Chapter 1

General Accounting Considerations

Notice to Readers

This chapter provides an overview of FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*. Readers are encouraged to refer to FASB ASC 606 for the full text, implementation guidance, and illustrations. Refer to subsequent chapters of this guide for accounting guidance on industry-specific implementation issues across a variety of industries.

This chapter also presents an accounting implementation issue developed to assist management in applying FASB ASC 606 and related interpretations from the FASB/IASB Joint Transition Resource Group for Revenue Recognition (TRG) to third party extended service warranty contracts within the scope of FASB ASC 606.

The AICPA Insurance Entities Revenue Recognition Task Force identified and developed this accounting implementation issue, and the AICPA Revenue Recognition Working Group and AICPA Financial Reporting Executive Committee (FinREC) approved it. They are a source of nonauthoritative accounting guidance for nongovernmental entities.

Lastly, https://www.fasb.org has information on activities from the TRG, including summaries of issues discussed.

Introduction

1.01 In May 2014, FASB and IASB issued a joint accounting standard on revenue recognition to address a number of concerns surrounding the inconsistencies and complexities in accounting for revenue transactions. FASB issued the update in the form of FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and the IASB issued International Financial Reporting Standards (IFRS) 15, *Revenue from Contracts with Customers*. FASB ASU No. 2014-09 amended the FASB ASC by creating Topic 606, *Revenue from Contracts with Customers*, and amending Subtopic 340-40, *Other Assets and Deferred Costs—Contracts with Customers*. The guidance in this update supersedes revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, along with most of the revenue recognition guidance under the 900 series of industry-specific topics. IFRS 15 will replace International Accounting Standard (IAS) 11, *Construction Contracts,* and IAS 18, *Revenue*.

1.02 As part of the boards' efforts to converge U.S. generally accepted accounting principles (U.S. GAAP) and IFRS, FASB ASC 606 eliminates the transaction- and industry-specific revenue recognition guidance under current U.S. GAAP and replaces it with a principles-based approach for revenue recognition.

1.03 FASB ASC 606-10-15-2 explains that FASB ASC 606 should be applied by entities to all contracts with customers except for a specific list of exceptions. These exceptions include contracts that are within the scope of other standards (for example, insurance contracts or lease contracts), financial instruments, guarantees (other than product or service warranties), and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

Authoritative Status and Effective Date

1.04 The guidance in FASB ASC 606 was originally effective for annual reporting periods of public entities[1] beginning on or after December 15, 2016, including interim periods within that reporting period. Early application was not permitted for public entities. For all other entities, the guidance in the new standard was originally effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018.

1.05 To allow entities additional time to implement systems, gather data, and resolve implementation questions, FASB issued ASU No. 2015-14, *Revenue From Contracts with Customers: Deferral of the Effective Date*, in August 2015, to defer the effective date of FASB ASU No. 2014-09 for one year.

1.06 As a result of this deferral, public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in FASB ASU No. 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application would be permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

1.07 All other entities should apply the guidance in FASB ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Application would be permitted earlier only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in FASB ASU No. 2014-09.

1.08 The IASB issued an amendment to IFRS 15 deferring the effective date by one year to 2018. The publication of the amendment, *Effective Date of IFRS 15*, follows from the IASB's decision in July 2015 to defer the effective date from January 1, 2017, to January 1, 2018, having considered the feedback to its consultation. Companies applying IFRS continue to have the option to apply the standard early.

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[1] A *public entity* is an entity that is any one of the following:

1. A public business entity
2. A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
3. An employee benefit plan that files or furnishes financial statements to the SEC.

Transitioning to the New Standard

1.09 FASB ASC 606-10-65-1 allows entities two options when transitioning to the guidance under FASB ASC 606. FASB ASC 606-10-65-1d1 explains that the first option is full retrospective application of the new standard, which requires reflecting the cumulative effect of the change in all contracts on the opening retained earnings of the earliest period presented and adjusting the financial statements for each prior period presented to reflect the effect of applying the new accounting standard. Retrospective application would be applied to interim periods, as well as annual periods presented. As stated in FASB ASC 606-10-65-1f, an entity following the full retrospective approach may elect any of the following practical expedients, applied consistently to all contracts:

- For completed contracts, an entity does not need to restate contracts that begin and are completed within the same annual reporting period.
- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
- For all reporting periods presented before the date of initial application, an entity does not need to disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.
- For contracts that were modified before the beginning of the earliest reporting period, an entity does not need to retrospectively restate the contract for those contract modifications in accordance with paragraphs 12–13 of FASB ASC 606-10-25. Instead, an entity should reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when
  - — identifying the satisfied and unsatisfied performance obligations,
  - — determining the transaction price, and
  - — allocating the transaction price to the satisfied and unsatisfied performance obligations.

1.10 As an alternative, under FASB ASC 606-10-65-1d2, entities may apply the amendments to the new standard retrospectively with the cumulative effect of initially applying the amendments recognized at the date of initial application. Under this transition method, an entity should elect to apply this guidance retrospectively either to all contracts at the date of initial application or only to contracts that are not completed contracts at the date of initial application. An entity should disclose whether it has applied this guidance to all contracts at the date of initial application or only to contracts that are not completed at the date of initial application.

1.11 When using the cumulative effect method described in paragraph 1.10, the entity should provide additional disclosures of the following, in reporting periods that include the date of initial application:

- The amount by which each financial statement line item is affected in the current reporting period by the application of the new standard as compared to the guidance that was in effect before the change

- An explanation of the reasons for significant changes

1.12 Both application methods include recording the direct effects of the change in accounting principle. Indirect effects that would have been recognized if the newly adopted accounting principles had been followed in prior periods would not be included in the retrospective application. FASB ASC 250-10-45-8 defines direct effects of a change in accounting principle as "those recognized changes in assets or liabilities necessary to effect a change in accounting principle." An example of a direct effect described in this section of FASB ASC 250 is an adjustment to an inventory balance to effect a change in inventory valuation method. Indirect effects are defined within FASB ASC 250-10-20 as "any changes to current or future cash flows of an entity that result from making a change in accounting principle that is applied retrospectively." An example of an indirect change is a change in royalty payments based on a reported amount such as revenue or net income.

Post-Standard Activity

1.13 To assist with implementation of the new standard, FASB and the IASB announced the formation of the TRG in June 2014. The objective of this group is to keep the boards informed of potential implementation issues that may arise as entities implement the new guidance. Members of the TRG include financial statement preparers, auditors, and financial statement users representing various industries, geographies, and public and private companies. Any stakeholder may submit a potential implementation issue for discussion at TRG meetings, to be evaluated and prioritized for further discussion by each board.

1.14 The TRG held two meetings in 2014, four in 2015, and two in 2016. A submission tracker is available on the TRG website at https://www.fasb.org that includes a listing of all revenue recognition implementation issues submitted and the current status of these issues.

1.15 In addition to advising the boards to defer the effective date, the TRG informed the boards that technical corrections were needed to further articulate the guidance in the standard. FASB has issued the following accounting updates subsequent to FASB ASU No. 2014-09:

a. FASB ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*

b. FASB ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*

c. FASB ASU No. 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting*

d. FASB ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

e. FASB ASU No. 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers* *f.* FASB ASU No. 2017-13, *Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments*

g. FASB ASU No. 2018-18, *Collaborative Arrangements (Topic 808): Clarifying the Interaction Between Topic 808 and Topic 606*

1.16 In June 2018, FASB staff released two memos based on discussion with the Private Company Council. The memos contain considerations for implementation of FASB ASC 606 related to the (1) definition of an accounting contract and short cycle manufacturing (right to payment) and (2) reimbursement of out-of-pocket expenses. The memos can be found on the FASB TRG web page.[2]

1.17 In November 2018, FASB staff released a memo that provides educational examples of revenue recognition implementation for private company franchisors. The FASB staff paper primarily targets questions related to the use of judgment in identifying performance obligations. The memo can be found on the FASB web page.[3]

Overview of FASB ASU No. 2014-09, *Revenue from Contracts with Customers*

1.18 As stated in FASB ASC 606-10-05-3, the core principle of FASB ASC 606 is that an entity should recognize revenue to depict the transfer of 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.

1.19 To recognize revenue under the new framework, FASB ASC 606-10-05-4 states that an entity should follow these five steps:

a. Step 1—Identify the contract(s) with a customer.

b. Step 2—Identify the performance obligations in the contract.

c. Step 3—Determine the transaction price.

d. Step 4—Allocate the transaction price to the performance obligations in the contract.

e. Step 5—Recognize revenue when (or as) the entity satisfies a performance obligation.

Step 1: Identify the Contract With a Customer

1.20 FASB ASC 606-10-25-2 defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." FASB ASC 606-10-25-1 states an entity should account for a contract with a customer that is within the scope of FASB ASC 606 when all of the following criteria are met:

a. It has the approval and commitment of the parties.

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[2] Readers should refer to the FASB website: https://www.fasb.org/cs/ContentServer?c=Page&cid=1176164066683&d=&pagename=FASB%2FPage%2FSectionPage

[3] Readers should refer to the FASB website: https://www.fasb.org/cs/Satellite?c=Document_C&cid=1176171580176&pagename=FASB%2FDocument_C%2FDocumentPage

b. Rights of the parties are identified.

c. Payment terms are identified.

d. The contract has commercial substance.

e. Collectibility of substantially all of the consideration is probable.

1.21 Paragraphs 1–8 of FASB ASC 606-10-25 provide guidance on identifying the contract with a customer. Paragraphs 3A–3C of FASB ASC 606-10-55 provide guidance for assessing the collectibility of consideration as required in paragraph 1e of FASB ASC 606-10-25.

1.22 FASB ASC 606-10-25-9 provides guidance on when multiple contracts should be combined under FASB ASC 606. Paragraphs 10–13 of FASB ASC 606-10-25 provide guidance on accounting for contract modifications.

Step 2: Identify the Performance Obligations in the Contract

1.23 An entity should assess the goods or services promised in a contract with a customer at contract inception. Each promise to transfer one of the following to the customer is considered a performance obligation, in accordance with FASB ASC 606-10-25-14:

a. A good or service (or bundle of goods or services) that is distinct

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

1.24 Paragraphs 15–18B of FASB ASC 606-10-25 provide guidance on how to determine a series of distinct goods or services and explicit and implicit promises to customers, and how to account for immaterial promised goods or services, and shipping and handling activities.

1.25 FASB ASC 606-10-25-19 explains that a good or service that is promised to a customer is distinct if both of the following criteria are met:

a. **Capable of being distinct**. The customer can benefit from a good or service either on its own or together with other resources that are readily available to the customer.

b. **Distinct within the context of the contract**. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

1.26 Paragraphs 20–22 of FASB ASC 606-10-25 provide guidance on determining if a promised good or service is distinct, and combining promised goods or services until an entity identifies a bundle of goods or services that is distinct.

Step 3: Determine the Transaction Price

1.27 FASB ASC 606-10-32-2 explains that the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

1.28 FASB ASC 606-10-32-3 explains that when determining the transaction price, an entity should consider the effects of all of the following:

a. Variable consideration (paragraphs 606-10-32-5 through 32-10 and 606-10-32-14)

b. Constraining estimates of variable consideration (paragraphs 606-10-32-11 through 32-13)

c. The existence of a significant financing component (paragraphs 606-10-32-15 through 32-20)

d. Noncash considerations (paragraphs 606-10-32-21 through 32-24)

e. Consideration payable to the customer (paragraphs 606-10-32-25 through 32-27).

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

1.29 FASB ASC 606-10-32-28 explains that the objective when allocating the transaction price is for an entity to allocate the transaction price to each separate performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

1.30 FASB ASC 606-10-32-29 explains that an entity should generally allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis.

1.31 Paragraphs 31–35 of FASB ASC 606-10-32 provide guidance on allocation of the transaction price based on stand-alone selling prices. Paragraphs 36–38 of FASB ASC 606-10-32 provide guidance on allocation of a discount. Paragraphs 39–41 of FASB ASC 606-10-32 provide guidance on allocation of variable consideration. Paragraphs 42–45 of FASB ASC 606-10-32 provide guidance on changes in the transaction price.

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

1.32 The requirements of FASB ASC 606-10-25-23 state that an entity should recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

1.33 As stated in FASB ASC 606-10-25-25, control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

1.34 For each performance obligation identified in accordance with paragraphs 14–22 of FASB ASC 606-10-25, paragraph 24 states that an entity should determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 27–29 of FASB ASC 606-10-25) or at a point in time (in accordance with FASB ASC 606-10-25-30). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

1.35 Paragraphs 27–29 of FASB ASC 606-10-25 provide guidance for determining if an entity transfers control of a good or service over time. Paragraphs 31–37 of FASB ASC 606-10-25 provide guidance for measuring progress toward complete satisfaction of a performance obligation, methods for measuring progress and reasonable measures of progress. FASB ASC 606-10-25-30 provides indicators of the transfer of control for performance obligations satisfied at a point in time.

Costs to Obtain or Fulfill a Contract With a Customer

Incremental Costs of Obtaining a Contract

1.36 As stated in FASB ASC 340-40-25-1, "an entity should recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs." FASB ASC 340-40-25-2 explains that the incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission). FASB ASC 340-40-25-3 further explains that costs to obtain a contract that would have been incurred regardless of whether the contract was obtained should be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

1.37 FASB ASC 340-40-25-4 allows for a practical expedient, stating that an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

Costs of Fulfilling a Contract

1.38 FASB ASC 340-40-25-5 requires an entity to recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).

b. The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.

c. The costs are expected to be recovered.

1.39 FASB ASC 340-40-25-6 explains that for costs incurred in fulfilling a contract with a customer that are within the scope of another topic (for example, FASB ASC 330, *Inventory*; or FASB ASC 360, *Property, Plant, and Equipment*), an entity should account for those costs in accordance with guidance in those topics or subtopics.

1.40 Paragraphs 7–8 of FASB ASC 340-40-25 provide guidance on identifying whether costs relate directly to a contract or should be expensed when incurred. Paragraphs 1–6 of FASB ASC 340-40-35 provide guidance on amortization and impairment of assets recognized in accordance with paragraph 1 or 5 of FASB ASC 340-40-25.

Disclosures

1.41 There are significant disclosure requirements in FASB ASC 606. FASB ASC 606-10-50-1 explains that the objective of the disclosure requirements is to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, and to achieve that objective an entity should disclose qualitative and quantitative information about the following:

a. Contracts with customers — including revenue recognized, disaggregation of revenue, and information about contract balances and performance obligations (including the transaction price allocated to the remaining performance obligations)

b. Significant judgments and changes in judgments affecting the amount of revenue and assets recognized — determining the timing of satisfaction of performance obligations (over time or at a point in time), and determining the transaction price and amounts allocated to performance obligations.

1.42 Paragraphs 1–23 of FASB ASC 606-10-50 and paragraphs 1–6 of FASB ASC 340-40-50 provide guidance on required disclosures and practical expedients. Paragraphs 89–91 of FASB ASC 606-10-55 provide considerations for disclosure of disaggregated revenue.

Other Topics

Presentation of Contract With a Customer

1.43 Paragraphs 1–5 of FASB ASC 606-10-45 provide guidance for determining presentation of the contract with a customer in the statement of financial position as a contract asset, a receivable or a contract liability.

Sale With a Right of Return

1.44 Paragraphs 22–29 of FASB ASC 606-10-55 provide guidance for accounting for sales with a right of return.

Warranties

1.45 Paragraphs 30–35 of FASB ASC 606-10-55 provide guidance on accounting for warranties.

Principal Versus Agent

1.46 Paragraphs 36–40 of FASB ASC 606-10-55 provide considerations for determining whether an entity is a principal or an agent in a contract with customers.

Customer Options for Additional Goods or Service — Material Rights

1.47 Paragraphs 41–45 of FASB ASC 606-10-55 provide guidance for accounting for customer options to acquire additional goods or services and material rights to the customer.

Customer's Unexercised Rights

1.48 Paragraphs 46–49 of FASB ASC 606-10-55 provide guidance for accounting for customer's unexercised rights.

Nonrefundable Upfront Fees

1.49 Paragraphs 50–53 of FASB ASC 606-10-55 provide guidance for accounting for nonrefundable upfront fees.

Licensing

1.50 Paragraphs 54–60 and 62–65B of FASB ASC 606-10-55 provide guidance for accounting for licenses of intellectual property.

Repurchase Agreements

1.51 Paragraphs 66–78 of FASB ASC 606-10-55 provide guidance for accounting for repurchase agreements.

Consignment Arrangements

1.52 Paragraphs 79–80 of FASB ASC 606-10-55 provide guidance for determining whether an arrangement is a consignment arrangement and the related accounting.

Bill-and-Hold Arrangements

1.53 Paragraphs 81–84 of FASB ASC 606-10-55 provide guidance for accounting for bill-and-hold arrangements.

Customer Acceptance

1.54 Paragraphs 85–88 of FASB ASC 606-10-55 provide guidance for evaluating customer acceptance of an asset.

Third-Party Extended Service Warranty Contracts Within the Scope of FASB ASC 606

This accounting implementation issue is relevant to the application of FASB ASC 606 to third-party extended service warranty contracts that are written by noninsurance entities. This issue is included in chapter 1, "General Accounting Considerations," because it is applicable to multiple industries.

1.55 FASB ASC 606-10-15-2 states (in part) the following:

> An entity shall apply the guidance in this Topic to all contracts with customers, except the following:
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> ...
>
> b. Contracts within the scope of Topic 944, *Financial Services—Insurance*.
>
> ...
>
> d. Guarantees (other than product or service warranties) within the scope of Topic 460, *Guarantees*.

1.56 In accordance with FASB ASC 606-10-15-2, an insurance entity should continue to apply the guidance in FASB ASC 944 to warranty contracts that are within the scope of FASB ASC 944 because they are written by an insurance entity.

1.57 This section focuses on extended warranty contracts, not written by an insurance entity, that meet the criteria in FASB ASC 606-10-55-31.

1.58 The FASB master glossary defines an *extended warranty contract* as "an agreement to provide warranty protection in addition to the scope of coverage of the manufacturer's original warranty, if any, or to extend the period of coverage provided by the manufacturer's original warranty."

Superseded Guidance

1.59 The guidance in FASB ASC 605-20, which included a reference to similarities between the short-duration contracts model under FASB ASC 944, has been superseded by FASB ASC 606. Paragraphs 1 and 6 of FASB ASC 605-20-25 have not been superseded by FASB ASC 606 and provide guidance on loss provisions for separately priced warranty and contract maintenance contracts.

Promised Goods or Services

1.60 In accordance with FASB ASC 606-10-25-16, entities should identify all the promised goods and services in a contract. The focus of this section is on extended warranty contracts that provide services for unscheduled repairs or replacement of the item under the contract for an unknown quantity of services for a fixed fee. It does not cover situations in which other services, such as scheduled product maintenance, are also provided. This section does not cover extended warranty contracts that only provide for the indemnification of or reimbursement to the customer for unscheduled repairs or replacement of the item (that is, contracts in which the company is not obligated to perform a service or engage others to perform a service, but merely to reimburse the customer).

1.61 At its January 26, 2015, meeting, the TRG discussed stand-ready performance obligations. Paragraph 11 of TRG Agenda Ref. No. 16, *Stand-Ready Performance Obligations*, provided examples that illustrate the benefit a customer obtains from the entity "standing ready." One example includes "a customer that purchases an extended product warranty for a piece of equipment that requires the entity to remediate any issues with the product when-and-if problems arise."

1.62 Paragraphs 31 and 32 of topic 5 of TRG Agenda Ref. No. 25, *January 2015 Meeting — Summary of Issues Discussed and Next Steps*, state the following:

> For Issue 1 [What is the nature of an entity's promise in a stand ready obligation], TRG members generally agreed with the position put forth by the staff in the TRG Agenda paper that, in some cases, the nature of the entity's promise in a contract is to "stand-ready" for a period of time, rather than to provide the goods or services underlying the obligation (for example, the actual act of removing snow in the snow removal example included in paragraph 33(a)). The TRG Agenda paper notes that the Boards acknowledged this as well in the Basis for Conclusions to the revenue standard. Several TRG members emphasized that judgment must be exercised when determining whether the nature of the entity's promise is (a) that of standing ready to provide goods or services or (b) to actually provide specified goods or services. It was further discussed that whether the entity's obligation is to provide a defined good or service (or goods and services) or, instead, to provide an unknown type or quantity of goods or services might be a strong indicator as to the nature of the entity's promise.

Some examples of stand-ready obligations that were discussed by the TRG include promises to transfer unspecified software upgrades at the software vendor's discretion, provide when-and-if-available updates to previously licensed intellectual property based on advances in research and development of pharmaceuticals, and snow removal from an airport's runway in exchange for a fixed fee for the year. In contrast, a promise to deliver a specified number of goods or increments of service would not be a stand-ready obligation (for example, a promise to deliver one or more specified software upgrades).

1.63 In accordance with discussion at the January 2015 TRG meeting, FinREC believes that an entity's promise in an extended warranty contract that is sold separately from the product covered would typically be viewed as a stand-ready obligation if the contract provides services for unscheduled repairs or replacement of the item under the contract for an unknown quantity of services for a fixed fee.

1.64 If an entity has concluded that the promise in an extended warranty contract that is sold separately from the product covered is a stand-ready obligation, then the entity should also determine the nature of the promise in the stand-ready obligation. FinREC believes the nature of a stand-ready obligation for an extended warranty contract that is sold separately from the product covered could be either to provide protection against damage to, loss, or malfunction of the warrantied item caused by various perils for the specified coverage period, or to fix, arrange to fix, or replace the covered product. FinREC believes that entities should use reasonable judgment in determining the nature of the promise of the stand-ready obligation and apply that interpretation consistently to similar fact patterns and consider the disclosure requirements of FASB ASC 606-10-50-12.

1.65 As expressed by several TRG members, judgment must be exercised when determining the nature of the entity's promise. Other types of extended warranty contracts with different repair or payment options should be analyzed separately to determine whether the promise is a stand-ready obligation or a promise to deliver a specified number of goods or increments of service.

1.66 In circumstances in which no additional services are included in the extended warranty contract, the stand-ready obligation would be the only performance obligation in the contract.

Satisfaction of Performance Obligation

1.67 FASB ASC 606-10-25-23 requires an entity to recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. FASB ASC 606-10-25-24 notes that a performance obligation may be satisfied over time or at a point in time. If one of the three criteria included in FASB ASC 606-10-25-27 are met, the entity transfers control of the good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time.

1.68 FinREC believes that the performance obligation of standing ready to provide protection against damage to, loss, or malfunction of the warrantied item caused by various perils for the specified coverage period, or to fix, arrange to fix, or replace the covered product under an extended warranty contract, which is sold separately from the product covered and provides services for unscheduled repairs or replacement of the item under the contract for an unknown quantity of services for a fixed fee, meets the criteria in FASB ASC 606-10-25-27a. The entity would therefore satisfy the performance obligation and recognize revenue over time instead of at a point in time. As explained in FASB ASC 606-10-55-6, this is based on the fact that another entity would not need to substantially reperform the work that the entity has completed to date if that other entity were to fulfill the remaining performance obligation to the customer. This view is also consistent with the TRG discussion relating to TRG Agenda Ref 16.

Measuring Progress Toward Complete Satisfaction of a Performance Obligation

1.69 In measuring progress toward complete satisfaction of a performance obligation, FASB ASC 606-10-25-31 states that "the objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation)." Paragraphs 1.70–1.71 describe two ways of viewing the nature of the promise and reflecting the satisfaction of an entity's performance obligation, depending on how the entity views its provision of service. FinREC believes that entities should use reasonable judgment in determining the nature of the promise of the stand-ready obligation and apply that interpretation consistently to similar fact patterns, and consider the disclosure requirements of FASB ASC 606-10-50-12.

1.70 FinREC believes an entity could view the nature of its performance obligation under an extended warranty contract that provides an unknown quantity of services for a fixed fee as standing ready to provide protection against damage to, loss, or malfunction of the warrantied item caused by various perils for the specified coverage period. As such, it provides assurance of use for the covered product for the coverage period that would include some involvement with the repair or replacement. If this view is taken, FinREC believes revenue should be recognized as the performance obligation is satisfied over the coverage period. FinREC believes that a liability should be recorded as the claims are incurred during the coverage period for the estimated cost to provide repairs that have not yet occurred for claims incurred on or prior to the end of the coverage period.

1.71 FinREC believes an entity could also view the nature of its performance obligation as standing ready to fix, arrange to fix, or replace the covered product under an extended warranty contract that provides an unknown quantity of services for a fixed fee. If this view is taken, FinREC believes revenue should be recognized as the performance obligation is satisfied over the period in which the entity is expected to repair or replace the item under warranty and related costs should be recognized as incurred. Although the claim is required to be incurred during the coverage period, services to repair or replace may be provided after the end of the coverage period. A portion of the transaction price would be a contract liability as of the end of the coverage period and would be recognized in revenue at the same time the costs to provide repairs for the remaining claims are expected to be incurred and expensed.

1.72 In accordance with FASB ASC 605-20-25-6, under either of the preceding views, a loss should be recognized immediately if the sum of the expected costs of providing services under the contract and any asset recognized for the incremental cost of obtaining a contract exceeds the related contract liability.

Methods for Measuring Progress

1.73 As discussed in FASB ASC 606-10-25-33, there are various appropriate methods of measuring progress that are generally categorized as output methods and input methods. FASB ASC 606-10-55-17 explains that "output methods include surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered." FASB ASC 606-10-55-20 explains that input methods include resources consumed, labor hours expended, costs incurred, time lapsed, or machine hours used relative to the total expected inputs to the satisfaction of that performance obligation. Considerations for selecting those methods are discussed in paragraphs 16–21 of FASB ASC 606-10-55. As required in FASB ASC 606-10-25-32, for each performance obligation the entity should apply a single method of measuring progress that is consistent with the objective in FASB ASC 606-10-25-31 and should apply that method consistent with similar performance obligations and in similar circumstances.

1.74 Paragraph 33 in topic 5 of TRG Agenda Ref. No. 25 states the following:

> For Issue 2, TRG members agreed with the position put forth by the staff in the TRG Agenda Paper that judgment should be exercised in determining the appropriate method to measure progress towards satisfaction of a stand-ready obligation over time, and the substance of the stand-ready obligation must be considered to align the measurement of progress towards complete satisfaction of the performance obligation with the nature of the entity's promise. Members generally agreed that the new revenue standard does not permit an entity to default to a straight-line measure of progress, but that a straight-line measure of progress (for example, one based on the passage of time) will be reasonable in many cases. Some TRG members observed that a straight-line measure of progress might not always be conceptually pure, but they acknowledged that a straight-line measure might be the most reasonable estimate an entity can make for a stand-ready obligation. The staff put forth the following two examples that were discussed by the TRG members:
>
> (a) In a snow removal scenario, the entity does not know, and it would likely not be able to reasonably estimate, how often (or how much) and/or when it will snow. This suggests the nature of the entity's promise is to stand ready to provide these services when-and-if it is needed. In this scenario, the entity may conclude that the customer does not benefit evenly throughout the one-year contract period. As a result, the entity would select a more appropriate measure of progress (for example, one based on its expected efforts to fulfill its obligation to stand ready to perform, which may be substantially greater during the winter months than during the summer months).
>
> (b) In a scenario in which an entity promises to make unspecified (that is, when-and-if available) software upgrades available to a customer, the nature of the entity's promise is fundamentally one of providing the customer with a guarantee. The entity stands ready to transfer updates or upgrades when-and-if they become available, while the

> customer benefits evenly throughout the contract period from the guarantee that any updates or upgrades developed by the entity during the period will be made available. As a result, a time-based measure of progress over the period during which the customer has rights to any unspecified upgrades developed by the entity would generally be appropriate.

1.75 In accordance with the views expressed by the TRG at the January 2015 meeting, FinREC believes that judgment should be exercised in determining the appropriate method to measure progress toward satisfaction of a stand-ready obligation under an extended warranty contract that is sold separately from the product covered and that provides an unknown quantity of services for a fixed fee. The nature of the stand-ready obligation — to provide protection against damage to, loss, or malfunction of the warrantied item caused by various perils for the specified coverage period or to fix, arrange to fix, or replace the covered product — should be considered to align the measurement of progress toward complete satisfaction of the performance obligation with the nature of the entity's promise.

1.76 FASB ASC 606-10-25-35 requires that

> [a]s circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

Reasonable Measures of Progress

1.77 FASB ASC 606-10-25-36 states the following:

> An entity shall recognize revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress toward complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress.

1.78 FASB ASC 606-10-25-37 states the following:

> In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognize revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

1.79 The guidance in paragraphs 31–37 of FASB ASC 606-10-25 and paragraphs 16–21 of FASB ASC 606-10-55 is a change from the guidance in FASB ASC 605-20-25-3, which required revenue from separately priced extended warranty and product maintenance contracts to be deferred and recognized on a straight-line basis over the contract period except in those circumstances in which sufficient historical evidence indicated otherwise. In contrast, in accordance with FASB ASC 606-10-25-36, if reliable information is not available (which could include historical evidence as well as other evidence such as industry statistics), default to a straight-line method is not permitted.

Portfolio Approach

1.80 FASB ASC 606-10-10-4 allows an entity to apply the guidance in FASB ASC 606 to a portfolio of contracts with similar characteristics if it reasonably expects that the effects on the financial statements would not differ materially from applying that guidance to the individual contracts within that portfolio.

Cost Guidance — Incremental and Acquisition

1.81 The guidance in FASB ASC 340-40-25-1 should be applied to extended warranty contracts accounted for under FASB ASC 606. This guidance requires that an entity recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

1.82 It should be noted that the guidance in FASB ASC 340-40 on incremental costs to obtain a contract differs from the guidance in FASB ASC 944-30-25-1A on acquisition costs related directly to the successful acquisition of new or renewal insurance contracts that is applicable to insurance entities. FASB ASC 944-30-25-1A requires capitalization of acquisitions costs that are either incremental direct costs or costs directly related to the successful acquisition of new or renewal insurance contracts. Directly related costs include the portion of employees' compensation directly related to contract acquisition. This contrasts with FASB ASC 340-40-25-3, under which the portion of an employee's compensation (that is not an incremental cost of obtaining the contract such as a sales commission) directly related to contract acquisition is required to be expensed because those costs would have been incurred regardless of whether the contract was obtained.