

# Technical Line

FASB – final guidance

## How the new revenue standard affects brokers and dealers in securities

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### What you need to know

- For certain investment banking advisory arrangements, the timing of revenue recognition may vary depending on the number and nature of the performance obligations identified.
- Broker-dealers likely need to recognize underwriting expenses and costs of advisory services and the related revenues (reimbursements) on a gross basis.
- Applying the standard to brokerage agreements that include only trade execution and security custody services may be complex.

### Overview

The new revenue recognition standard<sup>1</sup> issued by the Financial Accounting Standards Board (FASB or Board) requires broker-dealer entities to make additional judgments and estimates, such as whether performance obligations are satisfied at a point in time or over time, how to allocate transaction prices where multiple performance obligations are identified, when to recognize revenue based on the appropriate measure of the company's progress under the contract, and whether constraints on variable consideration should be applied due to uncertain future events.

This publication highlights key aspects of applying the FASB's standard to a broker-dealer entity's contracts with its customers, addresses significant changes to legacy practice and reflects the latest implementation insights.

As a reminder, the FASB deferred<sup>2</sup> the effective date to annual periods beginning after 15 December 2019 and interim periods in annual periods beginning after 15 December 2020, for entities that had not yet issued (or made available for issuance) financial statements that reflected the standard as of 3 June 2020 (i.e., certain private and not-for-profit entities). Early adoption is permitted. The deferral is intended to give these entities more time to implement the standard, given the operational and financial reporting challenges of the COVID-19 pandemic. Public entities, as defined by the standard, and some private and not-for-profit entities were already required to adopt the standard.

This publication, which contains a summary of the standard in the Appendix, supplements our Financial reporting developments (FRD) publication, [Revenue from contracts with customers \(ASC 606\)](#), and should be read in conjunction with it. The views we express in this publication may continue to evolve as implementation continues and additional issues are identified. For a discussion of how to apply the standard to asset management or distribution arrangements, see our separate Technical Line, [How the new revenue standard affects asset managers](#). For a discussion of how to apply the standard to asset servicing and other banking services, see our separate Technical Line, [How the new revenue standard affects banks](#).

Broker-dealer entities should also keep in mind that, when they adopt the new credit impairment standard,<sup>3</sup> they will need to estimate full lifetime expected credit losses for their accounts receivable and contract assets. As a reminder, they will need to do this after assessing collectibility under the revenue guidance to determine whether they have a contract with a customer. Refer to our FRD publication, [Credit impairment for short-term receivables under ASC 326](#), for more information.

## Key industry considerations

### Scope

The standard applies to all contracts with customers to provide goods or services in the ordinary course of business, unless they are in the scope of other US GAAP (e.g., guidance that addresses accounting for financial instruments<sup>4</sup>). Some common services provided by broker-dealers that are in the scope of the standard include:

- ▶ Trade execution services (including clearing services) for customers' purchases and sales of securities
- ▶ Custody and administrative services related to securities owned by customers
- ▶ Soft-dollar arrangements
- ▶ Securities underwriting
- ▶ Advisory services for public and corporate finance activities (e.g., merger-and-acquisition, financial restructuring)
- ▶ Distribution services

There are several aspects of the broker-dealer's activities that are outside the scope of the revenue standard. The accounting for a broker-dealer's proprietary trading operations and lending activities (including securities lending and repurchase arrangements) are not in the scope of the standard; however, a broker-dealer's agency activities (i.e., transacting on behalf of customers) are in scope. Recognition of interest and dividend income and expense from financial instruments owned or sold short, interest (rebate) from securities lending, repurchase agreements and similar arrangements also are outside the scope of the standard. Recognition of realized and unrealized gains and losses on the transfer and derecognition of financial instruments continue to be within the scope of Accounting Standards Codification (ASC) 860, *Transfers and Servicing*, and ASC 940, *Financial Services – Brokers and Dealers*.

A broker-dealer's arrangements may be partially within the scope of ASC 606 and partially in the scope of other standards. In these situations, the standard requires an entity to first apply the separation and/or measurement principles in the other guidance before applying the revenue standard. For example, a customer contract that provides trade execution services and a line of credit that allows the customer to buy securities on margin is partially in the scope of the standard (i.e., the portion related to trade execution) and partially in the scope of other standards (i.e., the accounting for the line of credit and any related borrowings would be subject to ASC 310, *Receivables*).

## Brokerage agreements

### *Contract duration*

A retail or institutional customer typically signs one contract with a broker-dealer that governs the terms and conditions for the services to be provided by the broker-dealer (i.e., the promised goods and services). Some common services include the following:

- ▶ Trade execution – This service is the completion of a buy or sell order for a security. When the investor places the trade, it goes to a broker, who determines the best way for it to be executed.
- ▶ Clearing (including settlement) – This service is the process of computing the obligations of the counterparties and facilitating the delivery of securities and the transfer of funds on the settlement date.
- ▶ Custody – This service involves keeping records of securities holdings on behalf of investors and monitoring the receipt of dividends and interest payments and corporate actions (e.g., share repurchases, mergers and acquisitions).
- ▶ Investment research – This service involves performing securities research and providing investment recommendations (see also the Soft-dollar arrangements section below).

A broker-dealer needs to determine when it has a contract with a customer. If the only fee in a cancelable contract is contingent on trades being executed (i.e., a trade commission), the contract generally does not meet the contract criteria (see Step 1 in the Appendix) until the customer submits a trade order, even if the customer deposits money or transfers securities into an account. That's because the customer has no obligation to pay the broker-dealer any consideration for its services. That is, the contract has no commercial substance until a trade order is placed.

A cancelable contract that includes a fee that is not contingent on trades being executed, by contrast, likely meets all of the criteria to be accounted for as a contract under the standard when the customer deposits money or transfers securities into an account, executes an initial trade or requests investment research or the contractual term of custody services has begun. Prior to these events, a contract would not exist under the standard because the arrangement is wholly unperformed, and either party could terminate it without significant penalty. However, a noncancelable contract (e.g., a contract that specifies a guaranteed minimum number of trades for a stated fee) likely meets the contract criteria when the contract is signed.

A typical retail brokerage contract generally can be terminated at will by either the customer or the broker-dealer without a termination penalty. ASC 606-10-25-3 explains that when a contract has no fixed duration and can be terminated or modified by either party at any time without penalty, an entity should apply the revenue guidance to the period in which the parties have enforceable rights and obligations, unless a customer has a material right that extends beyond that period (see the Evaluating the services provided as optional purchases section below for a discussion of material rights). For a broker-dealer, the period in which the parties have enforceable rights and obligations may be one day or less.

### ***Identifying performance obligations in a brokerage contract***

A broker-dealer should evaluate all of the services promised in the brokerage contract, including those implied by a broker-dealer's customary business practice, to identify the performance obligations.

Judgment is required to determine which services are capable of being distinct and are distinct within the context of the contract (i.e., separately identifiable). Generally, trade execution and clearing services are not separately identifiable in a typical retail contract because they are both inputs to the combined output of security trading. Therefore, they are bundled into a single performance obligation.

Generally, trade execution and custody services each provide a benefit to the customer either on its own or together with other resources that are readily available to the customer (i.e., a customer can benefit from custody services or trade execution services on their own). In addition, the two services are generally separately identifiable. That's because the two services do not significantly modify or customize one another, the broker-dealer is not providing a significant service of integrating the services into a combined output and the services are not highly interdependent or interrelated. The services are not highly interdependent or interrelated because the services do not significantly affect each other. For example, the broker-dealer is able to fulfill its promise to provide the trade execution service independent from its promise to provide custody services.

### **How we see it**

While broker-dealers may not separately charge their customers for certain services they provide (e.g., custody services, a specified number of free trades for new customers), these services may be considered separate performance obligations under the standard if they are capable of being distinct and are distinct in the context of the contract.

In addition, identifying goods and services that are implicitly promised in a contract (e.g., based on a broker-dealer's customary business practice) may be challenging. Broker-dealers may provide investment research and other services as customary business practices, even though these items may not be explicit in the contract or legally enforceable.

**Judgment is required to identify the performance obligations in a brokerage contract.**

### ***Evaluating the services provided as optional purchases***

Because trade execution is performed only when a customer requests that the broker-dealer initiate a trade, the customer has an option to purchase this service. Consideration resulting from the exercise of the option is not considered variable consideration<sup>5</sup> because the customer has a contractual right (but not an obligation) to choose the amount of additional distinct services (i.e., trade orders) that are purchased. However, if a contract stipulates a guaranteed minimum number of trades, those trades are considered performance obligations at contract inception, and only trades requested above the minimum are considered optional purchases. If there is no minimum, any trades beyond those that have already been executed also would be considered optional purchases.

Options in a contract are considered separate performance obligations if they provide a material right (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market) to the customer that it would not receive without entering into a contract. Broker-dealers should evaluate the option for trade execution services, including the pricing, quantitatively and qualitatively to determine whether it represents a material right. If the price of the option to purchase additional goods and services reflects the standalone selling price for that good or service, that option does not provide a material right and instead is a marketing offer.<sup>6</sup> In these circumstances, the trade execution services are accounted for only when the customer exercises the option to purchase the trade execution services.

Trade execution services priced at a discount from the standalone selling price (e.g., arrangements that provide volume discounts) may represent a material right that is accounted for as a separate performance obligation under the standard. FASB Transition Resource Group (TRG) members generally agreed<sup>5</sup> that in determining whether a volume discount is a material right, an entity should first evaluate whether the option exists independently of the existing contract. In other words, would the entity offer the same pricing to a similar high-volume customer independent of a prior contract with the entity? An affirmative answer would indicate that the volume discount is not a material right because it does not exceed the discount typically offered to a similar high-volume customer. If the entity typically would offer a higher price to a similar high-volume customer, that might indicate that the volume discount is a material right because the discount exceeds what the broker-dealer typically offers. Consider the following illustration, which is based on an example included in a TRG agenda paper<sup>7</sup> on material rights:

#### **Illustration 1: Volume discounts**

Broker-dealer (BD) enters into a brokerage agreement to provide trade execution services for an unspecified volume of shares in publicly traded companies to Customer A. The price per share traded in a subsequent year depends on the volume of shares Customer A trades in the current year. BD charges Customer A \$0.05 per share in year one, and the contract stipulates that if Customer A's share volume in year one exceeds 100,000 shares, the price per share will decrease to \$0.03 in year two. The pricing terms of BD's contract with Customer A are similar to the pricing terms BD offers to many of its customers.

Early in year one, Customer A enters into a contract with BD to execute a trade for 8,000 shares. Customer A is required to pay \$0.05 for each of those 8,000 shares.

#### **Analysis**

When determining whether the contract between BD and Customer A includes a material right, BD first evaluates whether the option provided to Customer A exists independently of the existing contract. To do this, BD compares the discount offered to Customer A with the discount it typically offers to similar high-volume customers that receive a discount independent of a prior contract with BD. A similar customer could be Customer B, who places a single order with BD to purchase 105,000 shares of a publicly traded company. If BD offers Customer A and Customer B the same discount, a material right likely would not exist.

Comparing the lower price it is offering Customer A in year two with its offers to other customers that also receive pricing contingent on prior purchases would not help BD determine whether Customer A would have received the same discount if it had not entered into the original contract. That is, determining whether an option represents a material right requires an entity to compare the discounted price the customer receives to the price another customer would receive without an existing contract with the entity.

Significant judgment is required to determine whether a volume discount provides the customer with a material right.

Broker-dealers also should consider whether the customer has a material right related to services to be provided beyond the contractual term of the arrangement (e.g., beyond one day if the contract can be terminated at will without a significant penalty). For example, if a broker-dealer provides custody services to a retail customer at a discount or for no consideration, the broker-dealer should first evaluate whether the option exists independently of the existing contract. In many cases, broker-dealers provide custody services to customers who do not have an existing contract with the broker-dealer for no consideration and, therefore, determine that there is no material right for future custody services.

**Significant judgment is required to determine whether a volume discount provides the customer with a material right.**

***Allocating the transaction price to performance obligations***

If there is more than one performance obligation, the transaction price is allocated in proportion to the relative standalone selling prices of the goods or services or by applying the variable consideration allocation exception, if it applies. As discussed above, typical retail contracts have at least two performance obligations upon a trade execution request (trade execution and custody). Under the standard, a single trade commission would need to be allocated between the two performance obligations. However, if the contract is terminable at will without a significant termination penalty, both performance obligations are satisfied by the end of the day, so no allocation is necessary – and revenue for both performance obligations are recognized at the same time – unless the broker-dealer separately presents trade execution services and custody services in its financial statements.

If there is only one performance obligation (e.g., there is no guaranteed minimum number of trades, and the option for trade execution services is not a material right), no allocation is required. For example, a retail brokerage contract that charges a fee for custody services should allocate that fee to the custody services performance obligation at contract inception.

***Accounting for optional purchases (e.g., options for additional trade execution services)***

If an optional trade is requested and that option is not a material right, the broker-dealer may account for this exercise of the option as a contract modification (see Step 1 in the Appendix) because it changes the enforceable rights and obligations of the original contract.

The standard requires an entity to account for a contract modification in one of three ways: (1) as a separate contract, (2) as a termination of the existing contract and the creation of a new contract or (3) as part of the existing contract. This determination depends on whether the added services are distinct and whether the added services are priced at their standalone selling price.

If a broker-dealer determines that the trade execution services are distinct and priced at their standalone selling price, it should account for the trade execution service as a separate contract, and it should not allocate any consideration from the trade commission to the custody services.

A broker-dealer that determines that the option for additional trade execution services is a material right should allocate a portion of the transaction price from each executed trade to the material right based on their relative standalone selling prices. The standard provides an alternative for determining the standalone selling price of the option.<sup>8</sup> This practical alternative applies when the goods or services are both (1) similar to the original goods and services in the contract (i.e., the entity continues to provide what it was already providing) and (2) provided in accordance with the terms of the original contract. This practical alternative may be applied to options for future trade execution services. Consider the following example:

**Illustration 2: Practical alternative to estimating the standalone selling price of an option**

Broker-dealer (BD) enters into a brokerage agreement to provide 10,000 trades for \$50,000 to Customer Z, payable at contract inception. Customer Z can request that BD execute additional trades (beyond the 10,000 minimum) for \$4 per trade. BD concludes that the discount on future trades is a material right because the customer would receive a material discount that exceeds any discount available to other similar customers.

***Analysis***

If BD chooses to use the practical alternative, it would determine the amount of the transaction price allocated to the option for additional trades by determining the additional trades expected to be provided and the corresponding expected consideration. BD determines, based on its historical experience, that customers similar to Customer Z will execute a total of 20,000 trades. The total consideration BD expects to receive is \$90,000 [\$50,000 + (\$4 x 10,000)] (i.e., the hypothetical transaction price). Assuming the standalone selling price for each trade is the same, the entity allocates \$4.50 (\$90,000/20,000) to each trade.

In many cases, commission income from trade execution services is recognized on the trade date.

Since there is a discount offered on the additional trades, this calculation will result in less revenue being allocated to the first 10,000 trades than the amount of consideration received for those trades. The difference between the consideration received (or that will be received) for the first 10,000 trades and the revenue allocated to those trades will represent the amount allocated to the option for additional trades using the practical alternative.

As the first 10,000 trades are executed, BD will recognize revenue of \$45,000 (10,000 trades times the allocated price of \$4.50 per trade). Consequently, at contract inception, the entity would allocate \$5,000 to the option to renew (\$50,000 cash received less \$45,000 revenue to be recognized as the first 10,000 are executed).

BD would update the hypothetical transaction price and allocation when its estimate of additional trades changes or when the actual number of trades differs from its expectations.

The amount allocated to the material right is recognized as revenue when the option for the additional trades priced at a discount is exercised or the option expires.

#### ***Trade date versus settlement date***

When a broker-dealer executes a trade determined to be a performance obligation satisfied at a point in time, it must determine the point in time at which it transfers control of that service to the customer. Under the standard, control refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Services are assets, even if only momentarily, when they are received and used.

Broker-dealers perform the service of providing the customer with the ability to acquire or dispose of rights to obtain the economic benefits of a financial instrument (e.g., stock, bonds, options).

Therefore, transfer of control of the trade execution performance obligation generally occurs on the trade date because that is when the underlying financial instrument (for a purchase) or purchaser (for a sale) is identified and the pricing is agreed upon (i.e., the broker-dealer has identified the counterparty and enters into the contract on behalf of the customer). On the trade date, the customer has obtained control of the service because it can direct the use of, and obtain substantially all of the remaining benefits from, the asset that comes from the trade execution service.

For example, in a security purchase transaction, the customer receives the benefits from changes in value of the underlying security on the trade date. In addition, the customer may direct the further sale of a purchased security to a third party as of the trade date. In a security sales transaction, a customer may not direct the use of the sale proceeds to purchase another security until the settlement date when the cash is deposited into its account. However, the customer is no longer subject to the risk of changes in value of the sold security on the trade date and thus has no rights to the underlying security or related risks and rewards once sold on the trade date.

An analysis of the indicators of the transfer of control in the standard (see Step 5 in the Appendix) also supports that control transfers on the trade date. On the trade date, the broker-dealer has a present right to payment for the trade execution performance obligation and the customer has obtained the significant risks and rewards of the service because the rights to the underlying security provided by the service are received on the trade date.

Even if the customer or the other counterparty to the transaction does not remit payment for the financial instrument on the scheduled settlement date, the broker-dealer will remedy the failure to perform by either party, so the customer still benefits from the rights to the financial instrument purchased (or the proceeds from the sale of the financial instrument) as of the trade date. This remedy may be similar to a warranty (i.e., a warranty of its agency service), which is

specifically addressed in the standard. The standard states<sup>9</sup> that warranties may provide a customer with assurance that the related product (whether a good or service) will function as the parties intended because it complies with agreed-upon specifications, which is consistent with the remedy a broker-dealer provides. These types of warranties are not accounted for as separate performance obligations. As a result, the broker-dealer may need to recognize a liability/expense for any obligations to remedy failures to perform as of the trade date.

Based on the above analysis, a broker-dealer generally should recognize the portion of the transaction price allocated to the trade execution performance obligation as revenue on the trade date. However, a broker-dealer that determines that clearing services are a separate performance obligation or the only performance obligation in the contract (e.g., certain contracts with institutional customers in which the broker-dealer only provides clearing services) needs to analyze its specific facts and circumstances and may reach different conclusions from those described above.

### Soft-dollar arrangements

The ASC Master Glossary describes soft-dollar arrangements as arrangements in which a broker-dealer provides research to a customer in return for trade order flow (a certain volume of trades) from that customer. These arrangements generate trade commissions for the broker-dealer when those trades are executed. The value of the research to be provided is typically based on a percentage of commission income. Soft-dollar customers typically are institutional investors or money managers. Soft-dollar research may be produced internally by the broker-dealer or purchased by the broker-dealer from a third party.

Soft-dollar arrangements may either be separately negotiated or negotiated as part of a contract for trade execution services. If a soft-dollar arrangement is included in a separate contract, it typically would meet the contract combination criteria if it is entered into at or near the same time, and the prices of the contracts are interdependent (see Step 1 in the Appendix). If the arrangement is not entered into at or near the same time, an entity may still need to consider the contract modification guidance if the soft-dollar arrangement affects the transaction price of a related trade execution contract.

Broker-dealers need to determine whether the obligation to provide, or the customer's option to receive (see section above on Evaluating the services provided as optional purchases), investment research services is distinct from the other promised goods or services in the contract. Investment research likely is considered a separate performance obligation from clearing, trade execution or custody services because the customer can benefit from the research services on their own, and they are distinct within the context of the contract.

A broker-dealer needs to allocate the transaction price to the performance obligations identified in the contract in proportion to the relative standalone selling price, unless the variable consideration allocation exception applies. When research services are combined with clearing or execution agreements and accounted for as a single contract, the transaction price is generally the commission fee defined in the contract between the broker-dealer and the customer.

If the customer can receive investment research from a third party, the broker-dealer needs to determine whether it is acting as a principal or an agent for the investment research services performance obligation (see Step 2 in the Appendix). In contracts where the broker-dealer is not primarily responsible for providing the investment research and has no discretion in the price that is charged to the customer for the third-party research, the broker-dealer likely will determine it is acting as an agent because it will not control the investment research provided by a third party before it is transferred to the customer. If it is acting as an agent, the broker-dealer recognizes the revenue allocated to the investment research net of the amount paid to the third party for the research.

Broker-dealers  
need to determine  
whether they are  
acting as a principal  
or an agent in  
providing  
investment  
research services  
to a customer.

The performance obligation associated with the research services may be satisfied at a point in time or over time, depending on the facts and circumstances of the contract. For example, a customer may be entitled to a certain number of calls with specific industry analysts (i.e., a service satisfied at a point in time) or access to analyst reports over the contract period (i.e., a service satisfied over time).

Revenue is recognized on the date that the research services are provided to the customer for those services that are determined to be satisfied at a point in time, and time elapsed is generally used to measure the progress of any research services determined to be satisfied over time.

In certain cases, the research services may be provided before sufficient trades are executed to generate payment to cover them. Satisfaction of performance obligations before payment is received results in a contract asset that is recognized until sufficient trades occur. When those trades occur, a portion of the trade commission received will reduce the contract asset. Likewise, payment received before the investment research performance obligation is satisfied results in a contract liability (e.g., deferred revenue). This outcome is consistent with the industry-specific guidance<sup>10</sup> for soft-dollar arrangements that was retained by the FASB.

### **Securities underwriting**

Securities underwriting refers to the process by which investment banks raise investment capital on behalf of corporations and governments that are issuing securities (both equity and debt).

There are several different ways in which a broker-dealer may participate in securities underwriting. The broker-dealer may act as managing underwriter (commonly referred to as the lead underwriter), co-managing underwriter (or co-lead) or participating underwriter.

An underwriting agreement is a contract between a corporation or government entity issuing new securities and the lead underwriter of the syndicate. The underwriting agreement states the public offering price, the underwriting spread, the net proceeds to the issuer and the settlement date.

A syndicate agreement, which is separate from the underwriting agreement, is a contract between participating members of an investment banking syndicate (sometimes called a syndicate contract or purchase group agreement).

Because the lead underwriter is given the legal authority to sign the underwriting agreement on behalf of the syndicate (through the syndicate agreement), all of the syndicate members are considered parties to the underwriting agreement (see Gross versus net reporting section below for a discussion of revenue allocated among members of a syndicate). Generally, each syndicate member named in the underwriting agreement is severally obligated to purchase the offered securities for their own accounts (in a firm commitment) or sell the offered securities to investors (in a best-efforts arrangement).

Underwriters earn revenue from the price difference (the underwriting spread) between the price they pay the issuer of securities and the public offering price.

Although a broker-dealer may perform different roles in the underwriting process, these services are essentially the same; the promised service is ultimately to raise capital for the issuer. Generally, the underwriting (sale) of securities is the only performance obligation in an underwriting agreement. However, the terms of individual underwriting agreements should be evaluated carefully to identify any other explicit or implicit promised goods and services (such as providing bridge financing, term loans or credit facilities) and to determine whether they represent separate performance obligations.

**The performance obligation associated with a typical underwriting agreement generally is satisfied on the trade date.**

The performance obligation associated with a typical underwriting agreement generally is satisfied on the trade date, so the fees (i.e., the underwriting spread) are recognized as revenue at that time. The trade date is the date the underwriter purchases the securities from the issuer (when the underwriting is performed on a firm commitment basis) or the date the underwriter sells the securities to third-party investors (when the underwriting is performed on a best-efforts basis).

#### ***Other considerations***

A “greenshoe option” or over-allotment option is a provision generally included in an underwriting agreement that gives the underwriter the right to sell more shares than originally planned by the issuer to react to demand in the market for the issuance that is greater than originally planned. Since a broker-dealer is not obligated to exercise the option, the over-allotment option is not considered a performance obligation until it is exercised. Upon exercise, the option would be accounted for as a contract modification because it changes the scope of the enforceable rights and obligations. The modification generally would be accounted for as a separate contract because it includes additional services that are distinct and are priced at their standalone selling price (i.e., the fees for underwriting the additional shares under the over-allotment option have the same per-share fee as the original underwriting services).

In addition to utilizing an over-allotment option, broker-dealers may buy and sell securities in the secondary market to stabilize the price for a period shortly after initial issuance of the securities. No additional shares are issued during these activities, so the purchases and sales of securities and resulting gains and losses are accounted for under ASC 860 and ASC 940, not ASC 606.

#### **Advisory services**

##### ***Identifying performance obligations in an advisory services contract***

Advisory services contracts for public and corporate finance activities (e.g., merger-and-acquisition, financial restructuring) may contain a variety of promised goods and services. For example, a broker-dealer engaged to assist a client in selling a business may promise the customer due diligence services, pre-transaction structuring advice, a fairness opinion and finding prospective buyers. A broker-dealer needs to determine whether each promised good or service is capable of being distinct and distinct in the context of the contract. For example, some due diligence services may be capable of being distinct, but they may not be distinct in the context of the contract because they are an input to the combined output of selling the business. In contrast, a fairness opinion may be both capable of being distinct and distinct within the context of the contract.

#### **How we see it**

Broker-dealers need to apply significant judgment to identify the performance obligations in an advisory services contract, and different conclusions may be reached based on the specific terms and conditions of the contract.

##### ***Applying the constraint to advisory services fees***

Many advisory services contracts contain variable consideration (e.g., a success fee). The amount of variable consideration a broker-dealer can include in the transaction price is limited to the amount for which it is probable that a significant reversal of cumulative revenue for the contract will not occur in future periods once the uncertainties related to the variability are resolved. At each reporting period, significant judgment will be required, and all facts and circumstances will need to be considered to determine whether it is probable that a significant revenue reversal will not occur.

Many success fees are contingent on the sale of a business or the announcement of a transaction and are calculated based on the sales price. This type of fee would have some of the characteristics listed in the standard as factors that increase the likelihood or magnitude of a

significant reversal of cumulative revenue for the contract. That is, the fee is highly susceptible to factors outside the entity's influence, the broker-dealer's experience with similar transactions has limited predictive value and there is a broad range of possible fee amounts. Because of the presence of these factors, a broker-dealer likely is unable to assert at contract inception that it is probable that a significant reversal of cumulative revenue for the contract will not occur if an estimate of the success fee were included in the transaction price. A broker-dealer needs to continually reassess whether the success fee should no longer be constrained at each reporting date.

#### ***Determining whether a performance obligation is satisfied over time or at a point in time***

Determining when control of an advisory services performance obligation transfers to the customer depends on the performance obligations identified in the contract. Certain services (e.g., financial advice on the structuring of a transaction that is identified as a separate performance obligation) may meet the criteria to be satisfied over time (see Step 5 in the Appendix) because the customer simultaneously receives and consumes the benefits of the service as the entity performs. Other services (e.g., assistance in selling the business, a fairness opinion) may not meet any of the criteria to be satisfied over time, so they are satisfied at a point in time.

Factors that may indicate that the customer does not simultaneously receive and consume the benefits of the service as the entity performs include the following:

- ▶ The nature of the promise made to the customer is predominantly to achieve a specified outcome (e.g., the sale or purchase of a business).
- ▶ The activities the broker-dealer performs do not produce benefits for the customer prior to the sale.
- ▶ The customer does not gain control of the knowledge obtained or produced by the broker-dealer.
- ▶ The amount of any nonrefundable fee is insignificant in relation to the overall amount of compensation the broker-dealer would receive upon completion of the transaction.

A broker-dealer should recognize the consideration allocated to the specific performance obligations when (or as) those performance obligations are satisfied. For example, in contracts where the only performance obligation identified is selling the business, which is satisfied at a point in time, the retainer fee (i.e., a nonrefundable up-front fee), announcement fee and success fee should not be recognized until the performance obligation has been satisfied (e.g., upon the close of the sale).

#### **Gross versus net reporting**

When other parties are involved in providing goods or services to a broker-dealer's customer, the broker-dealer needs to determine whether its performance obligation is to provide the good or service itself (i.e., the broker-dealer is a principal) or to arrange for another party to provide the good or service (i.e., the broker-dealer is an agent).

An entity is a principal if it controls a promised good or service before it transfers the good or service to a customer. To apply the principal versus agent guidance, an entity must first properly identify the specified good or service (or unit of accounting for the principal versus agent evaluation) to be provided to the customer. A specified good or service is defined as each distinct good or service (or distinct bundle of goods or services) to be provided to the customer. The FASB included this guidance to clarify that in a contract with a customer that includes more than one specified good or service, an entity may be a principal for some specified goods or services and an agent for others.

Two common areas where a broker-dealer needs to make a principal versus agent determination are securities underwriting and expense reimbursements.

#### **Securities underwriting**

A lead underwriter needs to determine whether it should present underwriting revenues gross (acting as a principal) or net (acting as an agent) of amounts allocated to the other syndicate members. In making this determination, a lead underwriter needs to evaluate whether it controls the underwriting service performed by the other syndicate members before it is transferred to the customer.

Indicators that an entity controls the specified good or service before it is transferred to the customer, along with the relevant facts for a lead underwriter, are as follows:

- ▶ *The entity is primarily responsible for fulfilling the promise to provide the specified good or service.* Syndicate members named in the underwriting agreement, for whom the lead underwriter is acting as a representative, are severally obligated to purchase the offered securities for their own accounts (in a firm commitment) or sell the offered securities to investors (in a best-efforts arrangement). The lead underwriter is not primarily responsible for their services.
- ▶ *The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer.* The lead underwriter does not have inventory risk because it does not purchase or commit to purchase the services of the syndicate members before obtaining the contract with the issuer.
- ▶ *The entity has discretion in establishing the price for the specified good or service.* The lead underwriter, as manager and representative of the syndicate group, negotiates the terms and conditions of the deal economics with the issuer. However, determination of the underwriting spread is largely based on industry convention and market conditions. The syndicate agreement separately details how the underwriting spread will be allocated among the syndicate members based on roles and responsibilities.

**Underwriters generally present underwriting revenues net of amounts allocated to other syndicate members.**

This analysis generally supports a conclusion that the lead underwriter is acting as an agent of the syndicate group, and therefore, the lead underwriter would present underwriting revenues net of amounts allocated to the other syndicate members (i.e., report only its portion of the underwriting spread).

An underwriter (whether it is the lead underwriter or a syndicate member) also needs to determine whether it should present underwriting revenues gross or net of related expenses (e.g., legal fees, travel, marketing). In order to make this determination, the broker-dealer must first identify the specified good or service, which is typically the underwriting service.

ASC 606-10-55-37A states that a principal obtains control of a good or service from another party that it then combines with other goods or services in providing the specified good or service to the customer. An underwriter generally uses the good or service (e.g., legal advice) as an input to the overall underwriting service, so the underwriter controls that good or service because it combines the good or service with other services to provide underwriting to the customer. In addition, consider the following analysis of the indicators that an entity controls the specified good or service before it is transferred to the customer:

- ▶ *The entity is primarily responsible for fulfilling the promise to provide the specified good or service.* The underwriter is responsible for providing the underwriting service. Vendors (e.g., attorneys) of the underwriter may contribute to the service, but they are not responsible to the customer.

- ▶ *The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer.* The underwriter has inventory risk because it purchases the services of the vendors before obtaining the contract with the issuer.
- ▶ *The entity has discretion in establishing the price for the specified good or service.* Although the underwriting spread is largely based on industry convention and market conditions, pricing is ultimately established by the underwriter. The broker-dealer's vendors have no discretion in establishing the price for the underwriting service.

This analysis generally supports a conclusion that the underwriter (whether it is the lead underwriter or a syndicate member) is the principal for the underwriting service. As a result, the underwriter would present its proportionate share of underwriting revenues and underwriting expenses on a gross basis, and the lead underwriter should not recognize expenses attributable to participating underwriters because these costs are legally the responsibility of the participating underwriters.

#### ***Expense reimbursements of costs of an advisory services contract***

A broker-dealer needs to determine whether it should present reimbursements received for costs incurred in revenue gross or net of the related expenses, and this determination is made at the level of the specified good or service identified in the contract. Direct reimbursement of expenses generally represents additional transaction price in the contract to provide advisory services rather than consideration for a separate performance obligation. A broker-dealer generally uses the good or service (e.g., travel, legal service) as an input to the distinct advisory service(s), so the broker-dealer controls that good or service because it combines the third party services with other services to provide advisory services to the customer. In addition, consider the following analysis of the indicators that an entity controls the specified good or service before it is transferred to the customer:

- ▶ *The entity is primarily responsible for fulfilling the promise to provide the specified good or service.* The broker-dealer is responsible for providing the advisory services. Vendors of the broker-dealer may contribute to the overall service, but they are not responsible for providing the service to the customer.
- ▶ *The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer.* The broker-dealer has inventory risk because it purchases the services of the vendors before the overall advisory services are transferred to the customer.
- ▶ *The entity has discretion in establishing the price for the specified good or service.* The broker-dealer determines the price of the advisory services and whether it is reimbursed for its out-of-pocket expenses. Vendors have no discretion in establishing the price for the advisory services.

This analysis generally supports a conclusion that the broker-dealer is the principal for the advisory services. As a result, we generally believe that broker-dealers should present revenue gross for reimbursements received for costs incurred under the standard.

#### **Contract costs**

##### ***Costs to obtain a contract***

Under ASC 340-40,<sup>11</sup> incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. For broker-dealers, sales commissions paid to employees or third parties that are related to obtaining a customer contract may require capitalization if an entity does not apply the practical expedient described in the Appendix. This may result in a change in practice for broker-dealers that currently expense these costs as incurred.

In contrast, some incentive payments such as bonuses and other compensation that are based on quantitative or qualitative metrics not related to contracts obtained (e.g., profitability, earnings per share, performance evaluations) likely do not meet the criteria for capitalization because they are not incremental costs of obtaining a contract. Due diligence and other legal expenses incurred before a contract is obtained also likely will not qualify as incremental costs to be capitalized because they would be incurred even if the contract was not obtained.

Any capitalized costs to obtain a contract are amortized on a systematic basis that is consistent with the transfer of the related goods or services (including goods or services provided under a specifically anticipated contract) to the customer.

### How we see it

The requirement to capitalize certain costs of obtaining a contract with a customer could change practice for some entities. Commissions paid for obtaining a new contract or customer, for example, may need to be capitalized, amortized and reviewed regularly for impairment. Entities recording such capitalized costs should also evaluate the regulatory net capital implications.

#### *Costs to fulfill a contract*

Sales commissions paid to employees that are directly related to obtaining a customer contract may require capitalization.

Entities should follow the guidance on costs incurred in fulfilling a contract with a customer that are within the scope of another ASC topic (e.g., ASC 350-40 on internal-use software, ASC 360 on property, plant and equipment). If no specific guidance is provided in another ASC topic, the standard requires an entity to recognize an asset for the costs incurred to fulfill a contract only if those costs meet certain criteria (see Contract costs in the Appendix). The standard also states that costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (i.e., costs that relate to past performance) are expensed as incurred.

A broker-dealer needs to evaluate whether costs incurred while providing advisory services (e.g., travel, meals) and other general fulfillment costs (e.g., salaries paid to employees) meet the capitalization criteria for costs to fulfill a contract. This determination depends on the distinct services identified as part of an advisory services contract (see Advisory services section above). For example, if the broker-dealer provides advisory services over time, the costs likely will not generate or enhance resources of the entity that will be used in satisfying performance obligations in the future because the services are concurrently being performed. If the broker-dealer identifies its performance obligation as selling the customer's business, costs incurred prior to selling the business may be capitalized if they generate or enhance resources of the broker-dealer that will be used in selling the customer's business. However, a broker-dealer also needs to evaluate whether these costs are expected to be recovered even if the business is not sold (e.g., through direct reimbursement or indirectly through the profit margin inherent in the contract from the fees that are not contingent on the sale of the business).

Any capitalized costs to fulfill a contract should be amortized, with the expense recognized as an entity transfers the related goods or services to the customer.

#### *Underwriting expenses*

Underwriting expenses include marketing and advertising fees, legal fees and other costs associated with setting up the syndicate group. ASC 940-340-25-3 specifies that underwriting expenses incurred before the issuance of the securities should be deferred.

**Endnotes:**

<sup>1</sup> Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, as amended, was created by Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, and various amendments.

<sup>2</sup> ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*.

<sup>3</sup> ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.

<sup>4</sup> Financial instruments and other contractual rights or obligations within the scope of the following topics are outside the scope of ASC 606: ASC 310, *Receivables*; ASC 320, *Investments – Debt and Equity Securities*; ASC 323, *Investments – Equity Method and Joint Ventures*; ASC 325, *Investments – Other*; ASC 405, *Liabilities*; ASC 470, *Debt*; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*.

<sup>5</sup> See TRG agenda paper no. 48 for further discussion of how to determine whether a contract contains an optional purchase or variable consideration.

<sup>6</sup> ASC 606-10-55-43.

<sup>7</sup> 18 April 2016 FASB TRG meeting; agenda paper no. 54.

<sup>8</sup> ASC 606-10-55-45.

<sup>9</sup> ASC 606-10-55-30.

<sup>10</sup> ASC 940-20-25-3.

<sup>11</sup> ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*, was created by ASU 2014-09.

## Appendix: The five-step revenue model and contract costs

The standard's core principle is that an entity recognizes revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. That principle is applied using five steps that require entities to exercise judgment when considering the terms of their contract(s) and all relevant facts and circumstances. Entities have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. This table summarizes the new revenue model and the guidance for contract costs.

### Step 1: Identify the contract(s) with the customer

#### *Definition of a contract*

An entity must first identify the contract, or contracts, to provide goods and services to customers. A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices but must meet the following criteria:

- ▶ The parties to the contract have approved the contract (in writing, orally or based on their 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 (i.e., 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

If these criteria are not met, an entity would not account for the arrangement using the model in the standard and would recognize any nonrefundable consideration received as revenue only when certain events have occurred.

#### *Contract combination*

The standard requires entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if they meet any of the following criteria:

- ▶ 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 another contract
- ▶ The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation

#### *Contract modifications*

A contract modification is a change in the scope and/or price of a contract. A contract modification is accounted for as a new contract separate from the original contract if the modification adds distinct goods or services at a price that reflects the standalone selling prices of those goods or services. Contract modifications that are not accounted for as separate contracts are considered changes to the original contract and are accounted for as follows:

- ▶ If the goods and services to be transferred after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract
- ▶ If the goods and services to be transferred after the contract modification are not distinct from the goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract
- ▶ A combination of the two approaches above: a modification of the existing contract for the partially satisfied performance obligations and the creation of a new contract for the distinct goods and services

## Step 2: Identify the performance obligation(s) in the contract

An entity must identify the promised goods and services within the contract and determine which of those goods and services (or bundles of goods and services) are separate performance obligations (i.e., the unit of accounting for purposes of applying the standard). An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract.

A promised good or service represents a performance obligation if (1) the good or service is distinct (by itself or as part of a bundle of goods or services) or (2) the good or service is part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

A good or service (or bundle of goods or services) is distinct if both of the following criteria are met:

- ▶ 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 (i.e., 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 in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract)

In assessing whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract, entities need to consider whether the nature of the promise is to transfer each of those goods or services individually or to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate two or more promises to transfer goods or services are not separately identifiable include, but are not limited to, the following:

- ▶ The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted
- ▶ One or more of the goods or services significantly modify or customize, or are significantly modified or customized by, one or more of the other goods or services promised in the contract
- ▶ The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract
- ▶ If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.

### ***Series guidance***

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer must be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must represent a performance obligation that would be satisfied over time and would have the same measure of progress toward satisfaction of the performance obligation (both discussed in Step 5), if accounted for separately.

### ***Customer options for additional goods or services***

A customer's option to acquire additional goods or services (e.g., an option for free or discounted goods or services) is accounted for as a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

### ***Principal versus agent considerations***

When more than one party is involved in providing goods or services to a customer, an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls the specified good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its

role is to arrange for another entity to provide the specified goods or services. Because it is not always clear whether an entity controls a specified good or service in some contracts (e.g., those involving intangible goods and/or services), the standard also provides indicators of when an entity may control the specified good or service as follows:

- ▶ The entity is primarily responsible for fulfilling the promise to provide the specified good or service
- ▶ The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (e.g., if the customer has a right of return)
- ▶ The entity has discretion in establishing the price for the specified good or service

### Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. When determining the transaction price, entities need to consider the effects of all of the following:

#### *Variable consideration*

An entity needs to estimate any variable consideration (e.g., amounts that vary due to discounts, rebates, refunds, price concessions, bonuses) using either the expected value method (i.e., a probability-weighted amount method) or the most likely amount method (i.e., a method to choose the single most likely amount in a range of possible amounts). An entity's method selection is not a "free choice" and must be based on which method better predicts the amount of consideration to which the entity will be entitled. To include variable consideration in the estimated transaction price, the entity has to conclude that it is probable that a significant revenue reversal will not occur in future periods. This "constraint" on variable consideration is based on the probability of a reversal of an amount that is significant relative to cumulative revenue recognized for the contract. The standard provides factors that increase the likelihood or magnitude of a revenue reversal, including the following: the amount of consideration is highly susceptible to factors outside the entity's influence, the entity's experience with similar types of contracts is limited or that experience has limited predictive value, or the contract has a large number and broad range of possible outcomes. The standard requires an entity to estimate variable consideration, including the application of the constraint, at contract inception and update that estimate at each reporting date.

#### *Significant financing component*

An entity needs to adjust the transaction price for the effects of the time value of money if the timing of payments agreed to by the parties to the contract provides the customer or the entity with a significant financing benefit. As a practical expedient, an entity can elect not to adjust the transaction price for the effects of a significant financing component if the entity expects at contract inception that the period between payment and performance will be one year or less.

#### *Noncash consideration*

When an entity receives, or expects to receive, noncash consideration (e.g., property, plant or equipment, a financial instrument), the fair value of the noncash consideration at contract inception is included in the transaction price.

#### *Consideration paid or payable to the customer*

Consideration payable to the customer includes cash amounts that an entity pays, or expects to pay, to the customer, credits or other items (vouchers or coupons) that can be applied against amounts owed to the entity or equity instruments granted in conjunction with selling goods or services. An entity should account for consideration paid or payable to the customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service. However, if the payment to the customer exceeds the fair value of the distinct good or service received, the entity should account for the excess amount as a reduction of the transaction price.

#### Step 4: Allocate the transaction price to the performance obligations in the contract

For contracts that have multiple performance obligations, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). When allocating on a relative standalone selling price basis, any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract. However, there are two exceptions.

One exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or 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, if 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
- ▶ Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the objective of allocating consideration in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer
- ▶ The other exception requires an entity to allocate a contract's entire discount to only those goods or services to which it relates if certain criteria are met.

To allocate the transaction price on a relative standalone selling price basis, an entity must first determine the standalone selling price of the distinct good or service underlying each performance obligation. The standalone selling price is the price at which an entity would sell a good or service on a standalone (or separate) basis at contract inception. Under the model, the observable price of a good or service sold separately in similar circumstances to similar customers provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity must estimate the standalone selling price by considering all information that is reasonably available to it, maximizing the use of observable inputs and applying estimation methods consistently in similar circumstances. The standard states that suitable estimation methods include, but are not limited to, an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach (if certain conditions are met).

#### Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

An entity recognizes revenue only when (or as) it satisfies a performance obligation by transferring control of the promised good(s) or service(s) to a customer. The transfer of control can occur over time or at a point in time.

A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time:

- ▶ The customer simultaneously 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
- ▶ 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

The transaction price allocated to performance obligations satisfied at a point in time is recognized as revenue when control of the goods or services transfers to the customer. If the performance obligation is satisfied over time, the transaction price allocated to that performance obligation is recognized as revenue as the performance obligation is satisfied. To do this, the standard requires an entity to select a single revenue recognition method (i.e., measure of progress) that faithfully depicts the pattern of the transfer of control over time (i.e., an input method or an output method).

## Licenses of intellectual property

The standard provides guidance on the recognition of revenue for licenses of intellectual property (IP) that differs from the model for other promised goods and services. The nature of the promise in granting a license of IP to a customer is either:

- ▶ A right to access the entity's IP throughout the license period (a right to access)
- ▶ A right to use the entity's IP as it exists at the point in time in which the license is granted (a right to use)

To determine whether the entity's promise is to provide a right to access its IP or a right to use its IP, the entity should consider the nature of the IP to which the customer will have rights. The standard requires entities to classify IP in one of two categories:

- ▶ Functional: This IP has significant standalone functionality (e.g., many types of software, completed media content such as films, television shows and music). Licenses of functional IP generally grant a right to use the entity's IP, and revenue for these licenses generally is recognized at the point in time when the IP is made available for the customer's use and benefit. This is the case if the functionality is not expected to change substantially as a result of the licensor's ongoing activities that do not transfer an additional promised good or service to the customer. If the functionality of the IP is expected to substantively change because of activities of the licensor that do not transfer additional promised goods or services, and the customer is contractually or practically required to use the latest version of the IP, revenue for the license is recognized over time. However, we expect licenses of functional IP to meet the criteria to be recognized over time infrequently, if at all.
- ▶ Symbolic: This IP does not have significant standalone functionality (e.g., brands, team and trade names, character images). The utility (i.e., the ability to provide benefit or value) of symbolic IP is largely derived from the licensor's ongoing or past activities (e.g., activities that support the value of character images). Licenses of symbolic IP grant a right to access an entity's IP, and revenue from these licenses is recognized over time as the performance obligation is satisfied (e.g., over the license period).

Revenue cannot be recognized from a license of IP before both (1) an entity provides (or otherwise makes available) a copy of the IP to the customer and (2) the beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the IP.

The standard specifies that sales and usage-based royalties on licenses of IP are recognized when the later of the following events occurs: (1) the subsequent sales or usage occurs or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). This guidance must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP (i.e., these types of arrangements are either entirely in the scope of this guidance or entirely in the scope of the general variable consideration constraint guidance).

## Contract costs

ASC 340-40, *Other Assets and Deferred Costs - Contracts with Customers*, specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers. The incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. ASC 340-40 cites commissions as a type of incremental costs that may require capitalization. The standard provides a practical expedient that permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less.

An entity accounts for costs incurred to fulfill a contract with a customer that are within the scope of other authoritative guidance (e.g., inventory, property, plant and equipment, internal-use software) in accordance with that guidance. If the costs are not in the scope of other accounting guidance, an entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- ▶ The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify
- ▶ The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future
- ▶ The costs are expected to be recovered

Any capitalized contract costs are amortized, with the expense recognized as an entity transfers the related goods or services to the customer. Any asset recorded by the entity is subject to an impairment assessment.