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Interpreting the New Revenue Recognition Standard: What All CPAs Need to Know

AICPA & CIMA staff



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By AICPA & CIMA staff

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Revenue Recognition Overview

Learning level

Intermediate

Course goal

This course is designed to explain why FASB and the International Accounting Standards Board (IASB®) came up with a single principles-based revenue standard. This course aims to identify when part or all of a contract with a customer is outside the scope of FASB Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*. Additionally, it outlines the five core principles described in FASB ASC 606.

Learning objectives

- Identify why FASB and the IASB developed a single principles-based revenue standard.
- Identify when part or all of a contract with the customer is outside the scope of FASB ASC 606.
- Identify the five core principles described in FASB ASC 606.

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Introduction

Understanding revenue recognition according to FASB ASC 606 is both a regulatory requirement and a strategic consideration. The five core principles it introduced are the blueprint for ensuring accuracy, consistency, and transparency in financial reporting. Grasping these principles empowers organizations to recognize revenue in a manner that truly reflects their economic realities and firm performance.

The shift towards a single principles-based revenue standard addressed the complexities of previous revenue requirements. This development streamlined the approach, aligning it with contemporary business practices and expectations. FASB and the IASB developed a principles-driven approach designed to reduce the inconsistencies and weaknesses found in earlier standards.

This course introduces revenue recognition under FASB ASC 606. It focuses on key points and core principles and outlines the scope and exceptions to the single principles-based standard of approach.

A single principles-based revenue standard (1.1)



Learning objective:

Determine why FASB and the IASB developed a single principles-based revenue standard.

Background

Revenue is an important performance metric used by preparers, investors, lenders, and other financial statement users to measure an entity's past performance, financial health, and future prospects. Prior to the issuance of the revenue recognition standard, generally accepted accounting principles in the United States of America (U.S. GAAP) failed to require detailed disclosures about an entity's revenue-generating activities and contained a wide variety of requirements and concepts for specific transactions and industries — this sometimes resulted in the use of different accounting treatments for similar transactions. Difficulty in applying revenue guidance was not limited to U.S. GAAP; entities that used International Financial Reporting Standards (IFRS® Standards) as their financial reporting framework were also challenged by limited available guidance.

Given its diversity, complexity, and importance, revenue is heavily scrutinized by regulators. Because revenue is so susceptible to fraud, it is specifically addressed by the AICPA and PCAOB, respectively, in AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*,[1] and AS 2401, *Consideration of Fraud in a Financial Statement Audit*.[2]

[1] All AU-C sections can be found in AICPA *Professional Standards*.

[2] All AS sections can be found in *PCAOB Standards and Related Rules*.

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Joint projects and exposure drafts

In 2002, FASB and the IASB (collectively referred to as "the boards") initiated a joint project to develop a single principles-based revenue standard. This joint project, along with several other projects, was announced in a memorandum of understanding commonly referred to as the "Norwalk Agreement." To increase the usefulness of revenue information to users of financial statements, this agreement included a discussion on the boards' plans to

- remove inconsistencies and weaknesses in existing revenue requirements;
- provide a more robust framework for addressing revenue issues;
- improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets;
- provide more useful information to users of financial statements through improved disclosure requirements; and
- simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

Over the course of two years thereafter, the boards issued the following three exposure drafts for public comment:

- *Revenue from Contracts with Customers*, exposed on June 24, 2010
- *Revenue from Contracts with Customers*, re-exposed on November 14, 2011
- *Revenue from Contracts with Customers — Proposed Amendments to the FASB* Accounting Standards Codification®, exposed on January 4, 2012

Issuance of the final standards

After the three exposure drafts, numerous comment letters, and public outreach, in May 2014 the boards issued joint accounting standards on revenue recognition that addressed the concerns regarding the complexity and lack of consistency when accounting for revenue transactions. Consistent with each board's policy,

- the IASB issued IFRS 15, *Revenue from Contracts with Customers*, and
- FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers* (Topic 606), which
  - amended FASB ASC by creating FASB ASC 606;
  - added a new subtopic, FASB ASC 340-40;
  - provided a principles-based framework for revenue recognition; and
  - superseded FASB ASC 605, *Revenue Recognition*, and either superseded or amended several existing revenue recognition requirements, including industry-specific topics within FASB ASC 900 (Industry) sections.



Key point

With only a few exceptions in discrete areas, differences between U.S. GAAP and IFRS Standards when accounting for revenue from contracts with customers have been eliminated.

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Subsequent developments

Subsequent to the issuance of ASU No. 2014-09, FASB issued several ASUs to address stakeholders' concerns, provide clarification, simplify, and provide other guidance. Issues include the following:

- Deferral of the effective date (ASU No. 2015-14)
- Principal versus agent considerations (ASU No. 2016-08)
- Identifying performance obligations and licensing (ASU No. 2016-10)
- Narrow-scope improvements and practical expedients (ASU No. 2016-12)
- Technical corrections and improvements (ASU No. 2016-20)
- Service concession arrangements (ASU No. 2017-10)
- Reporting comprehensive income (ASU No. 2017-14)
- Clarifying the scope and the accounting guidance for contributions received and contributions made for not-for-profit entities (ASU No. 2018-08)
- Collaborative arrangements (ASU No. 2018-18)
- Stock compensation (ASU No. 2019-08)
- Reference rate reform (ASU No. 2020-04)
- Effective dates for certain entities (ASU No. 2020-05)
- Codification improvements (ASU No. 2020-10)
- Franchisors — Revenue from contracts with customers (FASB ASC 952-606): Practical expedient (ASU No. 2021-02)



Key point

All ASUs mentioned in this course are located on FASB's website. When reviewing revenue recognition guidance, consider accessing FASB ASC 606 directly in the FASB ASC instead of individually reviewing each related ASU; the codification compiles all applicable ASUs into FASB ASC 606.

Knowledge check

1. What was the effect of issuing the revenue recognition standard?

    a. Created FASB ASC 606, *Revenue from Contracts with Customers*.
    b. Eliminated FASB ASC 340-40.
    c. Provided a rules-based framework for recognizing revenue.
    d. Increased several existing revenue recognition requirements and industry-specific topics within FASB ASC 900 (Industry) sections.

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Scope and scope exceptions (1.2)

Learning objective:

Identify when part or all of a contract with the customer is outside the scope of FASB ASC 606.

Within the scope of FASB ASC 606

FASB ASC 606 applies to any entity that enters into a contract with a customer to transfer goods or services, including the transfer of nonfinancial assets that are not within the scope of other authoritative guidance. The scope of FASB ASC 606 is very broad; entities may find that some parts of a contract with a customer are within the scope of FASB ASC 606 and other parts fall within the scope of other FASB ASC topics.

Not-for-profit entities

A not-for-profit entity will need to consider the guidance in FASB ASC 958-605, *Not-for-Profit Entities — Revenue Recognition*, when determining whether a transaction is a contribution within the scope of FASB ASC 958-605 or a transaction within the scope of FASB ASC 606.

Collaborative arrangement

A *collaborative arrangement* is a contractual arrangement that involves a joint operating activity. These arrangements involve two (or more) parties that meet both of the following requirements:

a. They are active participants in the activity.
b. They are exposed to significant risks and rewards dependent on the commercial success of the activity.[3]

An entity shall apply the guidance in FASB ASC 606 to a collaborative arrangement contract only if the counterparty (or counterparties) to the contract is a customer. A *customer* is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.[4]

Contracts partially within the scope of FASB ASC 606

A contract with a customer may be partially within the scope of FASB ASC 606 and partially within the scope of other FASB ASC topics.

- If the other FASB ASC topic specifies how to separate and measure one or more parts of the contract, apply that guidance first. An entity should exclude from the transaction price the amount of the part (or parts) of the contract that are initially measured in accordance with other FASB ASC

[3] FASB Master Glossary. https://asc.fasb.org/MasterGlossary

[4] FASB Master Glossary. https://asc.fasb.org/MasterGlossary

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topics and allocate to other parts of the contract the amount of the transaction price that remains (if any) to each performance obligation within the scope of FASB ASC 606.
- If the other FASB ASC topics do not specify how to separate and initially measure one or more parts of the contract, apply the initial measurement guidance in FASB ASC 606.

Scope exceptions

The following are outside of the scope of FASB ASC 606:

- Lease contracts within the scope of FASB ASC 840 or 842, *Leases*
- Contracts within the scope of FASB ASC 944, *Financial Services — Insurance*
- Certain financial instruments and other contractual rights or obligations within the scope of the following:
  - FASB ASC 310, *Receivables*
  - FASB ASC 320, *Investments — Debt Securities*
  - FASB ASC 321, *Investments — Equity Securities*
  - FASB ASC 323, *Investments — Equity Method and Joint Ventures*
  - FASB ASC 325, *Investments — Other*
  - FASB ASC 405, *Liabilities*
  - FASB ASC 470, *Debt*
  - FASB ASC 815, *Derivatives and Hedging*
  - FASB ASC 825, *Financial Instruments*
  - FASB ASC 860, *Transfers and Servicing*
- Guarantees other than product or service warranties within the scope of FASB ASC 460, *Guarantees*
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers (for example, two oil entities that agree to an exchange of oil to fulfill a demand from their customers in different specified locations on a timely basis).



Key point

Keep in mind that the scope of FASB ASC 606 is very broad — it applies to any entity that enters into a contract with a customer to transfer goods or services, including the transfer of nonfinancial assets that are not within the scope of other authoritative guidance.

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Example: Scope and scope exceptions

Sometimes parts of a contract with a customer fall within the scope of FASB ASC 606 whereas other parts of that same contract fall outside its scope but within the scope of other FASB ASC topics. Consider the example that follows.

Contract with a customer

Able Company entered into a written agreement with its customer, Hanson Inc., to lease a photocopy machine for a period of three years and to provide maintenance services on the machine and supply the customer with toner and paper during the same three-year period.

Assessment

The revenue Able Company receives from the leasing of the photocopier to Hanson Inc. is within the scope of FASB ASC 842 whereas the revenue received from both the maintenance services and the monthly supply of toner and paper are clearly within the scope of FASB ASC 606, with revenue being recognized over time for the maintenance agreement while the supply of toner and paper will be recognized at a point in time.

Knowledge check

2. Within the scope of FASB ASC 606, a collaborative agreement is identifiable in which scenario?

    a. A contract that involves only one party who is responsible for all risks and rewards.
    b. A contractual agreement with two or more participants sharing significant risks and rewards.
    c. An arrangement where parties are not exposed to any risks or rewards.
    d. A noncontractual agreement that does not involve any commercial activities.

3. Which of these is outside the scope of FASB ASC 606?

    a. Software and technology.
    b. Motion pictures, music, and other forms of media and entertainment.
    c. Franchisees.
    d. Insurance contracts.

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The five core principles (1.3)

Learning objective:

Identify when part or all of a contract with the customer is outside the scope of FASB ASC 606.

FASB ASC 606 provides a principles-based framework by introducing core principles that an entity should apply to recognize revenue. Unless specifically scoped out, these core principles are applicable to all contracts with customers; industry-specific revenue recognition guidance in FASB ASC 605 is superseded. To recognize revenue, an entity should apply the following five steps (core principles):

1. Identify the contracts with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

In addition to applying these five steps for recognizing revenue, the following select areas need to be considered when applicable:

- Accounting for incremental costs of obtaining a contract, as well as costs incurred to fulfill a contract (FASB ASC 340-40)
- Licenses (FASB ASC 606)
- Warranties (FASB ASC 606 or FASB ASC 460)

Objective

The overall objective of FASB ASC 606 is to report useful information to users of financial statements. Under the core principles, revenue is recognized to depict the transfer of promised goods or services to customers in amounts that reflect the consideration exchanged for goods or services. The five steps, illustrated in the table that follows, facilitate the attainment of this objective.

Step	Description	FASB ASC reference
1. Identifying the contract	Establishes the scope and scope exceptions for contracts with customers. For all contracts within the scope of FASB ASC 606, an entity should consider the terms of the contract and all relevant facts and circumstances when applying this guidance.	606-10-15

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2. Identifying performance obligations	Provides guidance for assessing the goods or services promised in a contract with a customer and identifying as a performance obligation each promise to transfer to the customer a good or a service (or a bundle of goods or services) that is distinct or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer.	606-10-25
3. Determining the transaction price	Provides guidance for determining the transaction price, which is the amount of consideration an entity expects to be entitled to in exchange for transferring promised goods or services to a customer (excluding amounts collected on behalf of third parties, such as some sales taxes).	606-10-32
4. Allocating the transaction price to performance obligations	Provides guidance for allocating the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration the entity expects to be entitled to in exchange for transferring the promised goods or services to the customer.	606-10-32
5. Recognize revenue as performance obligations are satisfied	Requires that an entity recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good	606-10-25

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	or service to a customer. An asset is transferred when (or as) the customer obtains control of that asset.	

Disclosure requirements

FASB ASC 606 requires disclosures that provide users of financial statements with comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from the entity's contracts with customers. These disclosures include the following:

- Disaggregation of revenue into appropriate categories
- Opening and closing balances of receivables, contract assets, and contract liabilities
- Information about satisfying performance obligations
- Significant judgments used in making determinations about revenue recognition from contracts with customers



Key point

FASB ASC 606 is a principles-based framework that provides five core principles that an entity should apply to recognize revenue.

Knowledge check

4. Which is the first step in the FASB ASC 606 revenue recognition process?

    a. Identifying performance obligations.
    b. Determine the transaction price.
    c. Identifying the contract.
    d. Allocating the transaction price to performance obligations.

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Summary

FASB ASC 606 and IFRS 15 have largely harmonized U.S. GAAP and IFRS for recognizing revenue from contracts with customers. Rather than refer to individual ASUs, use FASB ASC 606 — which compiles all relevant information — for comprehensive guidance. This standard applies broadly to any entity entering into a contract to transfer goods or services, including nonfinancial assets that fall outside the scope of other authoritative guidance. The five core principles of FASB ASC 606 ensure accurate revenue recognition and align with modern business practices, enhancing financial transparency and consistency.

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Solutions

Revenue Recognition Overview

Knowledge check solutions

1.

a. Correct. The issuance of the revenue recognition standard created FASB ASC 606.
b. Incorrect. The issuance of the revenue recognition standard created FASB ASC 340-40.
c. Incorrect. The issuance of the revenue recognition standard provided a principles-based framework for recognizing revenue, not a rules-based framework.
d. Incorrect. The issuance of the revenue recognition standard did not increase several existing revenue recognition requirements and industry-specific topics within the FASB ASC 900 sections. It eliminated several existing revenue recognition requirements and industry-specific topics within the FASB ASC 900 sections.

2.

a. Incorrect. If one party bears all risks and rewards, it is not a collaborative arrangement.
b. Correct. Collaborative arrangements involve joint operating activities where two or more parties are active participants and share significant risks and rewards based on the commercial success of the activity.
c. Incorrect. An essential element to consider is the extent of risk and reward exposure that will occur.
d. Incorrect. Collaborative arrangements typically involve commercial activities and formal agreements.

3.

a. Incorrect. Software and technology are within the scope of the revenue recognition standard.
b. Incorrect. Motion pictures, music, and other forms of media and entertainment are within the scope of the revenue recognition standard.
c. Incorrect. Franchisees are within the scope of the revenue recognition standard.
d. Correct. Insurance contracts are not within the scope of the revenue recognition standard.

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4.

a. Incorrect. This step involves assessing the goods or services promised in a contract and identifying each promise to transfer a good or service to the customer.
b. Incorrect. This involves determining the amount of consideration an entity expects to be entitled to in exchange for transferring promised goods or services to a customer.
c. Correct. This, the first step, involves considering the terms of the contract and all relevant facts and circumstances when applying the guidance.
d. Incorrect. This involves allocating the transaction price to each performance obligation in an amount that depicts the amount of consideration the entity expects to be entitled to in exchange for transferring the promised goods or services to the customer.

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Identifying the Contract With a Customer

Learning level

Intermediate

Course goal

This module discusses the first step of the revenue recognition process and related criteria when identifying the contract with a customer. In addition, key definitions related to revenue recognition are covered in this course.

Learning objectives

- Distinguish between a gain and revenue.
- Identify the criteria required for probable collectibility within the context of FASB ASC 606, *Revenue from Contracts with Customers*.
- Identify when an entity will need to continue to reassess whether a contract with a customer exists.

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Introduction

This course is designed to guide you through the first step of the revenue recognition process, focusing on identifying the contract with a customer. It starts with key definitions and distinctions between gain and revenue, which is crucial for accurate financial reporting and compliance. Next, a discussion on probable collectibility assessment within the context of FASB ASC 606 is presented. Finally, we will take a close look at the crucial aspect of reassessment criteria and combining contracts.

Overview

The core principle of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*, 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. To achieve this core principle, an entity should be able to perform the following:

- Step 1: Identify the contract with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price.
- Step 5: Recognize revenue when or as the entity satisfies a performance obligation.

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Key point

One key concept to remember is that the five steps are achieved consecutively; meaning if an entity cannot achieve the criteria in step 1, they cannot simply move on to step 2 and so on.

Revenue and gains



Learning objective

Distinguish between a gain and revenue.

Key definitions

Before delving into the application of step 1, it is important to understand the following definitions in the FASB ASC master glossary:

- contract. An agreement between two or more parties that creates enforceable rights and obligations.
- customer. A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
- revenue. Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from deriving or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operation.

FASB Concept Statement No. 6, *Elements of Financial Statement,* provides the following definition of *gains:*

> Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

FASB Concept Statement No. 6, further states in paragraph 84, that

> Gains and losses result from entities' peripheral or incidental transactions and from other events and circumstances stemming from the environment that may be largely beyond the control of individual entities and their managements. Thus, gains and losses are not all alike. There are several kinds, even in a single entity, and they may be described or classified in a variety of ways that are not necessarily mutually exclusive.

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The difference between revenue and gains

Although revenue and gains may appear to be similar, some significant differences exist. As noted in the definition, revenue results from an entity's ongoing major or central operations and activities, meaning revenue is derived from producing goods, rendering services, or other activities. Gains result from an entity's peripheral or incidental transactions and from other events and circumstances stemming from an environment that may be largely beyond the control of the entity and their management. Understanding the difference between gains and revenue is important because gains from peripheral or incidental transactions are outside the scope of FASB ASC 606 and, therefore, outside any of the course's content.



Exercise: Gain vs. revenue determination

Based upon the previously mentioned definitions, which are revenue and which are gains?

1. An entity sells equipment for $600. They manufacture the equipment at a cost of $500.
2. An entity sells equipment they no longer need for $600. They bought the equipment for $1,000 five years ago and have been depreciating it on a straight-line basis assuming a 10-year useful life.

Knowledge check

1. What is *revenue* as defined in FASB ASC 606?

    a. Inflows of assets of an entity or settlements of its liabilities (or a combination of both) from deriving or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operation.

    b. The results of an incidental transaction from an event and circumstance stemming from an environment beyond the control of individual entity.

    c. Outflows or other enhancements of an entity or settlements of its liabilities (or a combination of both) from deriving or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operation.

    d. The results of a peripheral transaction from an event and circumstance stemming from an environment beyond the control of individual entity.

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How to identify a contract(s) with a customer

FASB ASC 606 defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." FASB ASC 606-10-25-1 further specifies that a contract(s) with a customer exists only when all of the following criteria have been met:

- The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.
- The entity can identify each party's rights regarding the goods or services to be transferred.
- The entity can identify the payment terms for the goods or services to be transferred.
- The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).
- It is probable that the entity will collect *substantially all of the consideration* to which it will be entitled in exchange for the goods or services that will be transferred to the customer.



Key point

An entity's ability to repossess an asset transferred to a customer should not be considered for the purpose of assessing the entity's ability to mitigate its exposure to credit risk.

Here are some important considerations when assessing whether a contract exists with a customer:

- A contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party or parties.
- When evaluating whether collectibility of an amount of consideration is probable, an entity needs to consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession. Some entities find the collectibility criteria difficult to assess because of certain variables, such as contract modifications or non-cash considerations, that could that potentially affect the criteria.



Key point

To meet the definition of a contract with a customer that is within the scope of FASB ASC 606, the contract does not have to be in writing. A contract can be written, oral, or implied (such as a customary business practice).

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Enforceable rights

A contractual agreement between two or more parties creates enforceable rights and obligations.[1] It is important to realize that an entity's ability to enforce these rights and obligations may vary. Certain practices and processes for establishing contracts with customers can vary across legal jurisdictions (foreign and domestic), industries, and entities. In some places, consumer-friendly laws may invalidate a company's contracts with its customers if challenged in a court of law. Therefore, careful consideration will be needed for contracts that have been approved and committed to by the entity and its customers that may not be enforceable in a court of law in a specific jurisdiction. This evaluation may be more complex in situations in which contracts are entered into across multiple jurisdictions.

Collectibility



Learning objective

Determine the criteria required for probable collectibility within the context of FASB ASC 606, *Revenue from Contracts with Customers*.

Is collectibility probable?

An entity is required to assess whether it is probable that they will collect *substantially all of the consideration* they will be entitled to in exchange for the goods or services that will be transferred to the customer. Keep in mind that part of identifying whether a contract with a customer exists is based on the entity's assessment of whether the customer has the ability and the intention to pay the consideration in exchange for the goods or services being transferred. The objective of this assessment is to evaluate whether there is a substantive transaction between the entity and the customer, which is a necessary condition of step 1.

The collectibility assessment is partly a forward-looking assessment. This means that an entity should consider all of the facts and circumstances, including customary business practices and the entity's knowledge of its customer, when determining whether it is probable that it will collect substantially all of the consideration to which it is entitled. Keep in mind that the assessment is not necessarily based on the customer's ability and intention to pay the entire amount of promised consideration for the entire duration of the contract. When making this assessment, an entity should determine whether the contractual terms and its customary business practices indicate that the entity's exposure to credit risk is less than the entire consideration promised in the contract because the entity has the ability to mitigate its credit risk. Examples of contractual terms or customary business practices that might mitigate the entity's credit risk include the following:

[1] FASB *Accounting Standards Codification* 606-10-05-4

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- In some contracts, payment terms limit an entity's exposure to credit risk. For example, a customer may be required to pay a portion of the consideration promised in the contract before the entity transfers promised goods or services to the customer. In those cases, any consideration that will be received before the entity transfers promised goods or services to the customer would not be subject to credit risk.
- An entity may limit its exposure to credit risk if it has the right to stop transferring additional goods or services to a customer in the event that the customer fails to pay consideration when it is due. In those cases, an entity should assess only the collectibility of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer on the basis of the entity's rights and customary business practices. Therefore, if the customer fails to perform as promised and, consequently, the entity would respond to the customer's failure to perform by not transferring additional goods or services to the customer, the entity would not consider the likelihood of payment for the promised goods or services that will not be transferred under the contract.



Key point

When seller financing is provided, an entity will need to consider a variety of factors when evaluating collectibility of substantially all the considerations to which it will be entitled. Some of those factors might include the following:

- An analysis of commercially available lending terms for similar transactions
- The sufficiency of the down payment
- The borrower's creditworthiness
- Historical experience of the seller in similar transactions with similar customers

When assessing collectibility, an entity should *not* consider whether it can repossess an asset it transferred to a customer.

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Example: Mitigating credit risk

To further explain when credit risk can be mitigated, consider the following:

Facts:

- Service provider ABC entity enters into a three-year service contract with new customer XYZ at the beginning of a calendar month.
- XYZ has a very low credit quality.
- The transaction price of the contract is $720, and $20 is due at the end of each month.
- The stand-alone selling price of the monthly service is $20.



Example: Mitigating credit risk (continued)

- Both parties are subject to termination penalties if the contract is canceled.
- The ABC entity's history with this class of customer indicates that although it cannot conclude it is probable that XYZ will pay the transaction price of $720, XYZ is expected to make the payments required under the contract for at least nine months. If, during the contract term, XYZ stops making the required payments, ABC entity's customary business practice is to limit its credit risk by not transferring further services to XYZ and to pursue collection for the unpaid services.

Given the preceding facts, ABC entity needs to assess whether it is probable that it will collect substantially all of the consideration it will be entitled to in exchange for the services it transferred to XYZ. This would include assessing its history with this class of customer as well as its business practice of stopping service in response to a customer's non-payment.

Assessment

Based upon the preceding fact pattern:

- It would not be probable that ABC entity will collect the entire transaction price ($720) because of XYZ's low credit rating.
- ABC's exposure to credit risk is mitigated because it has the ability and intention (as evidenced by its customary business practice) to stop providing services when a customer does not pay the promised consideration for services provided when it is due.

Conclusion

ABC entity concludes that the contract meets the collectibility criteria because it is probable that XYZ will pay substantially all of the consideration to which ABC entity is entitled for the services transfer to the XYZ (that is, for the services ABC entity will provide as long as XYZ continues to pay for the services provided).

ABC entity would then apply the remaining guidance in FASB ASC 606 to recognize revenue and reassess the criteria only if there is an indication of a significant change in facts or circumstances such as XYZ not making their required payments.

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Key point

An entity's ability to repossess an asset transferred to a customer should not be considered when assessing the entity's ability to mitigate its exposure to credit risk.



Exercise: Collectibility[2]

The following example illustrates collectibility of consideration as described in step 1:

> Carl Construction, a real estate developer, enters into a contract for the sale of a building for $1 million. The customer, Neilson Enterprises, intends to open a restaurant in the building. The building is located in an area where new restaurants face high levels of competition, and Neilson Enterprises has little experience in the restaurant industry. Neilson Enterprises pays a nonrefundable deposit of $50,000 at the inception of the contract and enters into a long-term financing agreement with Carl Construction for the remaining 95% of the promised consideration.
>
> The financing agreement is provided on a nonrecourse basis, which means if Neilson Enterprises defaults, Carl Construction can repossess the building but cannot seek further compensation from Neilson Enterprises, even if the collateral does not cover the full value of the amount owed.

Does Carl Construction have a contract with Neilson Enterprises in accordance with FASB ASC 606? (As a reminder, in this example, Neilson Enterprises entered into the financing arrangement with Carl Construction with the intent of repaying the loan from the cash flow of the restaurant and has no other income or assets with which to repay the loan.)

[2] Exercise fact pattern originated from paragraphs 95–97 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 606-10-55.

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Exercise: Determining when collectibility of a membership fee is probable[3]

A1 Fitness, a health club, enters into a one-year membership with Susan Jones, a customer with low credit quality. The transaction price of the contract is $120, and $10 is due at the beginning of each month. The stand-alone selling price of the monthly service is $10.

On the basis of Susan Jones' credit history and in accordance with the customary business practice of A1 Fitness, Susan Jones is required to pay each month before AI Fitness provides her with access to their health club. In response to non-payment, A1 Fitness' customary business practice is to stop providing service to the Susan Jones upon non-payment.

Has A1 Fitness met the criteria that collectibility is probable?

Exercise: Determining when collectibility of a sale of units is probable with an implicit price concession[4]

Big Pharma Inc. sells 1,000 units of a prescription drug to customer Jenco Corporation for promised consideration of $1 million. This is the first sale Big Pharma Inc. has made to customer Jenco Corporation, which is located in a new region that is experiencing significant economic difficulty. Therefore, Big Pharma Inc. does not expect to be able to collect the full amount of the promised consideration from Jenco Corporation. Despite the possibility of not collecting the full amount, Big Pharma Inc. expects the region's economy to recover over the next two to three years and determines that a relationship with Jenco Corporation could help it forge relationships with other potential customers in the region.

Based on the assessment of the facts and circumstances, Big Pharma Inc. determines that it expects to provide a price concession and accept a lower amount of consideration from Jenco Corporation. Accordingly, Big Pharma Inc. concludes that the transaction price is not $1 million and, therefore, the promised consideration is variable. Big Pharma Inc. estimates the variable consideration and determines that it expects to be entitled to $400,000.

Is consideration probable because the implicit price concession is not the stated price consideration Big Pharma Inc. expects to receive from Jenco Corporation?

Portfolio approach

FASB ASC 606 permits, as a practical expedient, the application of a portfolio approach for contracts with customers having similar characteristics, provided that the effects on the entity's financial statements would not differ materially had FASB ASC 606 been applied to each individual contract within that portfolio.

How should an entity assess whether the results of a portfolio approach would differ materially from the application of FASB ASC 606 on a contract-by-contract basis? FASB indicates — in the "Basis of Conclusions" paragraph, paragraph 69, of Accounting Standards Update No. 2014-09, *Revenue from*

[3] Exercise fact pattern originated from FASB ASC 606-10-55-98J.

[4] Exercise fact pattern originated from paragraphs 99–101 of FASB ASC 606-10-55.

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Contracts with Customers (Topic 606) — that it did not intend for an entity to quantitatively evaluate each outcome and, instead, the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts.

When determining whether to apply step one to each individual contract with a customer or to elect the portfolio approach practical expedient, an entity will need to assess the cost versus benefits. Some entities may determine that the portfolio approach is best applied in step 1, and perhaps even step 3 in the application of FASB ASC 606, but this is based on varying facts and circumstances.

Although not all-inclusive, the following are some entities that may benefit from the application of the portfolio approach:

- A health care entity might want to consider the application of the portfolio approach. For example, it may evaluate whether to establish separate portfolios for uninsured self-pay patients, insured patients with co-payments, insured patients with deductibles, emergency room uninsured self-pay, elective surgery that is not medically necessary or covered by insurance, and so on.
- An educational institution may consider applying the portfolio approach when assessing collectibility of tuition and housing.

Knowledge check

2. A contract with a customer exists only when

    a. The parties to the contract have the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party or parties.

    b. The contract lacks commercial substance, so the risk, timing, and amount of the entity's future cash flows are expected to change as a result of the contract.

    c. It is probable that the entity will collect some of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

    d. The parties to the contract have approved the contract and are committed to performing their respective obligations.

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3. Which is correct regarding the collectibility assessment when assessing whether a contract exists with a customer?

    a. It is partly a forward-looking assessment, requiring an entity to use judgment and consider all the facts and circumstances, including customary business practices and the entity's knowledge of the customer.

    b. It is based on the customer's ability and intention to pay the entire amount of promised consideration for the entire duration of the contract.

    c. It is determined based on customary business practices that indicate that the seller's exposure to credit risk is greater than the entire consideration promised in the contract.

    d. It is based on the customer's ability to limit exposure to credit risk by continuing to provide the transferring of additional goods or services to a customer in the event that the customer fails to pay consideration when it is due.

Reassessment



Learning objective

Identify when an entity will need to continue to reassess whether a contract with a customer exists.

Reassessment criteria

If a contract meets the five-step criteria at assessment, an entity will not reassess the existence of a contract unless there is a significant change in the facts. At times, contracts may be modified for changes in scope, price, or both. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties involved in the contract. For example, a customer's financial capabilities may deteriorate to the point that further collectibility ceases to be probable and therefore the entity may need to reassess whether a contract for future goods or services continue to exist.

When a contract with a customer does not meet the five criteria and an entity receives consideration from the customer, the entity should recognize the consideration received as revenue only when one or more of the following events have occurred:

- The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.
- The contract has been terminated, and the consideration received from the customer is nonrefundable.
- The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

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An entity should recognize the consideration received from a customer as a liability until one of the preceding events occurs or until the five criteria are subsequently met. Depending on the facts and circumstances relating to the contract, the liability recognized represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability should be measured at the amount of consideration received from the customer.



Example: Reassessing the criteria for identifying a contract[5]

Longo Technologies licenses a patent to Sutra Inc., its customer, in exchange for a usage-based royalty. At the contract inception, the contract meets all the collectibility criteria and Longo Technologies accounts for the contract with Sutra Inc. in accordance with FASB ASC 606. Longo Technologies recognizes revenue when Sutra Inc.'s subsequent usage of the licensed patent occurs.

Facts

First year of the contract

- Sutra Inc. provides quarterly reports of usage and pays within the agreed-upon period.

Second year of the contract

- Sutra Inc. continues to use Longo Technologies' patent, but its financial condition declines.
- Sutra Inc.'s current access to credit and available cash on hand are limited.
- Longo Technologies continues to recognize revenue on the basis of Sutra Inc.'s usage throughout the second year.
- Sutra Inc. pays the first quarter's royalties but makes nominal payments for the usage of the patent in quarters 2, 3, and 4.
- Longo Technologies accounts for any impairment of the existing receivable and any credit losses on existing contract balances in accordance with other appropriate FASB ASC topics.



Example: Reassessing the criteria for identifying a contract (continued)

Third year of the contract

- Sutra Inc. continues to use Longo Technologies' patent.
- Longo Technologies learns that Sutra Inc. has lost access to credit and its major customers and thus the customer's ability to pay significantly deteriorates.
- Longo Technologies concludes that it is unlikely that Sutra Inc. will be able to make any further royalty payments for ongoing usage of the patent.

[5] Example fact pattern originated from paragraphs 106–109 of FASB ASC 606-10-55.

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- As a result of the significant change in facts and circumstances, Longo Technologies reassesses whether collectibility is probable and determines that the criteria has not been met because it is no longer probable that it will collect the consideration to which it will be entitled.
- Longo Technologies ceases to recognize any further revenue associated with Sutra Inc.'s future usage of its patent.
- Longo Technologies accounts for any impairment and additional credit loss on the existing receivable in accordance with other appropriate FASB ASC topics.

Conclusion

In year three, when Longo Technologies learned that Sutra Inc. had lost access to credit and its major customers, thereby significantly affecting their ability to pay the royalties, they reassessed that the collectibility was no longer probable and ceased recognizing any future revenue associated with Sutra Inc.'s usage of its patent.

Knowledge check

4. When a contract with a customer does not meet the five criteria and an entity receives consideration from the customer, when should the entity recognize the consideration received as revenue?

    a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.

    b. The contract has been terminated, and the consideration received from the customer is refundable.

    c. The entity maintains control of the goods or services to which the consideration has been received.

    d. The entity continues to transfer goods or services to the customer and the consideration received from the customer is nonrefundable.

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Combining contracts

An entity should combine two or more contracts if the contracts were entered into at or near the same time with the same customer or related parties of the customer if at least one of the following applies:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration in one contract depends on the price or performance of the other contract.
- The goods or services are a single performance obligation.

Although not all-inclusive, the following are examples of when an entity should consider combining separate contract with the same customer, keeping in mind that judgment is required because additional facts or different circumstances could result in a different conclusion.

- Entities that provide engineering and construction services in separate contracts with the same customer, whose contracts are issued at or near the same time, may need to combine these separate contracts if the two contracts are for the design and building of a single capital asset and would be deemed a single performance obligation had they been in a single contract; therefore, these contracts should likely should be combined.
- Educational institutions will need to determine if tuition and housing (or any other contracts entered into with the student) are contracted together in a single contract or in separate contracts. If entered into at or near the same time with the same student, specifically, if the contracts are negotiated as a package with a single commercial objective, the amount of consideration to be paid in one contract depends on the price or performance of the other contract, or if the services promised in the contracts are a single performance obligation, then the educational institution would combine the contracts. When making the determination of whether to combine contracts for tuition and housing, the educational institution would need to consider whether a discount (for example, financial aid) has been provided in a bundled arrangement. If the single commercial objective criterion has not been met, then the educational institution would treat the contracts as separate contracts and apply the guidance in FASB ASC 606 to each separate contract.

Knowledge check

5. Which indicates that a combined contract should be considered?
    a. The contracts are entered into at or near the same time and have a single commercial objective.
    b. The contracts have different commercial objectives.
    c. The amounts of consideration in the two contracts are independent of each other.
    d. The customer receives a discount as a result of an existing relationship.

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Connected concepts: Practical point for management

Here are some questions for management to consider when identifying a contract with a customer:

- Is there a formal or informal policy in place to approve and modify contracts with customers? Does that policy differ based on contract types?
- Are there controls around both the approval and modification of contracts with customers?
- Is there a need to engage expert legal advice to determine whether a contract with a customer is legally enforceable and/or has commercial substance?
- At the inception of the contract, how has management determined that it will collect substantially all of the consideration it is entitled to?
- How does management identify contracts that should be combined?
- Has management elected the use of the portfolio approach? If so, how did management determine which contracts with customers have similar characteristics?
- Can the judgments and assumptions used when identifying a contract with a customer be supported, and are they documented? Is that documentation and support sufficient enough for the company's auditors?

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Summary

Here are a few key takeaways:

- Don’t lose sight of the difference between revenue and gains. Transactions that meet the definition of a gain are outside of the scope of FASB ASC 606.
- FASB ASC 606 specifies that a contract(s) with a customer exists only when all of the criteria in step 1 have been met.
- FASB ASC 606 permits the application of a portfolio approach for contracts with customers having similar characteristics.
- An entity will not reassess the existence of a contract unless there is a significant change in the facts after a contract meets the five-step criteria.
- Keep in mind that under certain circumstances an entity should combine two or more contracts if the contracts were entered into at or near the same time with the same customer or related parties of the customer.
- Review the useful practical points for management.

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Solutions

Identifying the Contract With a Customer

Knowledge check solutions

1.

a. Correct. According to the FASB ASC master glossary, *revenue* is defined as inflows of assets of an entity or settlements of its liabilities (or a combination of both) from deriving or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operation.
b. Incorrect. This option is distinct from revenue and aligns with a definition of *gains*.
c. Incorrect. Outflows or reductions of liabilities from key operations like producing goods or rendering services do not qualify as revenue.
d. Incorrect. Gains are increases in equity from peripheral or incidental transactions and other events and circumstances beyond the control of the entity.

2.

a. Incorrect. Per FASB ASC 606, a contract does not exist if either party can unilaterally terminate a wholly unperformed contract without compensating the other party.
b. Incorrect. The contract must have commercial substance to be valid. An example of commercial substance is change in risk, timing, or amount.
c. Incorrect. The appropriate standard is that it's likely the entity will collect *substantially all* of the consideration it is entitled to in exchange for the goods or services to be transferred to the customer.
d. Correct. Under FASB ASC 606, a contract exists when both parties have approved it and are committed to fulfilling their obligations.

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3.

a. Correct. According to FASB ASC 606, the collectibility assessment requires a forward-looking judgment based on all relevant facts and circumstances.
b. Incorrect. The collectibility assessment does not solely rely on the customer's ability and intention to pay the full amount of promised consideration for the entire contract duration.
c. Incorrect. The assessment deliberately moves away from traditional business practices, emphasizing that the seller’s exposure to credit risk surpasses the total consideration specified in the contract.
d. Incorrect. This option misinterprets credit risk mitigation. The assessment should consider if the seller can limit its credit risk exposure. An entity may limit its exposure to credit risk if it has the right to stop, and not continue, transferring additional goods or services to a customer in the event that the customer fails to pay consideration when it is due

4.

a. Correct. According to FASB ASC 606, revenue recognition can occur once an entity has completed all its obligations and has received the majority or total of the promised nonrefundable payment from the customer. This process ensures clarity and accountability in financial reporting.
b. Incorrect. If a contract is terminated and the consideration received from the customer is eligible for a refund, the entity should not recognize this amount as revenue. This method ensures precise financial reporting and aligns with standard practices in revenue recognition.
c. Incorrect. The consideration should be recognized as a liability until obligations are fulfilled or consideration becomes nonrefundable.
d. Incorrect. If goods and services remain provided and the payment is nonrefundable, the entity should not recognize the received amount as revenue.

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5.

a. Correct. An entity should combine contracts made at or near the same time with the same customer or related parties if they share a single commercial objective. This means the contracts are designed to achieve a common goal.
b. Incorrect. Entities should avoid combining contracts with different commercial objectives, because this suggests that the contracts are not intended to achieve a common goal.
c. Incorrect. An entity should consolidate contracts if the consideration in one contract is contingent upon the price or performance of another. Conversely, if the contracts are independent of each other, this suggests that they are not interconnected within a single commercial objective.
d. Incorrect. Receiving a discount due to an existing relationship does not mean the contracts should be combined, because it suggests that each contract stands alone and should be accounted for separately to avoid inaccurate financial reporting.

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Exercise solutions

Exercise: Gain vs. revenue determination

1. The entity appears to be in the business of manufacturing and selling equipment. Therefore, the $600 represents revenue.

2. The entity does not appear to be in the business of selling equipment. Therefore, this is a peripheral activity and represents a $100 gain. The calculation is as follows: $1,000 divided by 10 years using the straight-line method, meaning $100 of depreciation annually, multiplied by five years would equal $500 in accumulated depreciation. The net book value before the equipment was sold would be $1,000 - $500 = $500. The gross proceeds of $600 from the sale less the net book value of the equipment would represent $100 and be classified as a gain.

Exercise: Collectibility

The answer is no. Carl Construction would conclude that it is not probable that it will collect substantially all of the consideration from Neilson Enterprises. Neilson Enterprises' ability and intention may be in doubt because there is significant risk, it lacks experience, and its loan liability is limited because the loan is nonrecourse. In reaching this conclusion, the real estate developer, Carl Construction, considered the following factors regarding its doubt about Neilson Enterprises' ability and intention to pay the loan:

- Neilson Enterprises' intention to repay the loan (which has a significant balance) would be derived primarily from the income generated from its restaurant business (which is a business facing significant risks because of high competition in the industry and its limited experience).
- Neilson Enterprises lacks other income or assets that could be used to repay the loan.
- Neilson Enterprises' liability under the loan is limited because the loan is nonrecourse.

Carl Construction will continue to assess the contract to determine whether the criterion in step 1 has been met.

Because it is not probable that Carl Construction will collect substantially all of the consideration from Neilson Enterprises, Carl Construction would record the nonrefundable deposit of $50,000 at the inception of the contract as follows:

Debit cash	$50,000	
		Credit deposit liability (or some other liability account) $50,000

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Exercise: Determining when collectibility of a membership fee is probable

Yes, collectibility is probable. The health club A1 Fitness does not have exposure to credit risk because all payments from the customer, Susan Jones, are made in advance, and A1 Fitness does not provide services unless the advance payment has been received. The contract meets the collectibility criterion because it is probable that A1 Fitness will collect the consideration to which it is entitled in exchange for the services that will be transferred to its customer Susan Jones; meaning, one month of payment in advance for each month of service.

Exercise: Determining when collectibility of a sale of units is probable with an implicit price concession

Consideration is probable but not at the stated price, the promised consideration of $1 million. Big Pharma Inc. considered its customer Jenco Corporation's ability and intention to pay the consideration and concluded that even though the region is experiencing economic difficulty, it is probable that it will collect $400,000 from Jenco Corporation. Even with the implicit price concession (a reduction of $600,000 from the stated promised consideration), Big Pharma Inc. concludes that the collectibility is probable based on an estimate of variable consideration (stated promised consideration of $1 million less the implicit price concession of $600,000) of $400,000.

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Identifying the Performance Obligations in the Contract

Learning objectives

- Identify the definition of a performance obligation.
- Identify promises of goods or services in a contract with a customer.
- Identify when a good or service is distinct within the context of a contract with a customer.

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Overview

The core principle of the revenue recognition standard 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.

To achieve the core principle of the revenue standard, an entity should be able to perform the following five steps:

- Step 1: Identify the contract with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price.
- Step 5: Recognize revenue when or as the entity satisfies a performance obligation.

We will focus primarily on concepts involving step 2, identifying the performance obligations in the contract.

Identifying the performance obligations in the contract

Definition of a performance obligation

After an entity has determined that it has a contract with a customer, meaning that the criterion in step 1 has been achieved, they will turn their attention to step 2. This is performed by assessing, at the inception of the contract, the types of goods or services, or both, promised in the contract with the customer. The entity will need to determine whether each of these goods or services, or both, meet the definition of a separate performance obligation. Therefore, it is important to understand the definition of a *performance obligation*, which is defined in the FASB *Accounting Standards Codification*® (ASC) master glossary as:

Performance Obligation: A promise in a contract with a customer to transfer to the customer either

a. a good or service (or a bundle of goods or services) that is distinct or
b. a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Promised goods and services identified in a contract

Generally, a contract with a customer will explicitly state the promised goods or services; however, promised goods and services need not be explicitly stated. A contract with a customer may also include promises that are implied. These implied promises might have originated by an entity's customary business practice, published policies, or specific statements if made at the time the customer entered into the contract. Implied promises may create a reasonable expectation that the entity will transfer to the customer a good or a service.

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Key point

Assessing whether a good or service is a performance obligation does not apply when the promised good or service

- is immaterial in the context of the contract with the customer, or
- does not include the activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, administrative tasks to set up a contract are not promised goods or services in the contract with the customer and would not be considered a performance obligation.

Keep in mind that the term *immaterial* is not defined in FASB ASC 606, *Revenue from Contracts with Customers*; consider referring to FASB ASC 105, *Generally Accepted Accounting Principles*. FASB ASC 105-10-05-6 explains that the provisions in the FASB ASC need not be applied to immaterial amounts.

Key point (continued)

A word of caution: Although FASB ASC 606-10-25-16A established that immaterial items are not required to be assessed as promised goods or services for purposes of identifying performance obligations, entities should consider the relative significance or importance of a particular promised good or service at the contract level rather than at the financial statement level, considering both the quantitative and the qualitative nature of the promised good or service in the contract.

FASB ASC 606-10-25-16B clarifies that this approach to materiality does not apply to customer options and related material rights, where specific guidance in paragraphs 41–45 of FASB ASC 606-10-55 applies.

The following types of promised goods or services may be included in a contract with a customer (note that this list is not all-inclusive):

- Sale of goods produced by an entity (for example, inventory of a manufacturer)
- Resale of goods purchased by an entity (for example, merchandise of a retailer)
- Resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal)
- Performing a contractually agreed-upon task (or tasks) for a customer
- Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides
- Providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party)

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- Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
- Constructing, manufacturing, or developing an asset on behalf of a customer
- Granting licenses
- Granting options to purchase additional goods or services (when those options provide a customer with a material right)

Material right

The term *material right* is not defined in FASB ASC 606 but is used quite often throughout the illustrative examples in FASB ASC 606. Understanding whether a customer was promised a material right is important because material rights generally give rise to separate performance obligations. Assessing whether an entity has granted a customer a material right might be a bit confusing. To assist in this assessment, an entity will need to consider whether the customer received a promise to acquire an additional good or service they would not have been entitled to had they not entered into the contract. The following examples, although not all-inclusive, might give rise to a material right:

- A customer purchases a good from an entity and upon completion of the transaction receives a coupon or voucher for a percentage off their next purchase.
- A customer who is part of an entity's customer loyalty program purchases a service from an entity, such as airfare, and receives a certain amount of loyalty points for future use.

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Example of determining whether a customer received a material right/separate performance obligation

The contract with the customer

Arrow Software Company enters into 100 separate contracts with its customers to provide one year of database maintenance services for $1,000 per contract. The terms of the contracts specify that at the end of the year, each customer has the option to renew the maintenance contract for a second year by paying an additional $1,000. Customers who renew for a second year also are granted the option to renew for a third year for $1,000. Arrow Software Company charges significantly higher prices for maintenance services to customers that did not initially sign up for the maintenance services. The annual maintenance service would be $3,000 in year 2 and $5,000 in year 3 for customers that did not initially purchase the renewal service or allowed the service to lapse.

Consideration in determining whether a customer received a material right/separate performance obligation

- The customers would not have received the renewal options had they not entered into the contracts with Arrow Software Company.
- The price for the database maintenance services would be significantly higher in years 2 and 3 without the initial purchase of the renewal service

Conclusion

Arrow Software Company would conclude that the renewal option in its contracts with customers provides a material right that the customers would not receive without entering into the contracts because the price for maintenance services would be significantly higher had those customers not initially elected to purchase the database maintenance services for years 2 and 3. Therefore, Arrow Software Company would conclude that the promise to provide the renewal option is a separate performance obligation.

Determining whether shipping and handling activities are separate performance obligations

An entity might perform shipping and handling activities related to the promise of a good, so an entity might question whether shipping and handling activities are considered performance obligations. To determine this, the following should be considered:

- If the shipping and handling activities are performed *before* the customer obtains control of the good, then they are not a promised service to the customer. Rather, the shipping and handling are activities to fulfill the entity's promise to transfer the good to the customer.
- If the shipping and handling activities are performed *after* the customer obtains control of the good, then the entity may elect to account for the shipping and handling as activities to fulfill the promise to transfer the good in accordance with paragraph 18b of FASB ASC 606-10-25. The entity would have to make an accounting policy election, and the application of the election would have to be consistently applied to similar types of transactions. Therefore, if the accounting policy election is made, an entity would not evaluate whether shipping and handling activities are promised services to

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its customers. Keep in mind that if revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities will need to be accrued.

Examples

The following examples illustrate the implementation of FASB ASC 606.



Disclosure illustrations: Shipping and handling

Walmart Inc.1

Excerpt from notes to financial statements for the 12 months ended January 31, 2024

Summary of significant accounting policies

Revenue recognition

Net sales

The Company recognizes sales revenue, net of sales taxes and estimated sales returns, at the time it sells merchandise or services to the customer. eCommerce sales include shipping revenue and are recorded upon delivery to the customer. Additionally, estimated sales returns are calculated based on expected returns.

[1]The full text of the financial statement can be found on the SEC's website at https://www.sec.gov/Archives/edgar/data/104169/000010416924000056/wmt-20240131.htm#if7bafa2f15c945fc9ed81e13b298f83b_118..

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Disclosure illustrations: Shipping and handling (continued)

Intel Corporation[2]

Excerpt from notes to financial statements for the fiscal year ended December 30, 2023

Note 2: Accounting policies

Revenue recognition

We recognize net product revenue when we satisfy performance obligations as evidenced by the transfer of control of our products or services to customers. Substantially all of our revenue is derived from product sales. Our products often include a software component, such as firmware, that is highly interdependent and interrelated with the product and is substantially accounted for as a combined performance obligation. In accordance with contract terms, revenue for combined performance obligations and standalone product sales is recognized at the time of product shipment from our facilities or delivery to the customer location, as determined by the agreed-upon shipping terms.

Advanced Micro Devices Inc.[3]

Excerpt from notes to financial statements for the fiscal year ended December 30, 2023

Summary of significant accounting policies

Revenue recognition

Revenue is recognized when a customer obtains control of promised goods or services and is recognized in an amount that reflects the consideration which the Company expects to receive in exchange for those goods or services. Sales, value-added, and other taxes collected concurrently with the provision of goods or services are excluded from revenue. Shipping and handling costs associated with product sales are included in cost of sales.

[2] The full text of the financial statement can be found on the SEC's website at https://www.sec.gov/Archives/edgar/data/50863/000005086324000010/intc-20231230.htm.
[3] The full text of the financial statement can be found at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000002488/000000248823000047/amd-20221231.htm.

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Connected concepts: Practical point for management

It is not uncommon for entities to transfer control of a good to a customer prior to that good being shipped. This is generally referred to as the free on board (FOB) shipping point. Entities are required to assess whether shipping and handling activities associated with these FOB shipping point transactions represent a separate performance obligation to a customer. Keep in mind that control of that good has already transferred to the customer, and therefore the shipping and handling activities are not part of the entity's promise to transfer the good to the customer.

Some entities may fail to realize that they must make an accounting election to not evaluate whether the shipping and handling are promised services to customers, meaning possible separate performance obligations. Note that this election will need to be applied consistently to similar transaction types.

Knowledge checks

1. Which statement best describes an implied promise in a contract with a customer?

    a. It needs to be explicitly stated in the contract.
    b. May be part of an entity's customary business practice.
    c. May be part of an entity's competitor's customary business practice.
    d. Creates an unreasonable expectation of the customer.

2. When can an entity avoid accounting for shipping and handling activities as a separate performance obligation?

    a. The shipping and handling activities occurred before the customer obtains control of the goods.
    b. The shipping and handling activities occurred after the customer obtained control of the good.
    c. The shipping and handling activities were an established customary business practice by the entity.
    d. The shipping and handling activities were explicitly stated in the contract with the customer.

Determining when a good or service has been identified as distinct

Significant judgment is required to determine whether goods or services are distinct. The importance of getting this right cannot be overstated. Yet, many entities find this determination quite challenging. FASB helped to clarify the guidance in FASB ASC 606 by providing extensive examples in the implementation guidance and illustrations section, FASB ASC 606-10-55. This authoritative guidance provides additional insight for making these challenging determinations.

When goods and services are distinct

To determine whether a promised good or service in a contract is a separate performance obligation, an entity will need to assess whether that good or service is distinct. Therefore, FASB ASC 606 explains that a good or service promised to a customer is distinct if both of the following criteria are met:

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- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises.

A series of distinct goods or services has the same transfer pattern to the customer if both of the following criteria are met:

- Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria to be a performance obligation satisfied over time.
- The same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

In assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable at the inception of the contract, an entity will need to determine the following:

- Whether a customer can benefit from the good or service if the good or service could be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that could generate economic benefits — Keep in mind that with some goods or services, a customer may be able to benefit from a good or service on its own.
- Whether a customer is able to benefit from the good or service only in conjunction with other readily available resources — A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, if an entity regularly sells a good or service separately, it indicates that a customer can benefit from the good or service on its own or with other readily available resources.

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The following example illustrates the implementation of FASB ASC 606.



Disclosure illustrations: Distinct performance obligations

Microsoft Corp.[4]

Excerpt from notes to financial statements for the 12 months ended June 30, 2024

Note 1: Accounting policies

Significant judgments

Our contracts with customers often include promises to transfer multiple products and services to a customer. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. When a cloud-based service includes both on-premises software licenses and cloud services, judgment is required to determine whether the software license is considered distinct and accounted for separately, or not distinct and accounted for together with the cloud service and recognized over time. Certain cloud services, primarily Office 365, depend on a significant level of integration, interdependency, and interrelation between the desktop applications and cloud services, and are accounted for together as one performance obligation. Revenue from Office 365 is recognized ratably over the period in which the cloud services are provided.

Judgment is required to determine the SSP for each distinct performance obligation. We use a single amount to estimate SSP for items that are not sold separately, including on-premises licenses sold with SA or software updates provided at no additional charge. We use a range of amounts to estimate SSP when we sell each of the products and services separately and need to determine whether there is a discount to be allocated based on the relative SSP of the various products and services.

In instances where SSP is not directly observable, such as when we do not sell the product or service separately, we determine the SSP using information that may include market conditions and other observable inputs. We typically have more than one SSP for individual products and services due to the stratification of those products and services by customers and circumstances. In these instances, we may use information such as the size of the customer and geographic region in determining the SSP.

Due to the various benefits from and the nature of our SA program, judgment is required to assess the pattern of delivery, including the exercise pattern of certain benefits across our portfolio of customers.

Our products are generally sold with a right of return, we may provide other credits or incentives, and in certain instances we estimate customer usage of our products and services, which are accounted for as variable consideration when determining the amount of revenue to recognize. Returns and credits are estimated at contract inception and updated at the end of

[4] The full text of the financial statement can be found on the SEC's website at https://www.sec.gov/Archives/edgar/data/789019/000095017024087843/msft-20240630.htm

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each reporting period if additional information becomes available. Changes to our estimated variable consideration were not material for the periods presented.

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Example: Goods or services that are distinct

The contract

Ace Partners, a software developer, enters into a contract with a customer, Jones Inc., to transfer a software license, perform an installation service, and provide unspecified software updates and technical support (online and telephone) for a two-year period. Ace Partners sells the license, installation service, and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is routinely performed by other software developers and does not significantly modify the software. The software remains functional without the updates and the technical support.

Assessment considerations

- Ace Partners assesses the goods and services promised to the customer Jones Inc. and observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support.
- Ace Partners took into consideration the fact that, although they integrate their software into the system of Jones Inc., the installation services do not significantly affect their customer's ability to use and benefit from the software license because the installation services are routine and can be obtained from alternate software providers.
- The software updates do not significantly affect Jones Inc.'s ability to use and benefit from the software license because the software updates in this contract are not necessary to ensure that the software maintains a high level of utility to Jones Inc. during the license period.
- Ace Partners observes that none of the promised goods or services significantly modifies or customizes one another and that they are not providing a significant service of integrating the software and the services into a combined output.

Conclusion

Based on Ace Partners' assessment, the following four performance obligations have been identified in the contract with Jones Inc.:

- The software license
- An installation service
- Software updates
- Technical support

Ace Partners reached the preceding conclusion because of the following:

- Jones Inc. can benefit from the updates together with the software license transferred at the outset of the contract. Therefore, Ace Partners concludes that its customer, Jones Inc., can benefit from each of the goods and services either on its own or together with the other goods and services that are readily available.
- The software and the services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated because Ace Partners would be able to fulfill its promise to transfer the initial software license independent from its promise to subsequently provide the installation service, software updates, or technical support.

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When goods and services are not distinct

When identifying performance obligations, FASB ASC 606-10-25-21 states that the objective is to determine whether an entity's promises to transfer goods or services to the customer are separately identifiable within the context of the contract or are instead a combined item or items to which the promised goods or services are inputs. Some factors that would indicate that two or more promises to transfer goods or services to a customer would not be considered as separately identifiable include the following:

- When an entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer — A combined output or outputs might include more than one phase, element, or unit.
- When one or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract
- When each of the goods or services is significantly affected by one or more of the other goods or services in the contract — For example, in some cases, an entity would not be able to fulfill its promise by transferring each of the goods or services independently.

When a good or service is not distinct, they should be combined with other promised goods or services until an entity identifies a bundle of goods or services that are distinct. In some cases, this would result in accounting for all the goods or services promised in a contract as a single performance obligation.

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The following examples illustrate the implementation of FASB ASC 606.



Disclosure illustrations: When goods or services are accounted for as a single performance obligation

Microsoft Corp.[5]

Excerpt from notes to financial statements for the 12 months ended June 30, 2024

Note 1: Accounting policies

Revenue recognition

Nature of products and services

Our hardware is generally highly dependent on and interrelated with the underlying operating system and cannot function without the operating system. In these cases, the hardware and software license are accounted for as a single performance obligation and revenue is recognized at the point in time when ownership is transferred to resellers or directly to end customers through retail stores and online marketplaces.

[5] The full text of the financial statement can be found on the SEC's website at: https://www.sec.gov/Archives/edgar/data/789019/000095017024087843/msft-20240630.htm.

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Disclosure illustrations: When goods or services are accounted for as a single performance obligation (continued)

Merck & Co., Inc.[6]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Summary of accounting policies

Revenue recognition

Recognition of revenue requires evidence of a contract, probable collection of sales proceeds, and completion of substantially all performance obligations. Merck acts as the principal in substantially all of its customer arrangements and therefore records revenue on a gross basis. The majority of the Company's contracts related to the Pharmaceutical and Animal Health segments have a single performance obligation — the promise to transfer goods. Shipping is considered immaterial in the context of the overall customer arrangement and damages or loss of goods in transit are rare. Therefore, shipping is not deemed a separately recognized performance obligation.



Example of goods and services that are not distinct within the context of a contract with a customer

The contract with the customer

A contractor enters into a contract to build a hospital for a customer. The contractor is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing.

Considerations in determining whether the goods and services are distinct

- The promised goods and services are capable of being distinct because the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the contractor's competitors will regularly sell many of these goods and services separately to other customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling, or holding those goods or services.
- The promises to transfer the goods and services are not separately identifiable as evidenced by the fact that the contractor provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.

[6] The full text of the financial statement can be found on the SEC's website at: https://www.sec.gov/ix?doc=/Archives/edgar/data/0000310158/000162828024006850/mrk-20231231.htm

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Example of goods and services that are not distinct within the context of a contract with a customer (continued)

Conclusion

The criterion has not been met for the goods and services to be considered distinct. Therefore, the contractor will account for all of the goods and services in the contract as a single performance obligation. To put it another way, the customer entered into a contract with the contractor to a hospital. Without the engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing, the hospital could not have been built.

Example of combining goods and services into one performance obligation

The contract

Merrill Corporation (Merrill) grants its customer Darren Partners (Darren) a three-year term license to antivirus software and promises to provide Darren with when-and-if available updates to that software during the license period. Merrill frequently provides updates that are critical to the continued utility of the software. Without the updates, Darren's ability to benefit from the software would decline significantly during the three-year arrangement.

Assessment considerations

Merrill considered whether the software and the updates are each promised goods or services in the contract and are each capable of being distinct because Darren can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to Darren), while Darren can benefit from the updates together with the software license transferred at the outset of the contract.

Conclusion

Merrill concludes that its promise to transfer the software license and to provide the updates when-and-if available are not separately identifiable because the license and the updates are, in effect, inputs to a combined item (antivirus protection) in the contract.

The updates significantly modify the functionality of the software (that is, they permit the software to protect Darren from a significant number of additional viruses that the software did not protect against previously) and are integral to maintaining the utility of the software license with Darren.

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Example of combining goods and services into one performance obligation (continued)

The license and updates fulfill a single promise (one performance obligation) to Darren in the contract (a promise to provide protection from computer viruses for three years).

Merrill will account for the software license and the when-and-if available updates as a single performance obligation because it has concluded that the nature of the combined good or service it promised to transfer to its customer Darren is computer virus protection for three years.



Connected concepts: Practical point for management

The following are some thoughts for management to consider when identifying performance obligations:

- Performance obligations may be explicitly stated in the contract and/or may be implied based on customary business practices.
- Do any of the contracts contain material rights to customers that need to be accounted for as separate performance obligation?
- When identifying performance obligations, have immaterial items been omitted? If there are immaterial items, how did management determine those items to be immaterial?
- If transactions with customers involve shipping and handling activities, is management going to assess whether the shipping and handling activities represent a separate performance obligation to the customer?
- Should management elect to not account for shipping and handling activities as separate performance obligations; and, if so, has that election been properly disclosed in the notes to the financial statements?
- How does management determine whether a promised good or service is distinct, particularly within the context of the contract?
- If a series of goods or services is provided to a customer, should management treat that series of goods or services as separate performance obligations or should they be treated as a single performance obligation?
- Has management established proper controls over the process used to identify performance obligations?

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Connected concepts: Practical point for small and medium-sized private companies

Unlike larger companies, many private companies do not have written contracts with their customers; therefore, it may be a bit more difficult for these private companies to identify performance obligations because some promises to customers may be based on customary business practices established over the years. Although not all-inclusive, these companies might want to consider the following:

- As private companies identify the customary business practices they have established, they should consider documenting them in writing to assist in the assessment of separate performance obligations as well as establish an overall consistent policy.
- When searching for customary business practices, consider reviewing notices posted at the business establishment such as, "We value our customers and provide training on all of our products free of charge."
- If a private company has a website, it should review its content to ensure that it has not stated something on the website that might be considered a customary business practice.

Knowledge check

3. Which would **not** result in a separately identifiable promise by an entity to transfer goods to a customer?

   a. Assessing whether the customer can benefit from each good on its own.
   b. Determining whether the customer is able to benefit from the good in conjunction with other readily available resources.
   c. Determining whether the goods are interdependent and significantly affect each other.
   d. Determining whether the goods can be fulfilled independently of one another.



Exercise: Maintenance services provided to end customer at no additional cost

An entity enters into a contract with a customer that is a distributor. The entity promises to provide maintenance services for no additional consideration (that is, "free") to any party (that is, the end customer) that purchases the product from the distributor. The entity outsources the performance of the maintenance services to the distributor and pays the distributor an agreed-upon amount for providing those services on the entity's behalf.

If the end customer does not use the maintenance services, the entity is not obliged to pay the distributor.

Is the promise to provide maintenance services for no additional consideration to the end customer a performance obligation?

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Exercise: Maintenance services provided to any party at no additional cost

In a contract with a distributor, an entity does not promise to provide any maintenance services. The entity typically does not provide maintenance services and, therefore, has not established a customary business practice. At the inception of the contract, the entity transfers control of the product to the distributor and, therefore, the contract is completed. Before the sale to the end customer, however, the entity makes an offer to provide maintenance services to any party that purchases the product from the distributor for no additional promised consideration.

Is the promise to provide maintenance services to any party that purchases the product from the distributor for no additional promised consideration a performance obligation?

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Summary

In conclusion, this course has provided a comprehensive study of the second step of the revenue recognition process when identifying performance obligations within a contract. The course has effectively connected the second step to practical management points, which are crucial for real-world applications, and illustrated through examples and exercises the implementation of FASB ASC 606, including distinct performance obligations and when goods or services are accounted for as a single performance obligation. Altogether, the focus on the second step reinforced the need to understand the key points and distinctions of a performance obligation and how it fits within the broader context of revenue recognition.

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Solutions

Identifying the Performance Obligations in the Contract

Knowledge check solutions

1.

a. Incorrect. It needs to be explicitly stated in the contract. A contract with a customer generally explicitly states the promised goods or services; however, promised goods and services identified in a contract may not be limited to what was explicitly stated in the contract. A contract with a customer may also include promises that are implied by an entity's customary business practices.
b. Correct. Promised goods and services identified in a contract may not be limited to what was explicitly stated in the contract. A contract with a customer may also include promises that are implied by an entity's customary business.
c. Incorrect. Promised goods and services identified in a contract may not be limited to what was explicitly stated in the contract. A contract with a customer may also include promises that are implied by an entity's customary business but is not concerned with the customary business practices of a competitor.
d. Incorrect. A contract with a customer may also include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises created a reasonable, and not unreasonable, expectation of the customer that the entity will transfer to the customer a good or service.

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2.

a. Incorrect. When the shipping and handling activities occurred before the customer obtains control of the goods, they are not a promised service to the customer. Rather, the shipping and handling are activities to fulfill the entity's promise to transfer the good to the customer, so an accounting policy election to not account for them as a separate performance obligation is not applicable.
b. Correct. After the customer obtains control of the good, then the entity may elect to account for the shipping and handling as activities to fulfill the promise to transfer the good, meaning the entity would be electing to not account for them as a separate performance obligation. The entity would have to make an accounting policy election, and the application of the election would have to be consistently applied to similar types of transactions. Therefore, if the accounting policy election is made, an entity would not evaluate whether shipping and handling activities are promised services to its customers. Keep in mind that if revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities will need to be accrued.
c. Incorrect. Whether the shipping and handling activities are an established customary business practice by the entity is not a consideration for determining if the shipping and handling is a separate performance obligation. After the customer obtains control of the good, then the entity may elect to account for the shipping and handling as activities to fulfill the promise to transfer the good, meaning the entity would be electing to not account for them as a separate performance obligation. The entity would have to make an accounting policy election, and the application of the election would have to be consistently applied to similar types of transactions. Therefore, if the accounting policy election is made, an entity would not evaluate whether shipping and handling activities are promised services to its customers. Keep in mind that if revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities will need to be accrued.
d. Incorrect. Whether the shipping and handling activities were explicitly stated in the contract with the customer is not a consideration for determining if the shipping and handling is a separate performance obligation. After the customer obtains control of the good, then the entity may elect to account for the shipping and handling as activities to fulfill the promise to transfer the good, meaning the entity would be electing to not account for them as a separate performance obligation. The entity would have to make an accounting policy election, and the application of the election would have to be consistently applied to similar types of transactions. Therefore, if the accounting policy election is made, an entity would not evaluate whether shipping and handling activities are promised services to its customers. Note that if revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities will need to be accrued.

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3.

a. Incorrect. Assessing whether the customer can benefit from each good on its own is part of determining whether there is a separately identifiable promise by an entity to transfer goods to a customer.
b. Incorrect. Determining whether the customer is able to benefit from the goods in conjunction with other readily available resources is part of determining whether there is a separately identifiable promise by an entity to transfer goods to a customer.
c. Correct. Determining whether the goods are interdependent and significantly affect each other is not part of determining whether there is a separately identifiable promise by an entity to transfer goods to a customer. When each of the goods is significantly affected by one or more of the other goods, an entity would not be able to fulfill its promise by transferring each of the goods or services independently.
d. Incorrect. Determining whether the goods can be fulfilled independently of one another is part of determining whether there is a separately identifiable promise by an entity to transfer goods to a customer.

Exercise solutions

Maintenance services provided to end customer at no additional cost (Peer-to-peer activity)

The promise to provide maintenance services is a performance obligation because it is part of the negotiated exchange between the entity and the distributor. The promise would represent a performance obligation regardless of whether the entity, the distributor, or a third party provides the service. Therefore, the entity will allocate a portion of the transaction price to the promise to provide maintenance services.

Maintenance services provided to any party at no additional cost

The promise of maintenance is not included in the contract between the entity and the distributor at contract inception; and, therefore, it is not a separate performance obligation. The entity did not explicitly or implicitly promise to provide maintenance services to the distributor or the end customers at inception. The obligation to provide maintenance services is accounted for in accordance FASB ASC 450 on contingencies.

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Determining the Transaction Price

Learning objectives

- Identify the definition of a transaction price.
- Identify variable consideration.
- Identify a significant financing component in a contract with a customer.

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Overview

The core principle of the revenue recognition standard is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration an entity expects to be entitled to in exchange for those goods or services.

To achieve the core principle of the revenue standard, an entity should be able to perform the following five steps:

- Step 1: Identify the contract with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price.
- Step 5: Recognize revenue when or as the entity satisfies performance obligations.

Let's focus on the concepts that involve step 3, determining the transaction price.

Implementation illustrations

See the appendix for sample disclosures taken from recently issued SEC 10-K filings which illustrate transaction price considerations under FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts from Customers*. Selected portions of these appendix examples are included, where appropriate.

The transaction price

Determining the transaction price

When an entity enters into a contract with a customer, the entity needs to consider the terms of the contract based on its customary business practices when determining the transaction price of the contract.

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, and not the amount that the entity expects to receive; meaning collection risk is not a factor used in determining the transaction price. Customer credit risk is addressed separately; an impairment to a related receivable is presented as an expense. Remember, collectibility was addressed in step 1 when determining whether a contract with a customer exists, and if collectibility is not considered probable, then a contract does not exist.

The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both. Excluded from the transaction price are amounts collected on behalf of third parties (for example, some sales taxes), but not all taxes. Specifically, FASB ASC 606-10-32-2A explains that an entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes).

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Accounting policy election

Many entities collect a variety of taxes on behalf of several taxing authorities. In the past, these entities did not include the taxes collected on behalf of third parties in their transaction price (i.e. revenue amount reported on their financial statements). FASB ASC 606 does not provide entities with the opportunity to exclude taxes collected on behalf of third parties unless those entities elect to exclude those taxes. Therefore, entities interested in excluding from their transaction price taxes collected on behalf of third parties will need to make an accounting policy election.

Keep in mind the following regarding this accounting policy election:

- The election applies to all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction, collected by the entity from a customer. Take the following, for example:
  - Sales tax
  - Use tax
  - Value added tax
  - Some excise taxes

FASB ASC 606 excludes from this accounting policy election taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process (such as in the case of gasoline, alcohol, and cigarettes).

When making this accounting policy election, make sure you are in compliance with the applicable disclosure requirements in FASB ASC 235, *Notes to the Financial Statements*.

Example disclosures

Many entities, including large public companies have elected to exclude sales tax collected on behalf of third parties from their transaction price (revenue reported in their financial statements).The following examples illustrate accounting policy disclosures under FASB ASC 606. These examples are presented for informational purposes and are not authoritative.

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Implementation illustration: Accounting policy election

Microsoft Corporation[1]

Excerpt from notes to financial statements for the fiscal year ended June 30, 2023

Revenue recognition

… Revenue is recognized net of allowances for returns and any taxes collected from customers, which are subsequently remitted to governmental authorities.

Seagate Technology[2]

Excerpt from notes to financial statements for the fiscal year ended June 28, 2024

Revenue recognition, sales returns and allowances, and sales incentives programs

Revenue from sales of products is generally recognized upon transfer of control to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products, net of sales taxes. This typically occurs upon shipment from the Company. When applicable, the Company includes shipping charges billed to customers in Revenue and includes the related shipping costs in Cost of revenue on the Company's Consolidated Statements of Operations.

Transaction price considerations

An entity will need to consider several factors when determining the transaction price. For example, the entity will need to assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be canceled, renewed, or modified. The nature, timing, and amount of consideration promised to a customer affects the transaction price, an entity will have to take into consideration the effects, when present, of all of the following when determining the transaction price:

- Variable consideration
- The existence of a significant financing component in the contract
- Noncash consideration
- Consideration payable to a customer
- Constraining estimates of variable consideration

[1] See the appendix for the complete note from which this excerpt was taken. The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000789019/000095017023035122/msft-20230630.htm.
[2] See the appendix for the complete note from which this excerpt was taken. The full text of the financial statement that includes the excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/1137789/000113778924000068/stx-20240628.htm.

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Key point

Under FASB ASC 606, the transaction price is based on the amount to which the entity expects to be entitled and not the stated contract price. Because of this, the transaction price may be less than the contract price, such as when the entity intends to offer a price concession; meaning “list price” does not always equate to transaction price.

Variable consideration

Identifying variable consideration

Many entities might find the identification and assessment of variable consideration challenging. The presence of variable consideration in a contract with a customer changes the transaction price, or part of that transaction price from fixed to variable. When the consideration promised in a contract includes a variable amount, an entity will need to estimate that variable amount of consideration when transferring the promised goods or services to the customer. Sometimes variability relating to the consideration promised to a customer may be explicitly stated in the contract, but often, especially when an entity has established a customary business practice, that is not the case, for explicitly stating that variable consideration is part of a contract with a customer is not required and therefore it can be implied. There are numerous types of variable considerations that could affect a transaction price. Here are several frequently identified variable consideration items and related application examples and exercises. Keep in mind that the following is not all inclusive:

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Variable consideration item	Application example	Exercise
Performance bonuses and penalties	Example of estimating variable consideration — Performance bonus or penalty?	Jacob Inc.
Price concessions		Larkin Partners
Discounts and rebates	Example of a rebate — Estimating variable consideration	Carter Company
Refunds		Jack Partners
Significant financing component	Example of a significant financing component	
Noncash considerations	Example of noncash consideration	
Coupons		Randall Inc.
Consideration payable to a customer		Jerkins Corp.
Constrained consideration		Roberts Inc.

If an entity's consideration is contingent on the occurrence or nonoccurrence of a future event, then the promised consideration becomes variable. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

The promised consideration is variable if either of the following circumstance exists:

- The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. Meaning, it is expected that the entity will offer a price concession. In some jurisdictions, industries, or customers, a price concession may be referred to as a discount, rebate, refund, or credit.
- Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

Estimating variable consideration

To estimate the amount of variable consideration, an entity will use either of the following methods, depending on which method better predicts the amount of consideration the entity will be entitled:

- *The expected value method*. This method is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
- *The most likely metho*d. This method is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has

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only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

Regardless of the method chosen, an entity needs to apply that method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration. When assessing the method that better predicts the consideration, an entity should consider all information that is reasonably available to identify the reasonable number of possible consideration amounts. This may include the use of historical, current, and forecast information.

Variable consideration examples and exercises

The following examples and exercises illustrate application of guidance for variable consideration under FASB ASC 606. See the appendix for excerpts taken from recently issued SEC 10-K filings. These examples are presented for informational purposes and are not authoritative.



Connected concepts: Practical point for management

The presence of variable consideration often creates challenges for management. When determining the transaction price typically significant judgment and estimates are necessary. The following are some items for management to consider:

- Can management provide support for their variable consideration estimates?
- Are management's estimates reasonable and fair?
- Did management use historical, current, and forecasted information to compute the variable consideration?
- Has management assessed whether it is probable that significant reversal in the amounts will not occur?
- Did management consider the various different possible scenarios, depending on the types of transactions?
- Which estimation method, the expected value method, or the most likely method best predicts the estimated variable consideration?
- Has management established a system of internal controls over the process of estimating variable consideration?
- Has management documented the process and assumptions used sufficiently enough to support their estimates to their auditors or outside accountants?

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Connected concepts: Practical point for small- and medium-sized private companies

Small and medium-sized private companies generally have less resources in terms of funds and experienced staff and therefore they might need third-party assistance to help them develop the transaction price and variable consideration component in more complex circumstances; therefore consider the following:

- Seek out third parties for assistance, and do not try to rely on external auditors since they cannot participate in management's estimates and assumptions without impairing their independence.
- The hiring of third parties, such as valuation specialists can be costly. Consider including additional money in the annual budget so you are not caught off guard with an unforeseen and unplanned for invoice.



Example: Estimating variable consideration — Performance bonus or penalty?

The contract

Atlas Inc., an equipment manufacturer, enters into a contract with its customer, World Co. to build a customized piece of equipment. The promise to transfer the equipment is a performance obligation that is satisfied over time.

Facts

- The promised consideration is $2.5 million, but that amount will increase or decrease depending on the timing of completion of the equipment. Specifically, for each day after March 31, 20X9, that the equipment is incomplete, the promised consideration is reduced by $10,000. For each day before March 31, 20X9, that the equipment is complete, the promised consideration increases by $10,000.
- Upon completion of the equipmentt, a third party hired by World Co. will inspect the equipment and assign a rating based on metrics that are defined in the contract. If the equipment receives a specified rating, Atlas Inc. will be entitled to an incentive bonus of $150,000.

Assessment

Atlas Inc. determines that the contract with World Co. contains variable consideration and prepares a separate estimate for each variable consideration element, meaning a separate estimate for the original consideration of $2.5 million, plus or minus $10,000 per day, and the incentive bonus.

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Example: Estimating variable consideration — Performance bonus or penalty? (continued)

Atlas Inc. may decide to use the expected value method to estimate the variable consideration associated with the daily penalty or incentive because there is a range of possible outcomes and Atlas Inc. Expects this method to better predict the amount of consideration it will be entitled to.

Atlas Inc. may also decide to use the most likely amount to estimate the variable consideration associated with the incentive bonus, because there are only two possible outcomes, an incentive bonus of $150,000 or $0.

Observations

This contract contained variable consideration,. Atlas Inc., or any entity in this similar situation, will need to use their judgment when determining which method, the expected value or the most likely methods, better predicts the amount of consideration they will receive from the customer, or in this case, World Co.



Exercise: Jacob Inc.

Variable consideration — Bonus versus refund

Jacob Inc. is a management consulting firm that has entered into a contract with Whey Enterprise. Jacob Inc. promises to provide cost management consulting services to Whey Enterprise over the course of the next six months. In return, Whey Enterprise promises to pay $20,000 at the beginning of each of the 6 months. At the end of the contract, Jacob Inc. will give Whey Enterprise a refund of $10,000 or will be entitled to an additional $10,000, depending on the level of cost savings received by Whey Enterprise.

Jacob Inc. has extensive experience with similar types of cost management consulting services and that experience is relevant to the contract. Jacob Inc. concludes that there is an 80% chance that they will receive the additional $10,000 — this uncertainty will be resolved in a relatively short period of time (six months), the contract does not have a large number of possible consideration amounts, and the consideration amount is not highly susceptible to external factors, meaning it is largely determined by the performance of Jacob Inc.

At the inception of the contract, what is the transaction price if Jacob Inc. uses the most likely value method, and what is the transaction price if Jacob Inc. uses the expected value method?

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Exercise: Larkin Partners

Price concession — Estimating variable consideration when it is not constrained

Larkin Partners enters into a contract with its customer, Shoppers World, a distributor, on December 1, 20X8. Larkin Partners transferred 1,000 cases of soap products at contract inception for a price stated in the contract of $100 per case (total consideration is $100,000). Payment from Shoppers World is due when Shoppers World sells the soap to the end customers. Shoppers World generally sells the soap within 90 days after they receive the product from Larkin Partners. Control of the soap transfers to the Shoppers World on December 1, 20X8.

On the basis of its past practices and to maintain its relationship with the Shoppers World, Larkin Partners anticipates granting a price concession to Shoppers World because this will allow them to discount the soap so it can move through the distribution chain.

Larkin Partners has significant experience selling soap and other similar soap products. Observable data indicate that, historically, Larkin Partners has granted a price concession of approximately 20% of the sales price for this soap. Current market information suggests that a 20% reduction in price will be sufficient to move the soap through the distribution chain; they have not granted a price concession significantly greater than 20% in many years.

If the variable consideration is considered, what is the transaction price?

Exercise: Carter Company

Application of a volume discount

Carter Company enters into a contract with its customer Dodge Partners on January 1, 20X8, to sell a sewing machine for $100 per unit. If Dodge Partners purchases more than 1,000 sewing machines in a calendar year, the contract specifies that the price per sewing machine is retrospectively reduced to $90 per sewing machine.

For the first quarter ended March 31, 20X8, Carter Company sells 75 sewing machines to Dodge Partners. Carter Company estimates that Dodge Partners' purchases will not exceed the 1,000-sewing machine threshold required for the volume discount in the calendar year.

Carter Company determines that it has significant experience with this sewing machine and with the purchasing pattern of Dodge Partners; thus, Carter Company concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $100 per unit) will not occur when the uncertainty is resolved (that is, when the total amount of purchases is known). Therefore, Carter Company recognizes revenue of $7,500 (75 units × $100 per unit) for the quarter ended March 31, 20X8.

In May 20X8, Dodge Partners acquires another company and in the second quarter ended June 30, 20X8, Carter Company sells an additional 500 sewing machines to Dodge Partners.

What is the amount of revenue Carter Company will recognize for the quarter ending June 30, 20X8, assuming that they now estimate that Dodge Partners' purchases will exceed the 1,000 sewing machine threshold for the calendar year?

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Example: Rebate — Estimating variable consideration

The contract

A local luggage and leather goods establishment, ACE, sells its large Travelers luggage for $500. With the purchase of each piece of Travelers luggage, the customers receive a rebate form entitling them to a $50 rebate is submitted no later than 90 days after the Travelers luggage purchase.

Assessment

- ACE determines that the transaction price of $500 contains variable consideration, meaning the $500 selling price is not fixed, but is instead variable based upon the issuance of the rebate to each customer.
- ACE has issued these types of rebates in the past for this exact luggage and similar pieces of luggage and based upon their extensive historical data they have determined that a customer will submit the $50 rebate 70% of the time.

Conclusion

Using the expected value method, ACE would calculate the transaction price on the sale of each piece of Travelers luggage as follows:

Selling price of each Travelers luggage of:	$500
Less the $50 rebate multiplied by 70% chance the customer will redeem the rebate ($50 × 70%)	(35)
Plus, the 30% chance the customer failed to redeem the $50 rebate or did not redeem the $50 rebate in time ($50 × 30%):	15
Using the expected value method ACE has determined that the transaction price for each Travelers luggage is:	$480

If ACE decided to use the most likely method to estimate the amount of variable consideration, it would calculate the transaction price of each piece of Travelers luggage as follows:

Selling price of each Travelers luggage of:	$500
Less the $50 rebate	(50)
Using the most likely method ACE has determined that the transaction price for each Travelers luggage is:	$450

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Example: Rebate — Estimating variable consideration (continued)

Here is the type of journal entity ACE would record:

Dr. Cash $500

Cr. Customer Rebate Liability ($20 if the expected value method were used and $50 if the most likely method were used)

Cr. Sales ($580 if the expected value method was used and $450 if the most likely method was used)

Exercise: Randall Inc.

Variable consideration — Coupons

Randall Inc., a manufacturer, sells 1,000 units of a product to a local retailer for $8 per unit. The retailer sells the product directly to customers for $10 per unit. Randall Inc. issues coupons for a $1 discount directly to customers via newspapers and flyers. The retailer accepts the coupons from the customers and thus, the customer pays $10 per unit without the coupon and $9 per unit with the coupon. The retailer submits all the coupons to the Randall Inc. and receives $1 per coupon submitted. At the time of the transfer of the products to the retailer, Randall Inc. concludes that it cannot reasonably estimate the number of coupons to be redeemed.

What is Randall Inc.'s transaction price of the sale?

Knowledge check

1. Which item would be outside of consideration with the entity's determination of the transaction price with a customer?

    a. Constraining estimates of variable consideration.
    b. The existence of a significant financing component in the contract.
    c. The renewal or modification of the contract.
    d. Consideration payable to a customer.

Refund liabilities

When an entity receives consideration from a customer and expects to refund some or all of that consideration to the customer, a refund liability will need to be recognized. This happens quite often with entities involved in the retail industry as well as those types of entities that have established either explicitly or implicitly through a customary business practice to accept product returns.

Because an entity expects to issue a refund to a customer, it will need to measure the refund liability as well as the impact this variable consideration has on the transaction price. FASB ASC 606 would require

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that the entity measure the refund liability as the amount of consideration it received or expects to receive (a receivable) that it did not expect to be entitled to, meaning the amount that would need to be returned. That amount would not be included in the transaction price. Like all estimates, the refund liability is updated at the end of each reporting period for changes in circumstances. An example of a refund liability would include a sale to a customer with a right of return.

Example disclosures

The following disclosures, taken from recently issued SEC 10-K filings, illustrate application of guidance for expected returns under FASB ASC 606. See the appendix for the complete notes from which these excerpts were taken. These examples are presented for informational purposes and are not authoritative.



Implementation illustration: Accounting policies for expected returns

Advanced Micro Devices Inc.[3]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Summary of significant accounting policies

Non-custom products: The Company transfers control and recognizes revenue when non-custom products are shipped to customers, which includes original equipment manufacturers (OEM) and distributors, in accordance with the shipping terms of the sale. Certain OEMs may be entitled to rights of return and rebates under OEM agreements. The Company also sells to distributors under terms allowing the majority of distributors certain rights of return and price protection on unsold merchandise held by them. The Company estimates the amount of variable consideration under OEM and distributor arrangements and, accordingly, records a provision for product returns, allowances for price protection and rebates based on actual historical experience and any known events.

[3] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at hhttps://www.sec.gov/Archives/edgar/data/2488/000000248824000012/amd-20231230.htm.

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Implementation illustration: Accounting policies for expected returns (continued)

Merck & Co. Inc.[4]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Revenue Recognition

The U.S. provision for aggregate customer discounts covering chargebacks and rebates was $12.5 billion in 2023, $12.3 billion in 2022, and $12.3 billion in 2021. Chargebacks are discounts that occur when a contracted customer purchases through an intermediary wholesaler. The wholesaler then charges the Company back for the difference between the price initially paid by the wholesaler and the contract price agreed to between Merck and the customer. The provision for chargebacks is based on expected sell-through levels by the Company's wholesale customers to contracted customers, as well as estimated wholesaler inventory levels. Rebates are amounts owed based upon definitive contractual agreements or legal requirements with private sector and public sector (Medicaid and Medicare Part D) benefit providers after the final dispensing of the product to a benefit plan participant. The provision for rebates is based on expected patient usage, as well as inventory levels in the distribution channel to determine the contractual obligation to the benefit providers. The Company uses historical customer segment utilization mix, sales forecasts, changes to product mix and price, inventory levels in the distribution channel, government pricing calculations and prior payment history to estimate the expected provision. Amounts accrued for aggregate customer discounts are evaluated on a quarterly basis through comparison of information provided by the wholesalers, health maintenance organizations, pharmacy benefit managers, federal and state agencies, and other customers to the amounts accrued. The accrued balances relative to the provisions for chargebacks and rebates included in *Accounts receivable* and *Accrued and other current liabilities* were $188 million and $2.3 billion, respectively, at December 31, 2023, and were $178 million and $2.7 billion, respectively, at December 31, 2022.

Outside of the United States, variable consideration in the form of discounts and rebates are a combination of commercially driven discounts in highly competitive product classes, discounts required to gain or maintain reimbursement, or legislatively mandated rebates. In certain European countries, legislatively mandated rebates are calculated based on an estimate of the governments total unbudgeted spending and the Company's specific payback obligation. Rebates may also be required based on specific product sales thresholds. The Company applies an estimated factor against its actual invoiced sales to represent the expected level of future discount or rebate obligations associated with the sale.

[4] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000310158/000162828024006850/mrk-20231231.htm.

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Implementation illustration: Accounting policies for expected returns (continued)

The Company maintains a returns policy that allows its U.S. pharmaceutical customers to return product within a specified period prior to and subsequent to the expiration date (generally, three to six months before and 12 months after product expiration). The estimate of the provision for returns is based upon historical experience with actual returns. Additionally, the Company considers factors such as levels of inventory in the distribution channel, product dating and expiration period, whether products have been discontinued, entrance in the market of generic or other competition, changes in formularies or launch of over-the-counter products, among others. Outside of the United States, returns are only allowed in certain countries on a limited basis.

Merck's payment terms for U.S. pharmaceutical customers are typically 36 days from receipt of invoice and for U.S. animal health customers are typically 30 days from receipt of invoice; however, certain products, including *Keytruda*, have longer payment terms up to 90 days. Outside of the United States, payment terms are typically 30 days to 90 days, although certain markets have longer payment terms.

Apple Inc.[5]

Excerpt from notes to financial statements for the 12 months ended September 28, 2024

Revenue from contracts with customers

The Company records reductions to Products net sales related to future product returns, price protection and other customer incentive programs based on the Company's expectations and historical experience.

Cencora, Inc.[6]

Excerpt from notes to financial statements for the 12 months ended September 30, 2024

Revenue recognition

The Company's customer sales return policy generally allows customers to return products only if the products can be resold at full value or returned to suppliers for full credit. The Company records an accrual for estimated customer sales returns at the time of sale to the customer based upon historical return trends.

[5] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/Archives/edgar/data/320193/000032019324000123/aapl-20240928.htm.

[6] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/1140859/000114085924000177/cor-20240930.htm.

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Implementation illustration: Accounting policies for expected returns (continued)

Target Corp.[7]

Excerpt from notes to financial statements for the 12 months ended February 3, 2024

Summary of accounting policies

Merchandise sales: We record almost all retail store revenues at the point of sale. Digitally originated sales may include shipping revenue and are recorded upon delivery to the guest or upon guest pickup at the store. Total revenues do not include sales tax because we are a pass-through conduit for collecting and remitting sales taxes. Generally, guests may return national brand merchandise within 90 days of purchase and owned and exclusive brands within one year of purchase. Sales are recognized net of expected returns, which we estimate using historical return patterns and our expectation of future returns.



Exercise: Jack Partners

Product sold with a right of return

Jack Partners enters into 100 contracts with various customers. Each contract includes the sale of one product, a scanner, for $100 (a total of 100 scanners × $100 = $10,000 total consideration). Cash is received when control of the scanner transfers to the customer. Jack Partners has an established customary business practice is to allow its customer with the ability to return any unused product within 30 days and receive a full refund. The cost of each of the scanners is $60, and Jack Partners sells those same scanners for $100 each. Because the contract allows Jack Partners customers with the ability to return the scanners, Jack Partners has determined that the consideration received from its customers is variable.

To estimate the variable consideration, Jack Partners decided to use the expected value and estimates that 97 scanners will not be returned, and therefore they expect to have three scanners returned within 30 days for the date of purchase. Jack Partners estimates that the costs of recovering the scanners will be immaterial because no reworking or repackaging would be needed, and therefore they expect that the returned scanners can be resold at a profit.

What is the journal entry Jack Partners will record, assuming the sale of 100 scanners has occurred upon the transfer of control to their customers?

[7] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000027419/000002741924000032/tgt-20240203.htm.

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Significant financing components

When there is a significant financing component

An entity will need to adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to in the contract provides the customer or the entity with a significant benefit from the financing.

Keep in mind that a significant financing component may exist regardless of whether it is explicitly stated in the contract, therefore a significant financing component may be implied by the payment terms in the contract.

When a significant financing component exists, an entity will need to recognize revenue from the transaction at an amount that reflects the price a customer would have paid had the customer paid cash for those goods or services, meaning the cash selling price. When assessing whether a significant financing component exists, all relevant facts and circumstances need to be considered, including both of the following:

- The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services
- The combined effect of both of the following:
  - The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
  - The prevailing interest rates in the relevant market

In accordance with FASB ASC 606, a significant financing component would not exist if any of the following factors are present:

- The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.
- A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity, such as if the consideration is a sales-based royalty.
- The difference between the promised consideration and the cash selling price of the good or service occurred for reasons other than the financing, for example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

When adjusting the promised amount of consideration for the significant financing component, at the contract's inception an entity would use a discount rate that reflects the customer's credit characteristics as well as any collateral or security provided by the customer, which may include the assets transferred in the contract. A discount rate may be determined by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services. The discount rate is determined at contract inception and therefore it is not updated for changes in interest rates or other circumstances, such as changes in the customer's credit risk.

The effects of the financing, either interest income or interest expense, is presented separately from revenue from contracts with customers in the statement of comprehensive income (statement of

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activities). Interest income or interest expense is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized when accounting for a contract with a customer.

Practical expedient — Policy election

An entity may elect not to adjust the promised amount of consideration for the effects of a significant financing component if the entity expects at the inception of the contract that the period between when the entity transfers a promised good or service to a customer will be one year or less from when the customer pays for that good or service.



Example: Significant financing component

Company A signs a contract with Company B for a business aircraft for a total promised consideration of $100 million. In negotiating the contract, Company A was willing to accept $100 million for the business aircraft provided that Company B paid in full in advance on the date the contract is signed. If Company B elected to pay when control of the aircraft transfers, the cash selling price would have been $109 million.

Company A concludes that, based on the contract terms, revenue will be recognized upon delivery of the aircraft. Further, Company A concludes that the contract contains a significant financing component based on the length of time between when the customer pays for the assets and when the entity transfers the assets to the customer is greater than one year, the significance of the financing component, as well as the prevailing interest rates in the market. Company A has also determined that the rate that should be used in adjusting the promised consideration is 6% which is the entity's incremental borrowing rate.

The following journal entries illustrate how Company A would account for the significant financing component:

Journal entry at contract inception $100 million is received from Company B:

Dr. Cash $100,000,000

Cr. Contract Liability $100,000,000

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Example: Significant financing component (continued)

Journal entry during the 18-month term between the signing of the contract and the transfer of the aircraft, the entity adjusts the promised amount of the consideration and accretes the contract liability by recognizing interest on $100,000,000 at 6% for 18 months:

Dr. Interest Expense $9,000,0000 ($9,000,000 = $100,000,000 contract liability × (6% interest for 18 months))

Cr. Contract Liability $9,000,000

Journal entry at the time Company A transfers the aircraft to Company B:

Dr. Contract Liability $109,000,000

Cr. Revenue $109,000,000

Knowledge check

2. When adjusting the promised amount of consideration for a significant financing component, which would be outside of consideration?

   a. A discount rate that reflects the customer's credit characteristics.
   b. Any collateral or security provided by the customer.
   c. Changes in interest rates subsequent to the inception of the contract.
   d. The discount rate calculated by using the difference between the promised consideration, compared to the price the customer would have paid in cash.

Noncash consideration

To determine the transaction price, if an entity agrees to a promised consideration in a form that is other than cash (for example a product or a service in lieu of cash), that consideration will need to be measured by estimating the fair value of the noncash consideration at the contract's inception. If the fair value of the noncash consideration cannot be reasonably estimated then the consideration would be measured indirectly, by looking at the stand-alone selling price (meaning the price the entity would sell a promised good or service separately to a customer) of the goods or services promised to the customer in exchange for the consideration.

Keep in mind that the measurement of the noncash consideration at the contract's inception may subsequently change, and that subsequent changes in the fair value of noncash consideration are not included in the transaction price.

If a customer contributes goods or services, such as materials, equipment, or labor, to facilitate the fulfillment of the contract, an entity will need to assess whether it obtains control of those contributed goods or services. If they did, then the contributed goods or services would be accounted for as noncash consideration received from the customer.

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Example: Noncash consideration

Sutra Corporation, a cloud-based service provider, enters into a contract with its customer, Longo Enterprises, to provide weekly cloud services for one year. The contract is signed on January 1, 2019, and work begins immediately. Sutra Corporation concludes that the service is a single performance obligation because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer.

In exchange for the service, Longo Enterprises promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

To determine the transaction price (and the amount of revenue to be recognized), Sutra Corporation measures the estimated fair value of the 5,200 shares at contract inception. Sutra Corporation measures its progress toward complete satisfaction of the performance obligation and recognizes revenue as each week of service is complete. Sutra Corporation does not reflect any subsequent changes in the fair value of the shares received (or receivable) in revenue.

Knowledge check

3. To determine the transaction price, if an entity agrees to a promised consideration in a form that is other than cash, that consideration will need to be measured by

    a. Estimating the fair value of the noncash consideration at the contract's inception.
    b. Looking at the stand-alone selling price of the goods or services promised to the customer in exchange for the consideration.
    c. Estimating the replacement value of the noncash consideration at the contract's inception.
    d. Estimating the cash value of the noncash consideration at the inception of the contract.

Consideration payable to a customer

Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer or to other parties that purchase the entity's goods or services from the customer. It may also include credit or other items, for example a coupon or voucher that can be applied against amounts owed.

Consideration payable to a customer is accounted for as a reduction of the transaction price and revenue unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity.

If consideration payable to a customer is a payment for a distinct good or service from the customer, then it is accounted for in the same way the entity would account for other purchases from suppliers. If the amount exceeds the fair value of the distinct good or service that the entity receives from the customer, then the excess will be a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, then all of the consideration payable to the customer will be a reduction of the transaction price.

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When the consideration payable to a customer is accounted for as a reduction of the transaction price, the reduction of revenue is recognized the later of either of the following events occurs:

- The entity recognizes revenue for the transfer of the related goods or services to the customer.
- The entity pays or promises to pay the consideration even if the payment is conditional on a future event. That promise might be implied by the entity's customary business practices.



Exercise: Jerkens Corp.

Consideration payable to a customer

Jerkens Corp., a soda manufacturer, sells 1,000 cases of soda to a local reseller, Foodies Inc., for $10,000. In addition, Jerkens Corp. pays $1,000 to Foodie Inc. in exchange for a product placement service; that service includes specified services of stocking, displaying, and supporting the soda. Jerkens Corp. determines, on the basis of similar transactions in the marketplace, that the fair value of the product placement service is $600.

Determine the transaction price for the sale of 100 cases of soda to Foodies Inc., along with the applicable journal entries Jerkens will record.

Knowledge check

4. Which correctly applies to consideration payable to a customer?

    a. Consideration payable to a customer is accounted for as a reduction of the transaction price and revenue unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity.
    b. Consideration payable to a customer is accounted for in the same way the entity would account for other purchases from suppliers.
    c. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, then all of the consideration payable to the customer will be an increase to the transaction price.
    d. Consideration payable to a customer includes cash amounts that an entity pays and other items, excluding coupons that can be applied against amounts owed.

Constraining estimates of variable consideration

It may be probable that a significant reversal in the amount of cumulative revenue recognized from some, or all, of the variable consideration amount included in the transaction price will not occur until the uncertainty associated with the variable consideration is subsequently resolved.

In assessing whether it is probable that a significant reversal will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity should consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

- The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include the following:

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  - Volatility in a market
  - The judgment or actions of third parties
  - Weather conditions
  - A high risk of obsolescence of the promised good or service
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time
- The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances
- The contract has a large number and broad range of possible consideration amounts

An entity will need to update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to reflect changes in circumstances at the end of each reporting period.

Exception to constraining estimates of variable consideration

An exception exists when accounting for consideration in the form of a sales-based or usage-based royalty that is promised in exchange for a license of intellectual property.

Example disclosure and exercises

The following disclosure, taken from a recently issued SEC 10-K filing, illustrates application of guidance for constrained revenue under FASB ASC 606. This example is presented for informational purposes and is not authoritative.

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Implementation illustration: Constrained revenue

Lockheed Martin Corp. Inc.[8]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Significant accounting policies— Revenue recognition

We determine the transaction price for each contract based on the consideration we expect to receive for the products or services being provided under the contract. For contracts where a portion of the price may vary, we estimate variable consideration at the most likely amount, which is included in the transaction price to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur. We analyze the risk of a significant revenue reversal and if necessary constrain the amount of variable consideration recognized in order to mitigate this risk.

At the inception of a contract we estimate the transaction price based on our current rights and do not contemplate future modifications (including unexercised options) or follow-on contracts until they become legally enforceable. Contracts are often subsequently modified to include changes in specifications, requirements, or price, which may create new or change existing enforceable rights and obligations. Depending on the nature of the modification, we consider whether to account for the modification as an adjustment to the existing contract or as a separate contract. Generally, modifications to our contracts are not distinct from the existing contract due to the significant integration and interrelated tasks provided in the context of the contract. Therefore, such modifications are accounted for as if they were part of the existing contract and recognized as a cumulative adjustment to revenue.



Exercise: Roberts Inc.

Estimating variable consideration when it is constrained

Roberts Inc. enters into a contract with its customer Foran Corp., a distributor, on December 1, 20X8. Roberts Inc. transfers 1,000 chairs at contract inception for a price stated in the contract of $100 per chair (total consideration is $100,000). Payment from Foran Corp. is due when they sell the chairs to the end customers. Foran Corp. generally sells the chairs within 90 days of obtaining them. Control of the chair's transfers to Foran Corp. on December 1, 20X8.

[8] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000936468/000093646824000010/lmt-20231231.htm.

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Exercise: Roberts Inc. (continued)

Estimating variable consideration when it is constrained

On the basis of its past practices and to maintain its relationship with Foran Corp., Roberts Inc. anticipates granting a price concession to Foran Corp. because this will enable the customer to discount the chair and thereby move the chairs through the distribution chain.

Roberts Inc. has experience selling similar products. However, these chairs have a high risk of obsolescence, and therefore Roberts Inc. experiences high volatility in the pricing of its chairs. The observable data indicate that historically Roberts Inc. has granted a broad range of price concessions ranging from 20% to 60% of the sales price for similar products. Current market information also suggests that a 15% to 50% reduction in price may be necessary to move the chairs through the distribution chain.

What is the transaction price assuming the Roberts Inc. has decided to use the expected value method to estimate the variable consideration?

Knowledge check

5. When assessing the constraining estimates of variable consideration, which would not increase the likelihood or the magnitude that a significant reversal of revenue would occur?

    a. The judgment or actions of third parties.
    b. The high risk of obsolescence of the promised good or services to the customer.
    c. Sales-based or usage-based royalty promised in exchange for a license of intellectual property.
    d. The practice of changing payment terms in similar contracts under similar circumstances.

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Summary

In conclusion, here are a few key takeaways when determining the transaction price highlighted in this course, along with practical examples. It's essential to consider various factors such as variable consideration, significant financing components, and noncash considerations. Remember that the transaction price is the amount of consideration expected to be entitled in exchange for transferring promised goods or services to a customer. Collectibility is addressed when the contract is identified, so collectibility should not be assessed when determining the transaction price. Additionally, you should select the estimation method that better predicts the amount of consideration the entity will be entitled to.

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Solutions

Determining the Transaction Price

Knowledge check solutions

1.

a. Incorrect. Constraining estimates of variable consideration will likely have pricing variations.
b. Incorrect. Payment terms over a period of time versus an upfront payment could lead to different transaction prices due to the time value of money.
c. Correct. When determining the transaction price, an entity assumes that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified and therefor the renewal or modification of the contract is not taken into consideration when determining the transaction price.
d. Incorrect. Consideration payable to a customer would affect the entity's determination of the transaction price.

2.

a. Incorrect. An entity would take into consideration a discount rate that reflects the customer's credit characteristics when adjusting the promised amount of consideration for a significant financing component.
b. Incorrect. An entity would take into consideration any collateral or security provided by the customer when adjusting the promised amount of consideration for a significant financing component.
c. Correct. The discount rate is determined at contract inception and therefore it is not updated for changes in interest rates or other circumstances, such as changes in the customer's credit risk.
d. Incorrect. When adjusting the promised amount of consideration for a significant financing component an entity would take into consideration the discount rate calculated by using the difference between the promised considerations, compared to the price the customer would have paid in cash.

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3.

a. Correct. To determine the transaction price, if an entity agrees to a promised consideration in a form that is other than cash, that consideration will need to be measured by estimating the fair value of the non-cash consideration at the contract's inception.
b. Incorrect. To determine the transaction price, if an entity agrees to a promised consideration in a form that is other than cash, that consideration will need to be measured by estimating the fair value of the non-cash consideration at the contract's inception and not by looking at the stand-alone selling price of the goods or services promised to the customer in exchange for the consideration.
c. Incorrect. To determine the transaction price, if an entity agrees to a promised consideration in a form that is other than cash, that consideration will need to be measured by estimating the fair value of the non-cash consideration at the contract's inception and not by estimating the replacement value of the non-cash consideration at the contract's inception.
d. Incorrect. To determine the transaction price, if an entity agrees to a promised consideration in a form that is other than cash, that consideration will need to be measured by estimating the fair value of the non-cash consideration at the contract's inception and not by estimating the cash value of the non-cash consideration at the inception of the contract.

4.

a. Correct. Consideration payable to a customer is accounted for as a reduction of the transaction price and revenue unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity.
b. Incorrect. If consideration payable to a customer is a payment for a distinct good or service from the customer, then it is accounted for in the same way the entity would account for other purchases from suppliers; otherwise, consideration payable to a customer is accounted for as a reduction of the transaction price and revenue.
c. Incorrect. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, then all of the consideration payable to the customer will be a reduction, and not an increase to the transaction price.
d. Incorrect. Consideration payable to a customer includes cash amounts that an entity pays and other items, including coupons that can be applied against amounts owed.

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5.

a. Incorrect. When assessing the constraining estimates of variable consideration, the judgment or actions of third parties would increase the likelihood or magnitude that a significant reversal of revenue would occur.
b. Incorrect. When assessing the constraining estimates of variable consideration, the high risk of obsolescence of the promised good or services to the customer would increase the likelihood or magnitude that a significant reversal of revenue would occur.
c. Correct. When assessing the constraining estimates of variable consideration, sales-based or usage-based royalty promised in exchange for a license of intellectual property would not increase the likelihood or magnitude that a significant reversal of revenue would occur. This is an exception found in FASB ASC 606.
d. Incorrect. When assessing the constraining estimates of variable consideration, the practice of changing payment terms in similar contracts under similar circumstances would increase the likelihood or magnitude that a significant reversal of revenue would occur.

Exercise solutions

Exercise: Jacob Inc.

Alternative answer 1 (Most likely method)

At contract inception, the consultant Jacob Inc., estimates the contract price by considering their experience with similar customers and determines that there is an 80% success rate in obtaining a bonus and therefore it is sufficient to for the consultant to expect to be entitled to $130,000 ($20,000 × 6 months + $10,000) .

Alternative answer 2 (The expected value method)

At the contract inception, the consultant Jacob Inc. estimates the transaction price by identifying the following possible consideration outcomes and their related probabilities:

$130,000 ($20,000 × 6 months plus $10,000) × 80% =	$ 104,000
$110,000 ($20,000 × 6 months less $10,000) × 20% =	22,000
	$ 126,000

Exercise: Larkin Partners

Using the expected value method, Larkin Partners, the entity, estimates the transaction price to be $80,000 ($80 × 1,000 products). Larkin Partners considered the fact that it has significant previous experience with this soap product and current market information that supports its estimate. In addition, despite some uncertainty resulting from factors outside its influence, based on its current market estimates, the Larkin Partners expects the price to be resolved within a short time frame. Therefore, they conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $80,000) will not occur when the uncertainty is resolved (that is, when the total amount of price concessions is determined).

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Given this, Larkin Partners recognizes $80,000 as revenue when the products are transferred on December 1, 20X8.

Exercise: Carter Company

Carter Company, the entity, will be required to retrospectively reduce the price per sewing machine unit to $90. Therefore, they will recognize revenue of $44,250 for the quarter ended June 30, 20X8. That amount is calculated from $45,000 for the sale of 500 sewing machine units (500 units × $90 per unit) less the change in transaction price of $750 (75 units × $10 price reduction) for the reduction of revenue relating to the sewing machine units sold for the quarter ended March 31, 20X8.

Exercise: Randall Inc.

If Randall Inc., the manufacturer, issues the coupons before the goods are transferred to the retailer, it would recognize $7,000 when the products are transferred to the retailer. The manufacturer Randall Inc. receives no distinct good or service in exchange for the coupon (variable consideration). They cannot reasonably estimate the number of coupons to be redeemed and therefore the transaction price is $7,000 ($8,000 less $1,000, representing the entire amount of coupons issued – 1,000 products sold to the retailer multiplied by $1).

Exercise: Jack Partners

Upon transfer of control of the 100 scanners, the entity Jack Partners would not recognize revenue for the three scanners they expect to be returned and prepares the following journal entries:

Cash	$10,000 *($100 × 100 scanners transferred)*	
Revenue		$9,700 *($100 × 97 scanners not expected to be returned)*
Refund Liability		300 *($100 refund × 3 scanners expected to be returned)*
Cost of sales	$ 5,820 *($60 × 97 scanners not expected to be returned)*	
Asset	180 *($60 × 3 scanners for its right to recover the scanners from customers on settling the refund liability)*	
Inventory		$6,000 *($60 × 100 scanners)*

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Exercise: Jerkens Corp.

The transaction price for the sale of soda cases is $9,600 ($10,000 less $400 representing the excess amount paid over fair value). The reseller, Jerkens Corp., paid the customer, Foodies Inc., $1,000 for a product placement service that had a fair value of $600; therefore, the excess amount of $400 would be considered a reduction in the revenue the reseller. Jerkens Corp. would recognize from the sale of 1,000 cases of soda at $10 per case, or $10,000.

1. (dr) Cash (or Accounts Receivable) $10,000

   (cr) Sales $10,000

   (to record the sale of 1,000 cases of soda at $10 per case)

2. (dr) Product Placement Expense $600

   (dr) Sales $400

   (cr) Cash (or accounts payable) $1,000

Exercise: Roberts Inc.

Alternative answer 1 — Assuming a significant reversal will not occur

Using the expected value method, the entity, Roberts Inc., estimates that a discount of 40% will be provided and, therefore, the estimate of the variable consideration is $60,000 ($60 × 1,000 products — chairs).

Alternative answer 2 — Taking into account a significant reversal will occur at 40%

The entity Roberts Inc., might consider using different factors that the 40% discount because they observe that the amount of consideration is highly susceptible to factors outside their influence (that is, risk of obsolescence) and it is likely that they may be required to provide a broad range of price concessions to move the chairs through the distribution chain. Assuming that they could not include its estimate of $60,000 (that is, a discount of 40%) in the transaction price because they could not conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Although their historical price concessions have ranged from 20% to 60%, market information currently suggests that a price concession of 15% to 50% will be necessary. Roberts Inc.'s actual results have been consistent with then-current market information in previous, similar transactions. Therefore, they conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur if they include $50,000 in the transaction price ($100 sales price and a 50% price concession) and, therefore, recognizes revenue at that amount.

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Determining The Transaction Price: Implementation Illustrations

This Appendix is included for supplementary purposes only and is not required for CPE credit.

Appendix

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The following examples, taken from recently issued SEC 10-K filings, illustrate transaction price considerations under FASB ASC 606. These examples are presented for informational purposes and are not authoritative.

Seagate Technology[1]

Excerpt from notes to financial statements for the 12 months ended June 28, 2024

Basis of Presentation and Summary of Significant Accounting Policies

Revenue Recognition and Sales Incentive Programs. The Company determines revenue recognition through the following steps: (1) identification of the contract with a customer; (2) identification of the performance obligations in the contract; (3) determination of the transaction price; (4) allocation of the transaction price to the performance obligations in the contract; and (5) recognition of revenue when, or as, the Company satisfies a performance obligation.

Revenue from sales of products is generally recognized upon transfer of control to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products, net of sales taxes. This typically occurs upon shipment from the Company. When applicable, the Company includes shipping charges billed to customers in revenue and includes the related shipping costs in cost of revenue on the Company's Consolidated Statements of Operations.

The Company records estimated variable consideration at the time of revenue recognition as a reduction to revenue. Variable consideration generally consists of sales incentive programs (such as price protection and volume incentives aimed at increasing customer demand). For original equipment manufacturers (OEM) sales, rebates are typically established by estimating the most likely amount of consideration expected to be received based on an OEM customer’s volume of purchases from the Company or other agreed-upon rebate programs. For the distribution and retail channel, these programs typically involve estimating the most likely amount of rebates related to a customer’s level of sales, order size, advertising, or point-of-sale activity as well as the expected value of price protection adjustments based on historical analysis and forecasted pricing environment. Marketing development program costs are accrued and recorded as a reduction to revenue at the same time that the related revenue is recognized.

The Company expenses sales commissions as incurred because the amortization period would have been one year or less. These costs are recorded as marketing and administrative on the Company’s Consolidated Statements of Operations.

[1] The full text of the financial statement that includes the following excerpt can be found on the SEC’s website at https://www.sec.gov/ix?doc=/Archives/edgar/data/1137789/000113778924000068/stx-20240628.htm

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Advanced Micro Devices Inc.[2]

Excerpt from notes to financial statements for the 12 months ended December 30, 2023

Summary of Significant Accounting Policies

Revenue Recognition. Revenue is recognized when a customer obtains control of promised goods or services and is recognized in an amount that reflects the consideration which the Company expects to receive in exchange for those goods or services. Sales, value-added, and other taxes collected concurrently with the provision of goods or services are excluded from revenue. Shipping and handling costs associated with product sales are included in cost of sales. Substantially all of the Company's revenue is derived from product sales, representing a single performance obligation.

Customers are generally required to pay for products and services within the Company's standard contractual terms, which are typically net 30 to 60 days. The Company has determined that it does not have significant financing components in its contracts with customers.

Non-custom products: The Company transfers control and recognizes revenue when non-custom products are shipped to customers, which includes OEM and distributors, in accordance with the shipping terms of the sale. Non-custom product arrangements generally comprise a single performance obligation. Certain OEMs may be entitled to rights of return and rebates under OEM agreements. The Company also sells to distributors under terms allowing the majority of distributors certain rights of return and price protection on unsold merchandise held by them. The Company estimates the amount of variable consideration under OEM and distributor arrangements and, accordingly, records a provision for product returns, allowances for price protection, and rebates based on actual historical experience and any known events.

The Company offers incentive programs to certain customers, including cooperative advertising, marketing promotions, volume-based incentives, and special pricing arrangements. When funds provided for such programs can be estimated, the Company recognizes a reduction to revenue at the time the related revenue is recognized; otherwise, the Company recognizes such reduction to revenue at the later of when: i) the related revenue transaction occurs; or ii) the program is offered. For transactions in which the Company reimburses a customer for a portion of the customer's cost to perform specific product advertising or marketing and promotional activities, such amounts are recognized as a reduction to revenue unless they qualify for expense recognition.

Custom products: Custom products, which are primarily associated with the Company's Gaming segment, are sold under non-cancellable purchases orders, for which the Company has an enforceable right to payment and which have no alternative use to the Company at contract inception, are recognized as revenue over the time of production of the products by the Company. The Company utilizes a cost-based input method, calculated as cost incurred plus estimated margin to determine the amount of revenue to recognize for in-process or completed customer orders at a reporting date. The Company believes that a cost-based input method is the most appropriate manner to measure how the Company

[2] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000002488/000000248824000012/amd-20231230.htm.

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satisfies its performance obligations to customers because the effort and costs incurred best depict the Company's satisfaction of its performance obligation.

Sales of custom products are not subject to a right of return and arrangements generally involve a single performance obligation. Generally, there are no variable consideration estimates associated with custom products.

Development and intellectual property licensing agreements: From time to time, the Company may enter into arrangements with customers that combine the provision of development services and a license to the right to use the IP. These arrangements are deemed to be single or multiple performance obligations based upon the nature of the arrangements. Revenue is recognized upon the transfer of control, over time or at a point in time, depending on the nature of the arrangements.

Merck & Co. Inc.[3]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Summary of Accounting Policies

Revenue Recognition –Recognition of revenue requires evidence of a contract, probable collection of sales proceeds and completion of substantially all performance obligations. Merck acts as the principal in substantially all of its customer arrangements and therefore records revenue on a gross basis. The majority of the Company's contracts related to the Pharmaceutical and Animal Health segments have a single performance obligation — the promise to transfer goods. Shipping is considered immaterial in the context of the overall customer arrangement and damages or loss of goods in transit are rare. Therefore, shipping is not deemed a separately recognized performance obligation.

The majority of revenues from sales of products are recognized at a point in time when control of the goods is transferred to the customer, which the Company has determined is when title and risks and rewards of ownership transfer to the customer and the Company is entitled to payment. The Company recognizes revenue from the sales of vaccines to the federal government for placement into vaccine stockpiles in accordance with Securities and Exchange Commission (SEC) Interpretation, *Commission Guidance Regarding Accounting for Sales of Vaccines and BioTerror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile*. This interpretation allows companies to recognize revenue for sales of vaccines into U.S. government stockpiles even though these sales might not meet the criteria for revenue recognition under other accounting guidance. For certain services in the Animal Health segment, revenue is recognized over time, generally ratably over the contract term as services are provided. These service revenues are not material.

[3] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000310158/000162828024006850/mrk-20231231.htm.

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The nature of the Company's business gives rise to several types of variable consideration including discounts and returns, which are estimated at the time of sale generally using the expected value method, although the most likely amount method is used for prompt pay discounts.

In the United States, sales discounts are issued to customers at the point of sale through an intermediary wholesaler (known as chargebacks) or in the form of rebates. Additionally, sales are generally made with a limited right of return under certain conditions. Revenues are recorded net of provisions for sales discounts and returns, which are established at the time of sale. In addition, if collection of accounts receivable is expected to be in excess of one year, sales are recorded net of time value of money discounts, which have not been material.

The U.S. provision for aggregate customer discounts covering chargebacks and rebates was $12.5 billion in 2023, $12.3 billion in 2022, and $12.3 billion in 2021. Chargebacks are discounts that occur when a contracted customer purchases through an intermediary wholesaler. The wholesaler then charges the Company back for the difference between the price initially paid by the wholesaler and the contract price agreed to between Merck and the customer. The provision for chargebacks is based on expected sell-through levels by the Company's wholesale customers to contracted customers, as well as estimated wholesaler inventory levels. Rebates are amounts owed based upon definitive contractual agreements or legal requirements with private sector and public sector (Medicaid and Medicare Part D) benefit providers after the final dispensing of the product to a benefit plan participant. The provision for rebates is based on expected patient usage, as well as inventory levels in the distribution channel to determine the contractual obligation to the benefit providers. The Company uses historical customer segment utilization mix, sales forecasts, changes to product mix and price, inventory levels in the distribution channel, government pricing calculations and prior payment history in order to estimate the expected provision. Amounts accrued for aggregate customer discounts are evaluated on a quarterly basis through comparison of information provided by the wholesalers, health maintenance organizations, pharmacy benefit managers, federal and state agencies, and other customers to the amounts accrued. The accrued balances relative to the provisions for chargebacks and rebates included in *Accounts receivable* and *Accrued and other current liabilities* were $188 million and $2.3 billion, respectively, at December 31, 2023, and were $178 million and $2.7 billion, respectively, at December 31, 2022.

Outside of the United States, variable consideration in the form of discounts and rebates are a combination of commercially-driven discounts in highly competitive product classes, discounts required to gain or maintain reimbursement, or legislatively mandated rebates. In certain European countries, legislatively mandated rebates are calculated based on an estimate of the government's total unbudgeted spending and the Company's specific payback obligation. Rebates may also be required based on specific product sales thresholds. The Company applies an estimated factor against its actual invoiced sales to represent the expected level of future discount or rebate obligations associated with the sale.

The Company maintains a returns policy that allows its U.S. pharmaceutical customers to return product within a specified period prior to and subsequent to the expiration date (generally, three to six months before and 12 months after product expiration). The estimate of the provision for returns is based upon historical experience with actual returns. Additionally, the Company considers factors such as levels of inventory in the distribution channel, product dating and expiration period, whether products have been

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discontinued, entrance in the market of generic competition, changes in formularies, or launch of over-the-counter products, among others. Outside of the United States, returns are only allowed in certain countries on a limited basis.

Merck's payment terms for U.S. pharmaceutical customers are typically 36 days from receipt of invoice and for U.S. Animal Health customers are typically 30 days from receipt of invoice; however, certain products, including *Keytruda*, have longer payment terms up to 90 days. Outside of the United States, payment terms are typically 30 days to 90 days, although certain markets have longer payment terms.

Lockheed Martin Corp. Inc.[4]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Significant Accounting Policies-Revenue Recognition

We determine the transaction price for each contract based on the consideration we expect to receive for the products or services being provided under the contract. For contracts where a portion of the price may vary (e.g. awards, incentive fees, and claims), we estimate variable consideration at the most likely amount, which is included in the transaction price to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur. We analyze the risk of a significant revenue reversal and, if necessary, constrain the amount of variable consideration recognized to mitigate this risk.

At the inception of a contract, we estimate the transaction price based on our current rights and do not contemplate future modifications (including unexercised options) or follow-on contracts until they become legally enforceable. Contracts are often subsequently modified to include changes in specifications, requirements, or price, which may create new or change existing enforceable rights and obligations. Depending on the nature of the modification, we consider whether to account for the modification as an adjustment to the existing contract or as a separate contract. Generally, modifications to our contracts are not distinct from the existing contract due to the significant integration and interrelated tasks provided in the context of the contract. Therefore, such modifications are accounted for as if they were part of the existing contract and recognized as a cumulative adjustment to revenue.

Apple Inc.[5]

Excerpt from notes to financial statements for the 12 months ended September 30, 2023

Revenue from Contracts with Customers

The Company recognizes revenue at the amount to which it expects to be entitled when control of the products or services is transferred to its customers. Control is generally transferred when the Company has a present right to payment and title, and the significant risks and rewards of ownership of products

[4] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000936468/000093646824000010/lmt-20231231.htm.
[5] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000320193/000032019323000106/aapl-20230930.htm.

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or services are transferred to its customers. For most of the Company's products net sales, control transfers when products are shipped. For the Company's services net sales, control transfers over time as services are delivered. Payment for products and services net sales is collected within a short period following transfer of control or commencement of delivery of services as applicable.

The Company records reductions to products net sales related to future product returns, price protection, and other customer incentive programs based on the Company's expectations and historical experience.

For arrangements with multiple performance obligations, which represent promises within an arrangement that are distinct, the Company allocates revenue to all distinct performance obligations based on their relative stand-alone selling prices (SSPs). When available, the Company uses observable prices to determine SSPs. When observable prices are not available, SSPs are established that reflect the Company's best estimates of what the selling prices of the performance obligations would be if they were sold regularly on a stand-alone basis. The Company's process for estimating SSPs without observable prices considers multiple factors that may vary depending upon the unique facts and circumstances related to each performance obligation including, where applicable, prices charged by the Company for similar offerings, market trends in the pricing for similar offerings, product-specific business objectives, and the estimated cost to provide the performance obligation.

The Company has identified up to three performance obligations regularly included in arrangements involving the sale of iPhone, Mac, iPad and certain other products. The first performance obligation, which represents the substantial portion of the allocated sales price, is the hardware and bundled software delivered at the time of sale. The second performance obligation is the right to receive certain product-related bundled services, which include iCloud, Siri, and Maps. The third performance obligation is the right to receive, on a when-and-if-available basis, future unspecified software upgrades relating to the software bundled with each device. The Company allocates revenue and any related discounts to these performance obligations based on their relative SSPs. Because the Company lacks observable prices for the undelivered performance obligations, the allocation of revenue is based on the Company's estimated SSPs. Revenue allocated to the delivered hardware and bundled software is recognized when control has transferred to the customer, which generally occurs when the product is shipped. Revenue allocated to the product-related bundled services and unspecified software upgrade rights is deferred and recognized on a straight-line basis over the estimated period they are expected to be provided.

For certain long-term service arrangements, the Company has performance obligations for services it has not yet delivered. For these arrangements, the Company does not have a right to bill for the undelivered services. The Company has determined that any unbilled consideration relates entirely to the value of the undelivered services. Accordingly, the Company has not recognized revenue and has elected not to disclose amounts related to these undelivered services.

For the sale of third-party products where the Company obtains control of the product before transferring it to the customer, the Company recognizes revenue based on the gross amount billed to customers. The Company considers multiple factors when determining whether it obtains control of third-party products, including evaluating if it can establish the price of the product, retains inventory risk for tangible products, or has the responsibility for ensuring acceptability of the product. For third-party applications sold

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through the App Store, the Company does not obtain control of the product before transferring it to the customer. Therefore, the Company accounts for all third-party application-related sales on a net basis by recognizing in services net sales only the commission it retains.

Target Corp.[6]

Excerpt from notes to financial statements for the 12 months ended February 3, 2024

Summary of Accounting Policies

Merchandise sales — We record almost all retail store revenues at the point of sale. Digitally originated sales may include shipping revenue and are recorded upon delivery to the guest or upon guest pickup at the store. Total revenues do not include sales tax because we are a pass-through conduit for collecting and remitting sales taxes. Generally, guests may return national brand merchandise within 90 days of purchase and owned and exclusive brands within one year of purchase. Sales are recognized net of expected returns, which we estimate using historical return patterns and our expectation of future returns. As of February 3, 2024, and January 28, 2023, the liability for estimated returns was $170 million and $174 million, respectively.

We routinely enter into arrangements with vendors whereby we do not purchase or pay for merchandise until the merchandise is ultimately sold to a guest. Under the vast majority of these arrangements, which represent less than 5% of consolidated sales, we record revenue and related costs gross. We concluded that we are the principal in these transactions for a number of reasons, most notably because we 1) control the overall economics of the transactions, including setting the sales price and realizing the majority of cash flows from the sale, 2) control the relationship with the customer, and 3) are responsible for fulfilling the promise to provide goods to the customer. Merchandise received under these arrangements is not included in inventory because the purchase and sale of this inventory are virtually simultaneous.

Revenue from Target gift card sales is recognized upon gift card redemption, which is typically within one year of issuance. Our gift cards do not expire. Based on historical redemption rates, a small and relatively stable percentage of gift cards will never be redeemed, referred to as "breakage." Estimated breakage revenue is recognized over time in proportion to actual gift card redemptions.

Guests receive a 5% discount on nearly all purchases and receive free shipping at Target.com when they use their Target Debit Card, RedCard Reloadable Account, Target Credit Card, or Target MasterCard (collectively, RedCards).

Target Circle program members earn Target Circle Rewards on various transactions. As of February 3, 2024, and January 28, 2023, deferred revenue of $117 million and $112 million, respectively, related to our Target Circle program was included in Accrued and Other Current Liabilities.

[6] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000027419/000002741924000032/tgt-20240203.htm.

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Credit card profit sharing: We receive payments under a credit card program agreement with TD. Under the agreement, we receive a percentage of the profits generated by the Target Credit Card and Target MasterCard receivables in exchange for performing account servicing and primary marketing functions. TD underwrites, funds, and owns Target Credit Card and Target MasterCard receivables, controls risk management policies, and oversees regulatory compliance.

Other Includes advertising revenue, Shipt membership and service revenues, commissions earned on third-party sales through Target.com, rental income, and other miscellaneous revenues.

Cencora[7]

Excerpt from notes to financial statements for the 12 months ended September 30, 2023

Revenue Recognition

The Company's revenues are primarily generated from the distribution of pharmaceutical products. The Company also generates revenues from global commercialization services, which include clinical trial support, post-approval and commercialization support, and global specialty transportation and logistics for the biopharmaceutical industry. See Note 15 for the Company's disaggregated revenue.

The Company recognizes revenue related to the distribution of products at a point in time when title and control transfers to customers, and there is no further obligation to provide services related to such products. Service revenue is recognized over the period that services are provided to the customer. The Company is generally the principal in a transaction; therefore, revenue is primarily recorded on a gross basis. When the Company is the principal in a transaction, it has determined that it controls the ability to direct the use of the product or service prior to the transfer to a customer, it is primarily responsible for fulfilling the promise to provide the product or service to its customer, it has discretion in establishing pricing, and it controls the relationship with the customer. Revenue is recognized at the amount of consideration expected to be received. For the distribution business, revenue is primarily generated from a contract related to a confirmed purchase order with a customer in a distribution arrangement and is net of estimated sales returns and allowances, other customer incentives, and sales tax.

The Company's customer sales return policy generally allows customers to return products only if the products can be resold at full value or returned to suppliers for full credit. The Company records an accrual for estimated customer sales returns at the time of sale to the customer based upon historical return trends. As of September 30, 2023 and 2022, the Company's accrual for estimated customer sales returns was $1,314.9 million and $1,532.1 million, respectively.

[7] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0001140859/000114085923000197/cor-20230930.htm.

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Delta Air Lines Inc.[8]

Excerpt from notes to financial statements for the year ended December 31, 2023

Note 2. Revenue Recognition

Ticket

Passenger Tickets. We defer sales of passenger tickets to be flown by us or that we sell on behalf of other airlines in our air traffic liability. Passenger revenue is recognized when we provide transportation. For tickets that we sell on behalf of other airlines, we reduce the air traffic liability when consideration is remitted to those airlines. The air traffic liability primarily includes sales of passenger tickets with scheduled departure dates in the future and travel credits, which can be applied as payment toward the cost of a ticket. We periodically evaluate the estimated air traffic liability and may record adjustments in our income statement. These adjustments relate primarily to tickets that expire unused (ticket breakage), refunds, exchanges, transactions with other airlines, and other items for which final settlement occurs in periods subsequent to the sale of the related tickets at amounts other than the original sales price.

We recognized approximately $7.4 billion, $4.2 billion and $2.2 billion in passenger revenue during the years ended December 31, 2023, 2022, and 2021, respectively, that had been recorded in our air traffic liability balance at the beginning of those periods.

Ticket Breakage. We estimate the value of tickets that will expire unused and recognize revenue at the scheduled flight date.

Regional Carriers. Our regional carriers include both third-party regional carriers with which we have contract carrier agreements ("contract carriers") and Endeavor Air, Inc., our wholly owned subsidiary. Our contract carrier agreements are primarily structured as capacity purchase agreements where we purchase all or a portion of the contract carrier's capacity and are responsible for selling the seat inventory we purchase. We record revenue related to our capacity purchase agreements in passenger revenue and the related expenses in regional carriers' expense.

Loyalty Travel Awards

Loyalty travel awards revenue is related to the redemption of mileage credits (miles) for travel. We recognize loyalty travel awards revenue in passenger revenue as miles are redeemed and transportation is provided. See below for discussion of our loyalty program accounting policies.

Travel-Related Services

Travel-related services are primarily composed of services performed in conjunction with a passenger's flight, including baggage fees, administrative fees, and on-board sales. We recognize revenue for these services when the related transportation service is provided.

[8] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at: https://www.sec.gov/ix?doc=/Archives/edgar/data/0000027904/000002790424000003/dal-20231231.htm.

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Loyalty Program

Our SkyMiles loyalty program generates customer loyalty by rewarding customers with incentives to travel on Delta. This program allows customers to earn miles by flying on Delta, Delta Connection carriers, and other airlines that participate in the loyalty program. When traveling, customers earn miles primarily based on the passenger's loyalty program status, fare class, and ticket price. Customers can also earn miles through participating companies. Miles are redeemable by customers in the future.

The loyalty program includes two types of transactions that are considered revenue arrangements with multiple performance obligations (1) passenger ticket sales earning miles and (2) sale of miles to participating companies.

Passenger Ticket Sales Earning Miles. Passenger ticket sales earning miles provide customers with (1) miles earned and (2) air transportation, which are each considered performance obligations. We value each performance obligation on a stand-alone basis. To value the miles earned, we consider the quantitative value a passenger receives by redeeming miles for a ticket rather than paying cash, which is referred to as equivalent ticket value (ETV). Our estimate of ETV is adjusted for miles that are not likely to be redeemed (mileage breakage). We use statistical models to estimate mileage breakage based on historical redemption patterns. A change in assumptions regarding the redemption activity for miles or the estimated fair value of miles expected to be redeemed could have a material impact on our revenue in the year in which the change occurs and in future years. We recognize mileage breakage proportionally during the period in which the remaining miles are actually redeemed.

We defer revenue for the miles when earned and recognize loyalty travel awards in passenger revenue as the miles are redeemed and transportation is provided. We record the air transportation portion of the passenger ticket sales in air traffic liability and recognize passenger revenue when we provide transportation or if the ticket goes unused.

Sale of Miles to Participating Companies. Customers earn miles based on their spending with participating companies (such as credit card, retail, ridesharing, car rental, and hotel companies) with which we have marketing agreements to sell miles. Our contracts to sell miles under these marketing agreements have multiple performance obligations. Payments are typically due to us monthly based on the volume of miles sold during the period, and the initial terms of our marketing contracts are from one to thirteen years. During the years ended December 31, 2023, 2022, and 2021, total cash sales from marketing agreements related to our loyalty program were $6.9 billion, $5.7 billion, and $4.1 billion, respectively, which are allocated to travel and other performance obligations as discussed below.

Our most significant contract to sell miles relates to our co-brand credit card relationship with American Express. Our agreements with American Express provide for joint marketing, grant certain benefits to Delta-American Express co-branded credit card holders (cardholders) and American Express Membership Rewards program participants, and allow American Express to market its services or products using our customer database. Cardholders earn miles for making purchases using co-branded cards, and certain cardholders may also check their first bag for free, are granted discounted access to Delta Sky Club lounges, and receive priority boarding and other benefits while traveling on Delta. Additionally, participants in the American Express Membership Rewards program may exchange their points for miles under the loyalty program. We sell miles at agreed-upon rates to American Express

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which are then provided to their customers under the co-branded credit card program and the Membership Rewards program.

We account for marketing agreements, including those with American Express, by allocating the consideration to the individual products and services delivered. We allocate the value based on the relative selling prices of those products and services, which generally consist of award travel, priority boarding, baggage fee waivers, lounge access, and the use of our brand. We determine our best estimate of the selling prices by using a discounted cash flow analysis using multiple inputs and assumptions, including (1) the expected number of miles awarded and number of miles redeemed, (2) ETV for the award travel obligation adjusted for mileage breakage, (3) published rates on our website for baggage fees, discounted access to Delta Sky Club lounges and other benefits while traveling on Delta, (4) brand value (using estimated royalties generated from the use of our brand), and (5) volume discounts provided to certain partners.

We defer the amount allocated to award travel as part of loyalty program deferred revenue and recognize loyalty travel awards in passenger revenue as the miles are redeemed and transportation is provided. Revenue allocated to services performed in conjunction with a passenger's flight (such as baggage fee waivers) is recognized as travel-related services in passenger revenue when the related service is performed. Revenue allocated to Delta Sky Club lounge access is recognized as miscellaneous in other revenue as access is provided. Revenue allocated to the remaining performance obligations, primarily brand value, is recorded as loyalty program in other revenue as miles are delivered.

Current Activity of the Loyalty Program. Miles are combined in one homogeneous pool and are not separately identifiable. Therefore, the revenue includes miles that were part of the loyalty program deferred revenue balance at the beginning of the period as well as miles that were issued during the period.

Microsoft Corporation[9]

Excerpt from notes to financial statements for the fiscal year ended June 30, 2023

Revenue recognition

Product Revenue and Service and Other Revenue

Product revenue includes sales from operating systems, cross-device productivity and collaboration applications, server applications, business solution applications, desktop and server management tools, software development tools, video games, and hardware (such as PCs, tablets, gaming and entertainment consoles, other intelligent devices, and related accessories).

Service and other revenue includes sales from cloud-based solutions that provide customers with software, services, platforms, and content (such as Office 365, Azure, Dynamics 365, and Xbox); solution

[9] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000789019/000095017023035122/msft-20230630.htm.

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support; and consulting services. Service and other revenue also includes sales from online advertising and LinkedIn.

Revenue Recognition

Revenue is recognized upon transfer of control of promised products or services to customers in an amount that reflects the consideration we expect to receive in exchange for those products or services. We enter into contracts that can include various combinations of products and services, which are generally capable of being distinct and accounted for as separate performance obligations. Revenue is recognized net of allowances for returns and any taxes collected from customers, which are subsequently remitted to governmental authorities.

Nature of Products and Services

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

Certain volume licensing programs, including Enterprise Agreements, include on-premises licenses combined with Software Assurance ("SA"). SA conveys rights to new software and upgrades released over the contract period and provides support, tools, and training to help customers deploy and use products more efficiently. On-premises licenses are considered distinct performance obligations when sold with SA. Revenue allocated to SA is generally recognized ratably over the contract period as customers simultaneously consume and receive benefits, given that SA comprises distinct performance obligations that are satisfied over time.

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

Revenue from search advertising is recognized when the advertisement appears in the search results or when the action necessary to earn the revenue has been completed. Revenue from consulting services is recognized as services are provided.

Our hardware is generally highly dependent on, and interrelated with, the underlying operating system and cannot function without the operating system. In these cases, the hardware and software license are accounted for as a single performance obligation and revenue is recognized at the point in time when

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ownership is transferred to resellers or directly to end customers through retail stores and online marketplaces.

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Allocating the Transaction Price to the Performance Obligations in the Contract

Learning objectives

- Identify the definition of a *stand-alone selling price*.
- Identify the allocation of a discount to performance obligations identified in a contract with a customer.
- Identify the allocation of variable consideration in a contract with a customer to the applicable performance obligations.

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Overview

The core principle of the revenue recognition standard is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration an entity expects to be entitled in exchange for those goods or services.

To achieve the core principle of the revenue standard, an entity should be able to perform the following five steps:

- Step 1: Identify the contract with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price to the performance obligations.
- Step 5: Recognize revenue when or as the entity satisfies performance obligations.

The focus of this discussion is step 4, allocating the transaction price to the performance obligations.

Implementation illustrations

See the appendix for sample disclosures taken from recently issued SEC 10-K filings which illustrate transaction price considerations under FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*. Selected portions of these sample disclosures are included where appropriate.

Allocating the transaction price to the performance obligations in the contract

If a contract with a customer has more than one performance obligation, step 4 describes how an entity should allocate the transaction price to each separate performance obligation in an amount that depicts the amount of consideration the entity expects to be entitled to for satisfying each separate performance obligation.

Stand-alone selling price

To allocate an appropriate amount of consideration to each performance obligation, FASB ASC 606-10-32-31 states that an entity will need to determine the stand-alone selling price at contract inception of the distinct goods or services underlying each performance obligation. The entity will then allocate the transaction price to each performance obligation at the contract's inception in proportion to those stand-alone selling prices.

The stand-alone selling price is the price an entity would sell a promised good or service separately to a customer. The best evidence of a stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers.

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Key point

An entity may have a contractually stated price list for their goods and services. Keep in mind that a contractually stated price list for an entity's goods or service may (but should not be presumed to be) the stand-alone selling price of that good or service.

Implementation illustrations

The following disclosures, taken from recently issued SEC filings, illustrate the allocation of consideration to performance obligations under FASB ASC 606. See the appendix for the complete notes from which these excerpts were taken. These examples are presented for informational purposes and are not authoritative.

Implementation illustration: Allocation of consideration to performance obligations

International Business Machines Corp.[1]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Note A: Significant accounting policies

Revenue

Arrangements with multiple performance obligations

… To the extent that a product or service in multiple performance obligation arrangements is subject to other specific accounting guidance, such as leasing guidance, that product or service is accounted for in accordance with such specific guidance. For all other products or services in these arrangements, the company determines if the products or services are distinct and allocates the consideration to each distinct performance obligation on a relative stand-alone selling price basis.

When products and services are not distinct, the company determines an appropriate measure of progress based on the nature of its overall promise for the single performance obligation. The revenue policies in the Services, Hardware, and/or Software sections below are then applied to each performance obligation, as applicable.

[1] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/51143/000005114324000012/ibm-20231231_d2.htm#fact-identifier-1179.

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Delta Air Lines Inc.[2]

Excerpt from notes to financial statements for the year ended December 31, 2023

Note 2: Revenue recognition

Loyalty program

… Our SkyMiles loyalty program generates customer loyalty by rewarding customers with incentives to travel on Delta. This program allows customers to earn miles by flying on Delta, Delta Connection carriers and other airlines that participate in the loyalty program. When traveling, customers earn miles primarily based on the passenger's loyalty program status, fare class and ticket price. Customers can also earn miles through participating companies. Miles are redeemable by customers in future periods for air travel on Delta and other participating airlines, access to Delta Sky Club and other program awards. To facilitate transactions with participating companies, we sell miles to non-airline businesses and other airlines.

The loyalty program includes two types of transactions that are considered revenue arrangements with multiple performance obligations (1) passenger ticket sales earning miles and (2) sale of miles to participating companies.

Passenger Ticket Sales Earning Miles. Passenger ticket sales earning miles provide customers with (1) miles earned and (2) air transportation, which are each considered performance obligations. We value each performance obligation on a standalone basis. To value the miles earned, we consider the quantitative value a passenger receives by redeeming miles for a ticket rather than paying cash, which is referred to as equivalent ticket value ("ETV"). Our estimate of ETV is adjusted for miles that are not likely to be redeemed ("mileage breakage"). We use statistical models to estimate mileage breakage based on historical redemption patterns. A change in assumptions regarding the redemption activity for miles or the estimated fair value of miles expected to be redeemed could have a material impact on our revenue in the year in which the change occurs and in future years. We recognize mileage breakage proportionally during the period in which the remaining miles are actually redeemed.

We defer revenue for the miles when earned and recognize loyalty travel awards in passenger revenue as the miles are redeemed and transportation is provided. We record the air transportation portion of the passenger ticket sales in air traffic liability and recognize passenger revenue when we provide transportation or if the ticket goes unused.

[2] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/27904/000002790424000003/dal-20231231.htm

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Delta Air Lines Inc. (continued)

Sale of Miles. Customers earn miles based on their spending with participating companies, such as credit card, retail, ridesharing, car rental and hotel companies, with which we have marketing agreements to sell miles. Our contracts to sell miles under these marketing agreements have multiple performance obligations. Payments are typically due to us monthly based on the volume of miles sold during the period, and the initial terms of our marketing contracts are from one to thirteen years. During the years ended December 31, 2023, 2022 and 2021, total cash sales from marketing agreements related to our loyalty program were $6.9 billion, $5.7 billion and $4.1 billion, respectively, which are allocated to travel and other performance obligations, as discussed below.

Our most significant contract to sell miles relates to our co-brand credit card relationship with American Express. Our agreements with American Express provide for joint marketing, grant certain benefits to Delta-American Express co-branded credit card holders ("cardholders") and American Express Membership Rewards program participants, and allow American Express to market its services or products using our customer database. Cardholders earn miles for making purchases using co-branded cards, and certain cardholders may also check their first bag for free, are granted discounted access to Delta Sky Club lounges and receive priority boarding and other benefits while traveling on Delta. Additionally, participants in the American Express Membership Rewards program may exchange their points for miles under the loyalty program. We sell miles at agreed-upon rates to American Express which are then provided to their customers under the co-brand credit card program and the Membership Rewards program.

We account for marketing agreements, including those with American Express, by allocating the consideration to the individual products and services delivered. We allocate the value based on the relative selling prices of those products and services, which generally consist of award travel, priority boarding, baggage fee waivers, lounge access and the use of our brand. We determine our best estimate of the selling prices by using a discounted cash flow analysis using multiple inputs and assumptions, including (1) the expected number of miles awarded and number of miles redeemed, (2) ETV for the award travel obligation adjusted for mileage breakage, (3) published rates on our website for baggage fees, discounted access to Delta Sky Club lounges and other benefits while traveling on Delta, (4) brand value (using estimated royalties generated from the use of our brand) and (5) volume discounts provided to certain partners.

We defer the amount allocated to award travel as part of loyalty program deferred revenue and recognize loyalty travel awards in passenger revenue as the miles are redeemed and transportation is provided. Revenue allocated to services performed in conjunction with a passenger's flight, such as baggage fee waivers, is recognized as travel-related services in passenger revenue when the related service is performed. Revenue allocated to Delta Sky Club lounge access is recognized as miscellaneous in other revenue as access is provided. Revenue allocated to the remaining performance obligations, primarily brand value, is recorded as loyalty program in other revenue as miles are delivered.

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Delta Air Lines Inc. (continued)

Current Activity of the Loyalty Program. Miles are combined in one homogeneous pool and are not separately identifiable. Therefore, the revenue is comprised of miles that were part of the loyalty program deferred revenue balance at the beginning of the period as well as miles that were issued during the period.

As previously discussed, the term *material right* is not defined in FASB ASC 606, but is used quite often throughout the examples in FASB ASC 606-55. Understanding whether a customer was promised a material right is important because material rights generally give rise to separate performance obligations. The entity will need to allocate the transaction price to each performance obligation, including material rights, identified in the contract on a relative stand-alone selling price basis. The assessment concerning whether an option grants a customer a material right is completed at contract inception.

When an option to acquire additional goods or services provide a material right to the customer, the customer is in effect paying in advance for future goods or services, and revenue attributable to the material right is recognized when those future goods or services are transferred or when the option expires. Specifically, FASB ASC 606 explains that

- the estimate of the stand-alone selling price of a customer option should reflect the discount that the customer would obtain when exercising the option, adjusted for both any discount that the customer could receive without exercising the option and the likelihood that the option will be exercised, and
- provides a practical alternative to allocating transaction price to an option. If a customer has a material right to acquire future goods or services that are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, the transaction price can be allocated to the optional goods or services by reference to the goods or services expected to be provided.

Estimating the stand-alone selling price

If a stand-alone selling price is not directly observable, an entity should estimate it. When estimating a stand-alone selling price, to maximize the use of observable inputs, an entity should consider all information, such as market conditions, entity-specific factors, and other information about the customer or class of customer that is reasonably available.

FASB ASC 606 provides the following list of suitable methods for estimating the stand-alone selling price of a good or service. Keep in mind that the list is not all inclusive.

- *Adjusted market assessment approach*. An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. This approach might also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
- *Expected cost plus a margin approach*.An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

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- *Residual approach*. An entity may estimate the stand-alone selling price by reference to the total transaction price less the sum of the observable stand-alone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate the stand-alone selling price of a good or service only if one of the following criteria is met:
  - The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative stand-alone selling price is not discernible from past transactions or other observable evidence).
  - The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a stand-alone basis (that is, the selling price is uncertain).

A combination of methods may be needed to estimate the stand-alone selling prices of the goods or services promised in a contract. This may occur if two or more of those goods or services are highly variable or their respective stand-alone selling prices are uncertain. When an entity uses a combination of methods, it should evaluate whether allocating the transaction price at those estimated stand-alone selling prices would be consistent with the allocation objective in FASB ASC 606.

Implementation illustrations

The following examples, taken from recently issued SEC 10-K filings, illustrate estimation of the stand-alone selling price under FASB ASC 606. See the appendix for the complete notes from which these excerpts were taken. These examples are presented for informational purposes and are not authoritative.

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Implementation illustrations: Estimating the stand-alone selling price

Apple Inc.[3]

Excerpt from notes to financial statements for the 12 months ended September 28, 2024

Revenue from contracts with customers

… For arrangements with multiple performance obligations, which represent promises within an arrangement that are distinct, the Company allocates revenue to all distinct performance obligations based on their relative stand-alone selling prices ("SSPs"). When available, the Company uses observable prices to determine SSPs. When observable prices are not available, SSPs are established that reflect the Company's best estimates of what the selling prices of the performance obligations would be if they were sold regularly on a stand-alone basis. The Company's process for estimating SSPs without observable prices considers multiple factors that may vary depending upon the unique facts and circumstances related to each performance obligation including, where applicable, prices charged by the Company for similar offerings, market trends in the pricing for similar offerings, product-specific business objectives and the estimated cost to provide the performance obligation.

The Company has identified the performance obligations regularly included in arrangements involving the sale of iPhone, Mac and iPad. The first material performance obligation, which represents the substantial portion of the allocated sales price, is the hardware and bundled software delivered at the time of sale. The second material performance obligation is the right to receive certain product-related bundled services, which include iCloud®, Siri® and Maps®. The Company allocates revenue and any related discounts to all of its performance obligations based on their relative SSPs. Because the Company lacks observable prices for product-related bundled services, the allocation of revenue is based on the Company's estimated SSPs. Revenue allocated to the delivered hardware and bundled software is recognized when control has transferred to the customer, which generally occurs when the product is shipped. Revenue allocated to product-related bundled services is deferred and recognized on a straight-line basis over the estimated period they are expected to be provided.

[3] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/320193/000032019324000123/aapl-20240928.htm.

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Implementation illustrations: Estimating the stand-alone selling price (continued)

Lockheed Martin Corp. Inc.[4]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Significant accounting policies — Revenue recognition

For contracts with multiple performance obligations, we allocate the transaction price to each performance obligation based on the estimated standalone selling price of the product or service underlying each performance obligation. The standalone selling price represents the amount we would sell the product or service to a customer on a standalone basis (i.e., not bundled with any other products or services). Our contracts with the U.S. Government, including FMS contracts, are subject to the Federal Acquisition Regulations (FAR) and the price is typically based on estimated or actual costs plus a reasonable profit margin. As a result of these regulations, the standalone selling price of products or services in our contracts with the U.S. Government and FMS contracts are typically equal to the selling price stated in the contract.

For non-U.S. government contracts with multiple performance obligations, we evaluate whether the stated selling prices for the products or services represent their standalone selling prices. We primarily sell customized solutions unique to a customer's specifications. When it is necessary to allocate the transaction price to multiple performance obligations, we typically use the expected cost plus a reasonable profit margin to estimate the standalone selling price of each product or service. We occasionally sell standard products or services with observable standalone sales transactions. In these situations, the observable standalone sales transactions are used to determine the standalone selling price.

[4] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000936468/000093646824000010/lmt-20231231.htm.

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Connected concepts: Practical point for management

Listed subsequently are considerations for estimating the stand-alone selling price of a good or service based on the method used.

Expected cost plus a margin approach

If management has decided to use the expected cost plus margin approach as their suitable method in estimating a stand-alone selling price, the following are some items to consider when assessing whether a margin is reasonable:

- Nature of proposal process (for example, a competitive bidding process, assuming competitors were similarly priced could be an indicator that contract value(s) approximates to a stand-alone selling price)
- Pricing practices (for example, the customer requires they receive certified cost or pricing data such as in the case with many government contracts)
- Pricing objectives that might include a desired or historical gross profit margin
- Effects of customization on pricing
- Pricing practices used to establish pricing of bundled products
- Effects of a proposed transaction on pricing (such as the size of the contract, targeted customer for example commercial or residential, corporate versus individual, and the like)
- Margins earned on similar contracts with different customers

Adjusted market assessment approach

If management has decided to use the adjusted market assessment approach as their suitable method in estimating a stand-alone selling price, the following are a few are examples of market conditions to consider:

- Competitor pricing for a similar or identical product
- Market awareness of and perception of the product
- Current market trends that will likely affect the pricing
- The entity's market share and position (for example, the entity's ability to dictate pricing)
- Effects of the geographic area on pricing
- Effects of customization on pricing
- Expected technological life of the product

Residual approach

Management needs to keep in mind that the residual approach may be used to estimate stand-alone selling price only in situations in which they sell the same product or service to different customers for a broad range of prices, making them highly variable, or when they have not yet established a price for a product or service because it has not been previously sold on a stand-alone basis.

Lastly, management may need to apply a combination of methods to estimate the stand-alone selling prices of the goods or services promised in a contract and must not lose sight of the fact that the methods used need to be applied on a consistent basis for similar products and services and customers.

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Connected concepts: Practical point for small and medium-sized private companies

Small and medium-sized private companies generally have fewer resources in terms of funds and experienced staff and therefore they might need third-party assistance to help them assess which permitted and reasonable estimated method(s) to use when determining the estimated stand-alone selling price. Therefore, consider the following:

- Seeking out the necessary third parties early in the process and not trying to rely on external auditors because the auditors cannot participate in management's estimates and assumptions without impairing their independence.
- The hiring of third parties can be costly, so getting approval for these additional costs and perhaps including them in an annual budget might be helpful so you are not caught off guard with an unforeseen and unplanned invoice.
- Obtaining industry data from a variety of free and paid resources such as federal government statistics, industry associations, and the like.



Example: Allocating the transaction price to the performance obligations in the contract

Facts

- An entity enters into a contract with a customer to sell Products A, B, and C in exchange for $100.
- The customer received a discount for purchasing the goods in a bundle because the stand-alone selling prices of each totaled $150 and exceeded the selling price.
- The entity will satisfy the performance obligations for each of the products at different points in time.
- The entity regularly sells Product A separately, and, therefore the stand-alone selling price is directly observable.
- The stand-alone selling prices of Products B and C are not directly observable.

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Example: Allocating the transaction price to the performance obligations in the contract (continued)

Allocation of the transaction price to the performance obligations in the contract

The entity estimates the stand-alone selling prices as follows:

Product	Stand-alone selling price
Product A	$50
Product B	25
Product C	75
Total	$150

The entity will allocate the contract price of $100 based on the relative stand-alone values as follows:

Product	Allocated transaction price	
Product A	$ 33	($50 ÷ $150 × $100)
Product B	17	($25 ÷ $150 × $100)
Product C	50	($75 ÷ $150 × $100)
Total	$100	

Knowledge check

1. Which method should be avoided for estimating the stand-alone selling price of a good or service as described in FASB ASC 606?

    a. The adjusted market assessment approach.
    b. The expected cost plus a margin approach.
    c. The residual approach.
    d. The discount approach.

Allocation of a discount

An entity may find that the transaction price in a contract with a customer contains a discount. When a customer receives a discount for purchasing a bundle of goods or services, the sum of the stand-alone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract.

Unless there is observable evidence that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity should allocate a discount proportionately to all

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performance obligations in the contract. The proportional allocation of the discount to each performance obligation is based on their relative stand-alone selling prices.

The discount should be allocated entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a stand-alone basis.
b. The entity also regularly sells on a stand-alone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle.
c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation(s) to which the entire discount in the contract belongs.

If the preceding criteria are met, and a discount is allocated entirely to one or more performance obligations in the contract, an entity should allocate the discount before using the residual approach to estimate the stand-alone selling price of a good or service. Sometimes it is appropriate to allocate a discount to some, or all, of the performance obligation in a contract and at other times, it is not. The following examples illustrate this concept.

Examples



Example: Allocating a discount[5]

Facts

- An entity enters into a contract with a customer to sell Products A, B, and C in exchange for $100.
- The performance obligations for each of the products at different points in time.
- The contract includes a discount of $40 on the overall transaction that will be allocated proportionately to all three performance obligations when allocating the transaction price using the relative stand-alone selling price method.
- The entity regularly sells Products B and C together for $60 and Product A for $40.
- The entity has evidence that the entire discount should be allocated to the promises to transfer Products B and C.

[5] Paragraphs 261–269 of FASB *Accounting Standards Codification* 606-10-55.

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Example: Allocating a discount (continued)

Allocation of discount

- When Product B and C are transferred to the Customer at the same point in time, the entity could
  - Account for the transfer of those products as a single performance obligation.
  - Allocate $60 of the transaction price to the single performance obligation and recognize revenue of $60 when Products B and C simultaneously transfer to the customer.
- When Product B and C are transferred to the Customer at different points in time, the allocated amount of $60 is individually allocated to the promises to transfer Product B (assuming stand-alone selling price of $55) and Product C (assuming stand-alone selling price of $45) as follows:

Product	Allocated Transaction Price	
Product B	$ 33	($55 ÷ $100 total standalone selling price × $60)
Product C	27	($45 ÷ $100 total standalone selling price × $60)
Total	$ 60	

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Example: When the residual approach is appropriate

Facts

- An entity enters into a contract with a customer to sell Products A, B, and C, and the contract includes a promise to transfer Product D.
- The total consideration in the contract is $130.
- The stand-alone selling price for Product D is highly variable because the entity sells Product D to different customers for a broad range of amounts ($15–$45). The entity decides to estimate the stand-alone selling price of Product D using the residual approach.
- The entity regularly sells Products B and C together for $60 and Product A for $40, and it has observable evidence that $100 should be allocated to those three products, and a $40 discount should be allocated to the promises to transfer Products B and C.

Using the residual approach, the entity estimates the stand-alone selling price of Product D to be $30 as follows:

Product	Stand-alone selling price	Method
Product A	$ 40	Directly observable
Products B and C	60	Directly observable with discount
Product D	30	Residual approach
Total	$130	



Example: When the residual approach is inappropriate

Facts

- An entity enters into a contract with a customer to sell Products A, B, and C, and the contract includes a promise to transfer Product D.
- The total consideration in the contract is $105.
- The stand-alone selling price for Product D is highly variable because the entity sells Product D to different customers for a broad range of amounts ($15–$45).
- The entity regularly sells Products B and C together for $60 and Product A for $40, and it has observable evidence of the stand-alone selling prices.

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Example: When the residual approach is inappropriate (continued)

Conclusion

Using the residual approach, the stand-alone selling price for Product D would be $5 ($105 transaction price less $100 allocated to Products A, B, and C). That would not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer Product D because $5 does not approximate the stand-alone selling price of Product D, which ranges from $15–$45. Given this, the entity should use another suitable method in estimating the stand-alone selling price of Product D to allocate the transaction price of $105 to Products A, B, C, and D using their respective relative stand-alone selling prices.

Variable consideration

An entity may find that the transaction price in a contract with a customer contains variable consideration. The variable consideration promised in a contract may be attributable to the entire contract or to a specific part of the contract, such as in the following:

- When the variable consideration is attributable to one or more, but not all, performance obligations in the contract, for example, a bonus may be contingent on an entity transferring a promised good or service within a specified period of time
- When the variable consideration is attributable to one or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation (For example, the consideration promised for the second year of a two-year cleaning service contract will increase on the basis of movements in a specified inflation index.)

A variable amount and subsequent changes to that amount should be allocated entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation, providing both of the following criteria are met:

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service.
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the overall objective for allocating the transaction price to performance obligations, when considering all of the performance obligations and payment terms in the contract.

If the variable consideration is not allocated entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation, the remaining amount of the transaction price should be allocated based on the allocation requirements related to allocation based on stand-alone selling price and allocation of a discount.

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Example: Allocation for software transaction

The facts — Scenario A:

- A customer enters into a contract for a perpetual license and one year of maintenance for a contractual amount of $1 million for the license and 13% for the maintenance (total consideration of $1,130,000).
- The customer has the contractual right to renew maintenance annually at 13% of the license fee.
- The entity's stand-alone selling price range for the software license is $950,000 to $1,050,000 and the stand-alone selling price range for maintenance is 12% to 16% of the license fee.

Assessment/conclusion — Scenario A

- Both the license and the maintenance are within the company's stand-alone selling price ranges.
- The entity would not need to reallocate consideration beyond the amounts stated in the contract and would allocate $1 million to the license and $130,000 (13%) to the maintenance.
- Because the renewal rate is within the company's stand-alone selling price range for maintenance, the company concludes that no material right related to the option to renew maintenance exists.

The facts — Scenario B

- Assume the same facts as scenario A, except the contractual price for maintenance is 10% of the license fee for both the initial year and any renewals.
- The entity's stand-alone selling price range for the software license is $950,000 to $1,050,000, and the stand-alone selling price range for maintenance is 12% to 16% of the license fee.

Assessment — Scenario B

- The license fee of $1 million is within the stand-alone selling price range; however, the 10% maintenance fee (both the initial year and any renewals) is not.
- The entity must allocate the consideration in an amount different from the stated contractual amounts, as the contractual amounts are not both within the stand-alone selling price range.
- The entity would have to determine what percentage to use as the stand-alone selling price to calculate the relative selling price of the maintenance.
- The entity has concluded that the contract contains material rights related to the right to renew maintenance, meaning that in this example an assessment of the qualitative and quantitative evaluation of materiality was previously performed.
- In determining the stand-alone selling price of the options, the entity concluded that there is a 100% likelihood that the customer will exercise the options.

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Example: Allocation for software transaction (continued)

Conclusion — Scenario B

The entity's policy is to use the midpoint of its identified range and anticipates the customer will renew the maintenance four times. Therefore, the company concluded that

- the discount on future maintenance from stand-alone selling price is $160,000 (the difference between the maintenance at the midpoint of the stand-alone selling price range of 14% [$140,000]) and
- the contractual renewal rate of 10% ($100,000) for the number of years the company expects the customer to renew is material to the contract (over 14% of the contract value).

Based upon the entity's assessments and conclusions, the allocation based upon the estimated fair value and not the alternative practical expedient would be as follows:

Performance obligation	Stand-alone selling price	Allocation of the transaction price
License	$1,000,000	$ 846,000
Maintenance (14%)	$ 140,000	$ 119,000
Material right	$ 160,000	$ 135,000
Total	$1,300,000	$1,100,000



Key point

When allocating an appropriate amount of consideration to each performance obligation, sometimes the transaction price includes a discount or variable consideration that relates entirely to one of the performance obligations in a contract.

Under these circumstances, FASB ASC 606 specifies when an entity should allocate the discount or variable consideration to one (or some) performance obligation(s) rather than to all performance obligations in the contract.

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Exercises



Exercise: KP Company

KP Company has a customer loyalty program that rewards a customer with one customer loyalty point for every $10 of purchases. Each point is redeemable for $1 discount on any future purchases.

During a reporting period, customers purchased products for $100,000 and earned 10,000 in points redeemable for future purchases. The stand-alone selling price of the purchased products is $100,000 and the entity expects 9,500 points to be redeemed. The entity estimates a stand-alone selling price of $0.95 per point (or $9,500 in total) on the basis of the likelihood of redemption.

At the end of the first reporting period, 4,500 of the points have been redeemed, and KP Company expects 9,500 points to be redeemed in total. During the second reporting period, an additional 4,000 points are redeemed; therefore, the cumulative points redeemed to date are 8,500. The entity now expects that 9,700 points will be redeemed in total. In the third reporting period, an additional 1,200 points are redeemed. The cumulative points now redeemed total 9,700 and KP Company does not expect that any additional points will be redeemed.

How many performance obligations are in the contract with the customer and how should the transaction price be allocated to the separate performance obligations?



Exercise: Voucher for future purchase

Entity A enters into a contract for the sale of Product A for $100. As part of the contract, the entity gives the customer a 40% voucher for any future purchases in the next 30 days up to $100. The entity intends to offer a 10% discount on all sales during the next 30 days as part of a seasonal promotion. Entity A estimates an 80% likelihood that a customer will redeem the voucher and that a customer will, on average, purchase $50 of additional product.

How many performance obligations are there, what is the transaction price and how should it be allocated to each performance obligation?

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Knowledge check

2. Which scenario best describes what to do when a discount (variable consideration) relates entirely to one of the performance obligations in a contract?

    a. An entity would continue to allocate the discount to each performance obligation in the contract with the customer.
    b. An entity would allocate the discount to that one performance obligation.
    c. An entity would not allocate the discount directly to each performance obligation in the contract, and would instead include the discount as a reduction to cost of goods sold.
    d. An entity would separate the performance obligation associated with the discount and create a new contract with the customer.

Change in the transaction price

After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

When there are any subsequent changes in the transaction price, an entity should allocate to the performance obligations in the contract on the same basis used at contract inception. Amounts allocated to a satisfied performance obligation should be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.



Key point

The transaction price should not be reallocated to reflect changes in stand-alone selling prices after contract inception. Amounts allocated to a satisfied performance obligation should be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

A change in the transaction price should be allocated entirely to one or more, but not all, performance obligations or distinct goods or services promised in a series that forms part of a single performance obligation only if both of the following criteria are met:

- The terms of the change in transaction price relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service
- Allocating the change in transaction price entirely to the performance obligation or the distinct good or service is consistent with the overall objective for allocating the transaction price to performance obligations, when considering all of the performance obligations and payment terms in the contract.

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Contract modifications and changes in the transaction price

When a change in the transaction price occurs after a contract modification, an entity should allocate the change in the transaction price in whichever of the following ways is applicable:

- Allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for as if it were a termination of the existing contract and the creation of a new contract
- In all other cases in which the modification was not accounted for as a separate contract, allocate the change in the transaction price to the performance obligations in the modified contract, meaning, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification.

Reassessment of variable consideration

At the end of each reporting period, an entity should update the estimated transaction price (including its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period.

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Example: Modification: Unpriced change order

Chapter 3, "Aerospace and Defense Entities," of the AICPA Audit and Accounting Guide *Revenue Recognition* provides the following example of an unpriced change order.

Facts

- A contractor enters into a contract with a customer to develop a satellite.
- After development starts, the customer changes the specifications of the satellite.
- The contractor is asked to process the changes; however, the price has not yet been approved and is not expected to be approved before the development is completed.
- These types of changes are common and the contractor has a history of executing unpriced change orders with this customer that it believes is predictive of future prices.

Assessment/conclusion

- The changes in the satellite specifications will be accounted for as a contract modification.
- The contractor determined that there is a valid expectation that the price for the modification will be approved based on specific facts and circumstances.
- The contractor expects the price of the scope change to be approved based on its experience with this particular customer and will estimate the change in transaction price based on a probability-weighted or most likely amount approach (whichever is most predictive), provided that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur when the price of the change order is approved.
- The contractor will re-evaluate the estimates of unpriced change orders at each reporting period.

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Connected concepts: Practical point for management

Management should consider the following when performing step 4:

- Establishing policies when determining the appropriate transaction price allocation, including variable consideration, material rights, discounts, and the like
- Establishing a process, including the methods used, for applying the relative stand-alone selling price approach when allocating the transaction price or the use of available exceptions
- Documenting those processes, procedures, and policies relating to the estimation of stand-alone selling prices
- Gathering evidence to support the estimates and assumptions used when estimating the stand-alone selling price and assessing whether those assumptions are reasonable
- Consider the implication of the policies, procedures, and processes on the general ledger and the internal control over the financial reporting system as a whole
- Establishing controls over how policies, procedures, and processes were established, and/or modified, tested for effectiveness, and the like

Connected concepts: Practical point for improving documentation

Small and medium-sized private companies generally have fewer resources in terms of funds and experienced staff. The business environment for many of these companies is far more relaxed than that of a public company and therefore many of the company's policies and procedures may be informal and not documented. To make the application of step 4 a bit easier, consider the following:

- Formally documenting the methods used when determining the stand-alone selling price of the applicable performance obligations
- Gathering written evidence to support the estimates and assumptions used when estimating the stand-alone selling price and assessing whether those assumptions are reasonable (This will help when the auditor's question the inputs used in arriving at these estimates and estimates.)
- Determining whether the company will need to make changes to their general ledger
- If possible, establishing controls over how policies, procedures, and processes were established, and/or modified, tested for effectiveness, and the like (This may be done by assigning different tasks to different employees.)

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Knowledge check

3. If the transaction price changes after contract inception, an entity will allocate the change to

    a. The performance obligations in the contract on the same basis used at contract inception.
    b. The performance obligations in the contract based on changes in the stand-alone selling prices of the performance obligations after the contract's inception.
    c. One performance obligation, regardless of the number of performance obligations at contract inception.
    d. The performance obligations identified in the contract in the same way the contract modification was allocated.

Summary

Here some key takeaways:

- Remember that, if a contract with a customer has more than one performance obligation, an entity should allocate the transaction price to each separate performance obligation.
- Keep in mind that the stand-alone selling price is the price an entity would sell a promised good or service separately to a customer.
- Don't forget that if a stand-alone selling price is not directly observable, an entity should estimate it.
- When there is no observable evidence that the entire discount relates to only one or more, but not all, performance obligations in a contract, an entity should allocate a discount proportionately to all performance obligations in the contract.
- If there are any subsequent changes in the transaction price, remember to allocate to the performance obligations in the contract on the same basis used at contract inception.

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Solutions

Allocating the Transaction Price to the Performance Obligations in the Contract

Knowledge check solutions

1.

a. Incorrect. This would include using competitor pricing to help in estimating the stand-alone selling price of a good or service.
b. Incorrect. FASB ASC 606 considers expected cost plus a margin approach a suitable method for estimating the stand-alone selling price of a good or service.
c. Incorrect This approach is used under very specific circumstances, such as when the entity has not established a price.
d. Correct. The discount approach is not a suitable method for estimating the stand-alone selling price of a good or service and is not described in FASB ASC 606.

2.

a. Incorrect. An entity would not allocate the discount to each of the performance obligations if it relates only to a specific performance obligation.
b. Correct. An entity would allocate the discount to that one performance obligation.
c. Incorrect. The discount would affect revenue.
d. Incorrect. There is no indication of an addition of distinct goods or services that would lead to the creation of a new contract.

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3.

a. Correct. Allocate change in the transaction price to the performance obligations in the contract on the same basis used at contract inception.
b. Incorrect. An entity will not allocate the change in the transaction price to the performance obligations in the contract based on changes in the stand-alone selling prices of the performance obligations after the contract's inception.
c. Incorrect. An entity will not simply allocate a change in the transaction price entirely to one performance obligation, if there is more than one performance obligation. The allocation is based on facts and circumstances to meet certain criteria to allocate the change to only one performance obligation.
d. Incorrect. An entity will not allocate the change in the transaction price to the performance obligations identified in the contract in the same way the contract modification was allocated. A change in the transaction price that arises as a result of a contract modification is accounted for in accordance with the guidance described FASB ASC 606 discussing contract modifications. When a change in the transaction price occurs after a contract modification, an entity should apply the guidance on changes in the transaction price to allocate the change in the transaction price in whichever of the following ways is applicable:
    - Allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification, and the modification is accounted for as if it were a termination of the existing contract and the creation of a new contract.
    - In all other cases in which the modification was not accounted for as a separate contract, allocate the change in the transaction price to the performance obligations in the modified contract, meaning, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification.

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Exercise solutions

Exercise: KP Company

The points provide a material right to the customers that they would not receive without entering into a contract; therefore, KP concludes that the points are a separate performance obligation.

The allocation of the transaction price to the product and the points based on a relative stand-alone selling price basis is as follows:

Product $100,000

Points 9,500

$109,500 – total of the combined stand-alone selling prices

Product = $91,324; ($100,000 ÷ $109,500 = 91.324%; 91.234% × $100,000)

Points = $8,676; ($9,500 ÷ $109,500 = 8.6757%; 8.6757% × $100,000)

End of the first period

At the end of the first period, KP will recognize revenue of $4,110 on the points (4,500 ÷ 9,500 points × $8,676).

End of the second period

At the end of the second period, KP adjusts the amount of points it believes would be redeemed from 9,500 to 9,700. 4,000 points were redeemed. Given this, KP will recognize revenue of $3,493 on the points (4,500 from the first period + 4,000 from the second period) ÷ 9,700 revised points = 87.63%) $8,676 × 87.63% = $7,603; $7,603 – $4,110 recognized in the first period = $3,493 of revenue for the second period.

End of the third period

The contract liability balance at the end of the third period is $1,073, representing the remaining revenue ($8,676 – $7,603).

Exercise: Voucher for future purchase

The discount voucher provides a material right to the customer that the customer would not receive without entering into that contract. The discount voucher is a separate performance obligation in the contract for the sale of Product A.

The transaction price is $100 (stand-alone selling price of Product A).

Because A intends to offer a 10% discount to all customers as part of a seasonal promotion, the 40% discount that the customer would obtain when exercising the voucher needs to be reduced by 10 percentage points to 30% to reflect the incremental value of the discount to the customer.

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Entity A's estimated stand-alone selling price of the discount voucher is $12: $50 average purchase of additional products × 30% incremental discount × 80% likelihood of exercising the option.

Although the stand-alone selling price of Product A is $100, the entity allocates $10.70 ($100 × [12 ÷ (12 + 100)]) of the $100 transaction price to the discount voucher and the remaining amount of $89.30 to Product A.

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Allocating The Transaction Price To The Performance Obligations In The Contract: Implementation Illustrations

This appendix is included for supplementary purposes only and is not required for CPE credit

Appendix

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Apple Inc.[1]

Excerpt from notes to financial statements for the 12 months ended September 28, 2024

Note 2 - Revenue Recognition

The Company recognizes revenue at the amount to which it expects to be entitled when control of the products or services is transferred to its customers. Control is generally transferred when the Company has a present right to payment and title and the significant risks and rewards of ownership of products or services are transferred to its customers. For most of the Company's Products net sales, control transfers when products are shipped. For the Company's Services net sales, control transfers over time as services are delivered. Payment for Products and Services net sales is collected within a short period following transfer of control or commencement of delivery of services, as applicable.

The Company records reductions to Products net sales related to future product returns, price protection and other customer incentive programs based on the Company's expectations and historical experience.

For arrangements with multiple performance obligations, which represent promises within an arrangement that are distinct, the Company allocates revenue to all distinct performance obligations based on their relative stand-alone selling prices ("SSPs"). When available, the Company uses observable prices to determine SSPs. When observable prices are not available, SSPs are established that reflect the Company's best estimates of what the selling prices of the performance obligations would be if they were sold regularly on a stand-alone basis. The Company's process for estimating SSPs without observable prices considers multiple factors that may vary depending upon the unique facts and circumstances related to each performance obligation including, where applicable, prices charged by the Company for similar offerings, market trends in the pricing for similar offerings, product-specific business objectives and the estimated cost to provide the performance obligation.

The Company has identified the performance obligations regularly included in arrangements involving the sale of iPhone, Mac and iPad. The first material performance obligation, which represents the substantial portion of the allocated sales price, is the hardware and bundled software delivered at the time of sale. The second material performance obligation is the right to receive certain product-related bundled services, which include iCloud®, Siri® and Maps. The Company allocates revenue and any related discounts to all of its performance obligations based on their relative SSPs. Because the Company lacks observable prices for product-related bundled services, the allocation of revenue is based on the Company's estimated SSPs. Revenue allocated to the delivered hardware and bundled software is recognized when control has transferred to the customer, which generally occurs when the product is shipped. Revenue allocated to product-related bundled services is deferred and recognized on a straight-line basis over the estimated period they are expected to be provided.

[1] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/320193/000032019324000123/aapl-20240928.htm

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For certain long-term service arrangements, the Company has performance obligations for services it has not yet delivered. For these arrangements, the Company does not have a right to bill for the undelivered services. The Company has determined that any unbilled consideration relates entirely to the value of the undelivered services. Accordingly, the Company has not recognized revenue, and does not disclose amounts, related to these undelivered services.

For the sale of third-party products where the Company obtains control of the product before transferring it to the customer, the Company recognizes revenue based on the gross amount billed to customers. The Company considers multiple factors when determining whether it obtains control of third-party products, including evaluating if it can establish the price of the product, retains inventory risk for tangible products or has the responsibility for ensuring acceptability of the product. For third-party applications sold through the App Store, the Company does not obtain control of the product before transferring it to the customer. Therefore, the Company accounts for all third-party application–related sales on a net basis by recognizing in Services net sales only the commission it retains.

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Lockheed Martin Corp. Inc.[2]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Significant accounting policies — Revenue recognition

For contracts with multiple performance obligations, we allocate the transaction price to each performance obligation based on the estimated standalone selling price of the product or service underlying each performance obligation. The standalone selling price represents the amount we would sell the product or service to a customer on a standalone basis (i.e., not bundled with any other products or services). Our contracts with the U.S. Government, including FMS contracts, are subject to the Federal Acquisition Regulations (FAR) and the price is typically based on estimated or actual costs plus a reasonable profit margin. As a result of these regulations, the standalone selling price of products or services in our contracts with the U.S. Government and FMS contracts are typically equal to the selling price stated in the contract.

For non-U.S. government contracts with multiple performance obligations, we evaluate whether the stated selling prices for the products or services represent their standalone selling prices. We primarily sell customized solutions unique to a customer's specifications. When it is necessary to allocate the transaction price to multiple performance obligations, we typically use the expected cost plus a reasonable profit margin to estimate the standalone selling price of each product or service. We occasionally sell standard products or services with observable standalone sales transactions. In these situations, the observable standalone sales transactions are used to determine the standalone selling price.

[2] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/0000936468/000093646824000010/lmt-20231231.htm

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International Business Machines Corp.[3]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Note A: Significant accounting policies

Revenue

The company accounts for a contract with a client when it has written approval, the contract is committed, the rights of the parties, including payment terms, are identified, the contract has commercial substance and consideration is probable of collection.

Revenue is recognized when, or as, control of a promised product or service transfers to a client, in an amount that reflects the consideration to which the company expects to be entitled in exchange for transferring those products or services. If the consideration promised in a contract includes a variable amount, the company estimates the amount to which it expects to be entitled using either the expected value or most likely amount method. The company's contracts may include terms that could cause variability in the transaction price, including, for example, rebates, volume discounts, service-level penalties, and performance bonuses or other forms of contingent revenue.

The company only includes estimated amounts in the transaction price to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. The company may not be able to reliably estimate contingent revenue in certain long-term arrangements due to uncertainties that are not expected to be resolved for a long period of time or when the company's experience with similar types of contracts is limited. The company's arrangements infrequently include contingent revenue. Changes in estimates of variable consideration are included in note C, "Revenue Recognition."

The company's standard billing terms are that payment is due upon receipt of invoice, payable within 30 days. Invoices are generally issued as control transfers and/or as services are rendered. Additionally, in determining the transaction price, the company adjusts the promised amount of consideration for the effects of the time value of money if the billing terms are not standard and the timing of payments agreed to by the parties to the contract provide the client or the company with a significant benefit of financing, in which case the contract contains a significant financing component. As a practical expedient, the company does not account for significant financing components if the period between when the company transfers the promised product or service to the client and when the client pays for that product or service will be one year or less. Most arrangements that contain a financing component are financed through the company's Financing business and include explicit financing terms.

[3] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/51143/000005114324000012/ibm-20231231.htm

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The company may include subcontractor services or third-party vendor equipment or software in certain integrated services arrangements. In these types of arrangements, revenue from sales of third-party vendor products or services is recorded net of costs when the company is acting as an agent between the client and the vendor, and gross when the company is the principal for the transaction. To determine whether the company is an agent or principal, the company considers whether it obtains control of the products or services before they are transferred to the customer. In making this evaluation, several factors are considered, most notably whether the company has primary responsibility for fulfillment to the client, as well as inventory risk and pricing discretion.

The company recognizes revenue on sales to solution providers, resellers and distributors (herein referred to as resellers) when the reseller has economic substance apart from the company and the reseller is considered the principal for the transaction with the end-user client.

The company reports revenue net of any revenue-based taxes assessed by governmental authorities that are imposed on and concurrent with specific revenue-producing transactions.

In addition to the aforementioned general policies, the following are the specific revenue recognition policies for arrangements with multiple performance obligations and for each major category of revenue.

Arrangements with multiple performance obligations

The company's global capabilities as a hybrid cloud platform and AI company include services, software, hardware and related financing. The company enters into revenue arrangements that may consist of any combination of these products and services based on the needs of its clients.

The company continues to develop new products and offerings and their associated consumption and delivery methods, including the use of cloud and as-a-Service models. These are not separate businesses; they are offerings across the segments that address market opportunities in areas such as analytics, data, cloud, security, AI and sustainability. Revenue from these offerings follows

the specific revenue recognition policies for arrangements with multiple performance obligations and for each major category of revenue, depending on the type of offering, which are comprised of services, software and/or hardware.

To the extent that a product or service in multiple performance obligation arrangements is subject to other specific accounting guidance, such as leasing guidance, that product or service is accounted for in accordance with such specific guidance. For all other products or services in these arrangements, the company determines if the products or services are distinct and allocates the consideration to each distinct performance obligation on a relative standalone selling price basis.

When products and services are not distinct, the company determines an appropriate measure of progress based on the nature of its overall promise for the single performance obligation.

The revenue policies in the Services, Hardware and/or Software sections below are applied to each performance obligation, as applicable.

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Services

The company's primary services offerings include consulting services, including business transformation; technology consulting and application operations including the design and development of complex IT environments to a client's specifications (e.g., design and build); cloud services; business process outsourcing; and infrastructure support. Many of these services can be delivered entirely or partially through cloud or as-a-Service delivery models. The company's services are provided on a time-and-material basis, as a fixed-price contract or as a fixed-price per measure of output contract and the contract terms generally range from less than one year to 5 years.

In services arrangements, the company typically satisfies the performance obligation and recognizes revenue over time. In design and build arrangements, the performance obligation is satisfied over time either because the client controls the asset as it is created (e.g., when the asset is built at the customer site) or because the company's performance does not create an asset with an alternative use and the company has an enforceable right to payment plus a reasonable profit for performance completed to date. In most other services arrangements, the performance obligation is satisfied over time because the client simultaneously receives and consumes the benefits provided as the company performs the services.

Revenue from time-and-material contracts is recognized on an output basis as labor hours are delivered and/or direct expenses are incurred. Revenue from as-a-Service type contracts, such as Infrastructure-as-a-Service, is recognized either on a straight-line basis or on a usage basis, depending on the terms of the arrangement (such as whether the company is standing ready to perform or whether the contract has usage-based metrics). If an as-a-Service contract includes setup activities, those promises in the arrangement are evaluated to determine if they are distinct.

In areas such as application management, business process outsourcing and other cloud-based services arrangements, the company determines whether the services performed during the initial phases of the arrangement, such as setup activities, are distinct. In most cases, the arrangement is a single performance obligation comprised of a series of distinct services that are substantially the same and that have the same pattern of transfer (i.e., distinct days of service). The company applies a measure of progress (typically time-based) to any fixed consideration and allocates variable consideration to the distinct periods of service based on usage. As a result, revenue is generally recognized over the period the services are provided on a usage basis. This results in revenue recognition that corresponds with the value to the client of the services transferred to date relative to the remaining services promised.

Revenue related to maintenance and technology lifecycle support and extended warranty is recognized on a straight-line basis over the period of performance because the company is standing ready to provide services.

In design and build contracts, revenue is recognized based on progress toward completion of the performance obligation using a cost-to-cost measure of progress. Revenue is recognized based on the labor costs incurred to date as a percentage of the total estimated labor costs to fulfill the contract. Due to the nature of the work performed in these arrangements, the estimation of cost at completion is complex, subject to many variables and requires significant judgment. Key factors reviewed by the company to estimate costs to complete each contract are future labor and product costs and expected

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productivity efficiencies. Changes in original estimates are reflected in revenue on a cumulative catch-up basis in the period in which the circumstances that gave rise to the revision become known by the company. Refer to note C, “Revenue Recognition,” for the amount of revenue recognized in the reporting period on a cumulative catch-up basis (i.e., from performance obligations satisfied, or partially satisfied, in previous periods).

The company performs ongoing profitability analyses of its design and build services contracts accounted for using a cost-to-cost measure of progress in order to determine whether the latest estimates of revenues, costs and profits require updating. If at any time these estimates indicate that the contract will be unprofitable, the entire estimated loss for the remainder of the contract is recorded immediately. For other types of services contracts, any losses are recorded as incurred.

In some services contracts, the company bills the client prior to recognizing revenue from performing the services. Deferred income of $3,444 million and $3,241 million at December 31, 2023 and 2022, respectively, is included in the Consolidated Balance Sheet. In other services contracts, the company performs the services prior to billing the client. When the company performs services prior to billing the client in design and build contracts, the right to consideration is typically subject to milestone completion or client acceptance and the unbilled accounts receivable is classified as a contract asset. At December 31, 2023 and 2022, contract assets for services contracts of $420 million and $426 million, respectively, are included in prepaid expenses and other current assets in the Consolidated Balance Sheet. The remaining amount of unbilled accounts receivable of $816 million and $788 million at December 31, 2023 and 2022, respectively, is included in notes and accounts receivable–trade in the Consolidated Balance Sheet.

Billings usually occur in the month after the company performs the services or in accordance with specific contractual provisions.

Hardware

The company’s hardware offerings include the sale or lease of Hybrid Infrastructure solutions including zSystems as well as Distributed Infrastructure solutions such as Power and Storage solutions. The capabilities of these products can also be delivered through as-a-Service or cloud delivery models, such as Infrastructure-as-a-Service and Storage-as-a-Service. The company also offers installation services for its more complex hardware products. Hardware offerings are often sold with distinct maintenance services, described in the Services section above.

Revenue from hardware sales is recognized when control has transferred to the customer which typically occurs when the hardware has been shipped to the client, risk of loss has transferred to the client and the company has a present right to payment for the hardware. In limited circumstances when a hardware sale includes client acceptance provisions, revenue is recognized either when client acceptance has been obtained, client acceptance provisions have lapsed, or the company has objective evidence that the criteria specified in the client acceptance provisions have been satisfied. Revenue from hardware sales-type leases is recognized at the beginning of the lease term. Revenue from rentals and operating leases is recognized on a straight-line basis over the term of the rental or lease.

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Revenue from as-a-Service arrangements is recognized either on a straight-line basis or on a usage basis as described in the Services section above. Installation services are accounted for as distinct performance obligations with revenue recognized as the services are performed. Shipping and handling activities that occur after the client has obtained control of a product are accounted for as an activity to fulfill the promise to transfer the product rather than as an additional promised service and, therefore, no revenue is deferred and recognized over the shipping period.

Software

The company's software offerings include hybrid platform software solutions, which contain many of the company's strategic areas including Red Hat, automation, data and AI, security and sustainability; transaction processing, which primarily supports mission-critical systems for clients; and distributed infrastructure software, which provides operating systems for zSystems and Power Systems hardware. These offerings include proprietary software and open-source software, and many can be delivered entirely or partially through as-a-Service or cloud delivery models, while others are delivered as on-premise software licenses.

Revenue from proprietary perpetual (one-time charge) license software is recognized at a point in time at the inception of the arrangement when control transfers to the client, if the software license is distinct from the post-contract support (PCS) offered by the company.

Revenue from proprietary term license software is recognized at a point in time for the committed term of the contract, unless consideration depends on client usage, in which case revenue is recognized when the usage occurs.

Proprietary term licenses often have a one-month contract term due to client termination rights, in which case, revenue would be recognized in that month for both the license and PCS. Clients may contract to convert their existing IBM term license software into perpetual license software plus PCS. When proprietary term license software is converted to perpetual license software, the consideration becomes fixed with no cancellability and, therefore, revenue for the perpetual license is recognized upon conversion, consistent with the accounting for other perpetual licenses, as described above. PCS revenue is recognized as described below.

The company also has open-source software offerings. Since open-source software is offered under an open-source licensing model and therefore, the license is available for free, the standalone selling price is zero. As such, when the license is sold with PCS or other products and services, no consideration is allocated to the license when it is a distinct performance obligation and therefore no revenue is recognized when control of the license transfers to the client. Revenue is recognized over the PCS period. In certain cases, open-source software is bundled with proprietary software and, if the open-source software is not considered distinct, the software bundle is accounted for under a proprietary software model.

Revenue from PCS is recognized over the contract term on a straight-line basis because the company is providing a service of standing ready to provide support, when-and-if needed, and is providing unspecified software upgrades on a when-and-if available basis over the contract term.

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Revenue from software hosting or Software-as-a-Service (SaaS) arrangements is recognized either on a straight-line basis or on a usage basis as described in the Services section above. In software hosting arrangements, the rights provided to the client (e.g., ownership of a license, contract termination provisions and the feasibility of the client to operate the software) are considered in determining whether the arrangement includes a license. In arrangements that include a software license, the associated revenue is recognized in accordance with the software license recognition policy above rather than over time as a service.

Financing

Financing income attributable to sales-type leases, direct financing leases and loans is recognized on the accrual basis using the effective interest method. Operating lease income is recognized on a straight-line basis over the term of the lease.

Standalone selling price

The company allocates the transaction price to each performance obligation on a relative standalone selling price basis. The standalone selling price (SSP) is the price at which the company would sell a promised product or service separately to a client. In most cases, the company is able to establish SSP based on the observable prices of products or services sold separately in comparable circumstances to similar clients. The company typically establishes SSP ranges for its products and services which are reassessed on a periodic basis or when facts and circumstances change.

In certain instances, the company may not be able to establish a SSP range based on observable prices, and as a result, the company estimates SSP. The company estimates SSP by considering multiple factors including, but not limited to, overall market conditions, including geographic or regional specific factors, internal costs, profit objectives and pricing practices. Additionally, in certain circumstances, the company may estimate SSP for a product or service by applying the residual approach. Estimating SSP is a formal process that includes review and approval by the company's management.

Services Costs

Recurring operating costs for services contracts are recognized as incurred. For fixed-price design and build contracts, the costs of external hardware and software accounted for under the cost-to-cost measure of progress are deferred and recognized based on the labor costs incurred to date (i.e., the measure of progress), as a percentage of the total estimated labor costs to fulfill the contract as control transfers over time for these performance obligations. Certain eligible, non-recurring costs (i.e., setup costs) incurred in the initial phases of business process outsourcing contracts and other cloud-based services contracts, including Software-as-a-Service arrangements, are capitalized when the costs relate directly to the contract, the costs generate or enhance resources of the company that will be used in satisfying the performance obligation in the future, and the costs are expected to be recovered. These costs consist of transition and setup costs related to the provisioning, configuring, implementation and training and other deferred fulfillment costs, including, for example, prepaid assets used in services contracts (i.e., prepaid software or prepaid maintenance). Capitalized costs are amortized on a straight-line basis over the expected period of benefit, which can include anticipated contract renewals or

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extensions, consistent with the transfer to the client of the services to which the asset relates. Additionally, fixed assets associated with these contracts are capitalized and depreciated on a straight-line basis over the expected useful life of the asset. If an asset is contract specific, then the depreciation period is the shorter of the useful life of the asset or the contract term. Amounts paid to clients in excess of the fair value of acquired assets used in business process outsourcing arrangements are deferred and amortized on a straight-line basis as a reduction of revenue over the expected period of benefit. The company performs periodic reviews to assess the recoverability of deferred contract transition and setup costs. If the carrying amount is deemed not recoverable, an impairment loss is recognized. Refer to note C, "Revenue Recognition," for the amount of deferred costs to fulfill a contract at December 31, 2023 and 2022.

In situations in which a business process outsourcing or other cloud-based services contract is terminated, the terms of the contract may require the client to reimburse the company for the recovery of unbilled accounts receivable, unamortized deferred contract costs and additional costs incurred by the company to transition the services.

Software Costs

Costs that are related to the conceptual formulation and design of licensed software programs are expensed as incurred to research, development and engineering expense; costs that are incurred to produce the finished product after technological feasibility has been established are capitalized as an intangible asset. Capitalized amounts are amortized on a straight-line basis over periods ranging up to three years and are recorded in software cost within cost of sales. The company performs periodic reviews to ensure that unamortized program costs remain recoverable from future revenue. Costs to support or service licensed programs are charged to software cost within cost of sales as incurred.

The company capitalizes certain costs that are incurred to purchase or develop internal-use software. Internal-use software programs also include software used by the company to deliver Software-as-a-Service when the client does not receive a license to the software and the company has no substantive plans to market the software externally. Capitalized costs are amortized on a straight-line basis over periods ranging up to three years and are recorded in selling, general and administrative expense or cost of sales, depending on whether the software is used by the company in revenue generating transactions. Additionally, the company may capitalize certain types of implementation costs and amortize them over the term of the arrangement when the company is a customer in a cloud-computing arrangement.

Incremental costs of obtaining a contract

Incremental costs of obtaining a contract (e.g., sales commissions) are capitalized and amortized on a straight-line basis over the expected customer relationship period if the company expects to recover those costs. The expected customer relationship period, determined based on the average customer relationship period, including expected renewals, for each offering type, is three years. Expected renewal periods are only included in the expected customer relationship period if commission amounts paid upon renewal are not commensurate with amounts paid on the initial contract. Incremental costs of obtaining a contract include only those costs the company incurs to obtain a contract that it would not have incurred if the contract had not been obtained. The company has determined that certain commissions

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programs meet the requirements to be capitalized. Some commission programs are not subject to capitalization as the commission expense is paid and recognized as the related revenue is recognized. Additionally, as a practical expedient, the company expenses costs to obtain a contract as incurred if the amortization period would have been a year or less. These costs are included in selling, general and administrative expenses.

Product warranties

The company offers warranties for its hardware products that generally range up to three years, with the majority being either one or three years. Any cost of standard warranties is accrued when the corresponding revenue is recognized. The company estimates its standard warranty costs for products based on historical warranty claim experience and estimates of future spending and applies this estimate to the revenue stream for products under warranty. Estimated future costs for warranties applicable to revenue recognized in the current period are charged to cost of sales. The warranty liability is reviewed quarterly to verify that it properly reflects the remaining obligation based on the anticipated expenditures over the balance of the obligation period. Adjustments are made when actual warranty claim experience differs from estimates. Costs from fixed-price support or maintenance contracts, including extended warranty contracts, are recognized as incurred.

Revenue from extended warranty contracts is initially recorded as deferred income and subsequently recognized on a straight-line basis over the delivery period because the company is providing a service of standing ready to provide services over such term.

Shipping and handling

Costs related to shipping and handling are recognized as incurred and included in cost in the Consolidated Income Statement.

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Delta Air Lines Inc.[4]

Excerpt from notes to financial statements for the year ended December 31, 2023

Note 2: Revenue recognition

Ticket

Passenger Tickets. We defer sales of passenger tickets to be flown by us or that we sell on behalf of other airlines in our air traffic liability. Passenger revenue is recognized when we provide transportation. For tickets that we sell on behalf of other airlines, we reduce the air traffic liability when consideration is remitted to those airlines. The air traffic liability primarily includes sales of passenger tickets with scheduled departure dates in the future and travel credits, which can be applied as payment toward the cost of a ticket. We periodically evaluate the estimated air traffic liability and may record adjustments in our income statement. These adjustments relate primarily to tickets that expire unused ("ticket breakage"), refunds, exchanges, transactions with other airlines and other items for which final settlement occurs in periods subsequent to the sale of the related tickets at amounts other than the original sales price.

We recognized approximately $7.4 billion, $4.2 billion and $2.2 billion in passenger revenue during the years ended December 31, 2023, 2022 and 2021, respectively, that had been recorded in our air traffic liability balance at the beginning of those periods.

As of December 31, 2023, all of our air traffic liability was recorded as a current liability. As of December 31, 2022, our air traffic liability was $8.3 billion, of which $100 million was included in other noncurrent liabilities on our balance sheet due to ticket validity extensions related to certain tickets and travel credits as of the end of 2022.

Ticket Breakage. We estimate the value of ticket breakage and recognize revenue at the scheduled flight date. Our ticket breakage estimates are primarily based on historical experience, ticket contract terms and customers' travel behavior.

Regional Carriers. Our regional carriers include both third-party regional carriers with which we have contract carrier agreements ("contract carriers") and Endeavor Air, Inc., our wholly owned subsidiary. Our contract carrier agreements are primarily structured as capacity purchase agreements where we purchase all or a portion of the contract carrier's capacity and are responsible for selling the seat inventory we purchase. We record revenue related to our capacity purchase agreements in passenger revenue and the related expenses in regional carrier expense. See Note 10, "Commitments and Contingencies," for additional information regarding contract carrier agreements.

[4] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/27904/000002790424000003/dal-20231231.htm

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Loyalty Travel Awards

Loyalty travel awards revenue is related to the redemption of mileage credits ("miles") for travel. We recognize loyalty travel awards revenue in passenger revenue as miles are redeemed and transportation is provided. See below for discussion of our loyalty program accounting policies..

Travel-Related Services

Travel-related services are primarily composed of services performed in conjunction with a passenger's flight, including baggage fees, administrative fees, and on-board sales. We recognize revenue for these services when the related transportation service is provided.

Loyalty Program

Our SkyMiles loyalty program generates customer loyalty by rewarding customers with incentives to travel on Delta. This program allows customers to earn miles by flying on Delta, Delta Connection carriers and other airlines that participate in the loyalty program. When traveling, customers earn miles primarily based on the passenger's loyalty program status, fare class and ticket price. Customers can also earn miles through participating companies. Miles are redeemable by customers in future periods for air travel on Delta and other participating airlines, access to Delta Sky Club and other program awards. To facilitate transactions with participating companies, we sell miles to non-airline businesses and other airlines.

The loyalty program includes two types of transactions that are considered revenue arrangements with multiple performance obligations (1) passenger ticket sales earning miles and (2) sale of miles to participating companies.

Passenger Ticket Sales Earning Miles. Passenger ticket sales earning miles provide customers with (1) miles earned and (2) air transportation, which are each considered performance obligations. We value each performance obligation on a standalone basis. To value the miles earned, we consider the quantitative value a passenger receives by redeeming miles for a ticket rather than paying cash, which is referred to as equivalent ticket value ("ETV"). Our estimate of ETV is adjusted for miles that are not likely to be redeemed ("mileage breakage"). We use statistical models to estimate mileage breakage based on historical redemption patterns. A change in assumptions regarding the redemption activity for miles or the estimated fair value of miles expected to be redeemed could have a material impact on our revenue in the year in which the change occurs and in future years. We recognize mileage breakage proportionally during the period in which the remaining miles are actually redeemed.

We defer revenue for the miles when earned and recognize loyalty travel awards in passenger revenue as the miles are redeemed and transportation is provided. We record the air transportation portion of the passenger ticket sales in air traffic liability and recognize passenger revenue when we provide transportation or if the ticket goes unused.

Sale of Miles. Customers earn miles based on their spending with participating companies, such as credit card, retail, ridesharing, car rental and hotel companies, with which we have marketing agreements to sell miles. Our contracts to sell miles under these marketing agreements have multiple performance obligations. Payments are typically due to us monthly based on the volume of miles sold during the period, and the initial terms of our marketing contracts are from one to thirteen years. During the years

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ended December 31, 2023, 2022 and 2021, total cash sales from marketing agreements related to our loyalty program were $6.9 billion, $5.7 billion and $4.1 billion, respectively, which are allocated to travel and other performance obligations, as discussed below.

Our most significant contract to sell miles relates to our co-brand credit card relationship with American Express. Our agreements with American Express provide for joint marketing, grant certain benefits to Delta-American Express co-branded credit card holders ("cardholders") and American Express Membership Rewards program participants, and allow American Express to market its services or products using our customer database. Cardholders earn miles for making purchases using co-branded cards, and certain cardholders may also check their first bag for free, are granted discounted access to Delta Sky Club lounges and receive priority boarding and other benefits while traveling on Delta. Additionally, participants in the American Express Membership Rewards program may exchange their points for miles under the loyalty program. We sell miles at agreed-upon rates to American Express which are then provided to their customers under the co-brand credit card program and the Membership Rewards program.

We account for marketing agreements, including those with American Express, by allocating the consideration to the individual products and services delivered. We allocate the value based on the relative selling prices of those products and services, which generally consist of award travel, priority boarding, baggage fee waivers, lounge access and the use of our brand. We determine our best estimate of the selling prices by using a discounted cash flow analysis using multiple inputs and assumptions, including (1) the expected number of miles awarded and number of miles redeemed, (2) ETV for the award travel obligation adjusted for mileage breakage, (3) published rates on our website for baggage fees, discounted access to Delta Sky Club lounges and other benefits while traveling on Delta, (4) brand value (using estimated royalties generated from the use of our brand) and (5) volume discounts provided to certain partners.

We defer the amount allocated to award travel as part of loyalty program deferred revenue and recognize loyalty travel awards in passenger revenue as the miles are redeemed and transportation is provided. Revenue allocated to services performed in conjunction with a passenger’s flight, such as baggage fee waivers, is recognized as travel-related services in passenger revenue when the related service is performed. Revenue allocated to Delta Sky Club lounge access is recognized as miscellaneous in other revenue as access is provided. Revenue allocated to the remaining performance obligations, primarily brand value, is recorded as loyalty program in other revenue as miles are delivered.

Current Activity of the Loyalty Program. Miles are combined in one homogeneous pool and are not separately identifiable. Therefore, the revenue is comprised of miles that were part of the loyalty program deferred revenue balance at the beginning of the period as well as miles that were issued during the period.

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Recognizing Revenue When a Performance Obligation Has Been Satisfied

Learning objectives

- Identify when the transfer of control to the customer occurs.
- Identify when a performance obligation has been satisfied at a point in time.
- Identify when a performance obligation has been satisfied over time.
- Determine the appropriate way to measure progress and change.

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Overview

The core principle of the revenue recognition standard is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration an entity expects to be entitled in exchange for those goods or services.

To achieve the core principle of the revenue standard, an entity should be able to perform the following five steps:

- Step 1: Identify the contract with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price.
- Step 5: Recognize revenue when or as the entity satisfies performance obligations.

We will focus on step 5.

Implementation illustrations

See the appendix for sample disclosures taken from recently issued SEC 10-K filings which illustrate the recognition of revenue at a point in time or over time and measurement of progress toward performance obligations under FASB *Accounting Standards Codification*® (ASC) 606, *Revenue from Contracts with Customers*. Selected portions of these examples are included where appropriate.

Recognize revenue when (or as) the entity satisfies a performance obligation — Transfer of control

FASB ASC 606 established specific criteria for an entity to satisfy to recognize revenue with one term standing out among the rest, and that term is control. Specifically, FASB ASC 606 explains 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 when (or as) the customer obtains control of that asset.

Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from that asset. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from, an asset.

Goods and services are assets, even only if momentarily, when they are received and used. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly. This can be achieved in many ways, such as the following:

- Using the asset to produce goods or provide services (including public services)
- Using the asset to enhance the value of other assets
- Using the asset to settle liabilities or reduce expenses
- Selling or exchanging the asset
- Pledging the asset to secure a loan, and holding the asset

An entity will need determine whether they satisfy each performance obligation

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- over time or
- at a point in time.

Based on the nature of the performance obligations and the terms and conditions within the contract, it is possible that payment may be made by the customer to the entity prior to or after the transfer of control. For example, in certain industries (such as the construction and software industries) payments are withheld as a way of providing the customer with assurance that the entity will successfully complete the milestones on the contract. Keep in mind that these withheld payments are not indicative of a significant financing component and careful consideration of the nature of payments compared to the timing of transfer of control is needed to make this determination.

Implementation illustrations

The following disclosures, taken from recently issued SEC filings, illustrate the transfer of control under FASB ASC 606. See the appendix for the complete notes from which these excerpts were taken. These examples are presented for informational purposes and are not authoritative.

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Implementation illustration — Transfer of control

Seagate Technology[1]

Excerpt from notes to financial statements for the 12 months ended June 28, 2024

Basis of presentation and summary of significant accounting policies

Revenue recognition, sales returns and allowances, and sales incentives programs

Revenue from sales of products is generally recognized upon transfer of control to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products, net of sales taxes. Typically, this occurs upon shipment from the Company. When applicable, the Company includes shipping charges billed to customers in revenue and includes the related shipping costs in cost of revenue on the Company's Consolidated Statements of Operations.

Apple Inc.[2]

Excerpt from notes to financial statements for the 12 months ended September 28, 2024

Revenue recognition

The Company recognizes revenue at the amount to which it expects to be entitled when control of the products or services is transferred to its customers. Control is generally transferred when the Company has a present right to payment and title and the significant risks and rewards of ownership of products or services are transferred to its customers. For most of the Company's Products net sales, control transfers when products are shipped. For the Company's Services net sales, control transfers over time as services are delivered. Payment for Products and Services net sales is collected within a short period following transfer of control or commencement of delivery of services, as applicable.

Lastly, chapter 11, "Engineering and Construction Contractors" of the AICPA Audit and Accounting Guide *Revenue Recognition* explains that materials procured to complete a performance obligation may not immediately transfer into the control of the customer. The term *uninstalled material* is used to describe goods that arrive at a job site in advance of the contractor installing them. Certain of these types of costs

[1] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/1137789/000113778924000068/stx-20240628.htm.
[2] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/320193/000032019324000123/aapl-20240928.htm.

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may qualify as an inventoriable cost under FASB ASC 330, *Inventory*, and may not quite yet be within the scope of FASB ASC 606.



Key point

The following is an example explaining how the transfer of control did not occur with the delivery of *uninstalled materials*.

As part of a contract with the customer, a contractor orders inventoriable material such as steel, concrete, and copper wire. These materials are not unique to this contract and can be used on other construction contracts. Materials for this contract normally arrive at the job site shortly before the contractor is expected to install these materials, and not significantly in advance of installation. However, an unexpected delay occurs due to weather and, as a result, these materials are now at the job site significantly in advance of the revised installation timing. In these circumstances, the contractor may determine that the customer has not obtained control of these goods, even though the goods are physically at the job site. These standard inventoriable materials, however, can be readily used by the contractor in other construction projects without incurring significant costs.

An evaluation should be performed to determine when the control of these materials might transfer to the customer. In some cases, the transfer of control may occur when the item is installed. In other cases, a transfer of control might occur prior to installation if, for example, a security interest in the materials passes to the owner through billing of the specific materials procured.

Performance obligations satisfied at a point in time

If a performance obligation is not satisfied over time, the performance obligation is satisfied at a point in time. To determine the point in time at which a customer obtains control of a promised asset and satisfies a performance obligation, the entity should consider the following transfer of control indicators, keeping in mind that the following is not all inclusive:

- The entity has a present right to payment for the asset. The customer's present obligation to pay for an asset may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in an exchange.
- The customer has legal title to the asset. Legal title may indicate which party to a contract has the ability to direct the use of and obtain substantially all of the remaining benefits from an asset or to restrict the access of other entities to those benefits. The transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
- The entity has transferred physical possession of the asset. The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits.
- The customer has the significant risks and rewards of ownership of the asset. The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the

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customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. When evaluating the risks and rewards of ownership of a promised asset, an entity should exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

- The customer has accepted the asset. The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.



Key point

Caution: Physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls.

Knowledge check

1. What determines if a performance obligation has been satisfied at a point in time, indicating transfer of control?

    a. The customer has a present right to payment for the asset.
    b. The entity has legal title to the asset.
    c. The customer has the significant risks and rewards of ownership of the asset.
    d. The customer is interested in accepting the asset.

Performance obligations satisfied over time

An entity transfers control of a good or service over time and satisfies a performance obligation allowing the entity to recognize revenue over time if one of the following criteria is met:

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

Simultaneous receipt and consumption of the benefits of the entity's performance

For some types of performance obligations, the assessment of whether a customer receives the benefits of an entity's performance as the entity performs and simultaneously consumes those benefits as they are received will be straightforward. Some examples include routine or recurring services (such as a cleaning service) in which the receipt and simultaneous consumption by the customer of the benefits of the entity's performance can be readily identified.

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At times, an entity may not be able to readily identify whether a customer simultaneously receives and consumes the benefits the entity performs. In these circumstances, a performance obligation is satisfied over time if an entity determines that another entity would not need to substantially re-perform the work that the entity has completed to date if another entity were to fulfill the remaining performance obligation to the customer. When determining whether another entity would not need to substantially re-perform the work the entity has completed to date, an entity should make both of the following assumptions:

- Disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity.
- Presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

Customer controls the asset as it is created or enhanced

When determining whether a customer controls an asset as it is created or enhanced, the asset that is being created or enhanced could be either *tangible* or *intangible*.

Entity's performance does not have an alternative use

An asset created by an entity's performance does not have an alternative use if the entity is

- restricted contractually from readily directing the asset for another use during the creation or enhancement or
- limited from readily directing the asset in its completed state for another use, such as in the case of medical devises that use the customer's proprietary intellectual property to work.

The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, this assessment is not updated unless the parties to the contract approve a contract modification that substantively changes the performance obligation.

Enforceable right to payment

The terms of the contract, as well as any laws that apply to the contract, should be considered when evaluating whether it has an enforceable right to payment for performance completed to date. The right to payment for performance completed to date does not need to be for a fixed amount. Keep in mind that at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised.

Reasonable measure of progress

An entity should recognize revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress toward the complete satisfaction of that performance obligation. An entity would not be able to reasonably measure its progress to satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress. In some circumstances, an entity may not be able to reasonably measure the outcome of a performance obligation. This may occur in the beginning of a contract with a customer. Under these

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circumstances, when an entity expects to recover the costs incurred in satisfying the performance obligation, the entity should recognize revenue only to the extent of the costs incurred until such time it can reasonably measure the outcome of the performance obligation.

Implementation illustrations and examples

The following disclosure, taken from a recently issued SEC filing, illustrates satisfaction of performance obligations at a point in time and over time under FASB ASC 606. See the appendix for the complete note from which this excerpt was taken. This example is presented for informational purposes and is not authoritative.



Implementation illustrations — Satisfaction of performance obligations at a point in time and over time

General Electric Co.[3]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Basis of presentation and summary of significant accounting policies

REVENUES FROM THE SALE OF EQUIPMENT

Performance obligations satisfied over time

We recognize revenue on agreements for the sale of customized goods including power generation and aerospace equipment and long-term construction projects on an over-time basis as we customize the customer's equipment during the manufacturing or integration process and obtain right to payment for work performed.

We recognize revenue as we perform under the arrangements using the percentage of completion method, which is based on our costs incurred to date relative to our estimate of total expected costs. Our estimate of costs to be incurred to fulfill our promise to a customer is based on our history of manufacturing or constructing similar assets for customers and is updated routinely to reflect changes in quantity or pricing of the inputs. We provide for potential losses on these agreements when it is probable that we will incur the loss.

Some of our contracts require us to make payments to customers related to failure to deliver our equipment on-time or meeting certain performance specifications, which is factored into our estimate of variable consideration using the expected value method and taking into consideration performance relative to our contractual obligations, specified liquidated

[3] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at: https://www.sec.gov/ix?doc=/Archives/edgar/data/40545/000004054520000009/ge10-k2019.htm

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damages rates, if applicable, and history of paying liquidated damages to the customer or similar customers.

During 2023, primarily as a result of changes in product and project cost estimates, we recorded additional project losses for certain Haliade-X contracts of $379 million. Further changes in our execution timelines or other adverse developments could result in further losses beyond the amounts that we currently estimate.

Our billing terms for these over-time contracts are generally based on achieving specified milestones. The differences between the timing of our revenue recognized (based on costs incurred) and customer billings (based on contractual terms) results in changes to our contract asset or contract liability positions. See Note 8 for further information.

Performance obligations satisfied at a point in time

We recognize revenue on agreements for noncustomized equipment including commercial aircraft engines and other goods we manufacture on a standardized basis for sale to the market at the point in time that the customer obtains control of the product, which is generally no earlier than when the customer has physical possession. We use proof of delivery for certain large equipment with more complex logistics, whereas the delivery of other equipment is estimated based on historical averages of in-transit periods (i.e., time between shipment and delivery).

Where arrangements include customer acceptance provisions based on seller or customer-specified objective criteria, we recognize revenue when we have concluded that the customer has control of the equipment and that acceptance is likely to occur. We do not provide for anticipated losses on point-in-time transactions prior to transferring control of the equipment to the customer.

Our billing terms for these point-in-time equipment contracts generally coincide with delivery to the customer. However, within certain businesses, we receive progress collections from customers for large equipment purchases to generally reserve production slots. Progress collections are not considered a significant financing component because they are intended to protect from the other party failing to adequately complete some or all of its obligations under the contract.

For certain commercial engine programs, we make payments to airlines related to future aircraft deliveries by airframers (aircraft allowances). We record aircraft allowances as a reduction in revenue when control of the engine is transferred to our airframer customer.

Some of our contracts require us to make payments to customers related to failure to deliver our equipment on-time or meeting certain performance specifications, which is factored into our estimate of variable consideration using the expected value method and taking into consideration performance relative to our contractual obligations, specified liquidated damages rates, if applicable, and history of paying liquidated damages to the customer or similar customers.

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Examples of performance obligations satisfied at a point in time and over time

Case 1

An entity is developing a multi-unit residential complex. A customer enters into a sales contract for a specified unit under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

The customer pays a deposit upon entering into the contract, and the deposit is refundable only if the entity fails to complete construction of the unit in accordance with the contract. The remainder of the contract price is payable upon obtaining physical possession of the unit. If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.

Question — Is the performance obligation satisfied over time or at a point in time?

Assessment — At the inception of the contract, the entity does not have an enforceable right to payment. The right to payment begins when the construction of the unit is complete and, therefore, the performance obligation is satisfied at a point in time.

Case 2

The customer pays a nonrefundable deposit upon entering into the contract and will make progress payment during the construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit.

Question — Is the performance obligation satisfied over time or at a point in time?

Assessment — The performance obligation is satisfied over time because the asset does not have alternate use because the contract precludes the transfer to another customer. In addition, the entity does have an enforceable right to payment for the work performed to date.

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Example of subscriptions received as part of a membership

Chapter 8, "Not-for-Profit Entities," of the AICPA Audit and Accounting Guide *Revenue Recognition* provides the following example related to recognizing revenue both over time and at points in time as performance obligations are satisfied.

A not-for-profit trade association (NFP) produces a quarterly journal that discusses and highlights research, issues, and trends of interest to its members and others in the respective discipline related to the NFP's mission. Members receive the NFP's quarterly journal as part of their annual membership dues, which are $300 per year. In addition to the quarterly journal, members receive other membership benefits, such as access to the members-only section of the association's website and legislative advocacy services. The NFP sells individual journals to others who are not members of the NFP for $25 per journal. The NFP has determined that there is no contribution included in the payment from the customer.

Based upon the following and further assessment, the NFP determined the following:

- *Step 1. Identify the contract* — A contract exists between the NFP and the member related to both membership and the journal subscription.
- *Step 2. Identify the performance obligations* — There are six promised goods or services in the contract:
  - The promise to the member to provide access to the website during the one-year term.
  - The promise to the member to provide legislative advocacy services during the one-year term.
  - The promise to the member of a subscription to provide four quarterly journals. (The NFP considers each quarterly journal a separate performance obligation.)

  The promises to deliver all of these goods and services are distinct. However, the promise to deliver access to the website and the promise to provide advocacy services are delivered concurrently and have the same measure of progress; therefore, they may be accounted for as if they were a single performance obligation (referred to as "membership benefits").
- *Step 3. Determine the transaction price* — The transaction price is the contract price of $300 for a one-year membership, which includes the subscription.
- *Step 4. Allocate the transaction price to performance obligations* — The transaction price should be allocated between the five performance obligations (which would include the four quarterly journals, and the membership benefits) based on the relative stand-alone selling prices of each performance obligation. The stand-alone selling price for each journal is the observable price of $25 because this is the price the NFP separately sells the journals to customers. The NFP does not sell membership separately without including the quarterly journals. Because there is no directly observable selling price, the NFP estimates the stand-alone selling price using the adjusted market assessment approach to estimate the stand-alone selling price for the membership, which is determined to be $250. The NFP would allocate the transaction price to the separate performance obligations as follows:

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Example of subscriptions received as part of a membership (continued)

Performance obligation	Stand-alone selling price	Percentage	Allocated transaction price
1st quarterly journal	$ 25	7%	$ 21
2nd quarterly journal	$ 25	7%	$ 21
3rd quarterly journal	$ 25	7%	$ 21
4th quarterly journal	$ 25	7%	$ 21
Membership benefits	$250	72%	$216
Total	$350	100%	$300

- Step 5. *Recognize revenue when each performance obligation is satisfied* — The NFP concludes the following:
  - The member simultaneously receives and consumes the member benefits of membership, and therefore the membership benefits performance obligation is satisfied over time. The NFP also concludes that the best measure of progress toward complete satisfaction of the membership performance obligation over time is a time-based measure. Therefore, $216 is recognized ratably over the one-year membership period.
  - Each quarterly journal is satisfied at a point in time, and revenue should be recognized when control of the journal has been transferred to the customer. Assuming the NFP concludes that control of the journal transfers to the customer upon shipment, $21 is recognized when each quarterly journal is shipped.

Knowledge check

2. To determine whether a performance obligation has been satisfied over time, which factor would be excluded?

   a. There is simultaneous receipt and consumption of the benefits of the entity's performance.
   b. The customer controls the asset as it is created or enhanced.
   c. The entity's performance has an alternative use.
   d. There is an enforceable right to payment.

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Exercise

The following has been extracted from paragraphs 159–172 of FASB ASC 606-10-55.

Monthly payroll services

An entity enters into a contract to provide monthly payroll processing services to a customer for one year. The promised payroll processing services are accounted for as a single performance obligation.

Is this contract a continuous performance obligation or a performance obligation satisfied at a point in time?

Consulting services

An entity enters into a contract with a customer to provide a consulting service that would result in the entity providing a professional opinion to the customer. The professional opinion relates to facts and circumstances that are specific to the customer. If the customer were to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the customer to compensate the entity for its costs incurred plus a 15% margin. The 15% margin approximates the profit margin that the entity earns from similar contracts.

Is this contract a continuous performance obligation or a performance obligation satisfied at a point in time?

Specialized satellite

An entity enters into a contract with a government agency to build a specialized satellite. The agency builds satellites for various customers (such as governments and commercial entities). The design and construction of each satellite differ substantially based on their customers' needs and the type of technology that is incorporated into the satellite.

At contract inception, is the performance obligation to build the satellite satisfied over time or at a point in time?

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Equipment

An entity enters into a contract with a customer to build an item of equipment. The payment schedule in the contract specifies that the customer must make an advance payment at contract inception of 10% of the contract price, regular payments throughout the construction period (amounting to 50% of the contract price), and a final payment of 40% of the contract price after construction is completed and the equipment has passed the prescribed performance tests. The payments are nonrefundable unless the entity fails to perform as promised. If the customer terminates the contract, the entity is entitled only to retain any progress payments received from the customer. The entity has no further rights to compensation from the customer.

At contract inception, is the performance obligation to build the equipment satisfied at a point in time or over time?

Measuring progress toward complete satisfaction of a performance obligation

For each performance obligation satisfied over time, an entity should recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to the customer, meaning the satisfaction of an entity's performance obligation.

A single method of measuring progress should be applied for each performance obligation satisfied over time and should apply that method consistently to similar performance obligations and in similar circumstances.

Key point

At the end of each reporting period, an entity should remeasure its progress toward complete satisfaction of a performance obligation satisfied over time.

Appropriate methods of measuring progress include output methods and input methods.

When performance obligations are satisfied continuously, the entity must determine the appropriate method to determine the progress toward completion. These methods include the following:

Output methods

Recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract.

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Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered.

When an entity evaluates whether to apply an output method to measure its progress, the entity should consider whether the output selected would faithfully depict the entity's performance toward complete satisfaction of the performance obligation.

An output method would not provide a faithful depiction of the entity's performance if the output selected would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in process or finished goods controlled by the customer that are not included in the measurement of the output.

The disadvantages of output methods are that the outputs used to measure progress may not be directly observable and the information required to apply them may not be available to an entity without undue cost, which is why an input method may be necessary.

Input methods

Recognize revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation relative to the total expected inputs to the satisfaction of that performance obligation (for example, resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used). If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis.

A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. An entity should exclude from an input method the effects of any inputs that do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

- When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognize revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract. For example, the costs of unexpected amounts of wasted materials, labor, or other resources that were incurred to satisfy the performance obligation.
- When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:
  - The good is not distinct.
  - The customer is expected to obtain control of the good significantly before receiving services related to the good.
  - The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.

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— The entity procures the goods from a third party and is not significantly involved in designing and manufacturing the good, but the entity is acting as a principal in accordance with FAS ASC 606.

Implementation illustration

The following disclosure, taken from a recently issued SEC filing, illustrates the measurement of progress toward completion of performance obligations under FASB ASC 606. See the appendix for the complete note from which this excerpt was taken. This example is presented for informational purposes and is not authoritative.



Implementation illustrations — Measurement of progress toward completion of performance obligations

International Business Machines Corp.[4]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Note A: Significant accounting policies

In areas such as application management, business process outsourcing, and other cloud-based services arrangements, the company determines whether the services performed during the initial phases of the arrangement (such as setup activities) are distinct. In most cases, the arrangement is a single performance obligation comprised of a series of distinct services that are substantially the same and that have the same pattern of transfer (i.e., distinct days of service). The company applies a measure of progress (typically time-based) to any fixed consideration and allocates variable consideration to the distinct periods of service based on usage. As a result, revenue is generally recognized over the period the services are provided on a usage basis. This results in revenue recognition that corresponds with the value to the client of the services transferred to date relative to the remaining services promised.



Key point

As circumstances change over time, the measure of progress should be updated to reflect any changes in the outcome of the performance obligation. Such changes to a measure of progress should be accounted for as a change in accounting estimate.

[4] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/51143/000005114324000012/ibm-20231231.htm.#

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Practical expedient

If an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.



Connected concepts: Practical point for management

It is important for management to be clear about when obligations are satisfied. Given this, management may want to consider the following when measuring revenue over time:

- Designing controls over the process used to determine the point in time at which control has transferred or to measure progress toward completion of a performance obligation satisfied over time
- To apply a single method of measuring progress for each performance obligation satisfied over time, and to make sure that that method is applied consistently to similar performance obligations and in similar circumstances
- Often, judgment is needed when assessing the satisfaction of performance obligations over time, so management will have to consider many criteria and sub-criteria (for example, the enforceability criteria for right to payment for performance completed to date and other assumptions may be subject to legal determination).
- Establish processes over contracts with customers, such as processes in accounting and legal departments.
- To remeasure progress toward complete satisfaction of a performance obligation at the end of each reporting period, keeping in mind that sometimes significant judgment may be needed
- Although judgment is needed in selecting the method of measuring progress toward complete satisfaction of a performance obligation, management does not simply have "free choice" to use any method. Management will likely need to establish parameters for selecting an input method or an output method and possibly design controls for reviewing the ongoing application of these methods.
- The more judgment is involved, the more robust documentation may be expected from the auditors, so consider gathering this information in writing sooner than later.

For performance obligations satisfied at a point in time, the determination about when control is transferred in some cases will require considerable judgment and analysis. Management should consider establishing effective activity-level controls (such as establishing and following shipping terms to ensure that revenue is recognized properly).

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Connected concepts: Practical point for small and medium-sized companies

All the practical points for management apply to small and medium-sized companies, but many of these companies lack the types of resources larger entities have. To achieve some of the considerations listed previously, especially in the area of documentation and the designing and testing of controls, management may be able to achieve some of the objectives through the actions of management or by hiring part-time resources.



Example: Modification resulting in cumulative catch-up adjustment[5]

Facts

- An entity, a construction company, enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of $1 million and a bonus of $200,000 if the building is completed within 24 months.
- The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time.
- At the inception of the contract, the entity expects the following:

Transaction price	$1,000,000
Expected costs	700,000
Expected profit (30%)	$ 300,000

- At the contract's inception, the entity excludes the $200,000 bonus from the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.
- The entity determines that the input measure, on the basis of costs incurred, provides an appropriate measure of progress toward complete satisfaction of the performance obligation.

[5] Example fact pattern originated from FASB ASC 606-10-55-129-133.

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Example: Modification resulting in cumulative catch-up adjustment (continued)

Year 1

- By the end of the first year, the entity has satisfied 60% of its performance obligation on the basis of costs incurred to date, which amounts to $420,000 (60% of the total expected costs of $700,000).
- The entity reassesses the variable consideration and concludes that the amount is still constrained and, therefore, not taken into account in the first year. The entity's cumulative revenue and costs recognized in the first year are:

Revenue ($1,000,000 multiplied by 60%)	$600,000
Costs ($700,000 multiplied by 60%)	420,000
Gross profit	$ 180,000

Year 2

- In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by $150,000 and $120,000, respectively.
- Total potential consideration after the modification is $1,350,000 ($1,150,000 fixed consideration + $200,000 completion bonus).
- In addition, the allowable time for achieving the $200,000 bonus is extended by 6 months to 30 months from the original contract inception date.
- At the date of the modification, on the basis of its experience and the remaining work to be performed, which is primarily inside the building and not subject to weather conditions, the entity concludes that it is probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognized and includes the $200,000 in the transaction price.
- In assessing the contract modification, the entity evaluates and concludes that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation. Therefore, the entity accounts for the contract modification as if it were part of the original contract.
- The entity updates its measure of progress and records a cumulative catch-up adjustment at the date of the modification as follows:

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Example: Modification resulting in cumulative catch-up adjustment (continued)

	Inception	End of year 1	Modification date
Transaction price	$1,000,000	$1,000,000	$1,150,000
Bonus	$200,000	Excluded	$200,000
Total potential consideration:	$1,200,000	$1,000,000	$1,350,000
Total expected costs:	$700,000	$700,000	$820,000
Actual costs:	-	$420,000	$420,000
Performance obligation percent satisfied:	-	60%	51.2%
Revenue	-	$600,000	$600,000
Catch-up adjustment	-	-	$91,200
Gross profit	-	$180,000	$271,200

Knowledge checks

3. Which statement best describes the output method?

    a. The output method recognizes revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract.
    b. The output method is used to measure the entity's progress when at the end of the reporting period, the entity's performance has produced work in process or finished goods controlled by the customer that are not included in the measurement of the output.
    c. The output method recognizes revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation relative to the total expected inputs to the satisfaction of that performance obligation.
    d. The output method is used to measure progress when information may not be directly observable and available to an entity without undue cost.

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4. What is a shortcoming of input methods in revenue recognition?

    a. Input methods recognize revenue on the basis of indirect measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract.
    b. Input methods are never adjusted to recognize revenue only to the extent of costs incurred.
    c. Input methods include the effects of any inputs that do not depict the entity's performance in transferring control of goods or services to the customer.
    d. Input methods exclude the effects of any inputs that don't depict the entity's performance in transferring control of goods or services to the customer.

5. As circumstances change over time, how should changes in the measure of progress be accounted for?

    a. The measure of progress shouldn't be updated to reflect any changes in the outcome of the performance obligation.
    b. The measure of progress should be updated to reflect any changes in the outcome of the performance obligation.
    c. The measure of progress changes should be accounted for as a correction of an error.
    d. The measure of progress changes shouldn't be accounted for as an accounting estimate.

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Exercise



Refurbishment of building and installation of new elevators

In November 20X2, an entity contracts with a customer to refurbish a three-story building and install new elevators for total consideration of $5 million. The promised refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time. Total expected costs are $4 million, including $1.5 million for the elevators. The entity determines that it is acting as a principal because it obtains control of the elevators before they are transferred to the customer at cost (meaning zero margin).

A summary of the transaction price and expected costs is as follows:

Transaction price	$5,000,000
Expected costs	
Elevators	$1,500,000
Other costs	$2,500,000
Total expected costs	$4,000,000

The customer obtains control of the elevators when they are delivered to the site in December 20X2, although the elevators will not be installed until June 20X3. The cost to procure the elevators of $1.5 million is significant relative to the total expected costs to completely satisfy the performance obligation of $4 million. The entity is not involved in designing or manufacturing the elevators.

On December 31, 20X2, the entity observed that other costs incurred, excluding the procurement of the elevators, were $500,000.

The entity uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation.

At December 31, 20X2, what amount should the entity recognize as revenue and what amount should the entity recognize as costs of goods sold?

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Summary

Here are some key takeaways:

- Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from that asset.
- Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset.
- If a performance obligation is not satisfied over time, the performance obligation is satisfied at a point in time.
- Keep in mind that physical possession may not coincide with control of an asset.
- The terms of the contract, as well as any laws that apply to the contract, should be considered when evaluating whether it has an enforceable right to payment for performance completed to date.
- A single method of measuring progress should be applied for each performance obligation satisfied over time and that method should be applied consistently to similar performance obligations in similar circumstances.
- The appropriate methods of measuring progress include output methods and input methods.

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Solutions

Recognizing Revenue When a Performance Obligation Has Been Satisfied

Knowledge check solutions

1.

a. Incorrect. To determine whether a performance obligation has been satisfied at a point in time to indicate transfer of control, the entity, not the customer, would have a present right to payment for the asset.
b. Incorrect. To determine whether a performance obligation has been satisfied at a point in time to indicate transfer of control, the customer, not the entity, would have legal title to the asset.
c. Correct. To determine whether a performance obligation has been satisfied at a point in time to indicate transfer of control, the customer would have significant risks and rewards of ownership of the asset.
d. Incorrect. To determine whether a performance obligation has been satisfied at a point in time to indicate transfer of control, the customer must have accepted the asset.

2.

a. Incorrect. To determine whether a performance obligation has been satisfied over time, it is important to consider if simultaneous receipt and consumption of the benefits of the entity's performance is present.
b. Incorrect. To assess if a performance obligation has been satisfied over time, check if the customer controls the asset as it is created or enhanced, such as in the case of a work in process.
c. Correct. Determining whether a performance obligation has been satisfied over time should not include the creation of an alternative use for the entity within its criteria.
d. Incorrect. To determine whether a performance obligation has been satisfied over time, enforceable right to payment would be a factor to consider.

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3.

a. Correct. Examples of an output method are a survey of completed performance to date or appraisal of results achieved because they are considered direct measurements of value.
b. Incorrect. The output method would not be the proper method to use to measure the entity's progress when at the end of the reporting period, the entity's performance has produced work in process or finished goods controlled by the customer that are not included in the measurement of the output. The input method would be a better method for measurement.
c. Incorrect. The input and not the output method recognizes revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation relative to the total expected inputs to the satisfaction of that performance obligation.
d. Incorrect. The output method would not be the method used to measure progress when information may not be directly observable and available to an entity without undue cost. The input method would be a better method for measurement.

4.

a. Incorrect. Input methods do not recognize revenue on the basis of direct or indirect measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract.
b. Incorrect. Input methods can be adjusted to recognize revenue proportional to the costs incurred, but this adjustment does not necessarily ensure an accurate reflection of the actual transfer of control.
c. Incorrect. Output, not input methods, include the effects of any inputs that do not depict the entity's performance in transferring control of goods or services to the customer.
d. Correct. One of the shortcomings of input methods is that they exclude the effects of inputs that do not accurately depict the entity's performance. This can potentially lead to inaccuracies in recognizing revenue.

5.

a. Incorrect. The measure of progress shouldn't be left unchanged because it is necessary at times.
b. Correct. As circumstances change over time, the measure of progress should be updated to reflect any change in the outcome of the performance obligation.
c. Incorrect. A change to a measure of progress is not an error but rather a change in an accounting estimate based on new information or circumstances.
d. Incorrect. A change in the measurement of progress would be accounted for as an accounting estimate.

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Exercise solutions

Monthly payroll services

The contract is not a performance obligation at a point in time. The performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed. The fact that another entity would not need to reperform payroll processing services for the service that the entity has provided to date also demonstrates that the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs. (The entity disregards any practical limitations on transferring the remaining performance obligation, including setup activities that would need to be undertaken by another entity.) The entity recognizes revenue over time by measuring its progress toward complete satisfaction of that performance obligation.

Consulting services

The entity needs to consider whether the customer simultaneously receives and consumes the benefits of the entity's performance. If the entity were to be unable to satisfy its obligation and the customer hired another consulting firm to provide the opinion, the other consulting firm would need to substantially reperform the work that the entity had completed to date because the other consulting firm would not have the benefit of any work in progress performed by the entity. The nature of the professional opinion is such that the customer will receive the benefits of the entity's performance only when the customer receives the professional opinion. However, the entity's performance obligation meets and is a performance obligation satisfied over time because of both of the following factors:

- The development of the professional opinion does not create an asset with alternative use to the entity because the professional opinion relates to facts and circumstances that are specific to the customer. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.
- The entity has an enforceable right to payment for its performance completed to date for its costs plus a reasonable margin, which approximates the profit margin in other contracts.

Consequently, the entity recognizes revenue over time by measuring the progress toward complete satisfaction of the performance obligation.

Specialized satellite

As part of that assessment, the entity considers whether the satellite in its completed state will have an alternative use to the entity. Although the contract does not preclude the entity from directing the completed satellite to another customer, the entity would incur significant costs to rework the design and function of the satellite to direct that asset to another customer. Consequently, the asset has no alternative use to the entity because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.

The entity's performance obligation is to be satisfied over time when building the satellite.

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Equipment

As part of that assessment, the entity considers whether it has an enforceable right to payment for performance completed to date if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. Even though the payments made by the customer are nonrefundable, the cumulative amount of those payments is not expected, at all times throughout the contract, to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date. This is because at various times during construction the cumulative amount of consideration paid by the customer might be less than the selling price of the partially completed item of equipment at that time. Consequently, the entity does not have a right to payment for performance completed to date.

Because the entity does not have a right to payment for performance completed to date, the entity's performance obligation is not satisfied over time and accordingly, the entity does not need to assess whether the equipment would have an alternative use to the entity. The entity also concludes that it will account for the construction of the equipment as a performance obligation satisfied at a point in time.

Refurbishment of building and installation of new elevators

The entity concludes that including the costs to procure the elevators in the measure of progress would overstate the extent of the entity's performance. Consequently, the entity adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. The entity recognizes revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (that is, at a zero margin).

As of December 31, 20X2, the entity observes the following:

- Other costs incurred, excluding elevators, equal $500,000 + $1,500,000 for the elevators = $2,000,000 Cost of Good
- Performance is 20% complete ($500,000 ÷ $2,500,000) = $700,000 + $1,500,000 for the elevators = $2,200,000 in Revenue

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Recognizing Revenue When a Performance Obligation Has Been Satisfied: Implementation Illustrations

This Appendix is included for supplementary purposes only and is not required for CPE credit.

Appendix

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The following examples, taken from recently issued SEC 10-K filings, illustrate the recognition of revenue at a point in time or over time and measurement of progress toward performance obligations under FASB ASC 606. These examples are presented for informational purposes and are not authoritative.

Advanced Micro Devices Inc.[1]

Excerpt from notes to financial statements for the 12 months ended December 30, 2023

Summary of significant accounting policies

Revenue recognition

Revenue is recognized when a customer obtains control of promised goods or services and is recognized in an amount that reflects the consideration which the Company expects to receive in exchange for those goods or services. Sales, value-added, and other taxes collected concurrently with the provision of goods or services are excluded from revenue. Shipping and handling costs associated with product sales are included in cost of sales. Substantially all of the Company's revenue is derived from product sales, representing a single performance obligation.

Customers are generally required to pay for products and services within the Company's standard contractual terms, which are typically net 30 to 60 days. The Company has determined that it does not have significant financing components in its contracts with customers.

Nature of products and services

Custom products

Custom products, which are primarily associated with the Company's Gaming segment, are sold under non-cancellable purchases orders, for which the Company has an enforceable right to payment, and which have no alternative use to the Company at contract inception, are recognized as revenue, over the time of production of the products by the Company. The Company utilizes a cost-based input method, calculated as cost incurred plus estimated margin, to determine the amount of revenue to recognize for in-process or completed customer orders at a reporting date. The Company believes that a cost-based input method is the most appropriate manner to measure how the Company satisfies its performance obligations to customers because the effort and costs incurred best depict the Company's satisfaction of its performance obligation.

[1] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at: https://www.sec.gov/ix?doc=/Archives/edgar/data/0000002488/000000248824000012/amd-20231230.htm.

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Sales of custom products are not subject to a right of return and arrangements generally involve a single performance obligation. Generally, there are no variable consideration estimates associated with custom products.

Development and intellectual property licensing agreements

From time to time, the Company may enter into arrangements with customers that combine the provision of development services and a license to the right to use the Company's IP. These arrangements are deemed to be single or multiple performance obligations based upon the nature of the arrangements. Revenue is recognized upon the transfer of control, over time or at a point in time, depending on the nature of the arrangements. The Company evaluates whether the licensing component is distinct. A licensing component is distinct if it is both (i) capable of being distinct and (ii) distinct in the context of the arrangement. If the license is not distinct, it is combined with the development services as a single performance obligation and recognized over time. If the license is distinct, revenue is recognized at a point in time when the customer has the ability to benefit from the license.

From time to time, the Company may enter into arrangements with customers that solely involve the sale or licensing of its patents or IP. Generally, there are no performance obligations beyond transferring the designated license to the Company's patents or IP. Accordingly, revenue is recognized at a point in time when the customer has the ability to benefit from the license.

Customers are generally required to pay for products and services within the Company's standard contractual terms, which are typically net 30 to 60 days. The Company has determined that it does not have significant financing components in its contracts with customers.

Seagate Technology[2]

Excerpt from notes to financial statements for the 12 months ended June 28, 2024

Basis of presentation and summary of significant accounting policies

Revenue Recognition and Sales Incentive Programs. The Company determines revenue recognition through the following steps: (1) identification of the contract with a customer; (2) identification of the performance obligations in the contract; (3) determination of the transaction price; (4) allocation of the transaction price to the performance obligations in the contract; and (5) recognition of revenue when, or as, the Company satisfies a performance obligation.

Revenue from sales of products is generally recognized upon transfer of control to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products, net of sales taxes. This typically occurs upon shipment from the Company. When applicable, the

[2] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/1137789/000113778924000068/stx-20240628.htm.

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Company includes shipping charges billed to customers in revenue and includes the related shipping costs in cost of revenue on the Company's Consolidated Statements of Operations.

The Company records estimated variable consideration at the time of revenue recognition as a reduction to revenue. Variable consideration generally consists of sales incentive programs (such as price protection and volume incentives aimed at increasing customer demand). For original equipment manufacturers (OEM) sales, rebates are typically established by estimating the most likely amount of consideration expected to be received based on an OEM customer's volume of purchases from the Company or other agreed-upon rebate programs. For the distribution and retail channel, these programs typically involve estimating the most likely amount of rebates related to a customer's level of sales, order size, advertising, or point-of-sale activity as well as the expected value of price protection adjustments based on historical analysis and forecasted pricing environment. Marketing development program costs are accrued and recorded as a reduction to revenue at the same time that the related revenue is recognized.

The Company expenses sales commissions as incurred because the amortization period would have been one year or less. These costs are recorded as marketing and administrative on the Company's Consolidated Statements of Operations.

Merck & Co. Inc.[3]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Summary of accounting policies

Revenue Recognition –Recognition of revenue requires evidence of a contract, probable collection of sales proceeds and completion of substantially all performance obligations. Merck acts as the principal in substantially all of its customer arrangements and therefore records revenue on a gross basis. The majority of the Company's contracts related to the Pharmaceutical and Animal Health segments have a single performance obligation — the promise to transfer goods. Shipping is considered immaterial in the context of the overall customer arrangement and damages or loss of goods in transit are rare. Therefore, shipping is not deemed a separately recognized performance obligation.

The vast majority of revenues from sales of products are recognized at a point in time when control of the goods is transferred to the customer, which the Company has determined is when title and risks and rewards of ownership transfer to the customer and the Company is entitled to payment. The Company recognizes revenue from the sales of vaccines to the federal government for placement into vaccine stockpiles in accordance with Securities and Exchange Commission (SEC) Interpretation, *Commission Guidance Regarding Accounting for Sales of Vaccines and BioTerror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile*. This interpretation allows companies to recognize revenue for sales of vaccines into U.S. government stockpiles even though these sales might not meet the criteria for revenue recognition under other

[3] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at: https://www.sec.gov/ix?doc=/Archives/edgar/data/0000310158/000162828024006850/mrk-20231231.htm.

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accounting guidance. For certain services in the Animal Health segment, revenue is recognized over time, generally ratably over the contract term as services are provided. These service revenues are not material.

The nature of the Company's business gives rise to several types of variable consideration including discounts and returns, which are estimated at the time of sale generally using the expected value method, although the most likely amount method is used for prompt pay discounts.

In the U.S., sales discounts are issued to customers at the point of sale through an intermediary wholesaler (known as chargebacks) or in the form of rebates. Additionally, sales are generally made with a limited right of return under certain conditions. Revenues are recorded net of provisions for sales discounts and returns, which are established at the time of sale. In addition, if collection of accounts receivable is expected to be in excess of one year, sales are recorded net of time value of money discounts, which have not been material.

The U.S. provision for aggregate customer discounts covering chargebacks and rebates was $12.5 billion in 2023, $12.3 billion in 2022, and $12.3 billion in 2021. Chargebacks are discounts that occur when a contracted customer purchases through an intermediary wholesaler. The wholesaler then charges the Company back for the difference between the price initially paid by the wholesaler and the contract price agreed to between Merck and the customer. The provision for chargebacks is based on expected sell-through levels by the Company's wholesale customers to contracted customers, as well as estimated wholesaler inventory levels. Rebates are amounts owed based upon definitive contractual agreements or legal requirements with private sector and public sector (Medicaid and Medicare Part D) benefit providers after the final dispensing of the product to a benefit plan participant. The provision for rebates is based on expected patient usage, as well as inventory levels in the distribution channel to determine the contractual obligation to the benefit providers. The Company uses historical customer segment utilization mix, sales forecasts, changes to product mix and price, inventory levels in the distribution channel, government pricing calculations and prior payment history in order to estimate the expected provision. Amounts accrued for aggregate customer discounts are evaluated on a quarterly basis through comparison of information provided by the wholesalers, health maintenance organizations, pharmacy benefit managers, federal and state agencies, and other customers to the amounts accrued. The accrued balances relative to the provisions for chargebacks and rebates included in *Accounts receivable* and *Accrued and other current liabilities* were $188 million and $2.3 billion, respectively, at December 31, 2023, and were $178 million and $2.7 billion, respectively, at December 31, 2022.

Outside of the U.S., variable consideration in the form of discounts and rebates are a combination of commercially driven discounts in highly competitive product classes, discounts required to gain or maintain reimbursement, or legislatively mandated rebates. In certain European countries, legislatively mandated rebates are calculated based on an estimate of the government's total unbudgeted spending and the Company's specific payback obligation. Rebates may also be required based on specific product sales thresholds. The Company applies an estimated factor against its actual invoiced sales to represent the expected level of future discount or rebate obligations associated with the sale.

The Company maintains a returns policy that allows its U.S. pharmaceutical customers to return product within a specified period prior to and subsequent to the expiration date (generally, three to six months

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before and 12 months after product expiration). The estimate of the provision for returns is based upon historical experience with actual returns. Additionally, the Company considers factors such as levels of inventory in the distribution channel, product dating and expiration period, whether products have been discontinued, entrance in the market of generic competition, changes in formularies, or launch of over-the-counter products, among others. Outside of the United States, returns are allowed only in certain countries on a limited basis.

Merck's payment terms for U.S. pharmaceutical customers are typically 36 days from receipt of invoice and for U.S. Animal Health customers are typically 30 days from receipt of invoice; however, certain products, including *Keytruda*, have longer payment terms up to 90 days. Outside of the United States, payment terms are typically 30 days to 90 days, although certain markets have longer payment terms.

Target Corp.[4]

Excerpt from notes to financial statements for the 12 months ended February 3, 2024

Summary of accounting policies

Merchandise sales — We record almost all retail store revenues at the point of sale. Digitally originated sales may include shipping revenue and are recorded upon delivery to the guest or upon guest pickup at the store. Total revenues do not include sales tax because we are a pass-through conduit for collecting and remitting sales taxes. Generally, guests may return national brand merchandise within 90 days of purchase and owned and exclusive brands within one year of purchase. Sales are recognized net of expected returns, which we estimate using historical return patterns and our expectation of future returns. As of February 3, 2024, and January 28, 2023, the liability for estimated returns was $170 million and $174 million, respectively.

We routinely enter into arrangements with vendors whereby we do not purchase or pay for merchandise until the merchandise is ultimately sold to a guest. Under the vast majority of these arrangements, which represent less than 5% of consolidated sales, we record revenue and related costs gross. We concluded that we are the principal in these transactions for a number of reasons, most notably because we 1) control the overall economics of the transactions, including setting the sales price and realizing the majority of cash flows from the sale, 2) control the relationship with the customer, and 3) are responsible for fulfilling the promise to provide goods to the customer. Merchandise received under these arrangements is not included in inventory because the purchase and sale of this inventory are virtually simultaneous.

Revenue from Target gift card sales is recognized upon gift card redemption, which is typically within one year of issuance. Our gift cards do not expire. Based on historical redemption rates, a small and relatively stable percentage of gift cards will never be redeemed, referred to as "breakage." Estimated breakage revenue is recognized over time in proportion to actual gift card redemptions.

[4] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at: https://www.sec.gov/ix?doc=/Archives/edgar/data/0000027419/000002741924000032/tgt-20240203.htm.

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Guests receive a 5% discount on nearly all purchases and receive free shipping at Target.com when they use their Target Debit Card, RedCard Reloadable Account, Target Credit Card, or Target MasterCard (collectively, RedCards).

Target Circle program members earn Target Circle Rewards on various transactions. As of February 3, 2024, and January 28, 2023, deferred revenue of $117 million and $112 million, respectively, related to our Target Circle program was included in Accrued and Other Current Liabilities.

Credit card profit sharing: We receive payments under a credit card program agreement with TD. Under the agreement, we receive a percentage of the profits generated by the Target Credit Card and Target MasterCard receivables in exchange for performing account servicing and primary marketing functions. TD underwrites, funds, and owns Target Credit Card and Target MasterCard receivables, controls risk management policies, and oversees regulatory compliance.

Other Includes advertising revenue, Shipt membership and service revenues, commissions earned on third-party sales through Target.com, rental income, and other miscellaneous revenues.

Apple Inc.[5]

Excerpt from notes to financial statements for the 12 months ended September 28, 2024

Revenue recognition

The Company recognizes revenue at the amount to which it expects to be entitled when control of the products or services is transferred to its customers. Control is generally transferred when the Company has a present right to payment and title and the significant risks and rewards of ownership of products or services are transferred to its customers. For most of the Company's Products net sales, control transfers when products are shipped. For the Company's Services net sales, control transfers over time as services are delivered. Payment for Products and Services net sales is collected within a short period following transfer of control or commencement of delivery of services, as applicable.

The Company records reductions to Products net sales related to future product returns, price protection, and other customer incentive programs based on the Company's expectations and historical experience.

For arrangements with multiple performance obligations, which represent promises within an arrangement that are distinct, the Company allocates revenue to all distinct performance obligations based on their relative stand-alone selling prices ("SSPs"). When available, the Company uses observable prices to determine SSPs. When observable prices are not available, SSPs are established that reflect the Company's best estimates of what the selling prices of the performance obligations would be if they were sold regularly on a stand-alone basis. The Company's process for estimating SSPs without observable prices considers multiple factors that may vary depending upon the unique facts and circumstances related to each performance obligation including, where applicable, prices charged by the

[5] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at: https://www.sec.gov/ix?doc=/Archives/edgar/data/320193/000032019324000123/aapl-20240928.htm.

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Company for similar offerings, market trends in the pricing for similar offerings, product-specific business objectives, and the estimated cost to provide the performance obligation.

The Company has identified the performance obligations regularly included in arrangements involving the sale of iPhone, Mac, and iPad. The first material performance obligation, which represents the substantial portion of the allocated sales price, is the hardware and bundled software delivered at the time of sale. The second material performance obligation is the right to receive certain product-related bundled services, which include iCloud®, Siri®, and Maps. The Company allocates revenue and any related discounts to all of its performance obligations based on their relative SSPs. Because the Company lacks observable prices for product-related bundled services, the allocation of revenue is based on the Company's estimated SSPs. Revenue allocated to the delivered hardware and bundled software is recognized when control has transferred to the customer, which generally occurs when the product is shipped. Revenue allocated to product-related bundled services is deferred and recognized on a straight-line basis over the estimated period they are expected to be provided.

For certain long-term service arrangements, the Company has performance obligations for services it has not yet delivered. For these arrangements, the Company does not have a right to bill for the undelivered services. The Company has determined that any unbilled consideration relates entirely to the value of the undelivered services. Accordingly, the Company has not recognized revenue, and does not disclose amounts, related to these undelivered services.

For the sale of third-party products where the Company obtains control of the product before transferring it to the customer, the Company recognizes revenue based on the gross amount billed to customers. The Company considers multiple factors when determining whether it obtains control of third-party products, including evaluating if it can establish the price of the product, retains inventory risk for tangible products or has the responsibility for ensuring acceptability of the product. For third-party applications sold through the App Store, the Company does not obtain control of the product before transferring it to the customer. Therefore, the Company accounts for all third-party application–related sales on a net basis by recognizing in Services net sales only the commission it retains.

General Electric Co.[6]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Basis of presentation and summary of significant accounting policies

REVENUES FROM THE SALE OF EQUIPMENT

Performance Obligations Satisfied Over Time. We recognize revenue on agreements for the sale of customized goods including power generation and aerospace equipment and long-term construction projects on an over-time basis as we customize the customer's equipment during the manufacturing or integration process and obtain right to payment for work performed.

[6] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at: https://www.sec.gov/ix?doc=/Archives/edgar/data/40545/000004054524000027/ge-20231231.htm.

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We recognize revenue as we perform under the arrangements using the percentage of completion method, which is based on our costs incurred to date relative to our estimate of total expected costs. Our estimate of costs to be incurred to fulfill our promise to a customer is based on our history of manufacturing or constructing similar assets for customers and is updated routinely to reflect changes in quantity or pricing of the inputs. We provide for potential losses on these agreements when it is probable that we will incur the loss.

Some of our contracts require us to make payments to customers related to failure to deliver our equipment on-time or meeting certain performance specifications, which is factored into our estimate of variable consideration using the expected value method and taking into consideration performance relative to our contractual obligations, specified liquidated damages rates, if applicable, and history of paying liquidated damages to the customer or similar customers.

During 2023, primarily as a result of changes in product and project cost estimates, we recorded additional project losses for certain Haliade-X contracts of $379 million. Further changes in our execution timelines or other adverse developments could result in further losses beyond the amounts that we currently estimate.

Our billing terms for these over-time contracts are generally based on achieving specified milestones. The differences between the timing of our revenue recognized (based on costs incurred) and customer billings (based on contractual terms) results in changes to our contract asset or contract liability positions. See Note 8 for further information.

Performance Obligations Satisfied at a Point in Time.

We recognize revenue on agreements for non-customized equipment including commercial aircraft engines and other goods we manufacture on a standardized basis for sale to the market at the point in time that the customer obtains control of the product, which is generally no earlier than when the customer has physical possession. We use proof of delivery for certain large equipment with more complex logistics, whereas the delivery of other equipment is estimated based on historical averages of in-transit periods (i.e., time between shipment and delivery).

Where arrangements include customer acceptance provisions based on seller or customer-specified objective criteria, we recognize revenue when we have concluded that the customer has control of the equipment and that acceptance is likely to occur. We do not provide for anticipated losses on point-in-time transactions prior to transferring control of the equipment to the customer.

Our billing terms for these point-in-time equipment contracts generally coincide with delivery to the customer; however, within certain businesses, we receive progress collections from customers for large equipment purchases, to generally reserve production slots. Progress collections are not considered a significant financing component as they are intended to protect from the other party failing to adequately complete some or all of its obligations under the contract.

For certain commercial engine programs, we make payments to airlines related to future aircraft deliveries by airframers (“aircraft allowances”). We record aircraft allowances as a reduction in revenue when control of the engine is transferred to our airframer customer.

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Some of our contracts require us to make payments to customers related to failure to deliver our equipment on-time or meeting certain performance specifications, which is factored into our estimate of variable consideration using the expected value method and taking into consideration performance relative to our contractual obligations, specified liquidated damages rates, if applicable, and history of paying liquidated damages to the customer or similar customers.

REVENUES FROM THE SALE OF SERVICES.

Consistent with our Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) discussion and the way we manage our businesses, we refer to sales under service agreements, which includes both goods (such as spare parts and equipment upgrades) and related services (such as monitoring, maintenance and repairs) as sales of "services," which is an important part of our operations. We sometimes offer our customers financing discounts for the purchase of certain equipment when sold in contemplation of long-term service agreements. These sales are accounted for as financing arrangements when payments for the equipment are collected through higher usage-based fees from servicing the equipment. See Note 8 for further information.

Performance Obligations Satisfied Over Time

We enter into long-term service agreements with our customers primarily within our Aerospace and Power segments. These agreements require us to provide preventative maintenance, overhauls, and standby "warranty-type" services that include certain levels of assurance regarding asset performance and uptime throughout the contract periods, which generally range from 5 to 25 years. We account for items that are integral to the maintenance of the equipment as part of our performance obligation, unless the customer has a substantive right to make a separate purchasing decision (e.g., equipment upgrade).

We recognize revenue as we perform under the arrangements using the percentage of completion method which is based on our costs incurred to date relative to our estimate of total expected costs. Throughout the life of a contract, this measure of progress captures the nature, timing, and extent of our underlying performance activities as our stand-ready services often fluctuate between routine inspections and maintenance, unscheduled service events, and major overhauls at predetermined usage intervals. We provide for potential losses on these agreements when it is probable that we will incur the loss.

Our billing terms for these arrangements are generally based on the utilization of the asset (e.g., per hour of usage) or upon the occurrence of a major maintenance event within the contract, such as an overhaul. The differences between the timing of our revenue recognized (based on costs incurred) and customer billings (based on contractual terms) results in changes to our contract asset or contract liability positions. See Note 8 for further information.

We also enter into long-term services agreements in our Renewable Energy segment. Revenues are recognized for these arrangements on a straight-line basis consistent with the nature, timing, and extent of our services, which primarily relate to routine maintenance and as needed equipment repairs. We generally invoice periodically as services are provided.

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Performance Obligations Satisfied at a Point in Time. We sell certain tangible products, largely spare parts, through our services businesses. We recognize revenues and bill our customers at the point in time that the customer obtains control of the good, which is generally at the point in time we deliver the spare part to the customer.

COLLABORATIVE ARRANGEMENTS. Our Aerospace business enters into collaborative arrangements and joint ventures with manufacturers and suppliers of components used to build and maintain certain engines. Under these arrangements, GE and its collaborative partners share in the risks and rewards of these programs through various revenue, cost, and profit-sharing payment structures. GE recognizes revenue and costs for these arrangements based on the scope of work GE is responsible for transferring to its customers. GE's payments to participants are primarily recorded as either cost of services sold ($3,781 million, $2,890 million, and $2,116 million for the years ended December 31, 2023, 2022, and 2021, respectively) or as cost of equipment sold ($663 million, $658 million and $751 million for the years ended December 31, 2023, 2022, and 2021, respectively). Our most significant collaborative arrangement is with Safran Aircraft Engines, a subsidiary of Safran Group of France, which sells LEAP and CFM56 engines through CFM International, a jointly owned non-consolidated company. GE makes substantial sales of parts and services to CFM International based on arms-length terms.

Procter & Gamble Co.[7]

Excerpt from notes to financial statements for the 12 months ended June 30, 2024

Summary of significant accounting policies

Revenue recognition

Our revenue is primarily generated from the sale of finished product to customers. Those sales predominantly contain a single performance obligation and revenue is recognized at a single point in time when ownership, risks, and rewards transfer, which can be on the date of shipment or the date of receipt by the customer. A provision for payment discounts and product return allowances is recorded as a reduction of sales in the same period the revenue is recognized. The revenue recorded is presented net of sales and other taxes we collect on behalf of governmental authorities. The revenue includes shipping and handling costs, which generally are included in the list price to the customer.

Trade promotions, consisting primarily of customer pricing allowances, merchandising funds, and consumer coupons, are offered through various programs to customers and consumers. Sales are recorded net of trade promotion spending, which is recognized as incurred at the time of the sale. Most of these arrangements have terms of approximately one year. Accruals for expected payouts under these programs are included as accrued marketing and promotion in the Accrued and other liabilities line item in the Consolidated Balance Sheets.

[7] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at: https://www.sec.gov/ix?doc=/Archives/edgar/data/80424/000008042420000059/pg-20200630.htm.

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International Business Machines Corporation[8]

Excerpt from notes to financial statements for the 12 months ended December 31, 2023

Note A. Significant accounting policies

Revenue

The company accounts for a contract with a client when it has written approval, the contract is committed, the rights of the parties, including payment terms, are identified, the contract has commercial substance and consideration is probable of collection.

Revenue is recognized when, or as, control of a promised product or service transfers to a client, in an amount that reflects the consideration to which the company expects to be entitled in exchange for transferring those products or services. If the consideration promised in a contract includes a variable amount, the company estimates the amount to which it expects to be entitled using either the expected value or most likely amount method. The company's contracts may include terms that could cause variability in the transaction price, including, for example, rebates, volume discounts, service-level penalties, and performance bonuses or other forms of contingent revenue.

The company includes only estimated amounts in the transaction price to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. The company may not be able to reliably estimate contingent revenue in certain long-term arrangements due to uncertainties that are not expected to be resolved for a long period of time or when the company's experience with similar types of contracts is limited. The company's arrangements infrequently include contingent revenue. Changes in estimates of variable consideration are included in note C, "Revenue Recognition."

The company's standard billing terms are that payment is due upon receipt of invoice, payable within 30 days. Invoices are generally issued as control transfers and/or as services are rendered. Additionally, in determining the transaction price, the company adjusts the promised amount of consideration for the effects of the time value of money if the billing terms are not standard and the timing of payments agreed to by the parties to the contract provide the client or the company with a significant benefit of financing, in which case the contract contains a significant financing component. As a practical expedient, the company does not account for significant financing components if the period between when the company transfers the promised product or service to the client and when the client pays for that product or service will be one year or less. Most arrangements that contain a financing component are financed through the company's Financing business and include explicit financing terms.

The company may include subcontractor services or third-party vendor equipment or software in certain integrated services arrangements. In these types of arrangements, revenue from sales of third-party vendor products or services is recorded net of costs when the company is acting as an agent between

[8] The full text of the financial statement that includes the following excerpt can be found on the SEC's website at https://www.sec.gov/ix?doc=/Archives/edgar/data/51143/000155837020001334/ibm-20191231x10k2af531.htm.

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the client and the vendor, and gross when the company is the principal for the transaction. To determine whether the company is an agent or principal, the company considers whether it obtains control of the products or services before they are transferred to the customer. In making this evaluation, several factors are considered, most notably whether the company has primary responsibility for fulfillment to the client, as well as inventory risk and pricing discretion.

The company recognizes revenue on sales to solution providers, resellers, and distributors (herein referred to as resellers) when the reseller has economic substance apart from the company and the reseller is considered the principal for the transaction with the end-user client.

The company reports revenue net of any revenue-based taxes assessed by governmental authorities that are imposed on and concurrent with specific revenue-producing transactions.

In addition to the aforementioned general policies, the following are the specific revenue recognition policies for arrangements with multiple performance obligations and for each major category of revenue.

Arrangements with Multiple Performance Obligations

The company's global capabilities as a hybrid cloud platform and AI company include services, software, hardware, and related financing. The company enters into revenue arrangements that may consist of any combination of these products and services based on the needs of its clients.

The company continues to develop new products and offerings and their associated consumption and delivery methods, including the use of cloud and as-a-Service models. These are not separate businesses; they are offerings across the segments that address market opportunities in areas such as analytics, data, cloud, security, AI, and sustainability. Revenue from these offerings follows the specific revenue recognition policies for arrangements with multiple performance obligations and for each major category of revenue, depending on the type of offering, which are comprised of services, software, and/or hardware.

To the extent that a product or service in multiple performance obligation arrangements is subject to other specific accounting guidance (such as leasing guidance) that product or service is accounted for in accordance with such specific guidance. For all other products or services in these arrangements, the company determines if the products or services are distinct and allocates the consideration to each distinct performance obligation on a relative standalone selling price basis.

When products and services are not distinct, the company determines an appropriate measure of progress based on the nature of its overall promise for the single performance obligation.

The revenue policies in the Services, Hardware, and/or Software sections below are applied to each performance obligation, as applicable.

Services

The company's primary services offerings include consulting services, including business transformation; technology consulting and application operations including the design and development of complex IT environments to a client's specifications (e.g., design and build); cloud services; business

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process outsourcing; and infrastructure support. Many of these services can be delivered entirely or partially through cloud or as-a-Service delivery models. The company's services are provided on a time-and-material basis, as a fixed-price contract or as a fixed-price per measure of output contract and the contract terms generally range from less than one year to 5 years.

In services arrangements, the company typically satisfies the performance obligation and recognizes revenue over time. In design and build arrangements, the performance obligation is satisfied over time either because the client controls the asset as it is created (e.g., when the asset is built at the customer site) or because the company's performance does not create an asset with an alternative use and the company has an enforceable right to payment plus a reasonable profit for performance completed to date. In most other services arrangements, the performance obligation is satisfied over time because the client simultaneously receives and consumes the benefits provided as the company performs the services.

Revenue from time-and-material contracts is recognized on an output basis as labor hours are delivered and/or direct expenses are incurred. Revenue from as-a-Service type contracts, such as Infrastructure-as-a-Service, is recognized either on a straight-line basis or on a usage basis, depending on the terms of the arrangement (such as whether the company is standing ready to perform or whether the contract has usage-based metrics). If an as-a-Service contract includes setup activities, those promises in the arrangement are evaluated to determine if they are distinct.

In areas such as application management, business process outsourcing, and other cloud-based services arrangements, the company determines whether the services performed during the initial phases of the arrangement, such as setup activities, are distinct. In most cases, the arrangement is a single performance obligation comprised of a series of distinct services that are substantially the same and that have the same pattern of transfer (i.e., distinct days of service). The company applies a measure of progress (typically time-based) to any fixed consideration and allocates variable consideration to the distinct periods of service based on usage. As a result, revenue is generally recognized over the period when the services are provided on a usage basis. This results in revenue recognition that corresponds with the value to the client of the services transferred to date relative to the remaining services promised.

Revenue related to maintenance and technology lifecycle support and extended warranty is recognized on a straight-line basis over the period of performance because the company is standing ready to provide services.

In design and build contracts, revenue is recognized based on progress toward completion of the performance obligation using a cost-to-cost measure of progress. Revenue is recognized based on the labor costs incurred to date as a percentage of the total estimated labor costs to fulfill the contract. Due to the nature of the work performed in these arrangements, the estimation of cost at completion is complex, subject to many variables and requires significant judgment. Key factors reviewed by the company to estimate costs to complete each contract are future labor and product costs and expected productivity efficiencies. Changes in original estimates are reflected in revenue on a cumulative catch-up basis in the period in which the circumstances that gave rise to the revision become known by the company. Refer to note C, "Revenue Recognition," for the amount of revenue recognized in the reporting

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period on a cumulative catch-up basis (i.e., from performance obligations satisfied, or partially satisfied, in previous periods).

The company performs ongoing profitability analyses of its design and build services contracts accounted for using a cost-to-cost measure of progress in order to determine whether the latest estimates of revenues, costs, and profits require updating. If at any time these estimates indicate that the contract will be unprofitable, the entire estimated loss for the remainder of the contract is recorded immediately. For other types of services contracts, any losses are recorded as incurred.

In some services contracts, the company bills the client prior to recognizing revenue from performing the services. Deferred income of $3,444 million and $3,241 million at December 31, 2023 and 2022, respectively, is included in the Consolidated Balance Sheet. In other services contracts, the company performs the services prior to billing the client. When the company performs services prior to billing the client in design and build contracts, the right to consideration is typically subject to milestone completion or client acceptance and the unbilled accounts receivable is classified as a contract asset. At December 31, 2023 and 2022, contract assets for services contracts of $420 million and $426 million, respectively, are included in prepaid expenses and other current assets in the Consolidated Balance Sheet. The remaining amount of unbilled accounts receivable of $816 million and $788 million at December 31, 2023 and 2022, respectively, is included in notes and accounts receivable–trade in the Consolidated Balance Sheet.

Billings usually occur in the month after the company performs the services or in accordance with specific contractual provisions.

Hardware

The company's hardware offerings include the sale or lease of Hybrid Infrastructure solutions including zSystems as well as Distributed Infrastructure solutions such as Power and Storage solutions. The capabilities of these products can also be delivered through as-a-Service or cloud delivery models, such as Infrastructure-as-a-Service and Storage-as-a-Service. The company also offers installation services for its more complex hardware products. Hardware offerings are often sold with distinct maintenance services, described in the Services section above.

Revenue from hardware sales is recognized when control has transferred to the customer which typically occurs when the hardware has been shipped to the client, risk of loss has transferred to the client and the company has a present right to payment for the hardware. In limited circumstances when a hardware sale includes client acceptance provisions, revenue is recognized either when client acceptance has been obtained, client acceptance provisions have lapsed, or the company has objective evidence that the criteria specified in the client acceptance provisions have been satisfied. Revenue from hardware sales-type leases is recognized at the beginning of the lease term. Revenue from rentals and operating leases is recognized on a straight-line basis over the term of the rental or lease.

Revenue from as-a-Service arrangements is recognized either on a straight-line basis or on a usage basis as described in the Services section above. Installation services are accounted for as distinct performance obligations with revenue recognized as the services are performed. Shipping and handling activities that occur after the client has obtained control of a product are accounted for as an activity to

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fulfill the promise to transfer the product rather than as an additional promised service and, therefore, no revenue is deferred and recognized over the shipping period.

Software

The company's software offerings include hybrid platform software solutions, which contain many of the company's strategic areas including Red Hat, automation, data and AI, security, and sustainability; transaction processing, which primarily supports mission-critical systems for clients; and distributed infrastructure software, which provides operating systems for zSystems and Power Systems hardware. These offerings include proprietary software and open-source software, and many can be delivered entirely or partially through as-a-Service or cloud delivery models, while others are delivered as on-premise software licenses.

Revenue from proprietary perpetual (one-time charge) license software is recognized at a point in time at the inception of the arrangement when control transfers to the client if the software license is distinct from the post-contract support (PCS) offered by the company.

Revenue from proprietary term license software is recognized at a point in time for the committed term of the contract, unless consideration depends on client usage, in which case revenue is recognized when the usage occurs.

Proprietary term licenses often have a one-month contract term due to client termination rights, in which case, revenue would be recognized in that month for both the license and PCS. Clients may contract to convert their existing IBM term license software into perpetual license software plus PCS. When proprietary term license software is converted to perpetual license software, the consideration becomes fixed with no cancellability and, therefore, revenue for the perpetual license is recognized upon conversion, consistent with the accounting for other perpetual licenses, as described above. PCS revenue is recognized as described below.

The company also has open-source software offerings. Because open-source software is offered under an open-source licensing model and therefore, the license is available for free, the standalone selling price is zero. As such, when the license is sold with PCS or other products and services, no consideration is allocated to the license when it is a distinct performance obligation and therefore no revenue is recognized when control of the license transfers to the client. Revenue is recognized over the PCS period. In certain cases, open-source software is bundled with proprietary software and, if the open-source software is not considered distinct, the software bundle is accounted for under a proprietary software model.

Revenue from PCS is recognized over the contract term on a straight-line basis because the company is providing a service of standing ready to provide support, when-and-if needed, and is providing unspecified software upgrades on a when-and-if available basis over the contract term.

Revenue from software hosting or Software-as-a-Service (SaaS) arrangements is recognized either on a straight-line basis or on a usage basis as described in the Services section above. In software hosting arrangements, the rights provided to the client (e.g., ownership of a license, contract termination provisions and the feasibility of the client to operate the software) are considered in determining whether

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the arrangement includes a license. In arrangements that include a software license, the associated revenue is recognized in accordance with the software license recognition policy above rather than over time as a service.

Financing

Financing income attributable to sales-type leases, direct financing leases, and loans is recognized on the accrual basis using the effective interest method. Operating lease income is recognized on a straight-line basis over the term of the lease.

Standalone selling price

The company allocates the transaction price to each performance obligation on a relative standalone selling price basis. The standalone selling price (SSP) is the price at which the company would sell a promised product or service separately to a client. In most cases, the company is able to establish SSP based on the observable prices of products or services sold separately in comparable circumstances to similar clients. The company typically establishes SSP ranges for its products and services which are reassessed on a periodic basis or when facts and circumstances change.

In certain instances, the company may not be able to establish a SSP range based on observable prices, and as a result, the company estimates SSP. The company estimates SSP by considering multiple factors including, but not limited to, overall market conditions, including geographic or regional specific factors, internal costs, profit objectives, and pricing practices. Additionally, in certain circumstances, the company may estimate SSP for a product or service by applying the residual approach. Estimating SSP is a formal process that includes review and approval by the company's management.

Services costs

Recurring operating costs for services contracts are recognized as incurred. For fixed-price design and build contracts, the costs of external hardware and software accounted for under the cost-to-cost measure of progress are deferred and recognized based on the labor costs incurred to date (i.e., the measure of progress), as a percentage of the total estimated labor costs to fulfill the contract as control transfers over time for these performance obligations. Certain eligible, non-recurring costs (i.e., setup costs) incurred in the initial phases of business process outsourcing contracts and other cloud-based services contracts, including Software-as-a-Service arrangements, are capitalized when the costs relate directly to the contract, the costs generate or enhance resources of the company that will be used in satisfying the performance obligation in the future, and the costs are expected to be recovered. These costs consist of transition and setup costs related to the provisioning, configuring, implementation and training and other deferred fulfillment costs, including, for example, prepaid assets used in services contracts (i.e., prepaid software or prepaid maintenance). Capitalized costs are amortized on a straight-line basis over the expected period of benefit, which can include anticipated contract renewals or extensions, consistent with the transfer to the client of the services to which the asset relates. Additionally, fixed assets associated with these contracts are capitalized and depreciated on a straight-line basis over the expected useful life of the asset. If an asset is contract specific, then the depreciation period is the shorter of the useful life of the asset or the contract term. Amounts paid to clients in excess

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of the fair value of acquired assets used in business process outsourcing arrangements are deferred and amortized on a straight-line basis as a reduction of revenue over the expected period of benefit. The company performs periodic reviews to assess the recoverability of deferred contract transition and setup costs. If the carrying amount is deemed not recoverable, an impairment loss is recognized. Refer to note C, "Revenue Recognition," for the amount of deferred costs to fulfill a contract at December 31, 2023 and 2022.

In situations in which a business process outsourcing or other cloud-based services contract is terminated, the terms of the contract may require the client to reimburse the company for the recovery of unbilled accounts receivable, unamortized deferred contract costs, and additional costs incurred by the company to transition the services.

Software costs

Costs that are related to the conceptual formulation and design of licensed software programs are expensed as incurred to research, development, and engineering expense; costs that are incurred to produce the finished product after technological feasibility has been established are capitalized as an intangible asset. Capitalized amounts are amortized on a straight-line basis over periods ranging up to three years and are recorded in software cost within cost of sales. The company performs periodic reviews to ensure that unamortized program costs remain recoverable from future revenue. Costs to support or service licensed programs are charged to software cost within cost of sales as incurred.

The company capitalizes certain costs that are incurred to purchase or develop internal-use software. Internal-use software programs also include software used by the company to deliver Software-as-a-Service when the client does not receive a license to the software and the company has no substantive plans to market the software externally. Capitalized costs are amortized on a straight-line basis over periods ranging up to three years and are recorded in selling, general and administrative expense, or cost of sales, depending on whether the software is used by the company in revenue generating transactions. Additionally, the company may capitalize certain types of implementation costs and amortize them over the term of the arrangement when the company is a customer in a cloud-computing arrangement.

Incremental costs of obtaining a contract

Incremental costs of obtaining a contract (e.g., sales commissions) are capitalized and amortized on a straight-line basis over the expected customer relationship period if the company expects to recover those costs. The expected customer relationship period, determined based on the average customer relationship period, including expected renewals, for each offering type, is three years. Expected renewal periods are included only in the expected customer relationship period if commission amounts paid upon renewal are not commensurate with amounts paid on the initial contract. Incremental costs of obtaining a contract include only those costs the company incurs to obtain a contract that it would not have incurred if the contract had not been obtained. The company has determined that certain commissions programs meet the requirements to be capitalized. Some commission programs are not subject to capitalization as the commission expense is paid and recognized as the related revenue is recognized. Additionally, as a practical expedient, the company expenses costs to obtain a contract as incurred if the

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amortization period would have been a year or less. These costs are included in selling, general, and administrative expenses.

Product warranties

The company offers warranties for its hardware products that generally range up to three years, with the majority being either one or three years. Any cost of standard warranties is accrued when the corresponding revenue is recognized. The company estimates its standard warranty costs for products based on historical warranty claim experience and estimates of future spending and applies this estimate to the revenue stream for products under warranty. Estimated future costs for warranties applicable to revenue recognized in the current period are charged to cost of sales. The warranty liability is reviewed quarterly to verify that it properly reflects the remaining obligation based on the anticipated expenditures over the balance of the obligation period. Adjustments are made when actual warranty claim experience differs from estimates. Costs from fixed-price support or maintenance contracts, including extended warranty contracts, are recognized as incurred.

Revenue from extended warranty contracts is initially recorded as deferred income and subsequently recognized on a straight-line basis over the delivery period because the company is providing a service of standing ready to provide services over such term.

Shipping and handling

Costs related to shipping and handling are recognized as incurred and included in cost in the Consolidated Income Statement.

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Accounting and Auditing Glossary

account. Formal record that represents, in words, money or other unit of measurement, certain resources, claims to such resources, transactions or other events that result in changes to those resources and claims.

account payable. Amount owed to a creditor for delivered goods or completed services.

account receivable. Claim against a debtor for an uncollected amount, generally from a completed transaction of sales or services rendered.

accountants' report. Formal document that communicates an independent accountant's (1) expression of limited assurance on financial statements as a result of performing inquiry and analytic procedures (Review Report); (2) results of procedures performed (type of Attestation Report); (3) non-expression of opinion or any form of assurance on a presentation in the form of financial statements information that is the representation of management (Compilation Report); or (4) an opinion on an assertion made by management in accordance with the Statements on Standards for Attestation Engagements (Attestation Report). An accountant's report does not result from the performance of an audit.

accounting. Recording and reporting of financial transactions, including the origination of the transaction, its recognition, processing, and summarization in the financial statements.

accounting change. Change in (1) an accounting principle; (2) an accounting estimate; or (3) the reporting entity. The correction of an error in previously issued financial statements is not an accounting change.

accounting estimate. A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.

accrual basis. Method of accounting that recognizes revenue when earned, rather than when collected. Expenses are recognized when incurred rather than when paid.

accrued expense. An expense incurred during an accounting period for which payment is not due until a later accounting period. This results from the purchase of services which at the time of accounting have only been partly performed, are not yet billable, or have not been paid for.

accumulated depreciation. Total depreciation pertaining to an asset or group of assets from the time the assets were placed in service until the date of the financial statement or tax return. This total is the contra account to the related asset account.

additional paid in capital. Amounts paid for stock in excess of its par value or stated value. Also, other amounts paid by stockholders and charged to equity accounts other than capital stock.

adjusting entries. Accounting entries made at the end of an accounting period to allocate items between accounting periods.

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amortization. The process of reducing a recognized liability systematically by recognizing revenues or by reducing a recognized asset systematically by recognizing expenses or costs. In accounting for postretirement benefits, amortization also means the systematic recognition in net periodic postretirement benefit cost over several periods of amounts previously recognized in other comprehensive income, that is, gains or losses, prior service cost or credits, and any transition obligation or asset.

analytical procedures. Substantive tests of financial information which examine relationships among data as a means of obtaining evidence. Such procedures include (1) comparison of financial information with information of comparable prior periods; (2) comparison of financial information with anticipated results (e.g., forecasts); (3) study of relationships between elements of financial information that should conform to predictable patterns based on the entity's experience; and (4) comparison of financial information with industry norms.

annual report. The annual report to shareholders is the principal document used by most public companies to disclose corporate information to their shareholders. It is usually a state-of-the-company report, including an opening letter from the Chief Executive Officer, financial data, results of continuing operations, market segment information, new product plans, subsidiary activities, and research and development activities on future programs. The Form 10-K, which must be filed with the SEC, typically contains more detailed information about the company's financial condition than the annual report.

appropriateness (of audit evidence). The measure of the quality of audit evidence, that is, its relevance and reliability in providing support for the conclusions on which the auditor's opinion is based.

assertions. Representations, explicit or otherwise, with respect to the recognition, measurement, presentation, and disclosure of information in the financial statements, which are inherent in management, representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing, and responding to the risks of material misstatement..

audit evidence. Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements.

audit risk. The risk that the auditor may unknowingly fail to modify appropriately his/her opinion on financial statements that are materially misstated.

audit sampling. Application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.

auditors' report. Written communication issued by an independent certified public accountant (CPA) describing the character of his/her work and the degree of responsibility taken. An auditor's report includes a statement that the audit was conducted in accordance with

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generally accepted auditing standards (GAAS), which require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, as well as a statement that the auditor believes the audit provides a reasonable basis for his/her opinion.

bad debt. All or portion of an account, loan, or note receivable considered to be uncollectible.

balance sheet. Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation of a specified date the entity's assets, liabilities, and the equity of its owners. Also known as a statement of financial condition.

bond. One type of long-term promissory note, frequently issued to the public as a security regulated under federal securities laws or state blue sky laws. Bonds can either be registered in the owner's name or are issued as bearer instruments.

book value. Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. Also known as carrying value.

business combinations. Combining of two entities. Under the purchase method of accounting, one entity is deemed to acquire another and there is a new basis of accounting for the assets and liabilities of the acquired company.

business risk. A risk resulting from significant conditions, events, circumstances, actions, or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

business segment. Any division of an organization authorized to operate, within prescribed or otherwise established limitations, under substantial control by its own management.

capital stock. Ownership shares of a corporation authorized by its articles of incorporation. The money value assigned to a corporation's issued shares. The balance sheet account with the aggregate amount of the par value or stated value of all stock issued by a corporation.

capitalized cost. Expenditure identified with goods or services acquired and measured by the amount of cash paid or the market value of other property, capital stock, or services surrendered. Expenditures that are written off during two or more accounting periods.

carrying value. Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. Also known as book value.

cash basis. A special purpose framework in which revenues and expenditures are recorded when they are received and paid.

cash equivalents. Short-term (generally less than three months), highly liquid investments that are convertible to known amounts of cash.

cash flows. Net of cash receipts and cash disbursements relating to a particular activity during a specified accounting period.

casualty loss. Sudden property loss caused by theft, accident, or natural causes.

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change in engagement. A request, before the completion of the audit (review), to change the engagement to a review or compilation (compilation) of financial statements.

class actions. A federal securities class action is a court action filed on behalf of a group of shareholders under Rule 23 of the Federal Rules of Civil Procedure. Instead of each shareholder bringing an individual lawsuit, one or more shareholders bring a class action for the entire class of shareholders.

common stock. Capital stock having no preferences generally in terms of dividends, voting rights, or distributions.

companies, going public. Companies become public entities for different reasons, but usually to raise additional capital. The SEC has prepared a guide for companies – Q&A: Small Business and the SEC – that provides a basic understanding about the various ways companies can become public and what securities laws apply. The SEC also has a list of some of the registration and reporting forms and related regulations that pertain to small and large companies.

comparative financial statement. Financial statement presentation in which the current amounts and the corresponding amounts for previous periods or dates also are shown.

compilation. Presentation in the form of financial statements information that is the representation of management (owners) without the accountant's assurance as to conformity with generally accepted accounting principles (GAAP).

comprehensive income. Change in equity of a business entity during a period from transactions and other events and circumstances from nonowner sources. The period includes all changes in equity except those resulting from investments by owners and distributions to owners.

confirmation. Auditor's receipt of a written or oral response from an independent third party verifying the accuracy of information requested.

consolidated financial statements. Combined financial statements of a parent company and one or more of its subsidiaries as one economic unit.

consolidation. The presentation of a single set of amounts for an entire reporting entity. Consolidation requires elimination of intra-entity transactions and balances.

contingent liability. Potential liability arising from a past transaction or a subsequent event.

continuing accountant. An accountant who has been engaged to audit, review, or compile and report on the financial statements of the current period and one or more consecutive periods immediately prior to the current period.

controls. Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context, (1) policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions; 2) procedures are actions to implement policies.

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control risk. Measure of risk that errors exceeding a tolerable amount will not be prevented or detected by an entity's internal controls.

controls tests. Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial report.

current asset. Asset that one can reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle, or within a year if more than one cycle is completed each year.

current liability. Obligation whose liquidation is expected to require the use of existing resources classified as current assets, or the creation of other current liabilities.

current value. (1) Value of an asset at the present time as compared with the asset's historical cost. (2) In finance, the amount determined by discounting the future revenue stream of an asset using compound interest principles.

debt. General name for money, notes, bonds, goods, or services which represent amounts owed.

definite criteria. A special purpose framework using a definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.

depreciation. Expense allowance made for wear and tear on an asset over its estimated useful life.

derivatives. Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security or index. For example, a stock option is a derivative because its value changes in relation to the price movement of the underlying stock.

detection risk. Risk that the auditor will not detect a material misstatement.

disclosure. Process of divulging accounting information so that the content of financial statements is understood.

discount. Reduction from the full amount of a price or debt.

dividends. Distribution of earnings to owners of a corporation in cash, other assets of the corporation, or the corporation's capital stock.

earnings per share (EPS). The amount of earnings attributable to each share of common stock. For convenience, the term is used to refer to either earnings or loss per share.

employee stock options plans. An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan. Employee Stock Options Plans should not be confused with the term "ESOPs," or Employee Stock Ownership Plans, which are retirement plans.

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employee stock ownership plans (ESOPs). An employee stock ownership plan (ESOP) is a retirement plan in which the company contributes its stock to the plan for the benefit of the company's employees. With an ESOP, you never buy or hold the stock directly. This type of plan should not be confused with employee stock options plans, which are not retirement plans. Instead, employee stock options plans give the employee the right to buy their company's stock at a set price within a certain period of time.

engagement partner. The partner or other individual appointed by the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, when required, has the appropriate authority from a professional, legal, or regulatory body.

engagement quality review. An objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed before the engagement report is released.

engagement quality reviewer. A partner, other individual in the firm, or an external individual appointed by the firm to perform the engagement quality review.

engagement team. All partners and staff performing the audit engagement and any other individuals who perform audit procedures on the engagement, excluding an auditor's external specialist5 and internal auditors who provide direct assistance on an engagement.

equity. Residual interest in the assets of an entity that remains after deducting its liabilities. Also, the amount of a business' total assets, less total liabilities. Also, the third section of a balance sheet, the other two being assets and liabilities.

equity security. Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, and call options) or dispose of (for example, put options) an ownership interest in an entity at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

error. Act that departs from what should be done; imprudent deviation, unintentional mistake or omission.

executive compensation: Where to find in SEC reports. The federal securities laws require clear, concise and understandable disclosure about compensation paid to CEOs and certain other high-ranking executive officers of public companies. You can locate information about executive pay in (1) the company's annual proxy statement; (2) the company's annual report on Form 10-K; and (3) registration statements filed by the company to register securities for sale to the public.

expenditures. Expenditures to which capitalization rates are to be applied are capitalized expenditures (net of progress payment collections) for the qualifying asset that have required the payment of cash, the transfer of other assets, or the incurring of a liability on which interest is recognized (in contrast to liabilities, such as trade payables, accruals, and retainages on which interest is not recognized).

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external information source. An external individual or organization that provides information that is used by the entity in preparing the financial statements or that has been obtained by the auditor as audit evidence, when such information is suitable for use by a broad range of users. When information has been provided by an individual or organization acting in the capacity of management's specialist, service organization, or auditor's specialist, the individual or organization is not considered an external information source with respect to that particular information.

extraordinary items. Events and transactions distinguished by their unusual nature and by the infrequency of their occurrence. Extraordinary items are reported separately, less applicable income taxes, in the entity's statement of income or operations.

Fair Disclosure, Regulation FD. On August 15, 2000, the SEC adopted Regulation FD to address the selective disclosure of information by companies and other issuers. Regulation FD provides that when an issuer discloses material nonpublic information to certain individuals or entities – generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information – the issuer must make public disclosure of that information. In this way, the new rule aims to promote the full and fair disclosure.

fair market value. Price at which property would change hands between a buyer and a seller without any compulsion to buy or sell.

federal securities laws. The laws that govern the securities industry, include the Securities Act of 1933; Securities Exchange Act of 1934; Investment Company Act of 1940; Investment Advisers Act of 1940; and Public Utility Holding Company Act of 1935.

financial statements. Presentation of financial data including balance sheets, income statements and statements of cash flow, or any supporting statement that is intended to communicate an entity's financial position at a point in time and its results of operations for a period then ended.

Firm. A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the AICPA and that is engaged in public practice.

first in, first out (FIFO). Accounting method of valuing inventory under which the costs of the first goods acquired are the first costs charged to expense. Commonly known as FIFO.

fiscal year. Period of 12 consecutive months chosen by an entity as its accounting period which may or may not be a calendar year.

fixed asset. Any tangible asset with a life of more than one year used in an entity's operations.

foreign currency translation. Restating foreign currency in equivalent dollars; unrealized gains or losses are postponed and carried in Stockholder's Equity until the foreign operation is substantially liquidated.

Form 10-K. This is the report that most publicly traded companies file with the SEC on an annual basis. It provides a comprehensive overview of the company's business and financial condition. Some companies choose to send their Form 10-K to their shareholders instead

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of sending a separate annual report. Currently, Form 10-K must be filed with the SEC within 90 days after the end of the company's fiscal year.

Form 10-Q. The Form 10-Q is a report filed quarterly by most reporting companies. It includes unaudited financial statements and provides a continuing view of the company's financial position during the year. The report must be filed for each of the first three fiscal quarters of the company's fiscal year and is currently due within 45 days of the close of the quarter. In addition to Form 10-Q, companies provide annual reports to their shareholders and file Form 10-K on an annual basis with the SEC.

Form 8-K. This is the "current report" used to report material events or corporate changes that have previously not been reported by the company in a quarterly report (Form 10-Q) or annual report (Form 10-K).

Forms 3, 4, 5. Corporate insiders-meaning a company's officers and directors, and any beneficial owners of more than 10% of a class of the company's equity securities registered under Section 12 of the Securities Exchange Act of 1934 – must file with the SEC a statement of ownership regarding those securities. The initial filing is on Form 3. Changes in ownership are reported on Form 4. Insiders must file a Form 5 to report any transactions that should have been reported earlier on a Form 4 or were eligible for deferred reporting.

fraud. Willful misrepresentation by one person of a fact inflicting damage on another person.

gain. Excess of revenues received over costs relating to a specific transaction.

general information technology (IT) controls. Controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information-processing controls and the integrity of information in the entity's information system. Also see **IT environment**.

general ledger. Collection of all assets, liability, owners' equity, revenue, and expense accounts.

generally accepted accounting principles (GAAP). Conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The highest level of such principles is set by the Financial Accounting Standards Board (FASB).

generally accepted auditing standards (GAAS). Standards set by the American Institute of Certified Public Accountants (AICPA) which concern the auditor's professional qualities and judgment in the performance of his/her audit and in the actual report.

going concern. Assumption that a business can remain in operation long enough for all of its current plans to be carried out.

going private. A company "goes private" when it reduces the number of its shareholders to fewer than 300 and is no longer required to file reports with the SEC.

goodwill. An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not for profit entity that are not individually identified and separately recognized.

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gross income. A tax term meaning all income from whatever source derived, except as otherwise provided in the income tax code.

guaranty. Legal arrangement involving a promise by one person to perform the obligations of a second person to a third person, in the event the second person fails to perform.

hedges. Protect an entity against the risk of adverse price or interest-rate movements on its assets, liabilities, or anticipated transactions. A hedge is used to avoid or reduce risks by creating a relationship by which losses on positions are counterbalanced by gains on separate positions in another market.

historical cost. The generally accepted method of accounting used in the primary financial statements that is based on measures of historical prices without restatement into units, each of which has the same general purchasing power.

income. Inflow of revenue during a period of time.

income statement. Summary of the effect of revenues and expenses over a period of time.

income tax basis. A special purpose framework that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.

initial public offerings (IPO). IPO stands for initial public offering and occurs when a company first sells its shares to the public.

initial public offerings, lockup agreements. Lockup agreements prohibit company insiders – including employees, their friends and family, and venture capitalists – from selling their shares for a set period of time. In other words, the shares are "locked up." Before a company goes public, the company and its underwriter typically enter into a lockup agreement to ensure that shares owned by these insiders do not enter the public market too soon after the offering.

insider trading. "Insider trading" actually includes both legal and illegal conduct. The legal version is when corporate insiders – officers, directors, and employees – buy and sell stock in their own companies. Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.

intangible asset. Asset having no physical existence such as trademarks and patents.

interest. Payment for the use or forbearance of money.

interim financial statements. Financial statements that report the operations of an entity for less than one year.

information-processing controls. Controls relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address risks to the integrity of information.

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inherent risk factors. Characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, before consideration of controls. Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk. Depending on the degree to which the inherent risk factors affect the susceptibility of an assertion to misstatement, the level of inherent risk varies on a scale that is referred to as *the spectrum of inherent risk*.

Inspection. Inspection is an evaluation of the adequacy of aspects of the firm's quality management policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them.

internal control. Process designed to provide reasonable assurance regarding achievement of various management objectives such as the reliability of financial reports.

inventory. Tangible property held for sale, or materials used in a production process to make a product.

investment. Expenditure used to purchase goods or services that could produce a return to the investor.

IT environment. The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies. For the purposes of this definition, (1) an *IT application* is a program or a set of programs that is used in the initiation, processing, recording, and reporting of transactions or information. IT applications include data warehouses and report writers; (2) the IT infrastructure comprises the network, operating systems, and databases and their related hardware and software; and (3) the IT processes are the entity's processes to manage access to the IT environment, manage program changes or changes to the IT environment, and manage IT operations.

journal. Any book containing original entries of daily financial transactions.

last in, first out (LIFO). Accounting method of valuing inventory under which the costs of the last goods acquired are the first costs charged to expense. Commonly known as LIFO.

lease. Conveyance of land, buildings, equipment, or other assets from one person (Lessor) to another (Lessee) for a specific period of time for monetary or other consideration, usually in the form of rent.

leasehold. Property interest a lessee owns in the leased property.

ledger. Any book of accounts containing the summaries of debit and credit entries.

lessee. Person or entity that has the right to use property under the terms of a lease.

lessor. Owner of property, the temporary use of which is transferred to another (lessee) under the terms of a lease.

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liability. Debts or obligations owed by one entity (Debtor) to another entity (Creditor) payable in money, goods, or services.

listing and delisting requirements. Before a company can begin trading on an exchange or the Nasdaq Stock Market, it must meet certain initial requirements or "listing standards." The exchanges and the Nasdaq Stock Market set their own standards for listing and continuing to trade. The SEC does not set listing standards. The initial listing requirements mandate that a company meet specified minimum thresholds for the number of publicly traded shares, total market value, stock price, and number of shareholders. After a company starts trading, it must continue to meet different standards set by the exchanges or the Nasdaq Stock Market. Otherwise, the company can be delisted. These continuing standards usually are less stringent than the initial listing requirements.

long-term debt. Debt with a maturity of more than one year from the current date.

loss. Excess of expenditures over revenue for a period or activity. Also, for tax purposes, an excess of basis over the amount realized in a transaction.

lower of cost or market. Valuing assets for financial reporting purposes. Ordinarily, "cost" is the purchase price of the asset and "market" refers to its current replacement cost. Generally accepted accounting principles (GAAP) requires that certain assets (e.g., inventories) be carried at the lower of cost or market.

management discussion and analysis (MD&A). SEC requirement in financial reporting for an explanation by management of significant changes in operations, assets, and liquidity.

management's specialist. An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

manipulation. Manipulation is intentional conduct designed to deceive investors by controlling or artificially affecting the market for a security. Manipulation can involve a number of techniques to affect the supply of, or demand for, a stock. They include spreading false or misleading information about a company; improperly limiting the number of publicly-available shares; or rigging quotes, prices, or trades to create a false or deceptive picture of the demand for a security.

marketable securities. Stocks and other negotiable instruments which can be easily bought and sold on either listed exchanges or over-the-counter markets.

mark-to-market. Method of valuing assets that results in adjustment of an asset's carrying amount to its market value.

matching principle. The concept that all costs and expenses incurred in generating revenues must be recognized in the same reporting period as the related revenues.

materiality. Magnitude of an omission or misstatements of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would change or be influenced.

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mergers. Mergers are business transactions involving the combination of two or more companies into a single entity. Most state laws require that mergers be approved by at least a majority of the company's shareholders if the merger will have a significant impact on the company.

modified cash basis. A special purpose framework that begins with the cash basis method (see Cash basis) and applies modifications having substantial support, such as recording depreciation on fixed assets or accruing income taxes.

NASDAQ. Nasdaq stands for the National Association of Securities Dealers Automated Quotation System. Unlike the New York Stock Exchange where trades take place on an exchange, Nasdaq is an electronic stock market that uses a computerized system to provide brokers and dealers with price quotes. The National Association of Securities Dealers, Inc. owns and operates The Nasdaq Stock Market.

net assets. Excess of the value of securities owned, cash, receivables, and other assets over the liabilities of the company.

net income. Excess or deficit of total revenues and gains compared with total expenses and losses for an accounting period.

net sales. Sales at gross invoice amounts less any adjustments for returns, allowances, or discounts taken.

net worth. Similar to equity, the excess of assets over liabilities.

network. An association of entities that includes one or more firms.

network firm. Another firm or entity that belongs to the same network as the firm.

nonpublic entity. Any entity other than (a) one whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally; (b) one that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market; or (c) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (a) or (b).

no-par stock. Stock authorized to be issued but for which no par value is set in the articles of incorporation. A stated value is set by the board of directors on the issuance of this type of stock.

no-par value. Stock or bond that does not have a specific value indicated.

notional. Value assigned to assets or liabilities that is not based on cost or market (e.g., the value of a service not yet rendered).

objectivity. Emphasizing or expressing the nature of reality as it is apart from personal reflection or feelings; independence of mind.

paid in capital. Portion of the stockholders' equity which was paid in by the stockholders, as opposed to capital arising from profitable operations.

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par value. Amount per share set in the articles of incorporation of a corporation to be entered in the capital stocks account where it is left permanently and signifies a cushion of equity capital for the protection of creditors.

parent company. Company that has a controlling interest in the common stock of another.

partner. Any individual with authority to bind the firm with respect to the performance of a professional services engagement. For purposes of this definition, *partner* may include an employee with this authority who has not assumed the risks and benefits of ownership. Firms might use different titles to refer to individuals with this authority.

personnel. Partners and staff in the firm.

predecessor accountant. An accountant who (a) has reported on the most recent compiled or reviewed financial statements or was engaged to perform but did not complete a compilation or review of the financial statements, and (b) has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

preferred stock. Type of capital stock that carries certain preferences over common stock, such as a prior claim on dividends and assets.

premium. (1) Excess amount paid for a bond over its face amount. (2) In insurance, the cost of specified coverage for a designated period of time.

prepaid expense. Cost incurred to acquire economically useful goods or services that are expected to be consumed in the revenue-earning process within the operating cycle.

prescribed form. Any standard preprinted form designed or adopted by the body to which it is to be submitted, for example, forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form.

present value. Current value of a given future cash flow stream, discounted at a given rate.

principal. Face amount of a security, exclusive of any premium or interest. The basis for interest computations.

professional standards. Standards promulgated by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under the "General Standards Rule" (ET sec. 1.300.001) or the "Compliance With Standards Rule" (ET sec. 1.310.001) of the AICPA code, or by other standard-setting bodies that set auditing and attest standards applicable to the engagement being performed and relevant ethical requirements.

proxy statement. The SEC requires that shareholders of a company whose securities are registered under Section 12 of the Securities Exchange Act of 1934 receive a proxy statement prior to a shareholder meeting, whether an annual or special meeting. The information contained in the statement must be filed with the SEC before soliciting a shareholder vote on the election of directors and the approval of other corporate action. Solicitations, whether by management or shareholders, must disclose all important facts about the issues on which shareholders are asked to vote.

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purchase method of accounting. Accounting for a merger by adding the acquired company's assets at the price paid for them to the acquiring company's assets.

quiet period. The term "quiet period," also referred to as the "waiting period," is not defined under the federal securities laws. The quiet period extends from the time a company files a registration statement with the SEC until SEC staff declares the registration statement "effective." During this period, the federal securities laws limit what information a company and related parties can release to the public. Rule 134 of the Securities Act of 1933 discusses these limitations.

ratio analysis. Comparison of actual or projected data for a particular company to other data for that company or industry in order to analyze trends or relationships.

real property. Land and improvements, including buildings and personal property that is permanently attached to the land or customarily transferred with the land.

receivables. Amounts of money due from customers or other debtors.

reconciliation. Comparison of two numbers to demonstrate the basis for the difference between them.

Registration Under the Securities Act of 1933. Often referred to as the "truth in securities" law, the Securities Act of 1933 has two basic objectives: (1) To require that investors receive financial and other significant information concerning securities being offered for public sale; and (2) To prohibit deceit, misrepresentations, and other fraud in the sale of securities. The SEC accomplishes these goals primarily by requiring that companies disclose important financial information through the registration of securities. This information enables investors, not the government, to make informed judgments about whether to purchase a company's securities.

Regulation D offerings. Under the Securities Act of 1933, any offer to sell securities must either be registered with the SEC or meet an exemption. Regulation D (or Reg D) provides three exemptions from the registration requirements, allowing some smaller companies to offer and sell their securities without having to register the securities with the SEC.

regulatory basis. A special purpose framework that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. An example is a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.

reissued report. A report issued subsequent to the date of the original report that bears the same date as the original report. A reissued report may need to be revised for the effects of specific events; in these circumstances, the report should be dual-dated with the original date and a separate date that applies to the effects of such events.

related party transaction. Business or other transaction between persons who do not have an arm's-length relationship (e.g., a relationship with independent, competing interests). The most common is between family members or controlled entities. For tax purposes, these types of transactions are generally subject to a greater level of scrutiny.

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relevant assertions. An assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement. A risk of material misstatement exists when (*a*) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (*b*) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (that is, the determination is based on inherent risk).

Relevant ethical requirements. Principles of professional ethics and ethical requirements to which the engagement team and engagement quality reviewer are subject, which consist of the AICPA code together with rules of applicable state boards of accountancy and applicable regulatory agencies that are more restrictive.

research and development (R&D). Research is a planned activity aimed at discovery of new knowledge with the hope of developing new or improved products and services. Development is the translation of research findings into a plan or design of new or improved products and services.

response (in relation to a system of quality management). Policies or procedures designed and implemented by the firm to address one or more quality risks. Policies are statements of what should, or should not, be done to address a quality risk or risks. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions. Procedures are actions to implement policies.

retained earnings. Accumulated undistributed earnings of a company retained for future needs or for future distribution to its owners.

revenue recognition. Method of determining whether or not income has met the conditions of being earned and realized or is realizable.

revenues. Sales of products, merchandise, and services; and earnings from interest, dividend, rents.

review. Accounting service that provides some assurance as to the reliability of financial information. In a review, a certified public accountant (CPA) does not conduct an examination under generally accepted auditing standards (GAAS). Instead, the accountant performs inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with GAAP or, if applicable, with a special purpose framework.

risks arising from the use of IT. Susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes. See **IT environment**.

risk assessment procedures. The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

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risk management. Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.

security. Any kind of transferable certificate of ownership including equity securities and debt securities.

significant class of transactions, account balance, or disclosure. A class of transactions, account balance, or disclosure for which there is one or more relevant assertions.

significant risk. An identified risk of material misstatement, (1) for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur, or, (2) that is to be treated as a significant risk in accordance with the requirements of other AU-C sections.

short-term. Current; ordinarily due within one year.

SSARS. Statements on Standards for Accounting And Review Services issued by the AICPA Accounting and Review Services Committee (ARSC).

start-up costs. (1) Costs, excluding acquisition costs, incurred to bring a new unit into production. (2) Costs incurred to begin a business.

statement of cash flows. A statement of cash flows is one of the basic financial statements that is required as part of a complete set of financial statements prepared in conformity with generally accepted accounting principles. It categorizes net cash provided or used during a period as operating, investing and financing activities, and reconciles beginning and ending cash and cash equivalents.

statement of financial condition. Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation as of a specified date, the entity's assets, liabilities, and the equity of its owners. Also known as *balance sheet*.

statutory basis. See Regulatory basis.

straight-line depreciation. Accounting method that reflects an equal amount of wear and tear during each period of an asset's useful life. For instance, the annual straight-line depreciation of a $10,000 asset expected to last ten years is $1,000.

strike price. Price of a financial instrument at which conversion or exercise occurs.

submission of financial statements. Presenting to a client or third party's financial statements that the accountant has prepared either manually or through the use of computer software.

subsequent event. Material event that occurs after the end of the accounting period and before the publication of an entity's financial statements. Such events are disclosed in the notes to the financial statements.

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successor accountant. An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement or an accountant who has accepted such an engagement.

sufficiency (of audit evidence). The measure of the quantity of audit evidence. The quantity of audit evidence necessary is affected by the auditor's assessment of the risks of material misstatement and the quality of the audit evidence obtained (that is, its appropriateness).

system of internal control. The system designed, implemented, and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. For purposes of GAAS, the system of internal control consists of five interrelated components: (1) Control environment, (2) the entity's risk assessment process, (3) the entity's process to monitor the system of internal control, (4) the information system and communication, and (5) control activities.

tangible asset. Assets having a physical existence, such as cash, land, buildings, machinery, or claims on property, investments or goods in process.

tax. Charge levied by a governmental unit on income, consumption, wealth, or other basis.

third party. All parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

trade date. Date when a security transaction is entered into, to be settled on at a later date. Transactions involving financial instruments are generally accounted for on the trade date.

treasury bill. Short-term obligation that bears no interest and is sold at a discount.

treasury bond. Long-term obligation that matures more than five years from issuance and bears interest.

treasury note. Intermediate-term obligation that matures one to five years from issuance and bears interest.

treasury stock. Stock reacquired by the issuing company. It may be held indefinitely, retired, issued upon exercise of stock options, or resold.

trial balance. A trial balance consists of a listing of all of the general ledger accounts and their corresponding debit or credit balances. Also, in a trial balance, no attempt is made to establish a mathematical relationship among the assets, liabilities, equity, revenues, and expenses except that total debits equal total credits.

unearned income. Payments received for services which have not yet been performed.

updated report. A report issued by a continuing accountant that takes into consideration information that he/she becomes aware of during his/her current engagement and that re-expresses his/her previous conclusions or, depending on the circumstances, expresses

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different conclusions on the financial statements of a prior period as of the date of his/her current report.

valuation allowance. Method of lowering or raising an object's current value by adjusting its acquisition cost to reflect its market value by use of a contra account.

variance. Deviation or difference between an estimated value and the actual value.

work in progress. Inventory account consisting of partially completed goods awaiting completion and transfer to finished inventory.

working capital. Excess of current assets over current liabilities.

working papers. (1) Records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the course of the audit. (2) Any records developed by a certified public accountant (CPA) during an audit.

yield. Return on an investment an investor receives from dividends or interest expressed as a percentage of the cost of the security.

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