No. XX), which are not authoritative, but provide detailed explanations of issues and examples. The minutes of the TRG meetings summarize the TRG's thoughts on the matters discussed.

### Examples

As noted above, Topic 606/IFRS 15 includes a large number of illustrative examples. Rather than repeating those examples, the end of each section of each chapter of this book identifies the examples in the standard that provide guidance on the topics just discussed.

The book also includes a number of illustrations that provide additional examples of the application of certain of the provisions in the standard. Such illustrations, when presented, follow the identification of the pertinent examples in the standard.

In certain areas, where the guidance lends itself to such a visual depiction, the book includes flowcharts illustrating the guidance on a particular topic.

Finally, the book includes several excerpts from public filings that illustrate topics discussed. Because Topic 606/IFRS 15 has not yet been adopted by all reporting companies, there are not relevant examples for all issues addressed. However, in certain areas, the new guidance is unchanged from previous guidance, and therefore, existing disclosures should be relevant. In future updates to the *Guide*, more public disclosure examples will be added.

### Alerts

The book also includes Practice Alerts, which are set off from the main discussion. Practice Alerts are intended to highlight issues that may arise in applying the provisions of the standard in practice.

Also set off from the main discussion are Disclosure Alerts, which highlight areas where there are disclosure requirements that apply to the topic just discussed. The disclosure requirements are discussed more comprehensively in Chapter 14, "Disclosure."

Finally, the book includes a number of Regulatory Alerts, which highlight areas where the U.S. Securities and Exchange Commission has taken an interest in a particular topic.

## CHAPTER 2

# SCOPE AND OVERVIEW OF TOPIC 606/IFRS 15

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### SUMMARY

The FASB added Topic 606, *Revenue from Contracts with Customers*, to the Accounting Standards Codification and the IASB issued IFRS 15, *Revenue from Contracts with Customers*, in May 2014, after a long joint project that sought to completely replace existing literature on revenue recognition. The guidance

issued by the two Boards covers all contracts with customers to provide goods, services, and rights to intellectual property.

Topic 606 and IFRS 15 describe a single model for revenue recognition, with a set of principles to be used in analyzing all contracts with customers. While there are a small number of exceptions to the principles, the model is consistent and the principles written in such a way that the Boards believe they can be applied to any type of contract.

The guidance in the two standards is virtually identical, and the Boards expect that the same revenue accounting should result under U.S. GAAP and IFRS in virtually all situations. While the same words are used to explain most principles, the differing structures of the two sets of literature mean that the numbering of paragraphs and sections differs. The chart below identifies the major topics covered by the standards and identifies where in the two sets of literature each topic is covered.

Topic	U.S. GAAP (ASC Reference)	IFRS (IFRS 15 paragraphs)
Background and Framework	606-10-05	IN7 – IN9
Objectives	606-10-10	1-4
Scope	606-10-15	5-8
Recognition	606-10-25	9-45
Measurement	606-10-32	46-90
Contract Costs	340-40	91-104
Presentation	606-10-45	105-109
Disclosure	606-10-50; 340-40-50	110-129
Transition and Effective Date	606-10-65	Appendix C
Implementation Guidance	606-10-55-1 through 55-91	Appendix B
Illustrations and Examples	606-10-55-92 through 55-413	IE1 – IE 327

Throughout this book, references to paragraphs in both standards are included where applicable. At the back of the book is a paragraph-by-paragraph cross reference between the U.S. GAAP and IFRS guidance that identifies where each paragraph is discussed in the text.

## SCOPE

Topic 606/IFRS 15, as suggested in the title, *Revenue from Contracts with Customers*, has a broad scope. In general, everything that accountants have traditionally considered a contractual arrangement to deliver goods or services is covered. There are no industries that are scoped out of the guidance, and there is no special industry-based guidance as there was in the past, particularly under U.S. GAAP.

A customer is defined as any party that has contracted with an entity to buy goods or services that are part of the entity's ordinary activities. While that definition may seem obvious and intuitive, it does exclude contracts to sell goods and services that are not part of an entity's ordinary activities. However, both U.S. GAAP, through the addition of ASC Topic 610-20, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets*, and IFRS, through amendments to IAS 16, *Property, Plant and Equipment*, and IAS 38, *Intangible Assets*,

effectively require the principles of the revenue recognition guidance to also be applied to sales of assets other than in the ordinary course of business.

Therefore, Topic 606 and IFRS 15 essentially apply to any sale of goods or services to any counterparty. The only exceptions, which are discussed further below, are related to:

- Contracts that have traditionally not been looked at as sales of goods and services in the past, and for which specific other guidance already exists.
- Certain transactions in which the counterparty is deemed not to be a customer.
- Unusual situations in which revenue is recognized even without a contract with a customer.

It is possible that a single contract could include one or more elements that qualify for one of these scope exceptions and one or more other elements that do not qualify for a scope exception. In that event, the elements within the scope of revenue literature must be separated from those that are not, so that each portion of the contract may be accounted for in accordance with the appropriate literature. That separation is handled as follows (ASC 606-10-15-4; IFRS 15, par. 7):

- If the accounting requirements for the non-revenue elements specify how such items are to be measured, those elements should be measured in accordance with that other guidance, with the remainder of the transaction price allocated to the revenue items. For example, a contract with a customer may also include the customer providing a loan to the entity. Because Topic 470 and IFRS 9 require debt to be initially measured at its fair value, consideration equal to the fair value of the debt would be allocated to the debt, with the remaining payments from the customer under the contract allocated to the goods and services covered by the revenue literature.
- If the accounting requirements for the non-revenue elements do not specify how such items should be measured, the guidance in Step 4 on the allocation of the transaction price (see the discussion in Chapter 6, "Allocating the Transaction Price to the Performance Obligations in the Contract") is used to allocate payments between the revenue and non-revenue items. For example, if a contract with a customer includes the sale of inventory items and the sale of a machine the company had previously used in operations, the sale of the machine would likely be considered a non-revenue item. The amount of the contracted sale price that would be allocated to the machine (and therefore taken into account in determining the gain or loss on the sale of the machine) would be determined in accordance with the principles of the revenue literature, because there is no other guidance that specifies how the sale of such items should be measured.

## Contracts Covered by Other Guidance

There are certain contracts that, while they may appear to be a contract with a customer, have always been covered in the accounting literature by specific

guidance tailored to those contracts. In general, the FASB and IASB decided to leave those contracts to be accounted for under the other literature; therefore, those contracts are excluded from the scope of Topic 606/IFRS 15. They include (ASC 606-10-15-2 and IFRS 15, par. 5):

- Leases – covered by Topic 840 (or 842), *Leases*, and IAS 17 (or IFRS 16), *Leases*.
- Insurance contracts – covered by Topic 944, *Financial Services—Insurance*, and IFRS 4, *Insurance Contracts*.
- Financial instruments (including derivatives) – covered by various ASC topics and various IFRSs.
- Guarantees – covered by Topic 460, *Guarantees*. In certain situations, a guarantee included in a revenue contract will not meet the scope of Topic 460, and will instead be considered in determining the transaction price under Topic 606/IFRS 15. (See the discussion in Chapter 5, “Determining the Transaction Price.”)
- Fixed-odds wagers (i.e., bets) – covered by IFRS 9 as these arrangements would generally be derivatives. Due to a specific scope provision, fixed-odds wagers in U.S. GAAP are within the scope of Topic 606 (ASC 924-815-25-1 (TRG Memo No. 47, *Whether Fixed Odds Wagering Contracts Are Included or Excluded from the Scope of Topic 606* [and IFRS 15])).

Amongst the implications of these scope exceptions is that most income-earning activities of financial institutions, including those associated with making loans, providing lines of credit, writing guarantees (e.g., letters of credit), and providing lease financing, are not in the scope of Topic 606/IFRS 15. However, certain fee-based services often performed by financial institutions, such as trust services and provision of safety-deposit boxes, as well as deposit-related services (such as operating ATMs and cashing checks), are not covered by financial instrument literature and therefore are in the scope of the revenue guidance (TRG Memo No. 36, *Credit Cards*).

### Contracts with Non-Customers

As noted above, a customer is any purchaser of an entity's goods or services in the ordinary course of business. However, there are certain transactions that involve the delivery of goods or services that are typically used in the ordinary course of business, but that are undertaken to facilitate other transactions, as opposed to being transactions that are intended to be income-generating transactions themselves. The FASB and IASB decided that those transactions should not be within the scope of the revenue standards.

#### Certain Nonmonetary Exchanges

One group of contracts that is excluded under this principle is contracts in which entities in the same line of business exchange goods to facilitate sales to end customers. For example, an oil company may have a contract to deliver oil to a customer in a particular location. Rather than transporting its own oil to the delivery location, the oil company may identify another oil company that already

owns oil in the delivery location. The two oil companies may then agree to exchange oil in different locations solely to ease the burden of delivery. Non-monetary exchanges such as this are not considered revenue transactions (ASC 606-10-15-2e; IFRS 15, par. 5d).

Generally, these exchanges are recognized in the accounting records at historical cost; the inventory traded away is removed from the books and the inventory received in the exchange is put on the books at the same carrying amount. Of course, the ensuing sale to the end customer is in the scope of the revenue guidance.

#### Collaborations

Also excluded from Topic 606/IFRS 15 are contracts, often called collaborations, in which an entity enters into a contract with another party with the objective of jointly developing a product or service for sale to other parties, with both parties intending to share in the risks and benefits of developing and selling that product or service. In those situations, the Boards concluded that the entity is not selling its goods or services to its collaboration partner, but is, instead, working to develop new goods or services to sell to others. Therefore, the collaboration is not considered a contract with a customer (ASC 606-10-15-3; IFRS 15, par. 6).

Determining whether an arrangement (or a portion of an arrangement) is a collaboration that meets this scope exception requires judgment. For example, a biotechnology company that performs research on a potential new medication may enter into an arrangement with a larger pharmaceutical company to fund continued development, with the larger company eventually intending to be the manufacturer and distributor of any resulting product, with profits shared between the biotechnology and pharmaceutical companies. That arrangement might well be deemed to qualify for the scope exception. However, if the larger pharmaceutical company originally developed the drug and comes to the biotechnology entity for development assistance, with the pharmaceutical entity retaining ownership of the drug and the right to sell any products developed, the biotechnology entity would likely be considered a service provider to the pharmaceutical customer, and the contract would be within the scope of Topic 606/IFRS 15.

Although evaluating whether a collaboration (or a portion of a collaboration) qualifies for the scope exception requires judgment, the conclusion may not always be of significant importance. While certain collaborations are excluded from the revenue recognition literature, it is not clear how they should be accounted for. Most such arrangements will be in the scope of ASC Topic 808, *Collaborative Arrangements*, for those applying U.S. GAAP, but that Topic does not provide guidance on recognition and measurement, as it is focused on presentation and the analysis of which items of expense should be recognized by parties to the collaboration. And there is no guidance on collaborative arrangements in IFRS. It is therefore likely that parties to collaborative arrangements that are excluded from the revenue literature will nonetheless analogize to that literature where doing so results in reasonable accounting (ASU 2014-09/IFRS 15, par. BC56).

## Revenue Recognized without a Contract

In certain businesses, revenue has commonly been recognized without regard to whether a contract exists. In general, this only occurs when the business creates a product that has a known market price. This is the case, for example, in agricultural businesses that create commodities or mining businesses that result in the creation of precious metals, such as gold (ASU 2014-09/IFRS 15, par. BC28). These situations are rare.

### OBJECTIVE

The core principle of Topic 606 and IFRS 15 is to “recognize 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” (ASC 606-10-05-3; IFRS 15, par. 2).

That core principle certainly seems reasonable and intuitive when read, however, it was carefully crafted to encompass certain concepts that Boards considered fundamental to achieving relevant and consistent financial reporting for revenue across many types of contracts.

1. The objective makes clear that it is the “transfer” of goods or services to the customer that results in revenue being recognized. Thus, work performed by the vendor does not lead to revenue until and unless the results of that work are transferred to the customer. The timing of revenue is evaluated from the point of view of the customer, not the vendor.
2. The objective notes that revenue is measured based on the “consideration” to which the entity will be entitled. This specifies the measurement objective as being related to the price in the contract, not the fair value of the goods and services being sold. While that outcome may seem obvious to many, fair value is the more common measurement characteristic in recent accounting literature, and was considered by the FASB and IASB in the development of the revenue standard.
3. The objective indicates that revenue is measured based on the amount to which the company “expects” to be entitled. The use of the word “expects” clarifies that the Boards decided that expectations of future events and resolution of uncertainties should be taken into account in the recognition of revenue. Some had advocated that any revenue based on “expectations” should be deferred until amounts became known, but the FASB and IASB decided that adopting that approach would produce less relevant information if outcomes were reasonably predictable.

## RECOGNITION AND MEASUREMENT

### Framework

To achieve the core principle, Topic 606/IFRS 15 lays out a five-step model that serves as a framework within which all of the judgments and analyses that go into determining when to recognize revenue and how much revenue to recognize

can be considered (ASC 606-10-05-4; IFRS 14, par. IN7). Each of these steps is discussed in significant detail in Chapters 3 through 7.

### Step 1: Identify the Contract with a Customer

Certain characteristics need to be met for a contract to permit revenue recognition. In general, a contract exists if there is an agreement between a buyer and seller that creates enforceable rights and obligations for the two parties. Only when there is such an agreement is there any revenue to recognize under Topic 606/IFRS 15. This step sets the base to which the rest of the steps in the model are applied.

Also included in this step is guidance on when to combine multiple contracts into a single contract for revenue recognition purposes, and what to do if a contract is modified, thereby changing the identified contract with a customer.

### Step 2: Identify the Performance Obligations in the Contract

Among the rights and obligations that will be set forth in the contract are:

1. The right of the buyer to receive goods or services from the seller, and
2. The obligation of the seller to provide those goods or services to the buyer.

Once the contract has been identified, the seller identifies what goods or services it has promised to provide to the buyer. The standard includes guidance on evaluating provisions of a contract to determine whether they should be regarded as creating promised goods or services.

If multiple goods or services are promised, the seller must determine whether each good or service is distinct from other goods or services in the arrangement, or must instead be combined with other goods or services to form a bundle that is distinct from other goods or services in the contract.

Each good or service or bundle of goods and/or services that is distinct is called a performance obligation under the standard. Performance obligations are then used as units that are evaluated for revenue recognition purposes in the rest of the model.

### Step 3: Determine the Transaction Price

In addition to rights and obligations over goods or services to be provided, a contract will include:

1. The obligation of the buyer to pay the seller for the goods or services, and
2. The right of the seller to collect that payment from the buyer.

Those provisions provide a starting point for determining the transaction price. Often, the payment terms are fixed and payment is due when goods or services are delivered. In that case, it is simple to determine the transaction price to be used in recognizing revenue.

However, the vendor needs to determine whether all amounts to be collected are appropriately reported as revenue. In addition, the contract may

include terms that make the transaction price variable. For example, the transaction price could vary due to usage-based payments, performance bonuses or penalties, rights of return or refund, or price protection.

Topic 606/IFRS 15 explains when and how much variable consideration to include as part of the transaction price, generally requiring variable consideration to be included in the transaction price to the extent it is probable such consideration will become due under the contract.

If the payments in the contract are in a form other than cash (e.g., equity instruments of the customer, or goods or services provided by the buyer to the seller), the standard provides that such consideration should be measured at its fair value, generally at contract inception.

In addition, the transaction price for purposes of revenue recognition sometimes must be adjusted from contractually stated amounts if the contract includes elements that go beyond the seller providing goods or services and the buyer paying for those goods and services. For example, the contract may include non-revenue elements, such as loans or transfers of financial instruments. In that case, appropriate amounts are allocated to the non-revenue elements (e.g., interest income or expense, or the financial instruments issued), with the remainder being considered as the transaction price for the goods or services.

#### *Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract*

In this step, the transaction price determined in Step 3 is allocated, or assigned, to the performance obligations identified in Step 2. Obviously, if there is only one performance obligation, the entire transaction price is associated with the single performance obligation. However, if there are multiple performance obligations, the transaction price must be allocated to those performance obligations.

Generally, this is done based on the standalone selling prices of the performance obligations in the contract. The standalone selling price of a performance obligation may be objectively determinable if it is regularly sold on a standalone basis. If not, the standalone selling price must be estimated through a reasonable technique. Once standalone selling prices for all performance obligations are estimated, the transaction price is generally allocated based on the relative values of the performance obligations, effectively allocating any discount in the contract to the performance obligations on a pro rata basis.

In certain unusual situations, the transaction price is allocated on a different basis. This occurs if either (1) the contract includes a discount from the normal prices of the promised goods and services, and it is clear from the seller's operations that the discount does not relate to all of the promised goods or services, or (2) the contract includes variable consideration and the variability relates only to some of the promised goods or services in the contract.

#### *Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation*

Once the transaction price has been allocated to the performance obligations in the contract, the amount of revenue allocated to each performance obligation is recognized when, or as, the entity performs by transferring the promised goods or services that make up the performance obligation to the customer.

A good or service is deemed to be transferred to the customer when the customer gains control over the good or service. A customer sometimes gains control of promised goods or services as performance occurs over time. In other instances, the customer gains control of a promised good or service at a single point in time, often when something is physically delivered to the customer.

When a performance obligation is satisfied over time, the seller must determine an appropriate measure of its progress toward satisfying the performance obligation, and then recognize revenue based on that progress measurement applied to the amount of the transaction price allocated to the performance obligation.

When a performance obligation is satisfied at a point in time, the seller must determine the appropriate point in time at which to recognize as revenue the amount of the transaction price allocated to the performance obligation.

#### **Applying the Framework**

The five-step model in the standard is logical and straightforward. It provides a structured way to explain revenue recognition and to categorize the thought process that accountants should go through to reach an appropriate conclusion about the timing and amount of revenue.

There are, of course, many decisions, judgments, evaluations, and analyses that go into applying this seemingly simple model. The next five chapters of this book go into some detail about the tasks and issues that arise in applying the model. However, there are several general points that arise repeatedly in applying the five-step framework that bear discussion before getting into the detail of each step.

#### *Grouping of Contracts*

Topic 606/IFRS 15 is written with a mind toward accounting for individual contracts. However, as discussed in detail in Chapter 3, "Identifying Contracts with Customers," there are certain situations in which multiple contracts must be combined for accounting purposes. Generally, this happens when something that is clearly negotiated as a package is documented in multiple contracts and, therefore, accounting for the contracts individually may not capture the true arrangement between the parties.

The standard also allows, but does not require, the application of its principles to a group of contracts, rather than to individual contracts within the group, whenever an entity reasonably believes that application of the standard on a portfolio basis would not result in materially different accounting than would

- The vendor may have continuing responsibilities related to the items already transferred to the customer. For example, the contract may include:
  - A warranty on transferred goods or services
  - A promise by the vendor to perform additional work to install, enhance, or improve the transferred good or service
  - A requirement for the vendor to store or deliver promised goods even though control transfers to the customer before delivery
- A vendor may also have continuing involvement with transferred goods or services when the customer holds a right of return or refund or when other provisions allow the vendor to reacquire transferred items from the customer.
- The transfer of all the initially promised goods or services in a contract may not end the vendor's involvement with the contract if the customer has been granted an option to purchase additional goods or services.

### ONGOING OBLIGATIONS ON DELIVERED GOODS OR COMPLETED SERVICES

In Step 5 of the model in Topic 606/IFRS 15, revenue is recognized when, or as, each performance obligation is satisfied. Generally, once a performance obligation is satisfied, the vendor is no longer concerned with the transferred good or service. However, some contracts include provisions that require the vendor to continue to perform activities related to goods or services even after they are delivered to the customer.

When a vendor is required to continue to perform services related to transferred items, those ongoing services must be evaluated to determine how they affect the accounting. At a high level, ongoing responsibilities related to already-transferred goods or services generally will indicate either (1) the performance obligation related to the transferred good or service has not been (fully) satisfied, or (2) the ongoing responsibilities related to the transferred good or service should be considered a separate performance obligation. Consideration of these situations is addressed in Step 2 of the model, as discussed in Chapter 4, "Identifying the Performance Obligations in the Contract."

In certain situations where a vendor has ongoing responsibilities regarding transferred goods or services, there is specific guidance on the related accounting that goes beyond general considerations of whether the ongoing responsibilities are a separate performance obligation or indicate that the performance obligation including transferred items is not yet fully satisfied.

#### Product Storage and Delivery

As discussed in Chapter 7, "Recognizing Revenue When (or as) the Entity Satisfies a Performance Obligation," it is possible for control of a good or service to be deemed to have transferred to the customer even though physical possession of the item remains with the vendor. For example, this can occur when:

- Control of a good has transferred under a bill-and-hold arrangement (ASC 606-10-55-81 through 83; IFRS 15, pars. B79 through B81).
- A good is being produced in a vendor's facility but the performance obligation is deemed to be satisfied over time because the asset has no alternative use to the vendor and the vendor has a right to payment at all points during the contract (ASC 606-10-25-27c; IFRS 15, par. 35c).

In these situations, the vendor is likely to be responsible (either explicitly or implicitly) for storing the assets until they are physically transferred to the customer and possibly also for shipping the items to the customer. These custodial and shipping responsibilities are conceptually additional performance obligations because they are services provided by the vendor in regard to assets that are owned (for accounting purposes, at least) by the customer. Similar activities related to goods for which revenue has not yet been recognized (and therefore are still owned, for accounting purposes, by the vendor) are not a promised good or service, because they relate to assets of the vendor.

Topic 606/IFRS 15 specifically acknowledges the need to consider such activities, noting that custodial services related to bill-and-hold goods, including storage and safekeeping, that are the responsibility of the vendor result in an additional performance obligation (ASC 606-10-55-84; IFRS 15, par. B82). While this paragraph is written in relation to bill-and-hold products, the same concept would apply to any goods that are held by the vendor despite control being deemed to have already been transferred to the customer. The vendor in such an arrangement should consider whether the obligation to store and ship the products is material, and, if so, consider it a performance obligation to which revenue would be allocated.

A similar issue arises when goods are deemed transferred to the customer when they leave the seller's premises (e.g., due to FOB shipping point terms, as discussed in Chapter 11, "Products"), but the seller is responsible for the transportation of the goods to the customer. The vendor's responsibility for managing the transportation of goods that have already been transferred to the customer is an additional promised good or service. Most likely, the promised goods and the promised shipping service would each be distinct, and the shipping service therefore would be a separate performance obligation.

In many cases, the value of the required post-transfer custodial or delivery services will be immaterial and, therefore, the vendor will be able to perform its accounting for the contract without actually treating those items as additional performance obligations.<sup>1</sup> In addition, U.S. GAAP includes an exception for shipping and handling (but not custodial or storage) services that allows them to be treated as fulfillment activities in all cases, with the costs accrued when revenue is recognized, rather than as performance obligations to which revenue is allocated (ASC 606-10-25-18B).

<sup>1</sup> As discussed in Chapter 4, "Identifying the Performance Obligations in the Contract," promised goods or services may be considered immaterial in the context of the contract under U.S. GAAP and,

therefore, be ignored for purposes of this analysis. Under IFRS, such items would not be scoped out entirely, but would likely be deemed immaterial under general principles.



**DISCLOSURE ALERT:** If a vendor elects to account for post-transfer shipping and handling activities as fulfillment activities rather than performance obligations, it should disclose this policy, if material (ASC 606-10-25-18B).

#### EXAMPLE: ACCRUING COST OF SHIPPING ACTIVITIES

*Ford Motor Company Form 10-Q— Quarter Ended March 31, 2017*

We have elected to recognize the cost for freight and shipping when control over vehicles, parts, or accessories have transferred to the customer as an expense in *Cost of sales*.

### Product Liability Laws and Indemnifications

In many jurisdictions, a vendor is liable under the law if its products harm people or damage property. These obligations are not due to negotiations or agreed-upon terms between the vendor and the customer, but are due to applicable laws. Laws and regulations that govern contracts must be taken into account in revenue recognition (e.g., in identifying the contract, as discussed in Chapter 3, “Identifying Contracts with Customers”). However, product liability laws do not require the transfer of an additional good or service to the customer. Rather, taking on obligations under product liability laws and regulations is considered to be a cost of fulfilling the obligation to transfer the underlying goods. Therefore, potential obligations under product liability laws are treated as contingent liabilities, as discussed in ASC 450-20, *Contingencies—Loss Contingencies*, and IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* (ASC 606-10-55-35; IFRS 15, par. B33). The outcome under both U.S. GAAP and IFRS is that accruals for such costs are made when losses are probable and can be estimated.

This accounting also applies if the vendor promises to indemnify the customer against any liabilities the customer may face from use of the vendor’s products, including liabilities related to violations of intellectual property rights (e.g., patents, copyrights) of third parties. Such promises do not involve transferring additional goods or services to the customer. Rather, they strengthen the vendor’s promise that the transferred good or service will function as required under the law and does not violate another entity’s property rights.

### Warranties

Many product sales include a warranty that provides the purchaser with some protection in the event the product does not perform as expected or requires post-sale servicing. Service arrangements (e.g., auto repair services) may also include warranties that protect the customer in the event the serviced item does not perform as expected or the results of the service are not as beneficial as promised. A warranty, in its most basic form, is a guarantee that if the product or service is defective, the vendor will repair it.

In general, a warranty requires that the seller repair or replace a warranted product if it fails to perform in the way it was designed and manufactured to

perform, or reperform a warranted service if the results are not as promised. These provisions are usually explicitly identified in the contract with the customer, but warranties may also be implied or required by laws or regulations (e.g., “lemon laws” that cover automobile sales in many states are a type of warranty). Because of a warranty commitment, the seller’s involvement with a product may not end after delivery. At a minimum, the seller must be prepared to honor the warranty for whatever period of time it is in force.

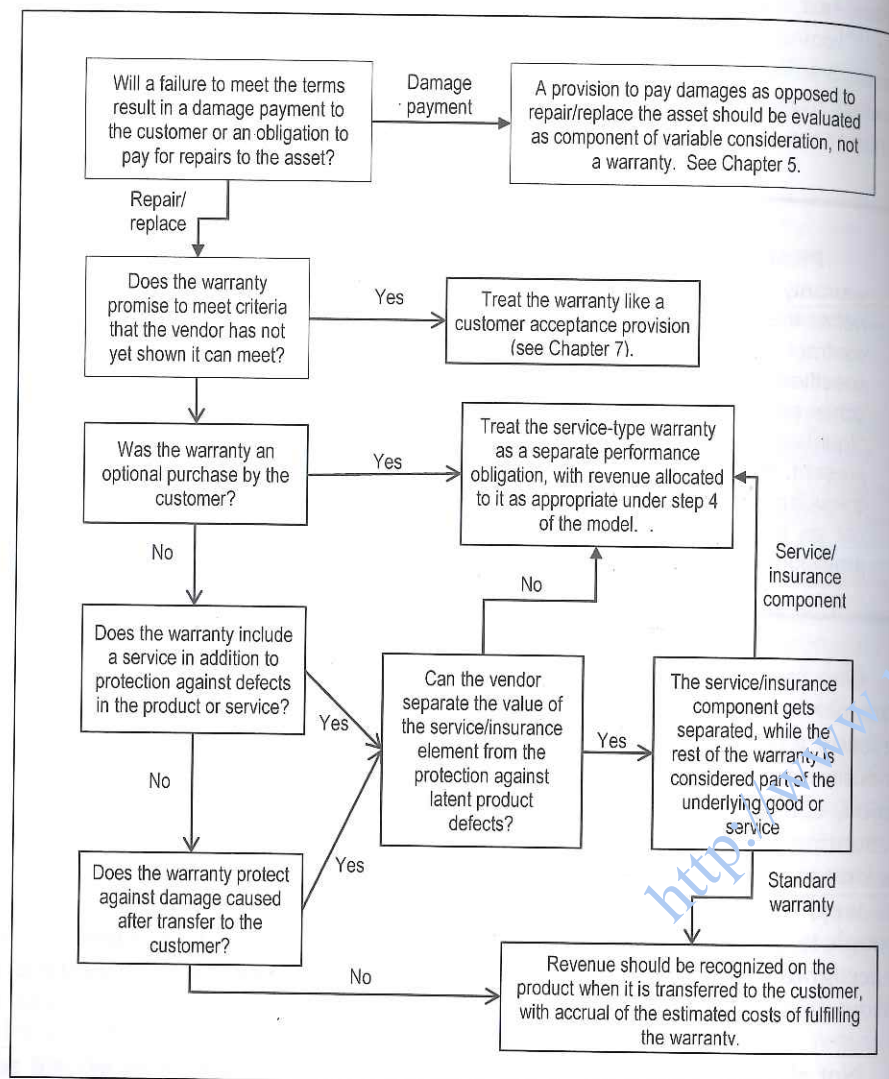
**PRACTICE POINTER:** In some cases, a provision that is identified as a warranty requires a payment from the vendor to the seller if a failure occurs, rather than requiring the vendor to repair or replace the asset. For example, a contract for cloud storage of data might promise 99.9% availability, with a specified payment from the vendor to the customer if that up-time is not achieved. When a provision like this that involves a payment (sometimes called “liquidated damages”) if service levels or product quality is not achieved is present, the potential payment should be evaluated as an element of variable consideration (see discussion in Chapter 5 “Determining the Transaction Price”), not as a warranty. As such, estimates of payments to be made under such provisions reduce the amount of revenue recognition.

One method of accounting for a transfer of a good or service subject to a warranty would be to treat the warranty as another performance obligation. Revenue would be allocated between the product and the warranty, with the amount allocated to the warranty recognized as revenue over the warranty period, consistent with other service transactions. Another possible method of accounting for a warranty would be to consider it when deciding whether the performance obligation related to the covered item has been satisfied. If analyzed this way, a question arises as to whether the warranty obligation is significant enough to prevent revenue recognition on the transferred item. Topic 606/IFRS 15 recognizes both of these accounting approaches, depending on the facts and circumstances.

Not all warranty provisions involve the same type of obligation, and some include provisions beyond a guaranty that the good or service will perform as promised. Therefore, the FASB and IASB determined that it is necessary to understand the substance of the warranty provisions to determine the proper accounting.

**DISCLOSURE ALERT:** A description of any warranties and related obligations is required (ASC 606-10-50-12; IFRS 15, par. 119). See further discussion in Chapter 14, “Disclosure.”

ILLUSTRATION 8-1: WARRANTIES



### Separately Priced Optional Warranties

The treatment of optional warranties under Topic 606/IFRS 15 reflects the fact that the customer has specifically requested and paid extra for the warranty. In such a situation, it is clear, because of the optional nature of the warranty, that it is not a part of or inseparable from the promised good or service that it covers.

When a warranty is optional, it is treated as a separate performance obligation in Step 2 of the model (see Chapter 4, "Identifying the Performance Obligations in the Contract") and is allocated a portion of the transaction price based on its relative stand-alone selling price in Step 4 of the model (see Chapter 4,

"Identifying the Performance Obligations in the Contract"). Revenue allocated to such a warranty is recognized as the warranty obligation is satisfied over its term (ASC 606-10-55-31; IFRS 15, par. B29).

**PRACTICE POINTER:** When a warranty is treated as a separate performance obligation, it is allocated revenue based on its relative stand-alone selling price, as discussed in Step 4 of the model. Theoretically, this means that the amount of revenue allocated to the warranty could be different than the stated price. However, if the warranty is truly optional, one of the following is often true:

1. The stand-alone selling price of the good or service is the stated price without the warranty, as there would be transactions where the good or service was sold at that price on its own, and the stand-alone selling price of the optional warranty is the stated price that is always charged when the warranty is chosen; or
2. The price of the warranted good or service is negotiated, but the same amount is always charged for the warranty itself, such that the stand-alone selling price of the good or service would be determined by the residual method.

In either of these situations, the amount of revenue allocated to the warranty performance obligation would, through the application of the guidance in Step 4 of the model, be equal to its stated price.

The recognition pattern for revenue allocated to an optional warranty should generally be straight-line as long as the coverage remains the same throughout the period. However, when a portion of the warranty coverage lasts longer than another portion of the coverage, that difference should be taken into account in recognizing revenue. In addition, if the vendor believes (e.g., based on historical evidence) that the costs of honoring the warranty will be incurred on other than a straight-line basis, this may suggest that the performance obligation is satisfied on other than a straight-line basis.

In some cases, a good or service will include a standard warranty and an optional extended warranty. For example, assume that all purchasers of a particular model of television receive a one-year warranty but have the option to extend the warranty to three years for an added charge. The arrangement should be accounted for as having a one-year standard warranty (as discussed below) and a two-year separately priced extension (which must be treated as a separate performance obligation).

Similarly, a car may come with a standard warranty on certain engine components, but the warranty may be upgraded to a "bumper-to-bumper" warranty for an additional fee. Again, the standard engine warranty in such a situation would be treated as a standard warranty, while the optional increased protection would be treated as a separate performance obligation.

### Warranties with Service Components

If the warranty is not an optional purchase, it will generally be accounted for as part of the performance obligation that includes the good or service covered by

the warranty. However, before the warranty is evaluated as part of the covered good or service, the vendor must consider whether the warranty includes a promise in addition to the promise that the product is free from defect and performs as intended (ASC 606-10-55-32; IFRS 15, par. B30). For example, a warranty provision could include, in addition to the promise to correct any latent defects in the good or service:

- A promise to provide upgrades, either as specified or on a when-and-if available basis.
- “Free” maintenance services, such as oil changes on a car, or virus protection software on a computer.
- Coverage against accidental damage that occurs after the item is transferred to the customer. When a warranty specifically covers damage that arises after the item is transferred to the customer, the warranty includes an insurance element (ASU 2014-09/IFRS 15, par. BC377).
- Performance monitoring services.

Any promise of services during the warranty period that goes beyond the promise that the product will perform as intended must be treated as a separate performance obligation, as discussed in Step 2 of the model (see Chapter 4, “Identifying the Performance Obligations in the Contract”). As such, consideration would be allocated to the service obligation under Step 4 of the model (see Chapter 6, “Allocating the Transaction Price to the Performance Obligations in the Contract”), which would be recognized as the service is performed. If a vendor concludes that it is not possible to separately account for the service portion of a warranty, the entire warranty must be treated as a separate performance obligation (ASC 606-10-55-34; IFRS 15, par. B32).

Determining whether a warranty includes a service in addition to protection against latent defects may require judgment. Factors to consider in this determination include (ASC 606-10-55-33; IFRS 15, par. B31):

- *Whether the warranty is required by law.* Generally, a company would not be required by law to provide post-transfer services to a customer. Instead, legally required warranties almost invariably are intended only to provide assurance that the transferred good or service is not defective and meets promised specifications. The fact that such warranties may cover faults that develop after the good is transferred to the customer is considered a way of operationalizing the assurance against latent defects. Therefore, a warranty that only provides protections required under the law likely does not contain a service element (ASU 2014-09/IFRS 15, par. BC377).
- *The length of the warranty.* The longer the warranty period, the more likely it is that the warranty is intended to cover damage or problems that arise after the product is transferred and are unrelated to any defects in the good transferred or service performed by the vendor. Of course, a vendor may well believe that if it has manufactured its product correctly, no failure will occur for a significant period of time, so judgment is necessary in evaluating longer warranties. However, a long warranty period com-

bined with a “100% no questions asked” repair or replacement promise likely includes an insurance service that must be separately accounted for.

- *Whether the entity is required to perform any tasks in the absence of a problem.* If the vendor is required to perform tasks under the warranty even before a problem is discovered (e.g., perform maintenance, provide upgrades), it is likely that those tasks represent a separate service. Conversely, if the vendor only needs to perform tasks pursuant to the warranty after a problem is discovered, those tasks are not indicative of a separate service.

#### Standard Assurance Warranties

A warranty that is not optional, but is bundled with the covered product or service, and only includes the promise that the covered item is free from defects and will perform as intended, is not treated as a separate performance obligation. Instead, it is considered an integral part of the product or service. However, different warranty provisions have different effects on the accounting for the covered item.

For example, if the seller commits to a product meeting certain specifications that have not yet been demonstrated, revenue should not be recognized until compliance with these specifications is achieved. In this situation, the warranty is akin to a customer acceptance provision. As discussed in Chapter 7, “Recognizing Revenue When (or as) the Entity Satisfies a Performance Obligation,” when customer acceptance is tied to the vendor meeting criteria that it cannot demonstrate have been met, the vendor cannot demonstrate that it has transferred control of the good promised in the contract.

Furthermore, if the warranty provisions are based on meeting criteria specific to a particular customer or product sale, the warranty should be evaluated as a customer acceptance provision based on customer-specified criteria, as discussed in Chapter 7, “Recognizing Revenue When (or as) the Entity Satisfies a Performance Obligation.” Again, in such circumstances, revenue for the promised good cannot be recognized until the vendor can demonstrate (or the customer acknowledges) that the product meets the specified criteria.

However, if a warranty is based on standard criteria that the vendor has demonstrated an ability to achieve, revenue is generally recognized upon transfer of the good or service. The costs of fulfilling the warranty in this situation are accounted for pursuant to the accounting guidance on provisions and contingent liabilities (Topic 460, *Guarantees*, or IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*) (ASC 606-10-55-32; IFRS 15, par. B30). The results are similar under U.S. GAAP and IFRS—the estimated costs of honoring the warranty must be accrued when revenue is recognized, and these cost accruals should be updated as estimates change.<sup>2</sup>

<sup>2</sup> In the unlikely event that costs of honoring the warranty cannot be estimated, U.S. GAAP states that revenue should not be recognized (ASC 460-10-25-6). While there is no similar guidance in IFRS, it is likely that if the costs of honoring the warranty cannot be estimated, the vendor would

not be able to demonstrate that it can meet the specifications in the contract. Therefore, revenue could not be recognized because the vendor would not be able to conclude it had transferred the specified item to the customer.

**GAAP EXAMPLE:** Example 44 (ASC 606-10-55-309; IFRS 15, par. IE223) illustrates the evaluation of whether a warranty includes a service in addition to assurance that the product functions as intended.

**DISCLOSURE ALERT:** When warranties are accounted for under Topic 460, the company is required to disclose information about the warranty, as well as a rollforward of the warranty liability for the period (ASC 460-10-50-8).

#### EXAMPLE: STANDARD WARRANTIES

[AUTHOR'S NOTE: While this excerpt is from a filing prepared under previous U.S. GAAP (Topic 605), the principles are consistent; therefore, the example should still be relevant.]

#### Dell Technologies, Inc. Form 10-K— Year Ended February 2, 2018

**Standard Warranty Liabilities.** We record warranty liabilities at the time of sale for the estimated costs that may be incurred under the terms of the limited warranty. The liability for standard warranties is included in accrued and other current and non-current liabilities on the Consolidated Statements of Financial Position. The specific warranty terms and conditions vary depending upon the product sold and the country in which we do business, but generally include technical support, parts, and labor over a period ranging from one to three years. Factors that affect our warranty liability include the number of installed units currently under warranty, historical and anticipated rates of warranty claims on those units, and cost per claim to satisfy our warranty obligation. The anticipated rate of warranty claims is the primary factor impacting our estimated warranty obligation. The other factors are less significant due to the fact that the average remaining aggregate warranty period of the covered installed base is approximately 16 months, repair parts are generally already in stock or available at pre-determined prices, and labor rates are generally arranged at pre-established amounts with service providers. Warranty claims are reasonably predictable based on historical experience of failure rates. If actual results differ from our estimates, we revise our estimated warranty liability to reflect such changes. Each quarter, we reevaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

\*\*\*\*\*

The Company records a liability for its standard limited warranties at the time of sale for the estimated costs that may be incurred. The liability for standard warranties is included in accrued and other current liabilities and other non-current liabilities in the Consolidated Statements of Financial Position.

Changes in the Company's liability for standard limited warranties are presented in the following table for the periods indicated:

	Fiscal Year Ended		
	February 2, 2018	February 3, 2017	January 29, 2016
	(in millions)		
Warranty liability: Warranty liability at beginning of period	\$ 604	\$ 574	\$ 679
Warranty liability assumed through EMC merger transaction	—	125	—
Costs accrued for new warranty contracts and changes in estimates for pre-existing warranties <sup>(a)(b)</sup>	905	852	754
Service obligations honored	(970)	(947)	(859)
Warranty liability at end of period	<u>\$ 539</u>	<u>\$ 604</u>	<u>\$ 574</u>
Current portion	\$ 367	\$ 405	\$ 381
Non-current portion	<u>\$ 172</u>	<u>\$ 199</u>	<u>\$ 193</u>

(a) Changes in cost estimates related to pre-existing warranties are aggregated with accruals for new standard warranty contracts. The Company's warranty liability process does not differentiate between estimates made for pre-existing warranties and new warranty obligations.

(b) Includes the impact of foreign currency exchange rate fluctuations.

#### OPTIONS ON TRANSFERRED GOODS

Some arrangements include provisions that allow items transferred to the customer to be transferred back to the vendor. The most common arrangement is a right of return in which a buyer may, for a limited period of time, return a product in exchange for a (full or partial) refund.

Less common provisions include those that allow the vendor to repurchase a product from the customer. Such provisions may exist, for example, in a contract between a vendor and a customer that is a dealer of the vendor's products to allow the vendor to redistribute products as needed. Other arrangements may include provisions under which a vendor and customer agree that a product will be returned to the vendor after a period of time. These arrangements may be used as a form of financing transaction, with the transferred products essentially serving as collateral for a loan.

In other transactions, a vendor may agree to repurchase a product (either mandatorily or upon exercise of an option by its customer) after the customer has used it for a period of time so that the customer is not forced to keep a product longer than necessary. Such repurchase arrangements serve the same economic purpose as a resale price guarantee, except they give the vendor control over the remarketing of the used product and the identity of the new owner.

Because provisions like these raise the possibility that the transfer of control of a product is only temporary, they call into question whether revenue should be recognized before the provisions expire.

**PRACTICE POINTER:** The accounting discussed herein applies when a contract with a customer includes (either explicitly or implicitly) provisions under which the vendor may repurchase items transferred to the customer. There may also be situations in which a vendor repurchases items from a customer without any contractual provisions. Such repurchases are separate transactions from the original sale to the customer and do not impact the accounting for the original sale (ASU 2014-09/IFRS 15, par. BC423).

### Rights of Return

Return rights are very common in product transactions. For example, almost any retail purchase can be returned for a limited period of time. Resellers and distributors are often granted rights of return to reduce their risk in case the product is difficult to resell. Sales of commercial products may have rights of return related to quality, performance testing, or other factors.

**PRACTICE POINTER:** Return rights are often documented in the contract with the customer. However, such rights may also exist due to industry practice, company policy, or laws and regulations. The relationship between the buyer and seller should be evaluated in full to determine whether unstated rights of return may exist. For example, an important customer of a company may have enough leverage to return goods beyond the limited period stated in the contract. Although the seller may be within its rights to deny such returns, some sellers accept returns from important customers even beyond stated terms. All rights of return, whether or not explicitly stated in a contract, must be considered.

### *Rights of Return versus Rights of Exchange*

The guidance regarding rights of return does not apply to rights given to customers to exchange one item for another of the same kind, quality, and price. These “like-kind” exchange rights are not treated as returns for accounting purposes and generally should have no effect on revenue recognition (ASC 606-10-55-28; IFRS 15, par. B26). Instead, the estimated costs of fulfilling those exchange rights expected to be exercised should be accrued at the time of sale.

This exception applies only to rights to exchange one product for another of the same type, quality, condition, and price. The intent is not to limit revenue recognition when the customer only has the ability to exchange the product for something similar (e.g., a different size or color). However, the exception is applied quite narrowly. For example, the following rights are evaluated as rights of return, not exchange, even though the customer cannot get his or her money back:

- A right that allows the customer to exchange the product for store credit toward any product. Because the customer can choose products that are different in function and value from the one returned, this is not a right of exchange, but a right of return (ASC 606-10-55-22; IFRS 15, par. B20).
- A manufacturer provides “stock rotation rights” to distributors or retailers that allow the reseller-customer to return products for credit toward other purchases. Again, because the credit is good toward a variety of products, the right must be treated as a right of return.
- A pharmaceutical company may allow its customers to exchange a product near the end of its shelf life for a “fresh” product. Even though the product is exactly the same formulation and dose, this would still be a right of return, not a right of exchange, because a fresh product is in better condition than an almost expired product.

### *Rights of Return versus Warranties and Customer Acceptance Provisions*

In some cases, a contract with a customer may allow the customer to return a product only if it is defective or fails to perform as promised. The accounting for such a provision depends on whether the return is for refund or for a replacement product. If the provision allows the customer to return a defective product for a refund, it should be accounted for as a right of return.

However, even when identified as a right of return, a provision that allows for the exchange of a defective product for a functional one is, for accounting purposes, a warranty or a customer acceptance provision, not a right of return (ASC 606-10-55-29; IFRS 15, par. B27). The accounting for warranties is discussed earlier in this chapter, as are considerations for distinguishing warranties from customer acceptance provisions.

### *Accounting for Rights of Return*

Granting a right of return or refund to a customer does not change the fact that the customer obtained control of the goods or services when they were transferred, so the existence of such a right does not prohibit revenue recognition under Topic 606/IFRS 15. In addition, a return right is not distinct from the underlying goods or services. Consequently, standing ready to provide the refund or accept the return is not a separate performance obligation (ASC 606-10-55-24; IFRS 15, par. B22).

Instead, the right of return is viewed as creating uncertainty about whether the transaction will be completed. Therefore, the requirements that apply to rights of return are similar to those that apply to uncertainty about transaction price (ASC 606-10-55-25; IFRS 15, par. B23). Consistent with that guidance, an entity should recognize revenue on a sale with a right of return to the extent that doing so will still allow the entity to conclude that it is probable that a significant revenue reversal will not occur once the return rights are exercised or expire. That is, the entity should recognize revenue to the extent that it is probable that customers will not exercise their rights of return. This may be difficult to determine in a single transaction. However, applying the principles of the standard to a portfolio (ASC 606-10-10-4; IFRS 15, par. 4) is likely to be helpful.

Return/refund estimates are subject to the same constraint as estimates of variable fees, so that a company will only recognize revenue to the extent it concludes that it is probable that doing so will not result in a significant revenue reversal. In most situations, even if the estimate of possible returns is significant or highly uncertain, some revenue can be recognized upon delivery of the products, because the entity can conclude that it is probable that at least some products will not be returned. However, if the likelihood of the customer exercising its right of return cannot be estimated, the vendor cannot conclude that recognizing revenue would not lead to a significant reversal in later periods, so all revenue would be deferred.

Presuming that some estimate can be made, an entity that grants customers a right of return should recognize revenue upon transfer of the products to the customer for the portion of products that are likely not to be returned. The entity should not recognize revenue for the remaining products and should instead recognize a refund liability for the amount to be refunded (ASC 606-10-55-23; IFRS 15, par. B21). The estimate of the refund liability must be updated continuously for changes in expectations about the number of returns, with adjustments affecting recorded revenue (ASC 606-10-55-26; IFRS 15, par. B24).

**PRACTICE POINTER:** In some cases, a customer may not receive all of its money back if it exercises a right of return. For example, electronics retailers sometimes charge a "restocking fee" for returned products. When the right of return generates only a partial refund, the nonrefundable consideration is not variable based on whether the return right is exercised. Therefore, the nonrefundable consideration is recognized as revenue upon transfer of the products to the customer, even though it relates to products that are expected to be returned (see TRG Memo No. 35, *Accounting for Restocking Fees and Related Costs*—discussion summarized in TRG Memo No. 44).

To the extent an entity expects returns, it should also recognize an asset related to the products that will be returned if the estimated number of customers exercises their return rights (ASC 606-10-55-23; IFRS 15, par. B21). The asset is initially measured at the recorded amount of the inventory (or other asset) transferred to the customer. However, the asset measurement should be reduced for expected costs that will be incurred to recover and recondition returned products. If the products cannot be reconditioned, the anticipated loss in value should be included in the asset measure. The asset balance should be updated each period for changes in estimates of the number of products to be returned (ASC 606-10-55-27; IFRS 15, par. B25).

**GAAP EXAMPLES:** Example 22 (ASC 606-10-55-202; IFRS 15, par. IE110) shows the accounting for sales with a right of return where an estimate of returns can be made.

Example 26 (ASC 606-10-55-227; IFRS 15, par. IE135) illustrates the accounting for a sale with a right of return when no estimate of returns can be made.

**DISCLOSURE ALERT:** A description of refund, return and similar provisions is required (ASC 606-10-50-12; IFRS 15, par. 119). See further discussion in Chapter 14, "Disclosure."

### ILLUSTRATION 8-2: PRODUCT SOLD WITH RIGHT OF RETURN

**Facts:** Example Company sells 100 units of Product A at \$100 per unit. Product A has an inventory cost of \$87 per unit, and repackaging any returned units for resale will cost \$15 per unit. Customers get a 30-day right of return on Product A and, ultimately, five of the 100 units are returned.

#### CASE 1

**Additional Facts:** Example Company determines at the time of sale that it cannot estimate the amount of returns it will receive, as the 100 units were sold in a single transaction and Product A is a new product.

#### Accounting:

Upon delivery:

- No revenue is recognized. The customer payment is recognized, along with a refund liability.

Dr. Cash	\$10,000	
Cr. Refund liability		10,000

- The inventory is removed from Example Company's books, to be replaced with a right to receive product returns. The products to be received are measured as the cost of the inventory less expected repackaging costs.

Dr. Cost of Sales (Impairment)	\$1,500	
Dr. Expected Product Returns	7,200	
Cr. Inventory		8,700

At the end of the return period:

- Revenue for products not returned is recognized.

Dr. Refund Liability	\$9,500	
Cr. Revenue		9,500

- The expected product returns asset is reduced and cost of sales recorded for products not returned.

Dr. Cost of Sales	\$6,840	
Cr. Expected Product Returns		6,840

- Cash is refunded on the returned products.

Dr. Refund Liability	\$500	
Cr. Cash		500

- Products are returned and repackaging costs are incurred on the returned products.

Dr. Inventory	\$435	
Cr. Cash		75
Cr. Expected Product Returns		360

**CASE 2**

**Additional Facts:** Example Company determines initially that it is probable that returns will be no more than 6% of sales.

**Accounting:**

Upon delivery:

- Revenue is recognized for products not expected to be returned, and a refund liability is recorded for products expected to be returned.

Dr. Cash	\$10,000	
Cr. Revenue		9,400
Cr. Refund Liability		600

- Cost of sales is recognized for products not expected to be returned.

Dr. Cost of Sales (\$87 × 94 units)	\$8,178	
Cr. Inventory		8,178

- The remaining inventory is removed from Example Company's books, to be replaced with a right to receive product returns. The products to be received are measured as the cost of the inventory less expected repackaging costs.

Dr. Cost of Sales	\$90	
Dr. Expected Product Returns	432	
Cr. Inventory		\$522

At the end of the return period:

- Additional revenue and cost of sales are recognized because returns were less than provided for the initial accounting.

Dr. Refund Liability	\$100	
Cr. Revenue		\$100
Dr. Cost of Sales	\$72	
Cr. Expected Product Returns		\$72

- Cash refunds are made for returned products.

Dr. Refund Liability	\$500	
Cr. Cash		\$500

- Products are returned and repackaging costs on returned products are incurred.

Dr. Inventory	\$435	
Cr. Cash		\$75
Cr. Expected Product Returns		360

**EXAMPLE: ESTIMATED RETURNS**

[AUTHOR'S NOTE: While this excerpt is from a filing prepared under previous U.S. GAAP (Topic 605), the principles are consistent; therefore, the example should still be relevant.]

**Urban Outfitters, Inc. Form 10-K—Year Ended January 31, 2016**

*Sales Return Reserve*

The Company records a reserve for estimated product returns where the sale has occurred during the period reported, but the return is likely to occur subsequent to the period reported. The reserve for estimated product returns is based on the Company's most recent historical return trends. If the actual return rate is materially different than the Company's estimate, sales returns would be adjusted in the future. The activity of the sales returns reserve for the years ended January 31, 2016, 2015, and 2014 was as follows:

	Balance at beginning of year	Additions	Deductions	Balance at end of year
Year ended January 31, 2016	\$ 19,804	96,707	(92,126)	\$ 24,385
Year ended January 31, 2015	\$ 17,089	80,390	(77,675)	\$ 19,804
Year ended January 31, 2014	\$ 14,448	64,313	(61,672)	\$ 17,089

**Puts, Calls, and Forwards on Transferred Items**

Sales of goods may include provisions under which the seller must or may repurchase the product sold (or a similar product), or a good of which the original product is a part (ASC 606-10-55-66; IFRS 15, par. B64). The existence of repurchase provisions raises questions about whether the contract should be accounted for as a contract to sell a product to a customer or as another kind of transaction. For example:

- A company enters into an arrangement with a contract manufacturer, under which the contract manufacturer will purchase a component or ingredient from the company, and then use that component or ingredient in the manufacture of another good, which the original seller will then purchase. If the sale of the component or ingredient is treated as a contract with a customer, the company will recognize revenue for that sale.

Instead, the arrangement with the contract manufacturer may be considered a contract in which the company is hiring the contract manufacturer to perform manufacturing services on the company's inventory, such that there is no sale (for accounting purposes) to the contract manufacturer.

- An entity sells inventory to a third party with an agreement that the entity will repurchase that inventory after a period of time. If the sale to the third party is treated as a contract with a customer, the entity will recognize revenue from that sale and will recognize revenue again on the same inventory after it has repurchased (and resold) the inventory. Alternatively, the transaction may be considered a financing transaction, with the inventory serving as collateral.
- An entity may retain a call option on transferred goods, under which the original seller may, but is not required to, repurchase the transferred goods at a later date or upon the occurrence of an event. This could be done, for example, because the original seller does not want to allow its reseller customer to sell the item at a low price, or because the original seller wants to have the option to reacquire the inventory if it finds a customer willing to pay more. In this situation, the seller has retained at least some control over the delivered goods; therefore, it is unclear whether revenue should be recognized.
- A purchaser may buy goods subject to a put option, under which the purchaser may require the seller to repurchase the transferred goods at a later date or upon the occurrence of an event. Purchasers may want this right because they only intend to use the purchased equipment for a portion of its useful life and want protection regarding the ability to sell used equipment at that point. Such a transaction may be considered a sale, with the put option being recognized by the original seller as a separate liability. However, the customer's intent in this transaction seems to be use of the equipment for a period of time, so lease accounting may seem appropriate.

In these and other situations, the existence of the repurchase provisions raises questions about the nature of the contract with a customer and about whether control of the items subject to the repurchase provisions has truly been transferred to the customer.

Topic 606/IFRS 15 includes implementation guidance on repurchase arrangements that depends largely on whether the customer is in control of when and if the repurchase occurs.

#### *Call Option or Forward Contract for Repurchase*

Under Topic 606/IFRS 15, revenue is recognized when a customer gains control of promised goods or services. However, if the seller has the right to reclaim the products (a call option) or if there is an unconditional repurchase agreement (a forward contract), the FASB and IASB conclude that the customer does not have control of the goods because it is restricted in what it can do with them as it must be able to honor the call option or forward contract. For example, the customer

might not be able to sell the goods to a third party without a way to reacquire them to satisfy the call option or forward contract.

**PRACTICE POINTER:** The existence of a call option indicates that the customer does not have control of the product regardless of the likelihood of the call option being exercised, as the customer must be prepared to honor the option. Therefore, the customer is restricted in its ability to control the asset.

The only exception to this would be if the call option is nonsubstantive (ASC 2014-09/IFRS 15, par. BC247). Reaching a conclusion that a call option is nonsubstantive is very difficult, as the fact that the parties included it generally indicates that it does have substance. A vendor that believes its contract with a customer includes a nonsubstantive call option should be prepared to explain not only why it is unlikely that the vendor would exercise the option, but also why it would be obvious to the customer that the option would never be exercised, such that the customer would be comfortable ignoring the option as it used the product.

When there is a call option or forward contract, the accounting model depends on the exercise price of the call or the settlement price of the forward.

If the price is equal to or greater than the original sale price (as adjusted for the time value of money), the transaction is considered a financing, with the excess of the repurchase price over the original sale price treated as interest or compensation for services performed or costs incurred by the counterparty (ASC 606-10-55-68 through 55-70; IFRS 15, pars. B66 through B68).

For example, in a contract manufacturing arrangement, inventory is often sold from an entity to a contract manufacturer with an agreement that the original seller will repurchase the inventory after the contract manufacturer has processed it. The repurchase price would cover the original sale price plus compensation for work performed by the contract manufacturer.

Such an arrangement could also occur in a situation in which the seller is in need of financing and decides to use its inventory, essentially, as collateral. In such arrangements, the repurchase price will generally compensate the "customer" for the time value of money between the dates of the sale and repurchase. These arrangements may be made with a reseller, such that the repurchase only occurs for products that the reseller cannot sell for at least the option or forward price. In such a situation, the option or forward expires if the customer resells the product.

If the exercise price is lower than the original sale price, the transaction is considered a lease, with the difference between the sale price and the repurchase price recognized as lease revenue from the sale date to the repurchase date (ASC 606-10-55-68; IFRS 15, par. B66).<sup>2</sup>

<sup>2</sup> The interaction of the revenue recognition and lease literature can create complications. For example, if the sale is part of a sale-leaseback and the seller-lessee also holds a repurchase option (or a

forward repurchase agreement exists), the transaction would be a financing, as the "customer," in this situation, is not using the asset in question (ASC 606-10-55-68).



A transaction like this may be fashioned as a forward contract if the customer wishes to use the product for only a portion of its life and does not want to worry about reselling it at a later date.

A vendor may want a call option on a product if it wishes to better manage the market for used products. By exercising a call option to reacquire the product, the vendor can ensure that used products are not dumped on the market at low prices, potentially affecting the market for new products.

In either case, the seller recognizes revenue if and when the option or forward expires due to a subsequent event, or if and when the option expires unexercised due to the passage of time (ASC 606-10-55-71; IFRS 15, par. B69).

**GAAP EXAMPLE:** Example 62 (ASC 606-10-55-401; IFRS 15, par. IE315) includes an example of a call option in a contract with a customer.

### ILLUSTRATION 8-3: PRODUCT FINANCING ARRANGEMENT

**Facts:** The Grenache Co. sells 100 cases of its wine to AMS Cellars for \$500 per case, receiving \$50,000 cash upon delivery. The contract calls for Grenache to repurchase any unsold cases from AMS in six months at \$525 per unit. The Grenache Co. estimates, based on its history of selling to AMS, that AMS will resell 94 of the 100 cases within six months and, therefore, The Grenache Co. believes it will repurchase six cases in six months at \$525 per case. Market interest rates are approximately 10% for secured borrowings. AMS sells 50 of the 100 cases to a third party three months later and sells another 44 cases just before the six months are up. The remaining six units are sold back to The Grenache Co. at the stipulated \$525 per case price. Holding costs for the wine are negligible.

**Accounting:** Because The Grenache Co. has agreed to purchase (a forward contract) AMS's remaining inventory at a price that equals the original sales price increased by an amount that represents a financing rate of return, the transaction should be treated as a financing arrangement. Therefore, no revenue can be recognized upon delivery, despite The Grenache Co.'s ability to estimate the outcome of the arrangement. Because no revenue is recognized, the inventory remains on The Grenache Co.'s books. The accounting is as follows:

At the inception of the arrangement, The Grenache Co. records the cash received:

Cash		\$50,000	
	Debt		\$50,000

For three months, The Grenache Co. records interest on the entire debt (\$50,000 × 10% effective rate × 1/4 of a year = \$1,250):

Interest Expense		\$1,250	
	Interest Payable		\$1,250

When AMS sells the first 50 units, The Grenache Co. recognizes revenue and eliminates that portion of the debt:

Debt		\$25,000	
	Interest Payable		\$625
	Revenue		\$25,625

For the remaining three months, The Grenache Co. records interest on the remaining debt (\$25,000 × 10% effective rate × 1/4 of a year = \$625):

Interest Expense		\$625	
	Interest Payable		\$625

When AMS sells the next 44 units, The Grenache Co. recognizes revenue and eliminates that portion of the debt:

Debt		\$22,000	
	Interest Payable		\$1,100
	Revenue		\$23,100

The Grenache Co. records the repurchase of the remaining six units:

Debt		\$3,000	
	Interest Payable		\$150
	Cash		\$3,150

The accounting is the same as if The Grenache Co. borrowed \$25,000 for three months and another \$25,000 for six months at a 10% interest rate, and then sold 50 cases of wine at \$512.50 per unit in three months and another 44 cases at \$525 per case in the next three months. This is consistent with the conclusion that the original transaction is essentially a financing transaction, rather than a true product sale.

### ILLUSTRATION 8-4: CALL OPTION ON USED EQUIPMENT

**Facts:** Equipment Co. sells Product X for \$100,000 and has a repurchase option on Product X that is exercisable three years after the original sale. Equipment Co. retains the call option so that its customer cannot resell the equipment for three years, as Equipment Co. believes that such lightly used equipment may impact its ability to sell new equipment at satisfactory prices. Equipment Co. believes that it is probable that it will not exercise the call option, as equipment that is more than three years old generally is not viewed as a good alternative to new equipment.

The call price is \$55,000 after three years. Product X has a cost basis of \$60,000 and an estimated useful life of 10 years.

**Accounting:** Because the call option is at a price lower than the original sale price of the equipment, Equipment Co. concludes that the transaction must be treated as a lease. The fact that Equipment Co. believes it will not exercise the option is not relevant, as the existence of the option means that the customer does not obtain control of the equipment. Equipment Co. concludes that the agreement should be treated as an operating lease.

The lease revenue to be recognized over three years is the difference between the original sale price and the call price, or \$45,000.

Original Sale:

Equipment Co. recognizes the receipt of payment, but no revenue, and transfers Product X from inventory to a long-term asset.

Cash	\$100,000
Refund Liability	\$55,000
Lease liability	45,000
Fixed Assets	\$60,000
Inventory	60,000

For each of the three years following the original sale:

Equipment Co. recognizes the difference between the original sales price and the residual value guarantee amount as lease income as follows:

Lease liability	\$15,000
Lease revenue	\$15,000

Equipment Co. records depreciation expense on Product X based on Product X's carrying value of \$60,000 and a 10-year life.

Depreciation Expense	\$6,000
Accum. Depreciation	\$6,000

At the end of year three:

If Equipment Co. exercises the option:

Refund Liability	\$55,000
Cash	\$55,000

If Equipment Co. does not exercise the option:

Refund Liability	\$55,000
Product Sale Revenue	\$55,000
Cost of Sales	\$42,000
Accum. Depreciation	\$18,000
Fixed Assets	\$60,000

### Put Option

In contrast to a seller's call option or forward repurchase contract, a put option held by the customer on transferred goods does not necessarily impact the customer's ability to control those goods. In the case of a put option, the customer is not required contractually to be able to transfer the goods back to the seller, as the customer may elect not to exercise the put option. Therefore, the existence of a put option held by the customer does not necessarily impact the timing of revenue recognition for the vendor.

Instead, Topic 606/IFRS 15 requires that the terms of the put option be considered to determine whether they appear to be designed to make exercising the option the logical choice for the customer. If so, the customer's control of the asset is limited, as it is when there is a forward repurchase contract or seller call option, because the customer must keep the asset in the condition necessary to exercise the option. To evaluate whether this is the case, Topic 606/IFRS 15

requires that the vendor consider whether the customer has a significant economic incentive to exercise its put option.

In general, a customer is considered to have a significant economic incentive to exercise a put option if the exercise price of the option is greater than the expected market value of the asset at the time the option is exercisable (ASC 606-10-55-73; IFRS 15, par. B71). While the standard does not provide any other examples of situations that may cause a significant economic incentive to exist, it does indicate that an exercise price in excess of expected market value is only an example of a significant economic incentive. For example, a significant economic incentive to exercise the option may also exist if the customer was only licensed to operate the asset for a limited period of time.

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**PRACTICE POINTER:** The evaluation of whether there is a significant economic incentive for the customer to exercise a put option is made only at the inception of the arrangement. Changes in the expected market value of the underlying asset subsequent to contract inception, therefore, do not cause a change in the characterization of the contract with the customer.

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If a significant economic incentive to exercise a put option exists, the accounting is the same as if the repurchase arrangement was a forward contract. Thus, if the exercise price of the put option is less than the original transaction price (taking into account the time value of money), the arrangement is accounted for as a lease (ASC 606-10-55-72; IFRS 15, par. B70), and if the exercise price of the put option is equal to or greater than the original transaction price, the arrangement is treated as a financing transaction (ASC 606-10-55-75; IFRS 15, par. B73). In either case, revenue is recognized by the vendor if the option expires unexercised (ASC 606-10-55-78; IFRS 15, par. B76).

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**PRACTICE POINTER:** A vendor and customer could achieve similar economics to a customer put option by including in the contract a guarantee from the vendor to the customer that the vendor will make a payment to the customer to the extent the customer is unable to resell the product for at least a stated amount. Because such a resale value guarantee does not result in the vendor actually reacquiring the product, it does not impact the customer's ability to control the product, so the transaction does not have to be considered a lease or a financing (ASU 2014-09/IFRS 15, par. BC431). Instead, such a provision would be accounted for under one of two models:

1. The resale value guarantee may be considered to satisfy the definition of a guarantee in Topic 460, *Guarantees*, in which case it would be accounted for using that guidance under U.S. GAAP.
  2. The provision could be viewed as causing the transaction price to be variable. That variability would be addressed as discussed in Chapter 5, "Determining the Transaction Price," such that revenue would not be recognized to the extent that it would be reasonably possible for a significant reversal of revenue to occur due to the resale value guarantee.
-

If the customer holds a put option and there is no significant economic incentive to exercise the option, the option does not impact the customer's ability to control the asset. Therefore, the vendor recognizes revenue when it otherwise would, with the put option treated as a right of return. As such, revenue is recognized in an amount that likely will not be subject to refund upon exercise of the right, as discussed previously in this chapter (ASC 606-10-55-74 and 55-76, IFRS 15, pars. B72 and B74).

**GAAP EXAMPLE:** Example 62 (ASC 606-10-55-401; IFRS 15, par. IE315) includes an example of a put option in a contract with a customer.

**EXAMPLES: PUT OPTIONS**

*Ford Motor Company Form 10-Q—Quarter Ended March 31, 2018*

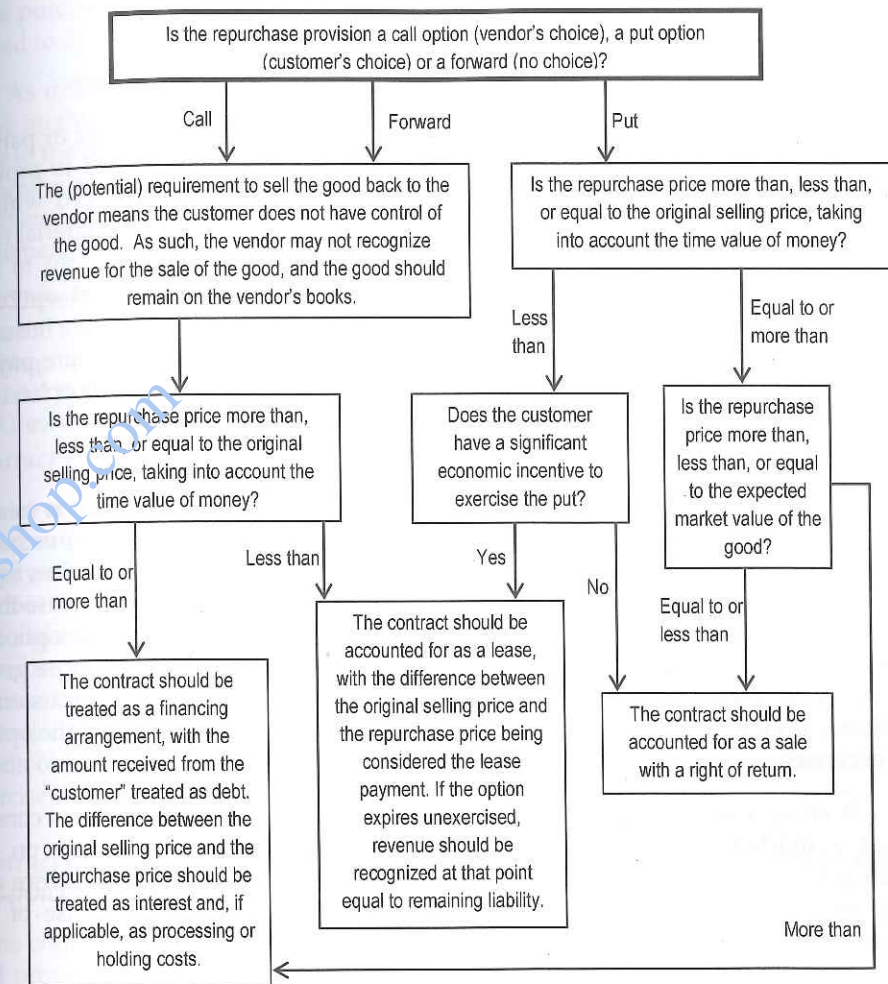
**Leasing Income.** We sell vehicles to daily rental companies with an obligation to repurchase the vehicles for a guaranteed amount, exercisable at the option of the customer. The transactions are accounted for as operating leases. Upon the transfer of vehicles to the daily rental companies, we record proceeds received in *Other liabilities and deferred revenue*. The difference between the proceeds received and the guaranteed repurchase amount is recorded in *Automotive revenues* over the term of the lease using a straight-line method. The cost of the vehicle is recorded in *Net investment in operating leases* on our consolidated balance sheet and the difference between the cost of the vehicle and the estimated auction value is depreciated in *Cost of sales* over the term of the lease.

*Tesla, Inc. Form 10-Q—Quarter Ended March 31, 2018*

We offer resale value guarantees or similar buy-back terms to certain customers who purchase vehicles and who finance their vehicles through one of our specified commercial banking partners. We also offer resale value guarantees in connection with automobile sales to certain leasing partners. Currently, both programs are available only in certain international markets. Under these programs, we receive full payment for the vehicle sales price at the time of delivery and our counterparty has the option of selling their vehicle back to us during the guarantee period, which currently is generally at the end of the term of the applicable loan or financing program, for a pre-determined resale value.

With the exception of two programs which are discussed within the *Automotive Leasing* section, we now recognize revenue when control transfers upon delivery to customers in accordance with the new revenue standard as a sale with a right of return as we do not believe the customer has a significant economic incentive to exercise the resale value guarantee provided to them. The process to determine whether there is a significant economic incentive includes a comparison of a vehicle's estimated market value at the time the option is exercisable with the guaranteed resale value to determine the customer's economic incentive to exercise. The performance obligations and the pattern of recognizing automotive sales with resale value guarantees are consistent with automotive sales without resale value guarantees with the exception of our estimate for sales return reserve. Sales return reserves for automotive sales with resale value guarantees are estimated based on historical experience plus consideration for expected future market values.

**ILLUSTRATION 8-5: REPURCHASE ARRANGEMENTS**



**CUSTOMER OPTIONS FOR ADDITIONAL GOODS AND SERVICES**

It is not uncommon for a contract with a customer to entitle the customer to purchase additional goods or services at a discount or to obtain "free" goods or services after a stated amount of purchases. A few examples of this are (ASC 606-10-55-41; IFRS 15, par. B39):

- Contract renewal options.
- Frequent flyer miles or similar loyalty points.
- Coupons for future purchases.

- A life sciences company gives a pharmaceutical company the right to manufacture and sell a drug that the life sciences company developed.
- The inventor of a new technology licenses it to a manufacturer to use in a new product.
- The owner of a trademarked character licenses that character's image to a consumer products company for use on clothing, toys, or other products.
- A sports team licenses its logo to a clothing manufacturer.
- A music production company licenses songs from its library for personal use, or use in movies, television commercials, or other material.

Licenses for these and other types of intellectual property can be limited based on time, geography, industry, use, frequency, and other factors. Fees for intellectual property licenses can have the same types of contingencies found in other contracts, including variability based on sales, usage, market prices, or other factors.

Topic 606/IFRS 15 generally requires that the same principles be applied in accounting for revenue from a license of intellectual property as from any other promised good or service. For example, when a license of intellectual property is included in a contract with other promised goods or services, the entity must consider whether the license is distinct just as it would with any other promised good or service.

However, the FASB and IASB decided that specific guidance was necessary to deal with certain aspects of intellectual property licenses, generally in response to feedback from financial statement preparers and users that questioned how the principles in Topic 606/IFRS 15 should be applied to those transactions. Specific guidance exists for:

- Determining whether a license represents a single promise or multiple promises.
- Determining whether a license is considered to be transferred to the customer at a point in time or over time.
- For licenses transferred at a point in time, identifying the point in time at which a license is considered to be transferred to a customer.
- For licenses transferred over time, identifying the beginning of the period of transfer.
- How to recognize revenue from sales or usage based royalties on intellectual property licenses.

This chapter discusses the specific guidance related to intellectual property licenses and addresses unique issues that arise in applying the general principles of Topic 606/IFRS 15 to intellectual property licenses. The discussion is organized by the steps of the model discussed in Chapters 3-7 of this book. Licenses of intellectual property do not pose any particular issues in applying Step 1 (Identify the Contract with a Customer) or Step 4 (Allocate the Transaction Price to the Performance Obligations in the Contract), and those steps are, therefore, not discussed below. The application of the other steps in the model that include intellectual property licenses is discussed below.

## IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

The analysis of Step 2 of the model begins with the seller identifying all of the promises it has made to transfer goods or services to the customer. As discussed in Chapter 4, "Identifying the Performance Obligations in the Contract," licenses to intellectual property are one of the examples of promised goods or services (ASC 606-10-25-18(i); IFRS 15, par. 26(i)). The nature of intellectual property licenses raises certain issues that are generally not raised by promises to transfer other goods or services, such as the following:

- A license can include restrictions based on time, geography, use, or other factors that are not a feature of the underlying intellectual property.
- A license to intellectual property can be granted mainly to allow the customer to use a good that incorporates that intellectual property or to access the benefits of a service.
- The same piece of intellectual property can be licensed to many customers at the same time, and the licensor can continue to use the licensed intellectual property.
- Some of the value in intellectual property arises from its exclusivity. That is, the customer is often interested in licensing intellectual property in part because the license will allow the customer to do something that those that have not licensed the same intellectual property are not permitted to do.
- Licensed intellectual property is often improved upon, and the customer may have the rights to those improvements.

### Identifying a License

Generally, it is not difficult to determine whether a license to intellectual property is included in an arrangement. However, sometimes a company uses its intellectual property to provide a service to a customer, but the customer does not have the right or ability to use the intellectual property on its own. In these situations, it may be difficult to determine whether the contract substantively includes a license to intellectual property.

In many cases, the timing of recognition of revenue will not be affected by the conclusion as to whether a license exists, because the license and service would not be considered distinct performance obligations in any event, and thus would be evaluated together for revenue recognition. However, this is not always the case. Therefore, as the guidance on intellectual property includes certain exceptions from the general guidance in Topic 606/IFRS 15 (e.g., the treatment of sales-based royalties and the prohibition on revenue recognition before the beginning of the license term, as discussed below), it may be important to determine whether a contract includes a license.

U.S. GAAP includes guidance useful in determining whether arrangements to provide cloud-based services (also referred to as "software-as-a-service" or "SaaS" arrangements) include a software license. While this guidance was written with regard to identifying software licenses, it is likely that a similar analysis

would be appropriate in considering whether a contract also includes a different type of license.<sup>1</sup>

In a SaaS arrangement, customers generally do not take possession of software. Rather, the software application or data resides on the vendor's or a third party's hardware and the customer accesses and uses the software on an as-needed basis through the cloud. Because the customer in a SaaS arrangement does not install the software on its own computer system, it may not be clear whether the customer has purchased a software license or merely the right to a service.

The guidance specifies that software that is hosted by a vendor is only considered to be licensed to the customer if all of the following are true (ASC 985-20-15-5 and 15-6, *Software/Costs of Software to be Sold, Leased or Marketed/Scope and Scope Exceptions*):

1. The customer has the contractual right to take possession of the software at any time during the hosting period.
2. The customer will not incur a significant penalty (in terms of cost and value in use) if it exercises its right to take possession of the software.
3. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

A SaaS arrangement meeting the above criteria should be considered to include a software license, as well as a promise to provide hosting for the customer's software.

A SaaS arrangement that does not meet all three of the above criteria should be accounted for as a contract to provide a service, and should not be considered to include a license of software, even if the contract includes language granting a license.

#### EXAMPLE: HOSTING ARRANGEMENTS

*Microsoft Form 10-Q—Quarter Ended September 30, 2017*

Licenses for on-premises software provide the customer with a right to use the software as it exists when made available to the customer. Customers may purchase perpetual licenses or subscribe to licenses, which provide customers with the same functionality and differ mainly in the duration over which the customer benefits from the software. Revenue from distinct on-premises licenses is recognized upfront at the point in time when the software is made available to the customer. In cases where we allocate revenue to software updates, primarily because the updates are provided at no additional charge, revenue is recognized as the updates are provided, which is generally ratably over the estimated life of the related device or license.

Certain volume licensing programs, including Enterprise Agreements, include on-premises licenses combined with Software Assurance ("SA"). SA conveys

<sup>1</sup> There is no similar guidance under IFRS. While the principles underlying the guidance in U.S. GAAP are also likely to be acceptable under IFRS,

this would likely not be the only acceptable method of making a similar judgment under IFRS.

rights to new software and upgrades released over the contract period and provides support, tools, and training to help customers deploy and use products more efficiently. On-premises licenses are considered distinct performance obligations when sold with SA. Revenue allocated to SA is generally recognized ratably over the contract period as customers simultaneously consume and receive benefits, given that SA comprises distinct performance obligations that are satisfied over time.

Cloud services, which allow customers to use hosted software over the contract period without taking possession of the software, are provided on either a subscription or consumption basis. Revenue related to cloud services provided on a subscription basis is recognized ratably over the contract period. Revenue related to cloud services provided on a consumption basis, such as the amount of storage used in a period, is recognized based on the customer utilization of such resources. When cloud services require a significant level of integration and interdependency with software and the individual components are not considered distinct, all revenue is recognized over the period in which the cloud services are provided.

#### Evaluating License Restrictions

It became apparent during implementation of Topic 606/IFRS 15 that there was confusion over how to determine whether a license should be evaluated as a single promise or multiple promises. This confusion largely stems from the fact that licenses often include restrictions based on time, geography, use, or other factors that are not a feature of the underlying intellectual property. Instead, these restrictions are a function of the license itself.

Some believed that because it is the license that is being transferred to the customer, and not the underlying intellectual property, a license would always be considered a single promise, with whatever restrictions were included as a feature of the promised item. However, that position was ultimately deemed to be inappropriate, as it could allow for promises that were functionally separate to be treated as one because they were included in a single license.

Instead, a licensor must consider whether attributes of its licenses (1) explicitly or implicitly cover the transfer of multiple distinct rights, each of which should be treated as a separate promised item in the contract, or (2) simply define the attributes of a single promised item (ASC 606-10-55-64; IFRS 15, par. B62).<sup>2</sup> There are examples in the standard that provide insight as to how to make this distinction, but the evaluation is largely left to judgment.

In making this evaluation, it is useful to consider that, unless the rights begin or end at different points in time, it is likely that the determination of

<sup>2</sup> In ASU 2016-10, "Identifying Performance Obligations and Licensing," the FASB provided additional application guidance related to licensing transactions. While the IASB incorporated similar clarifications in to IFRS 15 in April 2016, it did not provide as much guidance as did the FASB. Therefore, IFRS practitioners may wish to look at U.S. GAAP for additional discussion of some matters.

Those matters are highlighted in this chapter through footnotes. In most cases, despite the guidance not being exactly the same, it is expected that similar answers will be reached under U.S. GAAP and IFRS. When that is not the case, the footnote highlighting the difference in wording alerts readers to the potential different outcomes.

whether there is one promised item or multiple promised items will make little difference, as the timing and pattern of revenue recognition for the individual promises would likely be the same if the rights begin and end at the same time (ASU 2016-10, par. BC47).

In most cases, contractual restrictions on the use of licensed intellectual property are terms that define the scope of the promised item, rather than an indication that the contract includes multiple promised licenses. This will generally be the case when the restrictions do not change throughout the term of the license. For example, it is clear that the following types of restrictions merely establish the scope of the license:

- *License start and end dates.* The fact that a license expires after a period of time defines the boundary of the license, even if that expiration date is before the end of the intellectual property's useful life.
- *Restrictions on geography or field of use.* The fact that a license is limited to certain jurisdictions or to a particular industry or product category, for example, does not suggest that the license includes more than one promise. Again, such restrictions define what is being licensed.

When the restrictions vary throughout the term of the license, there is a greater likelihood that they establish the parameters of multiple promised items, rather than defining the aspects of the single promise. The following are examples of situations in which the attributes of the license likely indicate that the license incorporates multiple promises that should be accounted for separately.

*Scope of rights expands or contracts.* Some licenses allow the licensed intellectual property to be used in certain ways or in certain jurisdictions for one period of time and in other ways or jurisdictions for a different period of time. In this case, it is likely that the two sets of rights should be treated as separate promises in the contract with the customer. Each set of rights is likely capable of being distinct and, due to the fact that they exist for different times, are also distinct in the context of the contract. For example:

- A license to use patented technology allows the licensor to sell products incorporating the patented technology for five years in one class of product, and 10 years for a second class.
- A license to exhibit a film allows exhibition in the United States from a certain date, and China beginning at a later date.
- A license to use a sports team's logo allows the sale of clothing including the logo to begin immediately, with toys and sporting equipment to be added at a later date.

In each case, the scope of the license changes at a later date. If the scope expands, this indicates that the licensor does not transfer control of all of the rights covered by the contract at the beginning of the license term. Instead, the expansion of rights at a later date indicates that the vendor transfers those additional rights only at that later date. If the scope contracts at a later date, the licensor may transfer control of all rights at the beginning of the license term, but the fact that some rights will expire earlier indicates that they are both capable of being distinct and distinct in the context of the contract.

*Scope of licensed property expands.* In some cases, a license may provide the customer with the rights to use certain underlying intellectual property initially, with other intellectual property added at a later date. Again, the rights to use each set of underlying intellectual property would likely be distinct. For example:

- A license to stream a television show to viewers includes the right to immediately show all episodes that aired on network television more than six months prior to the license being signed, with rights to stream additional episodes added six months after those episodes air on the network.
- A license to use a company's patents in a particular area covers both existing patents and patents that may be developed in the future.

*Fee arrangements differ.* If a license of intellectual property includes fee arrangements that apply differently to different uses, jurisdictions, or pieces of underlying intellectual property, it is possible that the rights to the different uses, jurisdictions, or underlying intellectual property are separate promises. However, some such arrangements appear to simply acknowledge different outcomes from the way in which licensed property may be used, and do not indicate multiple promised items. For example:

- A license to incorporate software code into product offerings requires the licensor pay the licensee a fixed percentage royalty on sales of software licenses incorporating the licensed code, and a fixed annual payment per user for cloud service arrangements utilizing the licensed code. In this case, it appears that the different payment arrangements simply account for the fact that the customer may sell goods and services incorporating the licensed code in multiple ways, and do not indicate that the license should be considered multiple distinct promises.
- A license to sell products incorporating a licensed character specifies significantly different royalty rates for different jurisdictions or different product types. While such provisions may suggest multiple licenses, they may instead simply acknowledge that the subject products differ in profitability across jurisdictions or product types, necessitating a different royalty calculation.

In other cases, multiple fee arrangements are likely indicative of multiple promised items, as demonstrated by the parties specifying different payments. For example:

- As in Illustration 6-7, a contract includes licenses to two pieces of intellectual property for the same time period, with the contract including a fixed fee plus a variable fee that relates to the use of only one of the two pieces of intellectual property.
- A contract to use music from a library provides for a fixed fee for use in certain media, and a variable fee for use in others. This may indicate that the licenses to use the music in different forms of media are separate promised items.

*Multiple Time Windows.* It is not uncommon for licenses to films, television shows, and other media to allow the licensor to exhibit the content in multiple

windows with breaks between them. For example, a license may provide that a television station can show a Christmas film only in December every year.

Evaluating whether provisions like this create multiple promises or are aspects of a single promise is highly judgmental. However, a substantive break would generally be evaluated as if the right to use the intellectual property has been revoked during the break, and therefore the next window of usage would likely be considered a promise to transfer additional rights, and therefore be a separate performance obligation (ASU 2016-10, par. BC45). Factors to consider include:

- The longer the break, the more likely it is that the break in license term indicates multiple promises. In part, this is because the longer the break, the more likely it is that the intellectual property would be at a different place in its useful life during the second window. For example, the right to show a movie on television shortly after its theatrical run would generally be evaluated differently than the right to show the same movie on television five years later.
- If the intellectual property can be licensed to another party during the breaks in the license being evaluated, it is more likely the license should be evaluated as separate promises. On the other hand, if the holiday movie in the example above cannot be exhibited by another party for the rest of the year, the fact that the television station in question can only show it in December is simply a restriction that defines the license, not an indication of multiple licenses.
- The reason for the break in the license term needs to be considered. Continuing with the previous point, if the purpose of the break in license rights is to allow the licensor to license the property to others in the interim, it is more likely that the license with a break should be evaluated as multiple promised items. If the purpose of the break is to avoid oversaturation or allow a competitive product from the licensor to be in the spotlight, the break may not indicate the presence of multiple promised items.

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**DISCLOSURE ALERT:** Entities are required to disclose information about performance obligations including the nature of the goods or services the entity promises to transfer (ASC 606-10-50-12; IFRS 15, par. 119). This would include information about situations in which licenses are deemed to include multiple promised items.

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**GAAP EXAMPLES:** Example 59 (ASC 606-10-55-389; IFRS 15, par. IE303) exhibits a license with multiple restrictions that are all attributes of the license, rather than indications of multiple promises.

Examples 61A and 61B (ASC 606-10-55-399A) illustrate the analysis of whether a license should be considered one promised item or multiple promised items.<sup>3</sup>

### Maintenance and When-and-If-Available Updates

In many cases, intellectual property continues to be improved after a license is signed. For example, software companies often continue to develop new features or improve the efficiency of their software, and drugs are tested and approved for new uses and in new jurisdictions. In many cases, licenses give the customer the right to use improved intellectual property if improvements are made, but the vendor is not required to make any such improvements.

These types of provisions are often referred to as “when-and-if available” rights, as the customer gets the upgrades “when and if” they become available. Such rights are specifically identified as a promised good or service in a contract with a customer (ASC 606-10-25-18(e); IFRS 15, par. 26(e)).

Intellectual property licenses are sometimes accompanied by maintenance agreements that provide the customer with technical support on the licensed property, and perhaps access to on-line training materials and other information to assist in the use of the property. Maintenance provisions are very common in conjunction with software licenses. Maintenance or technical support is an additional promised good or service when it is included in a contract with a customer.

Both when-and-if-available upgrades and maintenance will generally be considered distinct from the license, as the underlying property generally can be used without the maintenance services or the potential updates. Therefore, revenue would generally be allocated between the license and such provisions, under the guidance in Step 4 of the model (see Chapter 6, “Allocating the Transaction Price to the Performance Obligations in the Contract”). These provisions are often evaluated as stand-ready obligations, as discussed in Chapter 4, “Identifying the Performance Obligations in the Contract,” and Chapter 7, “Recognizing Revenue When (or as) the Entity Satisfies a Performance Obligation.”

In some circumstances, maintenance or upgrades are necessary to fully utilize the licensed property. This may be the case if the maintenance contract or updates include information needed to keep licensed software up-to-date for recent events. In these situations, the ongoing items likely would not be distinct from the license, and revenue recognition would be evaluated for the combined license/maintenance/update bundle. When this occurs, it is likely that revenue from the initial license would be recognized over the maintenance period.

If such an arrangement includes a right for the customer to renew maintenance, it is likely the arrangement would be deemed to include a material right, as discussed below. For example, assume a license of software that could not be used effectively without ongoing maintenance, and that the vendor charges a fee

<sup>3</sup> These examples are not included in IFRS 15. However, the principles underlying the consideration of whether a license includes one or multiple

promises are the same, and therefore, these examples should be relevant under IFRS.

of \$10,000 for a perpetual license and one year of updates, with additional years of updates available at \$1,000 per year. In this case, the contract would initially be evaluated as a contract for one year of service for \$10,000, as the perpetual license would not be useful beyond the year without updates. Since additional years of service are effectively offered at a 90% discount to the first year, the renewal option would be evaluated to include a material right, as discussed below and in Chapter 8, "Continuing Involvement."

**GAAP EXAMPLES:** Example 10, Case C (ASC 606-10-55-140D), illustrates a software license that is dependent upon ongoing updates to be useful, causing the license and updates to be bundled as a single performance obligation.<sup>4</sup>

Example 11, Case A (ASC 606-10-55-141; IFRS 15, par. IE49), illustrates a situation in which software, updates, and technical support are distinct performance obligations.

### Renewal Options

Licenses often include renewal options that allow the customer to extend the license for payment of an additional stated fee. Maintenance agreements often are also extendable. Such renewal options must be considered to determine whether they represent material rights, as discussed in Chapter 8, "Continuing Involvement." In summary, if the renewal option provides for renewal at a price that is less than the price a non-customer would pay for the license or service covered by the option, the option is considered to provide a material right. One common situation in which renewal options could result in a material right is discussed immediately above.

As discussed in Chapter 8, "Continuing Involvement," if a renewal option provides a material right, some of the transaction price must be allocated to the renewal option, either based on the amount of the discount being offered, or based on estimates of how long the license or service will be provided, taking into account the expected outcome of the renewal option or options.

If a renewal option does not provide the customer with a material right, it is ignored in accounting for the license or maintenance agreement.

### Patent Guarantees

As noted above, part of the value in a license is the fact that those that have not obtained a similar license should be unable to access the intellectual property. Of course, that assumption of (semi-) exclusive use of the intellectual property would be invalid if the licensor does not own the intellectual property. For that reason, licenses often include a guarantee from the licensor that it owns a patent (or similar rights) to the licensed intellectual property, and that it will defend its rights against any parties that violate them.

<sup>4</sup> While this example is not included in IFRS 15, IFRS. A similar example, Example 55, is included in the accounting illustrated should be the same under IFRS 15.

Such guarantees are not considered promised goods or services, as they do not involve transferring additional products or services to the customer. Instead, they are provisions that provide additional assurance to the customer that the license that is transferred meets the specifications expected (ASC 606-10-55-64A; IFRS 15, par. B62).

### Identifying Performance Obligations

As with any other contract with a customer, the promises in a contract that includes a license must be evaluated to determine whether each promised good or service is distinct. If they are not distinct, the promises must be bundled until the bundle is distinct (ASC 606-10-55-55 and 56; IFRS 15, par. B53 and B54).

Licenses to intellectual property may not be distinct when they are included in contracts with other promised goods or services. In general, if the license is provided largely to ensure that the customer can use a good or service that is included in the same contract, the license is not distinct. For example:

- A license may be granted to the purchaser of a product that allows the customer to use technology embedded in the product only while using the product.
- A license to use certain software may be granted to a customer that subscribes to a database or online tool. If the only purpose of the software (e.g., a smartphone app) is to allow the customer to access the database or tool, the software license is not distinct.

In other situations, the evaluation of whether a license is distinct from other goods and services in a contract is largely similar to how the evaluation would be performed in any other contract. This evaluation is discussed in detail in Chapter 4, "Identifying the Performance Obligations in the Contract."

One issue that may arise in this evaluation is whether a license can convey to the customer all of the know-how and expertise that will be needed to benefit from the licensed intellectual property. For example, the developer of a piece of intellectual property such as a pharmaceutical product may be the only entity that can realistically manufacture the product. In this situation, a license of the right to sell the product may not be distinct from a promise to manufacture the product, as the customer could not reasonably use the license without the manufactured product. Similar situations could also exist in other types of licenses and must be carefully considered.

**GAAP EXAMPLES:** Example 10, Case C (ASC 606-10-55-140D), illustrates a software license that is dependent on updates to be useful, causing the license and updates to be bundled as a single performance obligation.<sup>5</sup>

Example 55 (ASC 606-10-55-364; IFRS 15, par. IE278) illustrates a situation in which a license and updates to the licensed property are not distinct.

<sup>5</sup> While this example is not included in IFRS 15, IFRS. A similar example, Example 55, is included in the accounting illustrated should be the same under IFRS 15.



Example 56 (ASC 606-10-55-367; IFRS 15, par. IE281) exhibits factors that would be relevant in determining whether a license to a product is distinct from a promise to manufacture that product.

#### EXAMPLE: EVALUATING WHETHER A LICENSE IS DISTINCT

*Editas Medicine, Inc. Form 10-Q—Quarter Ended March 31, 2018*

The promised good or services in the Company's arrangements typically consist of a license, or option to license, rights to the Company's intellectual property or research and development services. The Company provides options to additional items in such arrangements, which are accounted for as separate contracts when the customer elects to exercise such options, unless the option provides a material right to the customer. Performance obligations are promised goods or services in a contract to transfer a distinct good or service to the customer and are considered distinct when (i) the customer can benefit from the good or service on its own or together with other readily available resources and (ii) the promised good or service is separately identifiable from other promises in the contract. In assessing whether promised good or services are distinct, the Company considers factors such as the stage of development of the underlying intellectual property, the capabilities of the customer to develop the intellectual property on its own or whether the required expertise is readily available and whether the goods or services are integral or dependent to other goods or services in the contract.

#### *Juno Therapeutics Collaboration Agreement*

The Company has identified the following performance obligations: (i) Research License and the related research and development services during the Initial Research Program Term (the "Research License and Related Services"), (ii) three material rights related to the first Development and Commercialization Licenses related to each of the three research areas (each, a "First Development and Commercialization License Material Right"), (iii) six material rights related to the option to purchase up to three additional Development and Commercialization Licenses for two of the research areas (each, an "Additional License Material Right"), and (iv) JRC services during the Initial Research Program Term (the "JRC Services").

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The Company has concluded that the Research License is not distinct from the research and development services during the Initial Research Program Term as Juno Therapeutics cannot obtain the benefit of the Research License without the Company performing the research and development services. The services incorporate proprietary technology and unique skills and specialized expertise, particularly as it relates to genome editing technology that is not available in the marketplace. As a result, the Research License has been combined with the research and development services into a combined performance obligation. The Company has concluded that the First Development and Commercialization License Material Rights for each respective research area and the Additional License Material Right with the two research areas to which it relates are a separate performance obligation under Topic 606 as Juno Therapeutics is provided incremental licenses for additional consideration that represents a significant discount from amounts that would otherwise be offered outside the

context of the contract. These material rights, of which there are nine in total, are distinct from the other performance obligations in the arrangement as they are options in the contract that are not required for Juno Therapeutics to obtain the benefit of the other promised goods or services in the arrangement. Similarly, the Company has concluded the JRC Services performance obligation is distinct from the other obligations in the arrangement as the other performance obligations are not dependent upon the JRC Services.

#### *Allergan Pharmaceuticals Strategic Alliance and Option Agreement*

In March 2017, the Company entered into a Strategic Alliance and Option Agreement with Allergan to discover, develop, and commercialize new gene editing medicines for a range of ocular disorders (the "Allergan Agreement"). Over a seven-year research term, Allergan will have an exclusive option to exclusively license from the Company up to five collaboration development programs for the treatment of ocular disorders (each a "CDP"), including the Company's Leber Congenital Amaurosis type 10 program (the "LCA10 Program").

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Under the Allergan Agreement, the Company has identified a single performance obligation that includes (i) the research and development services during the Research Term (the "Allergan R&D Services"), and (ii) Steering Committee services during the Research Term (the "ASC Services"). The Company has concluded that the Allergan R&D Services is not distinct from the ASC Services during the Research Term. The Steering Committee provides oversight and management of the overall Allergan Agreement, and the members of the Steering Committee from the Company have specialized industry knowledge, particularly as it relates to genome editing technology. The Steering Committee is meant to facilitate the early stage research being performed and coordinate the activities of both the Company and Allergan. Further, the Steering Committee services are critical to the selection of a CDP, the ongoing evaluation of a CDP and the development and evaluation of the Option Package Criteria. Accordingly, the Company's participation on the Steering Committee is essential to Allergan receiving value from the Allergan R&D Services and as such, the ASC Services along with the Allergan R&D Services are considered one performance obligation (the "CDP Services").

## DETERMINE THE TRANSACTION PRICE

### Variable Fees

Step 3 of the model in Topic 606/IFRS 15 is to determine the transaction price. As discussed in Chapter 5, "Determining the Transaction Price," when a contract includes variable consideration, the vendor generally must estimate the outcome of the variable consideration arrangement, and include that estimate in the transaction price to the extent it is probable that doing so would not result in a significant revenue reversal.

While this guidance generally applies to license revenue just as it does to all other revenues from contracts with customers, there is an exception that applies to sales- and usage-based royalties on licenses of intellectual property. That

exception requires that revenue from these kinds of royalties be recognized at the later of when the related sales or usage occurs and when (or as) the performance obligation to which the royalty applies is satisfied (ASC 606-10-32-13 and 606-10-55-65; IFRS 15, pars. 58 and B63). That is, even if the licensor can estimate that some amount of sales-based or usage-based royalties will become due and control of the license has been transferred to the customer, the royalty revenue cannot be recognized until the related sales or use occurs.

**PRACTICE POINTER:** The requirements for sales-based and usage-based royalties were added as a result of feedback from users and preparers who stated that continual updating of estimates on the outcome of such provisions would be difficult and would not provide useful information (ASU 2014-09/IFRS 15, par. BC415).

While that explanation suggests that similar accounting could be appropriate for sales-based or usage-based payments on sales (rather than licenses) of intellectual property, or on sales of tangible goods, the Boards decided not to expand the treatment to those transactions.

As such, this exception should be applied only to the specific transactions, and should not be applied by analogy to any other transaction or provision (ASU 2014-09/IFRS 15, par. BC421).

In some contracts, a sales-based or usage-based fee could relate to both a license of intellectual property and another good or service. For example:

- A life sciences company may license a drug and agree to continue to assist in developing the drug, in exchange for a fixed fee plus a sales-based royalty on the drug, once it is commercialized.
- A franchise agreement requires the franchisee to pay fees based on its sales, and includes the right to use intellectual property, along with training, consulting, and equipment rental.
- A sale of a tangible product that includes a license to intellectual property embedded in it could include payments based, in part, on the usage of the tangible property by the customer.
- A software provider could agree to provide a license to software as well as professional services intended to make the software work better in the customer's environment, in exchange for a fee based, in part, on the number of transactions processed using the software.

When a contract with a sales-based or usage-based royalty includes an intellectual property license and one or more other goods or services, the royalty should not be bifurcated between the two promised goods or services (even if they are distinct performance obligations), with the intellectual property guidance being applied to a portion of the royalty, and the general guidance applied to the other portion. The FASB and IASB decided that doing so would be contrary to the basis for including the exception in the first place.

Instead, the Boards decided that the exception should apply to 100% of a sales-based or usage-based royalty that relates predominantly to a license of

intellectual property, and should not apply if an intellectual property license is less than the predominant item to which the royalty relates. An intellectual property license is predominant if the customer would ascribe significantly more value to the license than to the other items to which the royalty relates (ASC 606-10-55-65A and 55-65B; IFRS 15, pars. B63A and B63B).

**GAAP EXAMPLES:** Example 35 (ASC 606-10-55-270; IFRS 15, par. IE178) illustrates a licensing transaction with a sales-based fee.

Example 57 (ASC 606-10-55-375; IFRS 15, par. IE291) illustrates a franchise agreement that includes a sales-based royalty.

Example 60 (ASC 606-10-55-393; IFRS 15, par. IE307) illustrates the assessment of whether a license is the predominant item in a contract with a sales-based royalty.

Example 61 (ASC 606-10-55-395; IFRS 15, par. IE309) illustrates a license of a logo that includes a sales-based royalty.

## Financing Components

As discussed in Chapter 5, "Determining the Transaction Price," Topic 606/IFRS 15 requires the seller to consider whether there is a significant financing component embedded in the contract with the customer. A contract implicitly includes a financing element anytime payment is due at a different point in time from when goods or services are transferred to the customer. A financing component in a contract with a customer is implicitly a loan from the vendor to the customer, or vice-versa. Topic 606/IFRS 15 requires that the transaction price be adjusted to reflect the time value of money if that value is significant to the contract (ASC 606-10-32-15; IFRS 15, par. 60).

If there is a significant time period between the transfer of goods or services and the transfer of payment, the vendor should consider other available information to determine whether there is a significant financing component. Of course, all other things being equal, the longer the time period between payment and transfer of goods or services, the more likely it is that there is a significant financing component.

While factors relating to the timing and amount of payment are important to identifying a potentially significant financing component, Topic 606/IFRS 15 also acknowledges that sometimes the difference between the timing of payment and the timing of transfer of goods and services serves a different purpose. If so, the difference in timing does not give rise to a significant financing component that must be accounted for separately.

In addition, to ease the accounting implications of financing components, Topic 606/IFRS 15 includes a practical expedient that allows the vendor to treat as insignificant any financing component if the expected timing difference between payment and transfer of goods and services is one year or less (ASC 606-10-32-18; IFRS 15, par. 63). The decision as to whether to take advantage of

this practical expedient is an accounting policy decision that should be applied consistently to similar situations.

In certain situations, the one year practical expedient may apply to only a portion of the payments. For example, if payments are made quarterly over the three-year term of a license to functional intellectual property that is considered to be transferred at the beginning of the license term, discounting is not necessary related to the first year of payments if the practical expedient is used. The payments to be received in years 2 and 3 would, however, need to be discounted, with interest income being recognized between the beginning of the license and the payment date.

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**PRACTICE POINTER:** The expedient allows an entity to ignore a financing component if the length of the financing is one year or less. It does not, however, allow an entity to ignore the first year of financing in a component that is longer than that. For example, an entity that sells goods with payment due two years after delivery would need to account for interest in both years; the one-year exemption would not permit ignoring interest for the first year of the extended payment terms.

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**DISCLOSURE ALERT:** If an entity takes advantage of the practical expedient discussed above, that fact must be disclosed (ASC 606-10-50-22; IFRS 15, par. 129). See further discussion in Chapter 14, "Disclosure."

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The accounting for a significant financing component is further discussed in full in Chapter 5, "Determining the Transaction Price." The way the guidance would apply to several payment provisions common in intellectual property licenses is discussed below.

### *Royalties*

Topic 606/IFRS 15 states that a significant financing component does not exist if a portion of the transaction price is variable based on future events that are not in the customer's control, and the timing of payment is delayed only to allow those events to occur (or not occur) such that the amount of the payment can be calculated. This provision generally applies to sales-based or usage-based royalties. As noted previously, such amounts would not be recognized as revenue in a license of intellectual property until the sales occur, and payment is generally made at that point as well. That may be significantly later than the point at which the license is transferred to the customer, particularly if the license is considered to be a right to use that is transferred at the beginning of the license term, while royalty payments are made throughout the term. In this circumstance, the delay in payment is to allow the uncertainty to be resolved, rather than being related to a financing element (ASC 606-10-32-17; IFRS 15, par. 62).

### *Payment over License Term on a License of Functional Intellectual Property*

As discussed below, revenue from licenses of functional intellectual property (e.g., software, films, music, processes, databases) is often recognized at the beginning of the license term. However, payments in such arrangements are sometimes made over the license term. This means that a portion of the contract consideration will be paid significantly after revenue recognition. In this situation, unless the payments are delayed to allow for the outcome of an uncertainty (see above), it is likely that a financing component exists, representing a loan from the vendor to the customer.

### *Payment at Inception on a License of Symbolic Intellectual Property*

As discussed below, revenue from licenses of symbolic intellectual property (e.g., logos, trademarks, brand names) is generally recognized over the license period. However, if payment for such a license is made at inception or at the beginning of the license term, the payment will occur before the license is considered to be transferred to the customer. In that case, a financing component likely exists, representing a loan from the customer to the vendor, due to the prepayment.

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**GAAP EXAMPLES:** Example 59 (ASC 606-10-55-389; IFRS 15, par. IE303) illustrates a situation in which a financing component exists because payment for functional intellectual property occurs over the license term.

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**DISCLOSURE ALERT:** Entities are required to disclose information about significant payment terms in their contracts with customers, including whether the contracts include a significant financing component (ASC 606-10-50-12 and 50-20; IFRS 15, pars. 119 and 126). See further discussion in Chapter 14, "Disclosure."

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### ILLUSTRATION 13-1: FINANCING COMPONENTS

#### **Payment Is Delayed**

**Facts:** A software company licenses its software to a customer for three years. Payments of \$12,100 are due at the beginning of the license term and shortly after each of the next two anniversaries of the beginning of the license term. The software is considered functional intellectual property and the revenue from the license is therefore recognized at the start of the license term (see discussion below).

The software company cannot take advantage of the practical expedient that allows financing components to be ignored if the difference between the transfer of goods or service and payment is one year or less because the payments in years 2 and 3 are made over one year from the date the license is transferred to the customer. The software company concludes that the financing component is significant to the contract, and estimates that it would charge 10% interest to make a loan to this customer.

**Accounting:** To determine the transaction price, the software company discounts the payments back to the beginning of the license term, which is when the software is deemed to be transferred to the customer. The first payment is due on that date, so no discount applies. The second payment is due one year later, and that payment's present value, at a 10% discount rate, is \$11,000. The third payment is due in two years, so the discounted amount at a 10% rate is \$10,000. The transaction price is therefore  $\$12,100 + \$11,000 + \$10,000 = \$23,100$ .

At the beginning of the license term, the software company records:

Dr. Cash	12,100		
Dr. Receivable	21,000		
		Cr. Revenue	33,100

During the first year, the software company accrues interest on the receivable and then receives the second payment of \$12,100:

Dr. Receivable	\$2,100		
		Cr. Interest Income	2,100
Dr. Cash			12,100
		Cr. Receivable	12,100

During the next year, the software company again accrues interest on the receivable and receives the final payment:

Dr. Receivable	\$1,100		
		Cr. Interest Income	1,100
Dr. Cash			12,100
		Cr. Receivable	12,100

#### Payment in Advance

**Facts:** A movie studio agrees to license the image of one of its animated characters to a clothing manufacturer for a fixed fee of \$200,000. The customer pays in full upon signing of the license. Revenue on the symbolic intellectual property license will be recognized ratably over the term of the two-year license.

Revenue to be recognized during the first year of the contract will occur within one year of payment, so the practical expedient could apply to that revenue. However, the licensor determines that applying the practical expedient to a portion of the revenue in this case would be difficult and, therefore, elects not to apply the expedient.

The movie studio concludes that the financing component is significant to the contract, and estimates that it would charge 6% interest to make a loan to this customer.

**Accounting:** The movie studio recognizes the payment received upon the contract signing and a contract liability reflecting its obligation to transfer the license to the customer over the license term:

Dr. Cash	\$200,000		
		Cr. Contract Liability (Deferred Revenue)	200,000

During the first month, the movie studio recognizes interest expense on the loan at the appropriate interest rate:

Dr. Interest Expense	\$1,000		
		Cr. Contract Liability (Deferred Revenue)	1,000

To determine the appropriate amount of revenue to recognize each month, the movie studio determines the amount of monthly revenue recognition that will amortize the contract liability to zero, considering the accrual of interest at .5% each month. That figure is approximately \$8.864 per month:

Dr. Contract Liability (Deferred Revenue)	\$8.864		
		Cr. Revenue	8,864

Each month for the remainder of the license, the movie studio will recognize interest expense by applying the rate of .5% per month to the contract liability balance, and will recognize revenue of \$8,864, so that the contract liability balance will be zero at the end of the two-year license term. As a result, the movie studio will recognize revenue of approximately \$212,736 and interest expense of approximately \$12,736 over the license term.

### RECOGNIZE REVENUE WHEN (OR AS) THE ENTITY SATISFIES A PERFORMANCE OBLIGATION

As discussed in Chapter 7, "Recognizing Revenue When (or as) the Entity Satisfies a Performance Obligation," the determination of when to recognize revenue allocated to a performance obligation begins with consideration of certain factors that determine whether the performance obligation is deemed to be satisfied at a point in time or over time.

Due to the intangible nature of licenses to intellectual property, the criteria that are used to determine whether control of other goods and services transfers at a point in time or over time are often not useful in assessing when control of a license to intellectual property transfers. Instead, the FASB and IASB developed a special model for evaluating when a performance obligation that includes an intellectual property license is satisfied.

In virtually all cases involving products and services, a determination that a performance obligation is satisfied over time will result in recognizing revenue earlier than a determination that the performance obligation is satisfied at a point in time. This is because, when a performance obligation is satisfied at a point in time, that point in time generally occurs only after all of the work has been performed, because it is only then that control of the promised good or service can be transferred to the customer.

In a license of intellectual property, the result is reversed. When control of a license to intellectual property is deemed to occur at a point in time, that point in time is generally at the beginning of the license term (as long as the customer has access to the intellectual property at that point), because the customer has access at that point to the intellectual property, which exists in the form in which it is being licensed. In contrast, if a license to intellectual property is deemed to be