

Technical Line

FASB – final guidance

How the revenue recognition standard affects downstream oil and gas entities

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What you need to know

- ▶ Downstream oil and gas entities need to apply judgment when accounting for commodity sales contracts.
- ▶ Downstream entities with retail operations may need to consider the effects of brand licensing and franchise arrangements to identify performance obligations included in contracts with customers.

Overview

When applying the revenue recognition standard,¹ entities in the downstream oil and gas industry need to make judgments and estimates, such as identifying performance obligations.

This publication, which contains a summary of the standard in the appendix, highlights key aspects of applying the standard to a downstream oil and gas entity's contracts with its customers. It supplements our Financial reporting developments (FRD) publication, *Revenue from contracts with customers (ASC 606)*, and should be read in conjunction with it.

Scope and scope exceptions

Exchange agreements

The standard does not apply to nonmonetary exchanges between entities in the same line of business that are made to facilitate sales to customers other than the parties in the exchange. These types of transactions are common for downstream entities with refining or retail operations. For example, downstream entities often engage in buy/sell arrangements, which involve

purchases and sales of inventory with the same counterparty that may be treated as a single exchange transaction. Generally, entities follow the guidance in Accounting Standards Codification (ASC) 845, *Nonmonetary Transactions*, to account for these exchanges.

However, downstream entities must evaluate the nature of the inventory exchanged to determine whether these arrangements are in the scope of ASC 606. For example:

- ▶ If an entity gives up an equivalent type of inventory for what it receives (e.g., crude oil exchanged for crude oil, refined products exchanged for refined products), the transaction is a nonmonetary transaction that is accounted for under ASC 845 and is recognized at the carrying amount of the inventory.
- ▶ If an entity gives up finished goods in exchange for the receipt of raw materials (e.g., refined products exchanged for crude oil), ASC 845 states that the transaction is not an exchange transaction to facilitate sales to customers for the entity transferring the finished goods and, therefore, is in the scope of ASC 606. However, if the entity gives up raw materials or work in process for a finished good (e.g., crude oil exchanged for gasoline), the exchange generally would be considered a transaction to facilitate sales to customers and would be recognized at the carrying amount of the inventory.

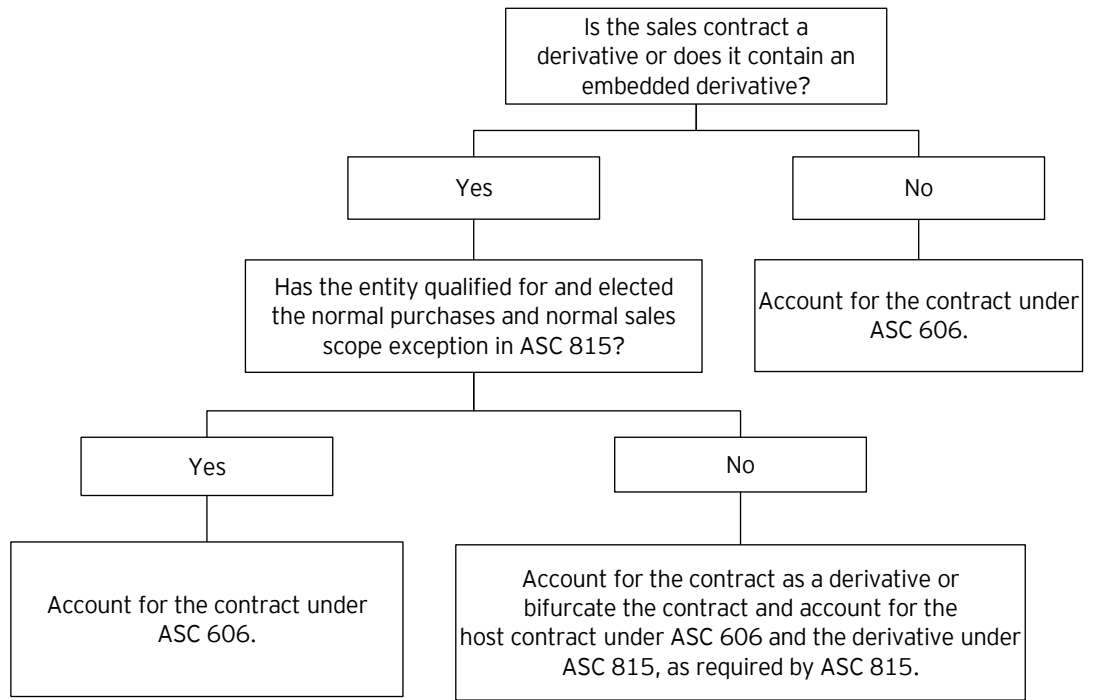
Downstream entities that exchange inventory must evaluate the nature of that inventory to determine whether an arrangement is in the scope of the standard.

Commodity sales contracts

Downstream entities typically sell crude oil and refined products to customers through either retail or wholesale agreements. The considerations below apply to both distribution channels.

Identifying the contract with the customer (Step 1)

Commodity sales contracts may meet the definition of a derivative or may contain embedded derivatives that may require bifurcation from the host contract with the customer. For example, derivatives may be embedded in fixed-price contracts or those in which the price is determined based on the location where the customer obtains control of the commodity. The decision tree below summarizes the accounting treatment for sales contracts with customers that may be a derivative or may contain an embedded derivative:



In many cases, each unit of a commodity is a separate performance obligation.

How we see it

The use of the normal purchases and normal sales exception under ASC 815, *Derivatives and Hedging*, affects an entity's scoping of ASC 606. For example, if entities have not qualified for and elected the normal purchases and normal sales exception for certain derivatives (e.g., long-term contracts for the sale to a customer of a specified quantity of product at each month-end spot price), these contracts (or portions of contracts) are outside the scope of ASC 606. This is important because an entity is required to present revenues accounted for under ASC 606 separately from other revenue activities (see the *Disclosure requirements* section below).

Determining the number and nature of performance obligations (Step 2)

An entity must identify the promised goods and services within the contract and determine which of those goods and services are distinct and, therefore, separate performance obligations. Because the standard requires entities to allocate the transaction price to performance obligations, identifying the correct performance obligation (i.e., the unit of accounting) is fundamental to recognizing revenue as the obligation is satisfied.

Downstream entities typically determine that, for each of their sales contracts, each barrel of oil or thousand cubic feet (Mcf) of natural gas is distinct because it could be sold separately and is not dependent on or highly interrelated with the other barrels or Mcf. The standard then requires entities to evaluate whether the units 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. If they are, the units are accounted for as a single performance obligation under the series guidance. An entity's determination of whether a sales contract to deliver a commodity contains a single performance obligation for a series of distinct units or multiple performance obligations for each unit affects how it applies the rest of the revenue model.

In assessing whether each unit has the same pattern of transfer, an entity must determine whether each distinct unit meets the criteria to be recognized over time and has the same measure of progress. One of the over-time criteria that downstream entities need to consider for these types of contracts is whether the customer simultaneously receives and consumes the benefits provided by the entity's performance as it transfers control of each barrel or Mcf to the customer (i.e., whether each of the distinct units meets the criteria to be recognized over time). This over-time criterion would not apply if the entity's performance creates an asset that the customer does not immediately consume upon transfer (e.g., the customer holds an inventory of oil).² Generally, downstream commodity contracts will have the same measure of progress.

A downstream entity should consider all facts and circumstances when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity.³ These facts and circumstances may include the characteristics of the commodity (e.g., whether it can be stored), the contract terms (e.g., whether the entity provides a continuous supply to meet immediate demand) and information about the delivery mechanisms and other infrastructure. The following illustrates how a downstream entity might evaluate performance obligations in a commodity sales contract:

Illustration 1: Sale of refined petroleum products to a customer who will store the product prior to usage

A downstream entity enters into a contract to sell 1,000 gallons of refined petroleum products to a customer that will store the product in its own tanks prior to usage. Because the customer will not consume the benefits of the commodity immediately upon receipt, the gallons of refined petroleum product being transferred would not meet the criteria to be accounted for as a single performance obligation under the series guidance. Therefore, each gallon of refined petroleum product would be considered a separate performance obligation under the contract.

Illustration 2: Sale of natural gas to a utility for use in a natural gas power plant

A downstream entity enters into a contract to supply a utility customer with natural gas for immediate consumption in a natural gas power plant. The customer will immediately receive and consume the benefits of this commodity. Therefore, the units of natural gas being transferred would meet the over-time criterion and have the same measure of progress and would be accounted for under the series guidance as a single performance obligation (assuming the other series guidance criteria have been met).

How we see it

We believe that contracts for the sale of oil usually contain multiple performance obligations because the customer typically does not simultaneously receive and consume the transferred oil and related refined products. However, entities need to evaluate the facts and circumstances of all sales contracts to determine whether the contract contains a single performance obligation or multiple performance obligations.

Pricing considerations (Steps 3, 4 and 5)***Fixed pricing***

If an entity determines that a fixed-price commodity contract is in the scope of the revenue standard (i.e., the contract is not a derivative, the contract is a derivative but the entity has elected to apply the normal purchases and normal sales exception, or the contract includes an embedded derivative but the entity has bifurcated the host contract from the derivative), the entity will need to determine the standalone selling price of each performance obligation to allocate the transaction price to the performance obligations in the contract.

The standard states that the standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. Entities should consider all information (including market conditions, entity-specific factors and information about the customer or class of customer) that is reasonably available to estimate the standalone selling price for each performance obligation. An entity must estimate that price if it doesn't have an observable price at which it sells the good or service separately in similar circumstances to similar customers.

When establishing pricing in fixed-price contracts, entities often consider depletion and lifting costs (as well as other operating costs) and often price these contracts with a goal of protecting margins on the sales throughout the course of the contract without regard to fluctuations in forward index curves. As such, the forward index curve is not generally a key input used by entities in pricing multi-period fixed-price commodity contracts. If the forward index curve is not a key input to price these contracts, we do not believe it would be necessary to use the forward index curve to determine the standalone selling price of each commodity that will be transferred in a multi-period fixed-price commodity contract as the forward index curve would not represent an observable price pursuant to ASC 606 (i.e., price of a good or service when the entity sells the good or service separately in similar circumstances and to similar customers). In such cases, the entity will need to determine whether the contracted price is representative of the standalone selling price of the commodity. This assessment will be particularly important when the fixed price varies over the contract term (e.g., there is a fixed rate per unit that decreases each period but is applied to a consistent volume).

How we see it

Downstream entities need to evaluate if the contracted price is representative of the standalone selling price of the commodity.

Market or index-based pricing (assuming the contract does not also include a lease)

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. Variable consideration is included in the transaction price. The standard requires an entity to estimate the amount of variable consideration to which it expects to be entitled and apply a constraint (see description of Step 3 in the appendix). For a commodity contract that uses market- or index-based pricing, an entity needs to estimate and include in the transaction price the amount of variable consideration for which it is probable that a significant reversal in the cumulative amount of revenues recognized for the contract will not occur when the uncertainty related to the market- or index-based pricing is resolved. That is, an entity includes in the transaction price variable consideration to the extent it determines that it is probable that a significant revenue reversal will not occur for the contract.

The standard provides an allocation exception (see the description of Step 4 in the appendix) that allows an entity to allocate variable consideration (e.g., the market price) to one or more (but not all) performance obligations (i.e., the distinct commodities transferred in that period) if certain criteria are met, instead of using the relative standalone selling price method (see the description of Step 4 in the appendix). Entities that qualify for this exception must apply it regardless of whether they determine that each barrel of oil or Mcf of gas is a separate performance obligation or part of a series of distinct goods or services that represent a single performance obligation. Most common commodity sales contracts with market- or index-based pricing terms satisfy the criteria for this allocation exception because the variable consideration relates specifically to an entity's efforts to transfer the distinct commodity units. Under the allocation exception, the downstream entity recognizes revenue in the period that control of the commodity (i.e., the distinct good or service) is transferred to the customer.

Volume discounts

Downstream entities may provide incentives to their customers through volume rebates or discounts. These rebates and discounts can take different forms, including tiered pricing (e.g., discounted pricing on purchases over a certain volume level). A volume rebate or discount that is applied retrospectively (i.e., the price of previously delivered products will be adjusted, often through the issuance of a credit) will be accounted for as variable consideration. This is because the final price of each good or service sold depends on the customer's total purchases subject to the rebate program. That is, the consideration is contingent upon the occurrence or nonoccurrence of future events. This view is consistent with Example 24⁴ in the standard.

Alternatively, volume rebates or discounts that are applied prospectively would generally be accounted for as a customer option (not variable consideration). This is because the consideration for the goods or services in the present contract is not contingent upon or affected by any future purchases. Rather, the discounts available from the rebate program affect the price of future purchases. Once an entity determines whether the rebates or discounts should be accounted for as an optional purchase or variable consideration, it would need to account for each as follows:

Optional purchase

If the volume rebate or discounts are deemed optional purchases, the entity must evaluate if these optional purchases represent material rights. A material right provides the customer with an option to purchase goods or services in the future at a discount (and is therefore accounted for as a performance obligation). The purpose of the material rights guidance is to identify and account for options that customers are paying for (often implicitly) as part of the current transaction. In making this evaluation, an entity should first evaluate whether the option is independent of the existing contract.⁵ That is, the entity must determine whether it would offer the same pricing to a similar high-volume customer with which it doesn't have a prior contract. If it would, the option to purchase future amounts is not a material right

If the customer can make up the deficiency quantities in future periods, the downstream entity has performance obligations to deliver those volumes at the customer's request.

because it provides a discount that doesn't exceed the discount typically offered to a similar high-volume customer. If the entity would typically charge a higher price to a similar customer, that indicates that the option is a material right because it offers a discount the customer wouldn't otherwise receive. If the option is determined to be a material right, it should be accounted for as a separate performance obligation under the contract. Alternatively, if the option is not a material right, it is considered a marketing offering and no consideration should be allocated to it. That is, there would be no accounting for the optional purchase until it is exercised by the customer.

Variable consideration

If an entity determines that a volume rebate or discount should be accounted for as variable consideration, subject to the constraint, it must be estimated at contract inception and allocated to each performance obligation.

The standard provides an allocation exception that requires variable consideration (e.g., the tiered price) to be allocated to one or more (but not all) performance obligations (i.e., the distinct commodities transferred in that period) if certain criteria are met. Entities that provide tiered pricing in their contracts need to consider whether these contracts meet the criteria for the allocation exception (see Step 4 in the appendix), including whether the variable consideration relates specifically to their efforts to transfer the commodity units and whether allocating the variable amount entirely to the individual performance obligations is consistent with the allocation objective.

How we see it

Downstream entities need to carefully assess whether volume-based tiered pricing in a sales agreement provides a material right that should be accounted for as a separate performance obligation.

Recognition (Step 5)

Take-or-pay or minimum volume commitments

Commodity sales contracts can be structured as more complex take-or-pay or minimum volume contracts, which specify minimum product quantities a customer will pay for even if it chooses not to receive them. Product quantities that a customer elects not to take in the specified delivery period are referred to in the oil and gas industry as "deficiency quantities." Some contracts prohibit customers from making up deficiency quantities in subsequent periods, while other contracts permit this practice.

- **Makeup period prohibited** – If a customer cannot make up deficiency quantities in future periods, the entity fulfills its performance obligations and recognizes revenue for the contractually specified quantities as each delivery period expires. At inception, and at each subsequent reporting period, an entity must determine if it expects the customer to take the minimum volume. If the downstream entity expects the customer to make up all deficiencies (i.e., they expect the customer to take the minimum volume), the entity would recognize revenue as the product is transferred. Alternatively, if the downstream entity expects that there will be any deficiency quantities that the customer cannot or will not make up, it will apply a breakage model (see below).
- **Makeup period permitted** – Many take-or-pay agreements or minimum volume contracts contain deficiency makeup periods that permit customers to acquire the commodity in a future period and make up contractually specified quantities of the commodity that they paid for but did not choose to receive in a prior period. If the customer can make up the deficiency quantities in future periods, the downstream entity has performance obligations to deliver those volumes at the customer's request (subject to contractual and capacity constraints). At inception and at subsequent reporting periods, the downstream entity must estimate if it expects that there will be deficiencies that the customer will or will not make up. If the

entity expects the customer will make up all deficiencies it is contractually entitled to, any consideration received relating to temporary deficiencies that will be made up in a future period will be deferred and the entity will recognize that amount when either of the following occurs:

- The customer makes up the volumes.
- The likelihood that the customer will exercise its right for deficiency volumes becomes remote (e.g., there is insufficient capacity to make up the volumes, the makeup period expires).

Alternatively, if the entity expects the customer will not make up all deficient volumes, the downstream entity will apply the breakage model described below.

In both of the cases described above, a downstream entity may collect nonrefundable payments from its customers for products that the customer has a right to receive in the future. However, the customer may ultimately leave that right unexercised (often referred to as breakage). If an entity expects to be entitled to breakage, the entity should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. In estimating any breakage amount, an entity has to consider the constraint on variable consideration. That is, if it is probable that a significant revenue reversal would occur for any estimated breakage amounts, an entity should not recognize those amounts until the breakage amounts are no longer constrained. If an entity does not expect to be entitled to a breakage amount, it should not recognize any breakage amounts as revenue until the likelihood of the customer exercising its rights becomes remote. The entity should routinely refine and evaluate estimates of breakage.

When determining the transaction price, the entity may need to evaluate whether the contract contains a significant financing component because of the timing difference between when it receives the consideration and when it transfers control of the goods to the customer. However, timing differences between the receipt of consideration and transfer of control of the goods that are due solely to the customer's deficiency quantities and the related makeup period likely will not give rise to a financing component. That is because the timing of the transfer of the commodity is at the discretion of the customer. The difference may be attributable to other causes, such as providing a customer assurance that the entity will complete its obligation under the contract, and the entity will need to apply judgment to determine whether a significant financing component exists.

Downstream operations

Downstream entities have three types of involvement with retail gas sales:

- (1) Dealer-owned, dealer-operated (DODO) stores – Stores are owned and operated by a third party. Transactions with these parties are considered wholesale arrangements.
- (2) Company-owned, company-operated (COCO) stores – Stores are owned and operated by the downstream entity.
- (3) Company-owned, dealer-operated (CODO) stores – Stores are owned by the downstream entity, but the downstream entity pays a dealer to operate the location.

In both company-owned operations (i.e., COCO and CODO), the downstream entity recognizes revenue at the point of sale to the end customer (i.e., at the pump) and both COCO and CODO operations are considered retail arrangements.

Branded fuel arrangements

Refiners or other suppliers often sell branded fuels to DODO retail gas stations (i.e., third-party customers of the downstream entity) that in turn sell them to the end user.

In some branded fuel arrangements for DODO operations, the downstream entity charges the dealer an annual fee for the right to use the brand and the right (and obligation) to use the entity's proprietary formula to create fuel (e.g., gasoline plus specified additives) that is marketed as "branded fuel." This type of arrangement typically involves two licenses of intellectual property (IP): (1) a license of IP for the right to access the brand and (2) a license of IP for the right to use the formula. The downstream entity needs to evaluate whether the two licenses of IP are distinct from each other or are a combined performance obligation to appropriately recognize revenue when (or as) the entity satisfies its performance obligation to the customer. Entities would follow the guidance in the standard for licenses to account for these transactions (see section below).

In other branded fuel arrangements, the downstream entity and the dealer enter into an exclusivity arrangement under which the entity provides the right to display its brand marks in exchange for the dealer's agreement to buy pre-formulated branded fuel only from the downstream entity. These arrangements generally do not set minimum purchase requirements. Instead, the entity and the dealer enter into separate contracts for the branded fuel. In this situation, there are several contracts: (1) the initial exclusivity agreement that conveys the right to access the brand marks and (2) each subsequent purchase of branded fuels. Entities must first determine if the exclusivity agreement and subsequent purchase of branded fuels should be accounted for separately or in combination. When making this evaluation, entities should consider the guidance in ASC 606-10-25-9, including if the contracts were entered into at or near the same time.

After assessing the requirement to combine contracts or analyze them separately, entities that determine combination is required must evaluate these combined contracts under ASC 606, including to identify the performance obligations and allocate transaction price between performance obligations. These performance obligations may include (1) the right to access the brand marks and (2) fuel purchases. Alternatively, if an entity determines that the contracts do not require combination, any consideration in the initial exclusivity agreement is allocated to the performance obligation to provide access to the brand IP and recognized over time, generally over the contract term, while each of the subsequent contracts is a sale of branded fuel, with separate performance obligations for each unit of the commodity (e.g., gallon of gasoline) recognized similar to the commodity sale contracts described above.

In either scenario, entities need to determine whether they include a customer option to purchase additional goods or services and, if so, whether that option should be considered a separate performance obligation. The option is a separate performance obligation only if it provides a material right 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 the class of customer in that geographical area or market.)

Licensing and franchise arrangements

Many downstream entities that engage in transactions with DODO retail operations grant licenses of IP to a third party (i.e., DODO store owners). Under such an arrangement, the downstream entity typically receives royalties in exchange for a license to use certain IP (e.g., trademarks, trade names, copyrights) in connection with the operation of a gas station under a franchise arrangement. Entities are required to classify IP as either functional or symbolic. Refer to the *Licenses of intellectual property* section in the appendix for the definition of functional and symbolic IP. Downstream entities commonly grant licenses of symbolic IP, such as a license to use an entity's trade name.

Sales- or usage-based royalties

Downstream entities commonly enter into arrangements that require the customer (i.e., DODO stores) to pay a sales- or usage-based royalty in exchange for the license of IP. Sales- or usage-based royalties received in exchange for licenses of IP are recognized at the later of when (1) the subsequent sale or usage occurs or (2) the performance obligation to which some or all of the sales- or usage-based royalty has been allocated is satisfied (in whole or in part). That is, an entity recognizes the royalties as revenue when (or as) the customer's subsequent sales occur, unless that recognition pattern accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty relates.

Estimating a sales- or usage-based royalty when there is a lag in reporting

Entities have questioned whether they can recognize revenue for sales- or usage-based royalties for licenses of IP on a lag if actual sales data is not available at the end of a reporting period. If the underlying sales or usage have occurred and the performance obligation to which the royalties relate has been satisfied (or partially satisfied), we believe that licensors without actual sales or usage data from the licensee need to make an estimate of royalties earned in the current reporting period.

The Chief Accountant of the Securities and Exchange Commission (SEC) noted in a speech⁶ that because the Financial Accounting Standards Board (FASB) did not provide "a lagged reporting exception" in the standard, the reporting of sales- and usage-based royalties may require estimation and should be supported by appropriate internal controls.

How we see it

Estimating royalties earned in the current reporting period by licensors without actual sales or usage data from the licensee requires significant judgment. Licensors without this data need to implement processes and controls to collect data and develop assumptions to make a reasonable estimate.

Nonrefundable minimum guarantees for symbolic licenses

Downstream symbolic license royalties are typically based on volume of purchases of refined product and commonly include minimum guarantees. The nonrefundable minimum guarantee (MG) effectively establishes a floor for the amount of consideration to be paid to the licensor. The MG is referred to in the industry as being "recouped against" sales-based royalties the licensor would have earned. The licensor earns additional sales-based royalties when the royalties exceed the nonrefundable MG. MGs may be negotiated for several reasons and may take different forms. For example, a contract might establish a minimum amount of consideration that is payable to the licensor in installments over the term of the license period, or the minimum amount of consideration could be paid at the beginning or end of the license period.

Contracts with a sales- or usage-based royalty and an MG include both fixed and variable consideration. Members of the Transition Resource Group (TRG) for revenue recognition generally agreed⁷ that various recognition approaches could be acceptable for nonrefundable MGs in licenses of symbolic IP, which require revenue to be recognized over time. The TRG agenda paper described two approaches. Under one, an entity would estimate the total consideration (i.e., the fixed minimum and the variable consideration from future royalties) and apply an appropriate measure of progress to recognize revenue as the entity satisfies the performance obligation, subject to the variable consideration constraint. Alternatively, an entity could apply a measure of progress to the fixed consideration and begin recognizing the variable component when the fixed amount is exceeded on a cumulative basis. The standard does not prescribe a single approach that must be applied in all circumstances in which a sales-based or usage-based royalty is promised in exchange for a license of IP and the contract includes a minimum guaranteed amount. An entity should disclose the accounting policy it selects because this would likely affect the amount and timing of revenue recognized.

An entity should disclose its accounting policy for recognizing revenue from franchise agreements.-Up-front fees in franchising and licensing arrangements

Downstream entities may receive fees up front when a DODO store opens and/or when they grant a new franchise or license term or extend the term of an existing franchise or licensing agreement. They also may receive ongoing royalties based on a percentage of sales. Under the standard, entities must evaluate whether up-front fees relate to the transfer of a promised good or service. These entities should determine whether the nonrefundable up-front fees are compensation for one or more of the following:

- An initial service (i.e., a performance obligation) that is satisfied at the onset of the arrangement
- Promises that are not distinct from the performance obligations satisfied throughout the life of the franchise or license agreement
- Activities that they must undertake to fulfill a contract (e.g., administrative, setup activities) and that do not transfer a good or service to a customer

The standard requires that the up-front fees be included in the transaction price and allocated to the performance obligations in the contract. That is, treatment of the nonrefundable up-front fees should be no different from any other consideration received by the entity as part of the arrangement.

Example 57 in the standard⁸ illustrates the accounting for a franchising arrangement with a nonrefundable up-front fee.

Loyalty and reward programs

Downstream entities engaged in COCO, CODO or DODO operations frequently offer loyalty or reward programs under which end customers accumulate points that they can redeem for “free” or discounted products or services. Under the standard, a loyalty or reward program is typically determined to provide a material right to customers that they would not receive without entering into a contract (see Step 2 in the appendix). A loyalty or reward program that is a material right should be identified as a performance obligation for purposes of revenue recognition.

Downstream entities are required to defer revenue for loyalty or reward programs that are a material right until the future good or service is provided (i.e., when the loyalty points are redeemed) or the option expires. Example 52 in the standard⁹ illustrates that an entity would update its estimate of how many points it expects to be redeemed at each reporting period.

Breakage for unused gift cards or loyalty points

Downstream entities engaged in COCO, CODO and DODO retail operations frequently sell gift cards that may not be redeemed or completely redeemed. Downstream entities may also issue loyalty or reward points that may not be redeemed or completely redeemed. When an entity expects to be entitled to a breakage amount, it should recognize breakage as revenue in proportion to the pattern of rights exercised by the customer. In estimating any breakage amount, an entity has to consider the constraint on variable consideration. That is, if it is probable that a significant revenue reversal would occur for any estimated breakage amounts, an entity should not recognize those amounts until the breakage amounts are no longer constrained. If an entity does not expect to be entitled to a breakage amount, it should not recognize any breakage amounts as revenue until the likelihood of the customer exercising its rights becomes remote.

Further, regardless of whether a downstream entity can demonstrate the ability to reliably estimate breakage, no such amounts should be estimated and recognized in income if the unused balances of gift cards are subject to the escheat or unclaimed property laws.

The guidance on breakage requires that an entity establish a liability for the full amount of the prepayment and recognize breakage on that liability as revenue proportionate to the pattern of rights exercised by the customer. If the prepayment element (e.g., the sale of a gift card) is one of multiple performance obligations identified in a contract, an allocation of the transaction price must be made between the identified performance obligations so the amount deferred as a contract liability may differ from the amount of prepayment received for the unsatisfied performance obligations. This is illustrated by Example 52 in the standard.¹⁰

Sales tax

Downstream entities (i.e., COCO and CODO) often collect sales tax from customers that they remit to the government. The standard includes a general principle that an entity should determine the transaction price, excluding amounts collected on behalf of third parties (e.g., some sales taxes). Entities would consider the principal versus agent guidance to determine whether amounts collected from customers for those taxes should be included in the transaction price. This could be a challenge for downstream entities that operate their own stores in numerous jurisdictions because the laws in some jurisdictions are unclear about which party to the transaction is primarily obligated to pay the taxes.

However, the standard¹¹ allows entities to make an accounting policy election to exclude from the transaction price certain types of taxes collected from customers (i.e., present revenue net of these taxes), including sales taxes, if they disclose that policy. This policy election says the scope includes “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)” but not taxes imposed on an entity’s gross receipts or the inventory procurement process.

If an entity elects to exclude sales taxes from the measurement of the transaction price, the entity would make that election for all taxes in the scope of the policy election.

Disclosure requirements

Downstream oil and gas entities are required to provide a comprehensive and coherent set of disclosures about revenue from contracts with customers. For public entities, these disclosures include disaggregated revenues, qualitative and quantitative information about contracts with customers and significant judgments made in applying the standard and costs to obtain or fulfill a contract. Nonpublic entities can choose to provide the same or streamlined disclosures.

Some of the specific disclosure requirements that may affect downstream oil and gas companies include:

- ▶ Entities have to present separately contracts with customers subject to the standard from other sources of revenue on the face of the financial statements or in the notes to the financial statements. This includes both the revenue amounts and the related receivables. For example, entities must separately disclose the revenues and related receivables from commodity sales contracts accounted for under the revenue standard and those accounted for as derivatives under ASC 815 (e.g., index-based contracts entities have not elected to treat as normal purchases and normal sales), even if amounts were generated under the same contract with the same counterparty.
- ▶ The standard requires a comprehensive set of disclosures about revenue from contracts with customers. Entities must evaluate whether separating different types of commodity sales contracts (e.g., by type of commodity, geographical region, type of contract) is appropriate to meet the disaggregation objective. Entities also have to reconcile any differences between this disclosure and segment disclosures. When determining the type of categories to use to disaggregate revenue, entities should consider how information

about revenue has been presented for other purposes, including disclosures presented outside the financial statements and information reviewed by the chief operating decision maker for evaluating the performance operating segments.

- ▶ Entities must disclose how much revenue recognized in the current period is associated with previously fulfilled (or partially fulfilled) performance obligations. They may need to consider how this applies to adjustments that may be resolved in subsequent periods (e.g., quality adjustments, volume true-ups, changes in variable consideration associated with volume discounts, changes in estimated breakage).
- ▶ Entities also have to disclose the aggregate amount of the transaction price that is allocated to performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period. For example, if an entity estimates a total transaction price (after applying the constraint on variable consideration) of \$24 million and has recognized \$18 million to date, it discloses that \$6 million of the transaction price is yet to be recognized, along with either quantitative or qualitative information on when the remaining transaction price is expected to be recognized.

Entities can elect to use an optional exemption that allows an entity not to make quantitative disclosures about remaining performance obligations in certain situations, including when contracts have an original expected duration of less than one year and when an estimate of the transaction price is made solely for disclosure purposes. These situations also include: (1) when an entity applies the right to invoice practical expedient¹² and (2) when variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation (i.e., a series of distinct goods or services) when certain criteria are met.

Entities that elect to use any of the standard's optional exemptions that allow them not to disclose the aggregate transaction price allocated to the remaining performance obligations must disclose which optional exemption(s) they are applying, the nature of the performance obligations, the remaining duration of the contract and a description of the variable consideration that has been excluded from the disclosure (e.g., the nature of the variability and how that variability will be resolved).

Endnotes:

- ¹ ASC 606, *Revenue from Contracts with Customers*.
- ² Paragraph BC128 of Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*.
- ³ 13 July 2015 TRG meeting; agenda paper no. 43.
- ⁴ ASC 606-10-55-216 through 220.
- ⁵ 9 November 2015 TRG meeting; agenda paper no. 48.
- ⁶ Speech by the SEC's former Chief Accountant, 9 June 2016. Refer to SEC website at <https://www.sec.gov/news/speech/bricker-remarks-35th-financial-reporting-institute-conference.html>.
- ⁷ 7 November 2016 TRG meeting; agenda paper no. 58.
- ⁸ ASC 606-10-55-375 through 55-376.
- ⁹ ASC 606-10-55-353 through 55-356.
- ¹⁰ ASC 606-10-55-353 through 55-356.
- ¹¹ ASC 606-10-32-2A.
- ¹² The FASB provided a practical expedient in ASC 606-10-55-18 for using an output method to measure progress toward completion of a performance obligation that is satisfied over time. If an entity demonstrates that the invoiced amount corresponds directly with the value to the customer of the entity's performance completed to date, the practical expedient allows an entity to recognize revenue in the amount for which it has the right to invoice.

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Appendix: The five-step revenue model and contract costs

The standard's core principle is that an entity will recognize 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 will be 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 will have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. This table summarizes the revenue model and the guidance for contract costs.

Step 1: Identify the contract(s) with the customer
<p>Definition of a contract</p> <p>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:</p> <ul style="list-style-type: none"> ▶ 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 <p>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.</p> <p>Contract combination</p> <p>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:</p> <ul style="list-style-type: none"> ▶ 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 <p>Contract modifications</p> <p>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:</p> <ul style="list-style-type: none"> ▶ 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 will need to consider the effects of all of the following:

Variable consideration

An entity will need 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 will need 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 will be 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 will be 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 will be recognized at the point in time when the IP is made available for the customer's use and benefit. This will be 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 will be 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 will be 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 will be 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 will be 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) will be 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. Further, ASC 340-40 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 will recognize 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.