



November 2016 TRG Meeting

This publication summarizes the November 7, 2016 meeting of the U.S. GAAP-only revenue transition resource group.

Following the publication of IFRS 15 and ASC 606 (collectively, the “new revenue standard”) by the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (collectively the “Boards”) in May 2014, the Boards created the Joint Transition Resource Group for Revenue Recognition (TRG). The purpose of the TRG is not to issue guidance but instead seek and provide feedback on potential issues related to the implementation of the new revenue standard. By analyzing and discussing potential implementation issues, the TRG helps the boards determine whether they need to take additional action, such as providing clarification or issuing other guidance. The TRG comprises financial statement preparers, auditors, and users from “a wide spectrum of industries, geographical locations and public and private organizations,” and board members of the FASB attend the TRG’s meetings. In addition, representatives from the Securities Exchange Commission (SEC), Public Company Accounting Oversight Board, International Organization of Securities Commissions and the American Institute of Certified Public Accountants are invited to observe the meetings.

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On January 21, 2016, the IASB announced that it had completed its decision-making process related to clarifying IFRS 15 and that it no longer plans to schedule further meetings of the IFRS constituents of the TRG. The IASB has nevertheless noted that the group has not been disbanded and if necessary can be recalled to discuss matters. In addition, the IASB will continue to facilitate through its website the submission of issues or difficulties that IFRS stakeholders come across as they implement the new standard's requirements. The April and November 2016 TRG meetings therefore included U.S. GAAP constituents only, but members of the IASB staff participated as observers.

Although the discussions at the U.S. GAAP-only TRG meeting on November 7, 2016 were limited to ASC 606, and certain interactions with other US standards, some of the discussions may be of interest to IFRS stakeholders due to the convergence of IFRS 15 and ASC 606. IFRS preparers should take account of the views of their local regulator in determining the extent to which the TRG discussions should affect their own reporting. For ease of reference, we have included IFRS 15 paragraph references within the Background sections for each issue.

The following topics were discussed at the November 7, 2016, meeting:

- Topic 1 — Revenue recognition over time.
- Topic 2 — Capitalization and amortization of the incremental costs of obtaining a contract.
- Topic 3 — Sales-based or usage-based royalties with a minimum guarantee.
- Topic 4 — Payments to customers.

The TRG generally agreed with the FASB staff's analysis of the topics and its views; it therefore did not recommend changes to ASC 606. The SEC observer emphasized a number of times during the meeting that entities will need to disclose their significant judgments, and the critical accounting policies established, related to applying ASC 606, including determining the amortization period of contract costs (Topic 2), the appropriate measure of progress for revenue from licenses of symbolic intellectual property (Topic 3), and the recognition period for up-front payments to customers (Topic 4).



Editor's Note

At the end of the meeting, the FASB announced that no additional TRG meetings are scheduled. However, the Board encouraged stakeholders to continue submitting implementation questions either directly to the TRG or through the FASB's technical inquiry process detailed on the FASB's website. While it acknowledged that it would be open to scheduling future TRG meetings to discuss implementation issues that are significant and far-reaching, the Board noted that it would be judicious in selecting topics, partly because some entities will be early adopting the standard as of January 1, 2017.

A board member noted that the following matters were still in progress:

- Technical corrections (revenue) — A final Accounting Standards Update ("ASU") is expected to be issued by the end of 2016 and will include 13 separate matters that the Board discussed previously. ASU 2016-20 ('Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers'), was subsequently issued in December 2016.
- Accounting for preproduction costs, including nonrecurring engineering costs — Under the FASB's proposed ASU on technical corrections (issued in May 2016), the guidance in ASC 340-10 on accounting for preproduction costs related to long-term supply arrangements would be superseded. As a result, an entity would apply the new guidance in ASC 340-40 on contract costs to these arrangements. However, because of concerns raised by stakeholders, the Board tentatively decided at its October 2016 meeting not to supersede the guidance in ASC 340-10.

Note that before making a final decision, and after the November 2016 TRG meeting, the FASB organized a workshop to discuss the accounting for such costs. The Board will also discuss further research on the accounting for non-recurring engineering and preproduction costs and the related reimbursements from customers at its February 15, 2017 meeting.

In addition, the FASB staff discussed questions it has received about disclosure requirements related to the following:

- **Disaggregation of revenue** — In response to a question about the form of this disclosure, the FASB staff indicated that a tabular reconciliation such as that in Example 41 (ASC 606-10-55-295 through 55-297) is not required; however, an entity must reconcile the amounts in accordance with ASC 606-10-50-6.
- **Remaining performance obligation** — Questions continue to be raised about this disclosure requirement. ASU 2016-20 issued in December 2016 provided clarification on this topic.
- **Contract balances** — A few questions were raised about ASC 606-10-50-8, which requires disclosure of revenue recognized from the prior year-end contract liability balance (ASC 606-10-50-8(b)) as well as out-of-period revenue recognized (ASC 606-10-50-8(c)). The FASB staff noted the following:
 - An entity may elect to provide a full rollforward of this information on a quarterly basis. Although the full rollforward is not required by ASC 606-10-50-8, the information disclosed may enable users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, which is the disclosure objective stated in ASC 606.
 - As part of the full rollforward, an entity may provide a gross figure that includes revenue recognized (1) from the prior recorded contract liability balance and (2) that flowed in and out of the balance in the same period (i.e., the typical line item (deduction) that would be present in a full rollforward of the contract liability balance).
 - To comply with the requirements, an entity may provide a quarterly rollforward for each quarter, separately, but may omit a year-to-date rollforward. That is, a calendar-year-end public company reporting its second quarter financial information may provide a rollforward of the three months ended March 31 and a separate rollforward of the three months ended June 30 but may forgo providing a rollforward of the six months ended June 30. The SEC observer did not explicitly accept or reject the FASB staff’s statements.

Topic 1 — Revenue recognition over time

Background: Step 5 of the new revenue standard requires entities to recognize revenue when (or as) the customer obtains control of each distinct good or service in the contract. An entity would satisfy a performance obligation over time by meeting one of the three criteria in ASC 606-10-25-27 [paragraph 35 of IFRS 15].

Under ASC 606-10-25-27(c) [paragraph 35(c) of IFRS 15], an entity’s performance must not create an asset with an alternative use, and the entity must have an enforceable right to payment for performance completed to date. In assessing whether an asset has an alternative use, the entity needs to consider both practical limitations and contractual restrictions on its ability to redirect the asset for another use. Further, the alternative-use assessment should be performed at contract inception and should not be updated unless a contract modification occurs that substantively changes the performance obligation.

When evaluating whether it has an enforceable right to payment, an entity should consider both the contractual terms and any laws that apply to it. The right to payment for performance completed to date must include compensation for costs incurred to date plus a reasonable profit margin. A termination provision that only compensates the entity for costs incurred, or a portion of costs incurred, would not be considered an enforceable right to payment for performance completed to date. However, a reasonable profit margin is not limited to (1) a fixed amount or (2) the amount the entity would have earned on the entire contract had it been completed. Rather, a reasonable profit margin should compensate the entity for performance completed during the entire duration of the contract and may be (1) based on a reasonable proportion of the entity’s expected profit margin or (2) a reasonable return on the entity’s cost of capital.

TRG Agenda Paper 56 discusses the following implementation questions stakeholders have raised regarding whether an entity should recognize revenue over time:

“Question 1: Can an entity that recognizes revenue at a point in time under current revenue recognition guidance be required to recognize revenue over time in accordance with [ASC 606]?”

The FASB staff believes that certain contracts that are currently accounted for on a point-in-time basis (e.g., production-of-goods contracts) may need to be accounted for over time under ASC 606 because such goods have no alternative use to the entity, and the entity has an enforceable right to payment. Example A in TRG Agenda Paper 56 discusses a two-year contract for the production of customized goods that represent a manufacturing service under the

new standard because (1) the customized goods would not have an alternative use to the entity and (2) the entity had an enforceable right to payment (for its incurred costs plus a reasonable margin) if the contract were terminated. The staff cautioned that while the example was not meant to illustrate that all contracts for customized goods would be accounted for on an over-time basis, an entity should not presume that it would continue to recognize revenue at a point in time under ASC 606. Rather, it would need to assess the criteria in ASC 606-10-25-27 to determine whether it should recognize revenue over time. If none of the criteria are met, it should recognize revenue on a point-in-time basis.

“Question 2: In assessing whether [its] performance creates an asset with no alternative use in accordance with [ASC] 606-10-25-27(c), should an entity consider the completed asset or the in-production asset?”

The FASB staff noted that ASC 606 requires an entity to consider an asset in its completed state and that the alternative-use assessment should take into account whether a significant amount of rework would be needed before the asset could be transferred to another customer (ASC 606-10-25-28 and paragraph BC136 of ASU 2014-09 “Revenue from Contracts with Customers”). Example B in TRG Agenda Paper 56 discusses an entity that produces customized goods with unique design specifications for each customer. The customization occurs after 75 percent of the manufacturing process is completed. However, because of the product customization that occurs in the final 25 percent of the manufacturing process, the entity cannot sell the customized products to other customers in their completed state without incurring significant costs to rework the products. Because of the practical limitations that incurring significant rework costs would impose, the assets do not have an alternative use to the entity. Accordingly, regardless of the timing of the customization in the production process, the entity should consider whether the completed asset could be redirected to another customer without the need for significant rework on the customized goods.

“Question 3: How and when should an entity determine whether it has an enforceable right to payment in accordance with [ASC] 606-10-25-27(c)?”

The FASB staff noted that under ASC 606-10-55-14, an entity should consider the following in addition to assessing the terms of the contract:

- “[L]egislation, administrative practice, or legal precedent that confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer.”
- “[R]elevant legal precedent that indicates that similar rights to payment for performance completed to date in similar contracts has no binding legal effect.”
- “[A]n entity’s customary business practice of choosing not to enforce a right to payment that has resulted in the right being rendered unenforceable in that legal environment.”

In addition, paragraph BC145 of ASU 2014-09 notes that the right to payment does not need to be a present unconditional right but merely an enforceable right for an entity to demand payment if the contract were terminated for reasons other than the entity’s failure to perform before completion of the contract. Further, on a basis consistent with the guidance in ASC 606-10-55-13, a customer’s termination of a contract in the absence of the customer’s right to terminate would indicate that the entity has the right to continue performing its obligations under the contract, which would create an enforceable right to payment from the customer.

Example C in TRG Agenda Paper 56 illustrates the staff’s analysis of the criterion in ASC 606-10-25-27(c) regarding the enforceable right to payment. The staff concluded that the entity met the over-time revenue recognition criteria because (1) the entity produced customized ice cream machines, and such machines did not have an alternative use to the entity (i.e., because significant rework would be needed to redirect the assets to another customer), and (2) the entity had an enforceable right to payment at contract inception. In addition, the entity met the requirements in ASC 606-10-25-14 and 25-15 that it account for the machines as a series of distinct goods or services. As a result, the entity would record a cumulative catch-up adjustment to revenue for 50 completed and 10 in-process ice cream machines that it built in anticipation of an additional contract with a customer, for a total of 300 machines. Further, it would recognize the revenue at inception of the new contract.

Summary: The FASB staff noted that constituents have repeatedly submitted technical inquiries related to this topic and that therefore TRG Agenda Paper 56 was largely educational in nature. TRG members generally agreed with the FASB staff's views on Question 1 and appreciated confirmation of the principles and required analysis. In addition, the TRG benefitted from the staff's clarification that there is no presumption or default position under the new standard in connection with recognizing revenue over time and that therefore an entity's prior conclusions may or may not result in a similar outcome under the new guidance. Several TRG members also highlighted that an entity must assess when to recognize revenue on a contract-by-contract basis and that conclusions may therefore differ even for contracts with the same customer. Further, TRG members generally agreed that each contract should be evaluated and that an entity should not presume that it would continue to recognize revenue at a point in time (or over time) because it had done so under current revenue guidance.

TRG members generally agreed with the FASB staff's view on Question 2 that the alternative-use assessment should be performed at contract inception and should take into account the characteristics of the asset that will ultimately be transferred to the customer. Much of the TRG's discussion focused on the timing of the customization relative to the finished goods promised in a contract. TRG members and the FASB staff generally agreed that depending on the facts and circumstances, an enforceable right to payment may not be required before customization for the contract to qualify for over-time revenue recognition (e.g., an entity need not obtain an enforceable right to payment for standardized raw materials needed in the final customized product). In such circumstances, performance on the customer's contract may begin only once those standardized raw materials are placed into the customization phase of the product. One TRG member noted that in Example B of the agenda paper, customization does not occur until 75 percent of the manufacturing process is complete.

The FASB staff and TRG members generally agreed that the absence of the enforceable right to payment during the first 75 percent of the manufacturing process would not prohibit over-time revenue recognition (as long as the entity has an enforceable right to payment once the customization occurs). That is, the customer's contract may only begin when the customization commences and continues through the final completion of the product.

TRG members also generally agreed with the FASB staff's view on Question 3 that the determination of an enforceable right to payment should be made by using the contractual terms and relevant legal precedent, regardless of the entity's history or intention of enforcing those terms.

Topic 2 — Capitalization and Amortization of Incremental Costs of Obtaining a Contract

Background: The incremental costs of obtaining a contract with a customer must be capitalized if the entity expects to recover those costs (ASC 340-40-25-1) [paragraph 91 of IFRS 15]. Such incremental costs are defined as those the entity would not have incurred if the contract had not been obtained (ASC 340-40-25-2) [paragraph 92 of IFRS 15] (e.g., a sales commission). In addition, the asset recognized for the incremental costs of obtaining a contract with a customer should be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset is related (ASC 340-40-35-1) [paragraph 99 of IFRS 15].

It is common for entities to pay sales commissions to employees, and those commissions often meet the definition of incremental costs of obtaining a contract. The accounting for sales commissions is generally straightforward in situations in which (1) the commission is a fixed amount or a percentage of contract value and (2) the contract is not expected to be (or cannot be) renewed. However, if compensation plans are complex, it may be difficult to determine which costs are truly incremental and to estimate the period of amortization related to them.

Examples of complex scenarios include:

- Plans with significant fringe benefits.
- Salaries based on the employee's prior-year signed contracts.
- Commissions paid in different periods or to multiple employees for the sale of the same contract.
- Commissions based on the number of contracts the sales person has obtained during a specific period.
- Legal and travel costs incurred in the process of obtaining a contract as well as anticipated contract renewals.

TRG Agenda Paper 57 discusses the following implementation questions stakeholders have raised regarding incremental costs to obtain a contract:

“Question 1: Which costs to obtain a contract are incremental?”

Stakeholders have expressed concern that the term “incremental” could lead to broad interpretations of the types of costs that would qualify as costs to be capitalized under ASC 606. In response to these concerns, the FASB staff noted that an entity should consider whether costs would have been incurred if the customer (or the entity) decided that it would not enter into the contract just as the parties were about to sign the contract. If the costs (e.g., such as the legal costs to draft the contract) would have been incurred even though the contract was not executed, then they would not be incremental costs of obtaining a contract. See Appendix A for examples from TRG Agenda Paper 57 that the FASB staff analyzed in considering Question 1.

“Question 2: How should an entity determine the amortization period for an asset recognized for the incremental costs of obtaining a contract with a customer?”

The staff noted that the amortization guidance in ASC 340-40 is conceptually consistent with that on estimating the useful lives of long-lived assets. Since entities currently use judgment to estimate useful lives of long-lived assets, the staff believes that entities would also do so in determining amortization periods for assets related to incremental costs to obtain a contract.

Thus, when estimating the amortization period of an asset arising from incremental costs of obtaining a contract, entities should (1) identify the contract(s) to which the cost (i.e., commission) is related (see Question 2a below), (2) determine whether the commission on a renewal contract is commensurate with the commission on the initial contract (see Question 2b below), and (3) evaluate the facts and circumstances to determine an appropriate amortization period that would extend beyond the contract period if there are anticipated renewals associated with the costs of obtaining the contract.

However, the staff noted its belief that while ASC 606 does not require amortization over the average customer term or life, such amortization may be appropriate as long as the period is not inconsistent with the requirements in ASC 340-40-35-1. An entity should use judgment in assessing the goods or services to which the assets are related.

The FASB staff specifically addressed the following regarding an entity’s determination of an amortization period:

“Question 2a: How should an entity determine whether a sales commission relates to goods or services to be transferred under a specific anticipated contract?”

During the development of ASC 606, the Board decided that the capitalized asset for incremental costs could be related to goods or services under a specific anticipated contract. The FASB staff believes that an entity should consider using judgment in determining the contract(s) to which a commission is related.

The staff noted that if an entity pays a commission on the basis of only the initial contract without an expectation that the contract will be renewed (given the entity’s past experience or other relevant information), amortizing the asset over the initial contract term would be an appropriate application of ASC 606. However, if the entity’s past experience indicates that a contract renewal is likely, the amortization period could be longer than the initial contract term if the asset is related to goods or services to be provided during the contract renewal term [paragraph 34 of TRG Agenda Paper 57].

“Question 2b: If a sales commission is paid for an initial contract and also paid for contract renewals, how should an entity evaluate whether the sales commission paid on the contract renewal is commensurate with the sales commission paid on the initial contract?”

The Board stated that amortizing an asset over a period longer than the initial contract would not be appropriate when a commission is paid on a contract renewal that is commensurate with the commission paid on the initial contract

[paragraph BC309 of ASU 2014-09]. In addition, on the basis of discussions at the TRG's January 2015 meeting (and TRG Agenda Paper 23), the staff noted that stakeholders believe that they may consider the relative levels of effort to obtain an original and renewal contract in assessing whether the commissions are "commensurate with" the original and renewal contracts.

The FASB staff clarified that a renewal commission is "commensurate with" an initial commission if the two commissions are reasonably proportionate to the respective contract value (e.g., 5 percent of the contract value is paid for both the initial and the renewal contract). Similarly, the FASB staff thinks it would be reasonable for an entity to conclude that a renewal commission is not "commensurate with" an initial commission if it is disproportionate to the initial commission (e.g., 2 percent renewal commission as compared to a 6 percent initial contract commission) (paragraph 23 of TRG Agenda Paper 23).

Summary: TRG members generally agreed with the staff's views on Question 1 and the framework for analyzing whether costs are incremental. They also generally agreed that, as a litmus test, costs would not be considered incremental if they would have been incurred even if the customer (or the entity) decided that it would not enter into the contract just as the parties are about to sign the contract.

In a manner consistent with prior discussions of the timing of cost recognition,¹ TRG members confirmed their general agreement that entities should continue to refer to existing GAAP on liability recognition to determine whether and, if so, when, a liability needs to be recorded in connection with a contract with a customer. Therefore, an entity should initially apply the specific guidance on determining the recognition and measurement of the liability (e.g., commissions, payroll taxes, 401(k) match). If the entity recognizes a liability, only then should it determine whether to record the related debit as an asset or expense.

One TRG member highlighted a difference between the guidance in ASC 606 on capitalizing costs to obtain a contract and the accounting under current practice. The new standard requires costs to be incremental rather than both direct and incremental as they are under current GAAP (e.g., on originating loans and acquiring insurance policies). Accordingly, the TRG generally acknowledged that this difference may lead to a broader pool of costs that are subject to capitalization (i.e., entities may be required to capitalize certain costs in accordance with the new standard that they would not have capitalized under current GAAP if they elected a capitalization policy).

However, the TRG cautioned that entities would need to use judgment to determine whether certain costs, such as commissions paid to multiple employees for the signing of a contract, are truly incremental. The FASB staff encouraged entities to apply additional skepticism to understand whether an employee's compensation (i.e., commissions or bonus) — particularly for individuals in different positions in the organization and employees who are ranked higher in an organization — is related solely to executed contracts or is also influenced by other factors or metrics (e.g., employee general performance or customer satisfaction ratings). TRG members emphasized that only those costs that are incremental (e.g., resulted from obtaining the contract) may be capitalized (provided that other asset recognition criteria are met).

In addition, the TRG generally agreed with the staff's views that the amortization period should reflect the period in which the entity expects to receive benefits from the underlying goods or services to which the asset is related. TRG members emphasized that in estimating an amortization period, entities will need to apply judgment to determine the related goods and services and assess what contracts (i.e., initial contract and renewals) include those goods and services. An entity would need to make judgments similar to those it made when determining the amortization or depreciation period for other long-lived assets.

In response to a question from a TRG member, the FASB staff confirmed that TRG Agenda Paper 57 does not create a rebuttable presumption that an entity must use the estimated life of the customer relationship as the estimated

¹ Certain implementation issues related to incremental costs to obtain a contract were discussed at the January 26, 2015, TRG meeting. See Deloitte's January 2015 Clearly IFRS – IASB and FASB Joint Transition Resource Group for Revenue Recognition publication (issued February 2015) for more information.

amortization period. Therefore, entities may use, but should not default to using, the estimated life of the customer relationship as the amortization period. Further, several TRG members suggested that the minutes to the meeting include a description of factors that an entity may consider when determining the appropriate estimate of the amortization period of the asset. A Board member noted that the staff would consider the recommendation but also reminded TRG members that entities estimate amortization periods and useful lives for other long-lived assets and that they could consider similar factors in their estimates of amortization periods for costs incurred to obtain a contract.

Topic 3 — Sales-Based or Usage-Based Royalties with a Minimum Guarantee

Background: In exchange for a license of intellectual property (IP), an entity may be compensated in the form of a sales-based or usage-based royalty (i.e., the amount of consideration varies on the basis of the customer’s subsequent sales or usage of the license of the underlying IP). Although the royalty represents a form of variable consideration, which is generally required to be estimated and constrained under the new revenue standard, there is an exception for consideration in the form of a sales-based or usage-based royalty related to licenses of IP. Under this exception, revenue should not be recognized until the later of (1) the occurrence of the underlying sales or usage or (2) the satisfaction (or partial satisfaction) of the related performance obligation. That is, an entity is not required to estimate the amount of royalties it expects to earn at contract inception; rather, it would recognize revenue as the subsequent sales or usage occurs or the associated performance obligation has been satisfied (or partially satisfied).

In some cases, the sales-based or usage-based royalty may be subject to a minimum guarantee, which establishes a floor for the amount of consideration to be paid to the entity.

Consider the following example, adapted from Example 1 in TRG Agenda Paper 58:²

Example

An entity enters into a five-year arrangement to license IP. The license requires the customer to pay a sales-based royalty of 5 percent of the customer’s gross sales associated with the IP; however, the contract includes a guarantee that the entity will receive a minimum of \$5 million for the entire five-year period.

At contract inception, the entity estimates the customer’s gross sales and related royalties to be paid to the entity for each of the years are as follows:

(\$ in millions)	Year 1	Year 2	Year 3	Year 4	Year 5
Gross sales	15.00	30.00	40.00	20.00	60.00
Royalties	0.75	1.50	2.00	1.00	3.00
Total estimated royalties equal \$8.25 million.					

² Example 1 discusses a license of a trademark, which is considered symbolic IP. The example here has been adapted to omit the type of IP to illustrate the alternative views for symbolic and functional IP, as described in the agenda paper’s two questions.

Because the minimum guarantee establishes a fixed amount of consideration to which the entity will be entitled, stakeholders have raised questions about whether and how the sales- based or usage-based royalty exception should be applied in these cases. Specifically, TRG Agenda Paper 58 notes that stakeholders raised the following questions:

“Question 1: How does a minimum guarantee impact the recognition of sales- based or usage-based royalties promised in exchange for a license of symbolic [IP]?”³

- **View A** — Recognize revenue as the subsequent sales or usage occurs in accordance with ASC 606-10-55-65 if an entity expects that the total royalties will exceed the minimum guarantee.
- **View B** — Estimate the transaction price (as fixed consideration plus expected royalties to be earned over the license term), and recognize revenue over time by using an appropriate measure of progress “subject to the restriction that the cumulative revenue recognized cannot exceed the cumulative royalties once the minimum guarantee has been met” (see paragraph 19 of TRG Agenda Paper 58).
- **View C** — Recognize the minimum guarantee over time by using an appropriate measure of progress. Once the minimum guarantee has been met, recognize the incremental royalties as the subsequent sales or usage occurs.

The table below, adapted from TRG Agenda Paper 58, outlines the recognition pattern associated with each view:

(\$ in millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Effect of View
View A	0.75 (0.75)	1.50 (2.25)	2.00 (4.25)	1.00 (5.25)	3.00 (8.25)	Under View A, revenue is recognized on a basis that is consistent with the manner in which royalties are earned.
View B	1.65 (1.65)	1.65 (3.30)	1.65 (4.95)	0.30 (5.25)	3.00 (8.25)	Under View B, the total estimated revenue of \$8.25 million is recognized on a straight-line basis over the five years of the license. Starting in year 4, when the cumulative amount of royalties exceeds the minimum guarantee of \$5 million, the entity recognizes the remaining consideration when the subsequent sales occur.
View C	1.00 (1.00)	1.00 (2.00)	1.00 (3.00)	1.25 (4.25)	4.00 (8.25)	Under View C, the minimum guarantee of \$5 million is recognized on a straight-line basis over the five-year license term. Starting in year 4, when the cumulative amount of royalties exceeds the minimum guarantee, the entity would begin recognizing the incremental royalties as the subsequent sales occur.

The FASB staff noted that it does not believe that ASC 606 prescribes a “one-size-fits-all” model for recognizing revenue when a license is subject to a sales- based or usage-based royalty with a minimum guarantee. The staff indicated that in selecting an appropriate measure of progress for recognizing revenue over time, an entity should use judgment and consider that while the views described in the agenda paper are reasonable interpretations of ASC 606,

³ As described in ASC 606-10-55-59 and 55-60, symbolic IP does not have significant stand-alone functionality; therefore, the utility of the IP is significantly derived from the entity’s past or ongoing activities undertaken to maintain or support the IP. Therefore, a symbolic-IP license gives the customer a right to access the entity’s IP, and revenue should generally be recognized over time. Under IFRS 15, licenses are either a right to access the entity’s intellectual property as it exists throughout the license period or a right to use the intellectual property as it exists at a point in time. The U.S. GAAP approach has the potential for certain licenses to be treated as a right to access even though there is no expectation that the entity will undertake activities regarding the intellectual property. This may be the case, for example, if an entity licenses the use of a brand/trade name that it no longer supports or maintains. These different classifications could result in differences in the manner in which revenue is recognized under U.S. GAAP as compared to IFRS. For additional information about this topic, see Deloitte’s Clearly IFRS – Clarifications publication.

there may be other appropriate ways to measure progress. In addition, the FASB staff reminded stakeholders that because diversity in practice may exist, entities will be required to disclose the significant judgments made in applying ASC 606, including the methods used to recognize revenue and determine the transaction price.

“Question 2: How does a minimum guarantee impact the recognition of sales- based or usage-based royalties promised in exchange for a license of functional [IP]?”⁴

Stakeholders have articulated the following two views:

- **View A** — A minimum guarantee related to functional IP should be recognized as revenue at the point in time that the entity transfers control of the license to the customer. Any royalties that exceed the minimum guarantee should be recognized as the subsequent sales or usage occurs in accordance with ASC 606-10-55-65.
- **View B** — If an entity expects the royalties to exceed the minimum guarantee, it should recognize all the revenue when the subsequent sales or usage occurs in accordance with ASC 606-10-55-65. That is, no revenue would be recognized at the point in time that control of the license transfers to the customer.

The table below outlines the recognition pattern associated with each view:

(\$ in millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Effect of View
View A	5.00 (5.00)	— (5.00)	— (5.00)	0.25 (5.25)	3.00 (8.25)	Under View A, the entire minimum guarantee of \$5 million is recognized when control of the license transfers to the customer in year 1. Starting in year 4, when the cumulative amount of royalties exceeds the minimum guarantee, the entity would begin recognizing the incremental royalties as the subsequent sales occur.
View B	1.00 (1.00)	1.00 (2.00)	1.00 (3.00)	1.25 (4.25)	4.00 (8.25)	Under View B, revenue is recognized on a basis that is consistent with the manner in which royalties are earned.

The FASB staff believes that View A is the appropriate application of ASC 606. In reaching this view, the FASB staff emphasized that a “guaranteed amount is not variable consideration; therefore, it is not subject to the royalties recognition constraint. Under ASC 606, a performance obligation to transfer a license for functional intellectual property is satisfied at a point in time. Consequently, the fixed consideration is recognized when an entity transfers control of the license. However, the variable consideration in the form of a royalty (that is, the amount above the fixed consideration) is recognized in accordance with the royalty’s recognition constraint.”

Summary: For licenses of symbolic IP (Question 1), TRG members agreed that ASC 606 does not require application of a single attribution approach in all situations in which a sales-based or usage-based royalty contract with a customer includes a minimum guaranteed amount of consideration and the entity expects the royalties will exceed the guaranteed minimum. An entity should evaluate its facts and circumstances to determine which method under the standard best depicts its progress toward completion. In addition, there was some debate about whether the application of View C would be akin to the use of two measures of progress for the same performance obligation.

TRG members generally agreed that the three views outlined in TRG Agenda Paper 58 could be reasonable interpretations of ASC 606, subject to the following “guard rails”:

⁴ As described in ASC 606-10-55-59 and 55-63, functional IP has significant stand-alone functionality (e.g., the ability to process a transaction, perform a function or task, or be played or aired). Because an entity’s activities do not significantly change the functionality and utility of the IP, a functional-IP license gives the customer a right to use the IP, and revenue should generally be recognized at a point in time.

- In the application of View A or View B, the estimated sales-based or usage-based royalties must exceed the minimum guarantee.
- If View B is applied, the entity will need to periodically revisit its estimate of the total consideration (fixed and variable) and update its measure of progress accordingly, which may result in a cumulative adjustment to revenue.

The SEC observer agreed with the TRG members' conclusions but emphasized that entities will need to consider disclosing appropriate information. For example, to assist users in understanding which view is being applied, registrants would need to disclose the key judgments they applied in selecting a measure of progress for recognizing revenue from a license of symbolic IP in the financial statements and in the critical accounting estimates section of the Management's Discussion and Analysis ("MD&A").

For licenses of functional IP (Question 2), TRG members agreed with the staff's analysis and conclusion that View A appropriately applies ASC 606.

In addition, one TRG member underscored the distinction between fixed and variable consideration by noting that recognition of a minimum guarantee (i.e., fixed amount of consideration) as revenue upon delivery of a functional license should not be contingent on the occurrence or nonoccurrence of a future event (e.g., regulatory approval).



Editor's Note

To describe the application of View A, one TRG member used an example in which (1) a functional license is transferred to a customer at the beginning of a five-year contract in exchange for royalties from the customer's sales and (2) the entity is guaranteed to receive \$1 million per year. Ignoring any potential effects of financing, the entity should recognize the total minimum guarantee of \$5 million for the contract at the beginning of year 1. This is because the \$5 million is fixed as a result of the minimum guarantee, and the license is functional (revenue is recognized at a point in time). Additional royalty revenue would be recognized if royalties exceed the \$1 million minimum guarantee in any year.

Other TRG members and the FASB staff generally agreed that the example appropriately reflects the application of View A.

Topic 4 — Payments to Customers

Background: As discussed in TRG Agenda Paper 59, much of the guidance in the new revenue standard on the recognition, measurement, and presentation of consideration payable to a customer (e.g., cash, coupons, credits, or vouchers)(ASC 606-10-32-25 through 32-27) [paragraphs 70 through 72 of IFRS 15] is based on existing U.S. GAAP (ASC 605-50). However, since there is a lack of explicit guidance on whether an up-front payment that an entity makes to a customer should be recognized as an asset (and subsequently "amortized" as a reduction of revenue) or recognized immediately as a reduction of revenue, diversity in practice has resulted. Accordingly, stakeholders have questioned whether such diversity will continue under the new revenue standard. In addition, stakeholders have expressed that if an asset is recorded for an up-front payment made to customer, the new revenue standard is unclear about the asset's amortization period.

The FASB staff believes that in certain circumstances, the new revenue standard is clear about how to account for up-front payments made to customers. For example, if the counterparty is a customer,⁵ the payment should be recognized as a reduction of revenue unless it is in exchange for a distinct good or service. If the up-front payment is not in exchange for a distinct good or service and is related entirely to a current contract, the new revenue standard specifies that it should be recorded as an asset and subsequently “amortized” as a reduction of revenue as the contract’s goods or services are transferred to the customer. The recording of an asset and subsequent amortization is predicated on the fact that the asset represents an advance of funds to the customer, which the entity recovers as goods or services are transferred to the customer.

However, the FASB staff believes that the new revenue standard is less clear on the timing of the up-front payment when either (1) a revenue contract does not yet exist (i.e., an entity makes a payment to incentivize the customer to enter into a revenue contract with the entity) or (2) the up-front payment is related to goods or services to be transferred under a current contract and anticipated future contracts. Accordingly, stakeholders have articulated two views about when an up-front payment to a customer should be recognized as a reduction of revenue.

The staff analyzed the following two views in TRG Agenda Paper 59 regarding two scenarios in the context of two different types of contracts — an IT outsourcing services contract and a supply arrangement (see Appendix B for additional information about the scenarios):

- **View A** — Up-front payments to customers should be recognized as an asset and “amortized” as a reduction of revenue as the related goods or services are provided to the customer, which may continue beyond the current contract term. Proponents of View A believe that recognizing the payment beyond the current contract term better reflects the economics of the transaction in certain situations. In addition, proponents of View A noted that under other guidance in U.S. GAAP, entities can recognize payments over a period longer than the current contract term⁶. Thus, because it may exist beyond the current legally enforceable contract, the asset should be evaluated periodically for recoverability.
- **View B** — Up-front payments to customers should be recognized as a reduction of revenue only over the current contract term (i.e., recognition of the up-front payment should not extend beyond the current contract term). If a contract does not exist, then the up-front payment should be recognized as a reduction of revenue immediately. Proponents of View B asserted that the new revenue standard focuses on legally enforceable rights and obligations related to an entity’s accounting for a contract with a customer, as opposed to future optional contracts, even if such contracts are anticipated.

As noted in TRG Agenda Paper 59, the FASB staff believes that the new revenue standard does not explicitly describe how to account for up-front payments in these situations and that both views have merit and may also “result in the same financial reporting outcome.” However, the staff reiterated that the selection of either view is not an accounting policy election but should be made after entities “understand the nature of the payment to the customer, understand the rights and obligations in the contract, evaluate the relevant facts and circumstances, apply the guidance in ASC 606 on consideration payable to a customer, consider whether other GAAP is applicable, and apply professional judgment.” Although some diversity in practice may continue under the new revenue standard, the FASB staff emphasized that the increased disclosure requirements related to judgments made in the determination of the transaction price (ASC 606-10-50-17) [paragraph 123 of IFRS 15] should help users understand an entity’s accounting for up-front payments to customers.

⁵ The scope of the issue in TRG Agenda Paper 59 is limited to payments to customers (and potential customers). It does not apply to payments made to third parties that are not customers.

⁶ Proponents of View A specifically referred by analogy to previous TRG discussions related to the scope of the guidance on consideration payable to a customer (see Deloitte’s March 2015 and July 2015 Clearly IFRS – IASB and FASB Joint Transition Resource Group for Revenue Recognition publications (issued April and August 2015, respectively)), the guidance on amortizing capitalized contract costs in ASC 340-40, and the subsequent measurement guidance on intangible assets other than goodwill in ASC 350-30.

Summary: Unlike the FASB staff, which supported both views, TRG members generally expressed support only for View A. However, TRG members generally agreed that View A does not require an entity to recognize an asset in all situations; rather, the entity should consider whether the payment meets the definition of an asset, which requires consideration of whether the payment results in a probable future economic benefit.

One TRG member pointed out that in TRG Agenda Paper 59 [paragraph 15(a)], an up-front payment was compared to an advance of funds to the customer. The TRG member expressed concern that such a comparison implied that the up-front payment provided the customer with a significant benefit of financing (i.e., a significant financing component). The FASB staff confirmed that it did not intend to imply that an up-front payment represents a significant financing component in a contract with a customer.

In addition, the SEC observer noted that an entity will need to use judgment in assessing up-front payments and reinforced the need for appropriate disclosure of its conclusions reached both in the financial statements and MD&A. Also, the SEC observer noted that in forming its views about the topic, the SEC staff intends to analyze the guidance in ASC 606 independently of its past decisions that were based on the current guidance in ASC 605.

Appendix A — Examples and Analysis: TRG Agenda Paper 57

The table below outlines the views discussed at the TRG meeting on the examples in TRG Agenda Paper 57 and the views selected by the FASB staff.

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Fixed employee salaries	<p>Example 1: An entity pays an employee an annual salary of \$100,000. The employee's salary is based upon the employee's prior-year signed contracts and the employee's projected signed contracts for the current year. The employee's salary will not change based on the current year's actual signed contracts; however, salary in future years likely will be impacted by the current year's actual signed contracts. What amount, if any, should the entity record as an asset for incremental costs to obtain a contract during the year?"</p>	<p>View A: "Determine what portion of the employee's salary is related to sales projections and allocate that portion of the salary as an incremental cost to obtain a contract." View B: "Do not capitalize any portion of the employee's salary as an incremental cost to obtain a contract. The costs are not incremental costs to any contract because the costs would have been incurred regardless of the employee's signed contracts in the current year."</p>	<p>View B. "None of the employee's salary should be capitalized as an incremental cost to obtain a contract.... Whether the employee sells 100 contracts, 10 contracts, or no contracts, the employee is still only entitled to a fixed salary." "[T]he objective of the requirements in [ASC] 340-40-25-1 is not to allocate costs that are associated in some manner with an entity's marketing and sales activity. The objective is to identify the incremental costs that an entity would not have incurred if the contract had not been obtained."</p>
Some, but not all, costs are incremental	<p>Example 2: An entity pays a 5% sales commission to its employees when they obtain a contract with a customer. An employee begins negotiating a contract with a prospective customer and the entity incurs \$5,000 of legal and travel costs in the process of trying to obtain the contract. The customer ultimately enters into a \$500,000 contract and, as a result, the employee receives a \$25,000 sales commission. What amount should the entity capitalize as an incremental cost to obtain the contract?"</p>	<p>View A: "The entity should capitalize only \$25,000 for the sales commission. Those costs are the only costs that are incremental costs to obtain the contract because the entity would not have incurred the costs if the contract had not been obtained." View B: "The entity should capitalize \$30,000, which includes the sales commission, legal expenses, and travel expenses. The entity would not have been able to obtain the contract without incurring those expenses."</p>	<p>View A. "The... sales commission is the only cost that the entity would not have incurred if the contract had not been obtained. While the entity incurs other costs that are necessary to facilitate a sale (such as legal, travel and many others), those costs would have been incurred even if the customer decided at the last moment not to execute the contract." If an entity "incurs the same type of legal and travel expenses to negotiate a contract, but the customer decides not to enter into the contract right before the contract was to be signed by both parties, the travel and legal expenses would still have been incurred even though the contract was not obtained. However, the commission would not have been incurred."</p>

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Timing of commission payments	<p>Example 3: An entity pays an employee a 4% sales commission on all of the employee's signed contracts with customers. For cash flow management, the entity pays the employee half of the commission (2% of the total contract value) upon completion of the sale, and the remaining half of the commission (2% of the total contract value) in six months. The employee is entitled to the unpaid commission, even if the employee is no longer employed by the entity when payment is due. An employee makes a sale of \$50,000 at the beginning of year one. What amount should the entity capitalize as an incremental cost to obtain the contract?"</p>	<p>View A: "Capitalize half of the commission (\$1,000) and expense the other half of the commission (\$1,000)." View B: "Capitalize the entire commission (\$2,000)."</p>	<p>View B. "The commission is an incremental cost that relates specifically to the signed contract and the employee is entitled to the unpaid commission. [The timing of payment does not affect] whether the costs would have been incurred if the contract had not been obtained.... In this fact pattern, only the passage of time needs to occur for the entity to pay the second half of the commission. However, [there] could be other fact patterns in which additional factors might impact the payment of a commission to an employee." For example, an entity could make the second half of the commission contingent upon selling additional services to the customer or upon the customer completing a favorable satisfaction survey for six months. Therefore, "an entity will need to assess its specific compensation plans to determine the appropriate accounting for incremental costs of obtaining a contract."</p>

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Commissions paid to different levels of employees	<p>Example 4: An entity's Salesperson receives a 10% sales commission on each contract that he or she obtains. In addition, the following employees of the entity receive sales commissions on each signed contract negotiated by the salesperson: 5% to the manager and 3% to the regional manager. Which commissions are incremental costs of obtaining a contract?"</p>	<p>View A: "Only the commission paid to the salesperson is considered incremental because the salesperson obtained the contract." View B: "Only the commissions paid to the salesperson and the manager are considered incremental because the other employee likely would have had no direct contact with the customer." View C: "All of the commissions are incremental because the commissions would not have been incurred if the contract had not been obtained."</p>	<p>View C. ASC 606, "does not make a differentiation based on the function or title of the employee that receives the commission. It is the entity that decides which employee(s) are entitled to a commission directly as a result of entering into a contract." In the staff's view, it is possible that several commission payments are incremental costs of obtaining the same contract. However, stakeholders are encouraged to ensure that each of the commissions are incremental costs of obtaining a contract with a customer, rather than variable compensation (for example, a bonus) which would not be incremental because it is based on a number of factors (i.e., the bonus determination also relies on factors other than sales).</p>
Commission payments subject to a threshold	<p>Example 5: An entity has a commission program that increases the amount of commission a salesperson receives based on how many contracts the salesperson has obtained during an annual period. The breakdown is as follows:</p> <ul style="list-style-type: none"> • 0-9 contracts — 0% commission • 10-19 contracts — 2% of value of contracts 1-19 • 20+ contracts — 5% of value of contracts 1-20+ <p>Which commissions are incremental costs of obtaining a contract?"</p>	<p>View A: "No amounts should be capitalized because the commission is not directly attributable to a specific contract." View B: "The costs are incremental costs of obtaining a contract with a customer and, therefore, the costs should be capitalized."</p>	<p>View B. "The entity would apply other GAAP to determine whether a liability for the commission payments should be recognized. When a liability is recognized, the entity would recognize a corresponding asset for the commissions when a liability is recognized. This is because the commissions are incremental costs of obtaining a contract with a customer. The entity has an obligation to pay commissions as a direct result of entering into contracts with customers. The fact that the entity's program is based on a pool of contracts (versus a program in which the entity pays 3% for all contracts) does not change the fact that the commissions would not have been incurred if the entity did not obtain the contracts with those customers."</p>

Appendix B — Examples and Analysis: TRG Agenda Paper 59

The table below, reproduced (with minor editorial modifications) from TRG Agenda Paper 59, outlines the FASB staff's views on the scenarios presented in the agenda paper's examples.

Example/ Scenario	Facts	Analysis — View A	Analysis — View B
Example 1, Scenario A — IT outsourcing services	Service Provider makes a \$1 million payment to a customer as part of the negotiations in a contract to provide IT outsourcing services. The payment to the customer was negotiated because the customer will incur costs to terminate employees and dispose of equipment that is currently utilized in the operations to be outsourced. The contract has a noncancellable term of five years. The entity estimates that the customer will pay a fee of \$6 million for five years of services. The payment to the customer is made in connection with a legally enforceable contract (that is, the customer only receives the \$1 million when it commits to the outsourcing contract).	The up-front payment relates to the noncancellable five-year contract. Therefore, the entity would record an asset for the payment and amortize it as a reduction of revenue as the services are provided to the customer over a five-year period.	Same as View A.
Example 1, Scenario B — IT outsourcing services	Assume the same fact pattern as Example 1, Scenario A, except that the contract is cancellable at the end of any month for no penalty (which results in a month-to-month contract under ASC 606). Although the customer has the right to cancel the contract, Service Provider expects the customer to continue to purchase services for five years because the customer has limited ability to perform the services internally given the customer terminated employees and disposed of equipment. Additionally, the customer has incurred significant set-up costs and will incur the significant set-up costs to change vendors. Finally, Service Provider knows from past experience with entering into similar contracts with other customers that most customers do not cancel contracts. Service Provider has no previous revenue from contracts with this customer.	The up-front payment relates to the five-year expected term of the contract. The entity would record an asset for the payment and amortize it as a reduction of revenue over the expected term (that is, considering renewal options the customer is expected to exercise). The asset would be periodically assessed for recoverability.	The current contract term is only one month. Therefore, the up-front payment should be offset against the one month of revenue. In this example, the payment exceeds revenue for the first month.

Example/ Scenario	Facts	Analysis — View A	Analysis — View B
Example 2, Scenario A — Supply arrangement	Supplier makes a \$1 million payment to a customer as part of the negotiations in a three-year exclusive supply contract to provide specialized parts to a customer that are a component in one of the customer’s main products. The payment is made as an incentive and to also reimburse the customer for costs to be incurred to switch from an existing supplier, including termination fees and other costs. The supply contract stipulates a price of \$100 per part. The customer provides a non-binding forecast of its supply requirements, which forecasts expected total purchases of 100,000 parts over the contract period (for a total of \$10 million). Supplier has no previous revenue from contracts with this customer.	The up-front payment relates to the expected 100,000 parts. The entity would record an asset for the payment and amortize it as a reduction of revenue as the anticipated units are provided to the customer. The asset would be periodically assessed for recoverability.	Because the customer is not required to make any purchases, the entity has no revenue contract with the customer. Therefore, the entire up-front payment would be recognized in the income statement when the payment is made.
Example 2, Scenario B — Supply arrangement	Assume the same facts as Example 2, Scenario A, except that in this scenario Supplier receives a purchase order for 20,000 parts at the time the payment is made. However, consistent with Scenario A, Supplier expects that the customer’s purchase volume will be 100,000 parts.	Same as Example 2, Scenario A.	The current contract is for 20,000 units. The up-front payment would be recorded as an asset and then would be amortized as a reduction of revenue as the 20,000 units are provided to the customer.

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