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Technical Line

FASB — final guidance

How the new revenue recognition standard affects automotive entities

In this issue:

What you need to know

- Automotive entities need to exercise judgment to determine whether to recognize revenue at a point in time or over time under the new standard. Entities that have already adopted the standard have reached different conclusions based on different facts and circumstances.
- Some original equipment manufacturers have had to change how they recognize sales incentives and service-type warranties under the new revenue standard. Original equipment manufacturers also need to carefully consider whether transactions with a repurchase option or a residual value guarantee qualify as sales.
- Automotive suppliers need to exercise judgment to determine whether pre-production and tooling activities are promises in a contract and whether those activities transfer a good or service to their customers.
- This publication has been updated to address issues related to identifying the contract with a customer, recognizing revenue at a point in time or over time and accounting for customer options for additional goods or services, pre-production and tooling activities and consideration payable to a customer.

Overview

The new revenue standard[1] issued by the Financial Accounting Standards Board (FASB or Board) requires entities in the automotive industry to make additional judgments and estimates.

Building a better working world

This publication highlights key aspects of applying the FASB's standard to automotive entities' contracts with their customers, addresses significant changes to legacy practice and reflects the latest implementation insights. Automotive entities include automotive suppliers and original equipment manufacturers (OEMs).

As a reminder, the FASB deferred[2] 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.

Automotive entities should also keep in mind that, when they adopt the new credit impairment standard,[3] 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.

Identifying a contract with a customer (updated September 2019)

Automotive suppliers typically enter into multi-year supply arrangements with OEMs to design, manufacture and supply parts that OEMs use in the production of vehicles. Additionally, OEMs typically enter into agreements with car dealers to sell the cars and trucks they produce.

These arrangements usually are governed by a master supply arrangement (MSA) that establishes the overall terms and conditions of the business arrangement between the suppler and OEM or the OEM and the dealer (e.g., scope of services, pricing, payment terms, warranties, other rights and obligations). To make a purchase, the customer typically must issue a purchase order or make another approved authorization that references the MSA and specifies the products and quantities to be delivered.

In these types of arrangements, an MSA will likely not create enforceable rights and obligations and will not be considered a contract in the scope of the standard because each party's rights and obligations regarding the goods to be transferred are not identifiable. This is because, while the MSA may specify the pricing or payment terms, it usually does not specify the specific goods or quantities of goods to be transferred.

However, it is likely that the MSA and the customer order, taken together, would be considered a contract in the scope of the standard. Therefore, automotive entities need to evaluate both the MSA and the subsequent customer order(s) together to determine whether and when the criteria in Accounting Standards Codification (ASC) 606-10-25-1 are met.

We note that an MSA may include an enforceable clause requiring the customer to purchase a minimum quantity of goods. In these cases, the MSA alone may be considered a contract under the standard because enforceable rights and obligations exist for the minimum amount of goods or services.

Customer options for additional goods or services (updated September 2019)

Automotive contracts often include options for the customer to acquire additional goods or services. These additional goods and services may be priced at a discount or may even be offered free of charge. Options to acquire additional goods or services at a discount can come in many forms, including sales incentives, volume-tiered pricing structures, annual price reductions over the contract duration (e.g., 3% a year over five years) with or without reference to the volume of parts purchased, or contract renewal options (e.g., waiver of certain fees, reduced future rates).

Under the standard, an option to acquire additional goods or services is a separate performance obligation in a contract with a customer only 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).

Automotive entities that grant options to customers to acquire additional goods or services will need to use judgment to determine which options provide material rights to the customers.

The Board indicated in the Background Information and Basis for Conclusions of ASU 2014-09[4] that the purpose of this guidance is to identify and account for options that customers are paying for (often implicitly) as part of the current transaction. If the option provides a material right to the customer, the entity is required to allocate a portion of the transaction price to the material right at contract inception. The revenue allocated to the material right is recognized when (or as) the option is exercised (and the underlying future goods or services are transferred) or when the option expires. In contrast, if a customer option is not deemed to be a material right and is instead a marketing offer, there is no accounting for the option and no accounting for the underlying goods or services until those subsequent purchases occur.

The FASB did not provide any bright lines about what constitutes a "material" right. An option to purchase additional goods or services in the future at the current standalone selling price could be a material right if prices are highly likely to significantly increase or if the standalone selling price for the product is highly likely to significantly increase, depending on the facts and circumstances of the contract. This is because the customer is being offered a discount on future goods or services compared to what others will have to pay in the future as a result of entering into the previous contract.

An entity that determines that an option is a separate performance obligation (because the option provides the customer with a material right) has to determine the standalone selling price of the option. If the option's selling price is not observable, the entity needs to estimate it, taking into consideration the discount the customer would receive in a standalone transaction and the likelihood that the customer will exercise the option. Example 49 in the standard illustrates how to calculate the standalone selling price of an option that was determined to be a material right.[5]

The standard also provides a practical alternative to estimating the standalone selling price of the option.[6] Under this alternative, the entity allocates a portion of the transaction price to the option by reference to the total goods or services expected to be provided to the customer and the corresponding expected consideration. To use this practical alternative, an entity needs to determine that the goods or services covered by the option are both similar to the original goods and services in the contract (i.e., the entity continues to provide what it was already providing[7]) and provided in accordance with the terms of the original contract.

Other OEM considerations

Vehicle sales

An OEM typically sells the cars and trucks that it produces to a dealer that then sells the vehicles to consumers. Under the standard, an OEM recognizes revenue for the sale of a vehicle when it transfers control of the vehicle to its customer (i.e., the dealer). Control of the vehicle transfers to the dealer when the dealer has the ability to direct the use and obtain substantially all the remaining benefits of the vehicle.

OEMs need to carefully evaluate whether they have transferred control of a vehicle to the dealer upon shipment or delivery. The transfer of title, as dictated by the shipping terms, is only one indicator for determining the point in time when control transfers. OEMs also need to consider when they have the right to payment from the customer, when they have transferred the significant risks and rewards of ownership to the customer and the timing of customer acceptance of the vehicle, among other indicators.

In addition, an OEM needs to consider whether it has an agreement to repurchase the vehicle or provide a resale value guarantee, which could mean that a transaction should be accounted for as a lease, a sale with a right of return or a financing arrangement. Refer to the section on repurchase agreements and residual value guarantees below for further discussion.

OEMs may also have affiliate (captive) finance companies that purchase vehicles from dealers and lease the vehicles to retail customers in separate transactions. These repurchases typically do not result from an option that exists in the contract between the OEM and the dealer. Under the standard's control model, OEMs need to assess whether the possibility that vehicles will be repurchased by their captive finance companies precludes them from recognizing revenue when they ship or deliver the vehicles to dealers.

How we see it

Under legacy guidance, OEMs were permitted to recognize revenue on vehicles repurchased by their captive finance companies as they were shipped to the dealer if certain criteria were met. While the new standard provides indicators of when control transfers, they generally align with the legacy criteria, and an OEM that meets those criteria will likely be able to recognize revenue under the new standard.

For example, under legacy guidance, one of the criteria to recognize revenue is that the OEM has delivered the vehicle to the dealer, the risks and rewards of ownership have passed to the dealer and the retail customer's failure to enter into a lease with the OEM's captive finance company would not allow the dealer to return the vehicle to the OEM. One indicator of control transfer in the new standard is that the customer has the risks and rewards of ownership of the asset.

Sales incentives

OEMs frequently provide sales incentives in contracts to sell vehicles. These incentives come in many forms (including free or discounted goods or services and cash) and are offered to both dealers and retail consumers. Under the standard, the accounting for these incentives may differ depending on the form of the incentive.

Free goods or services

OEMs need to carefully evaluate sales incentives offered in the form of free goods or services to the retail customer after the OEM's sale of the vehicle to the dealer to determine whether they are separate performance obligations. Examples of such incentives include free roadside assistance and free maintenance that the retail customer receives for a specified period.

As noted in the Basis for Conclusions in ASU 2014-09,[8] all goods or services promised to a customer as a result of a contract could give rise to performance obligations, including a promise to provide a good or service in the future. While many of the free goods or services that OEMs offer as sales incentives are ultimately used by the retail consumer after he or she buys the vehicle from the dealer, they may represent promises the OEM makes to the dealer if those rights existed when the OEM sold the vehicle to the dealer. This applies to both explicit or implicit rights and promises.

As a result, OEMs need to evaluate free goods and services to determine whether they are promised goods or services in their contracts with dealers. If an OEM determines that the free goods and services are distinct and, therefore, separate performance obligations, the OEM will allocate a portion of the transaction price to these items.

The standard allows entities to disregard promised goods and services that are deemed immaterial in the context of the contract. Because of this guidance, entities are not required to aggregate and assess immaterial items at the entity level. For example, an OEM may determine based on the contractual terms that free roadside assistance provided to retail customers for a specified period of time is immaterial, but the free maintenance in the same contract is not immaterial.

OEMs need to apply judgment in making this assessment, particularly when multiple free goods and services are provided in one contract. If multiple goods or services in a contract are individually immaterial in the context of the contract but material in the aggregate, an OEM should not disregard them when identifying performance obligations. That is, the OEM must account for a material portion of the promised goods or service in the contract and can't avoid accounting for a material portion of the contract by concluding that the individual promised goods or services in the contract are immaterial.

Free goods or services may be performance obligations under the standard.

Example 12[9] in the standard illustrates how a manufacturing entity that sells products to a distributor that then resells them to an end customer could determine whether free goods or services provided in a contract are performance obligations.

How we see it

OEMs may need to change how they account for free goods or services under the new standard. Under legacy guidance, there was diversity in practice. OEMs need to evaluate whether these incentives are separate performance obligations under the new standard and consider whether they are material in the context of the contract.

Cash incentives

OEMs typically offer a wide variety of cash incentives to dealers and retail customers (e.g., volume bonus, consumer cash). The amount of cash incentive the dealer or retail customer will be eligible for is generally not known at the time the OEM sells the vehicle to the dealer.

Under the standard, cash incentives (or credits or other items such as coupons that can be applied against amounts owed to the OEM) paid by the OEM to dealers and retail customers either represent a fixed discount or result in variable consideration. A cash incentive is a discount if the dollar amount is fixed and not contingent on future events. Therefore, OEMs are likely to account for cash incentives they offer as variable consideration because the dollar amounts depend on the timing and method of purchase (cash, lease or financing) of the vehicle by the retail consumer.

An OEM estimates the amount of variable consideration (taking into account variable cash incentives), using either the expected value method or the most-likely-amount method, based on whichever method better predicts the amount of consideration the OEM will be entitled to from the dealer. The standard states that when applying either of these methods, an entity should consider all information (historical, current and forecast) that is reasonably available to the entity. Additionally, the estimate should reflect amounts explicitly promised under the contract and implied through the OEM's customary business practices or intentions under the current contract, including cash incentives that OEMs anticipate offering.

If an entity (OEM) has a history of providing this type of consideration to customers (either the dealers or retail customers), the guidance on estimating variable consideration requires the entity to consider such amounts at the contract's inception when the transaction price is determined, even if the entity (OEM) has not yet provided or promised to provide this consideration to the customer.[10]

How we see it

Estimating future cash incentives may be a change in practice for OEMs. Under legacy guidance, these entities typically recorded the cost of cash incentives as a reduction of revenue at the later of the sale of the vehicle to the dealer or the date the incentive was offered. OEMs have to assess whether their historical models for estimating cash incentives are appropriate, and they may need to update their processes and internal controls over identifying and estimating cash incentives.

Allocating cash incentives to multiple performance obligations

Once an OEM has identified the separate performance obligations and determined the transaction price, the standard requires an OEM to allocate the transaction price to the performance obligations. The relative standalone selling price method is the default method for allocating the transaction price. However, the FASB noted in the Basis for Conclusions in ASU 2014-09[11] that this method may not always result in a faithful depiction of the amount of consideration to which an entity expects to be entitled from the customer. Therefore, the standard provides two exceptions to the relative standalone selling price method to allocate the transaction price, related to the allocation of variable consideration and discounts.

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 in the contract 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. Two criteria must be met to apply this exception. The first criterion requires that the terms of a variable payment specifically relate to an entity's efforts to satisfy a performance obligation or transfer a distinct good or service that is part of a series. The second criterion requires the entity to confirm that allocating the consideration in this manner is consistent with the overall allocation objective of the standard in ASC 606-10-32-28.

OEMs need to apply judgment in determining how to allocate cash incentives when multiple performance obligations exist in a contract. An OEM may allocate variable cash incentives solely to the sale of the vehicle (and not other performance obligations in the contract, such as maintenance) if it can demonstrate that the terms of the payment relate specifically to the OEM's efforts to transfer the vehicle and allocating the incentive to the vehicle results in an amount that reflects the consideration to which the OEM expects to be entitled in exchange for transferring the vehicle to the customer.

Under the other exception, if an entity determines that a discount inherent in a contract is not related to all of the promised goods or services in the contract, the entity should allocate the contract's entire discount to only those goods or services to which it relates. An entity would make this determination when the price of certain goods or services is largely independent of the price of other goods or services in the contract. In these situations, an entity would be able to effectively "carve off" an individual performance obligation or a group of the performance obligations in the contract and allocate the contract's entire discount to that performance obligation or group of performance obligations.

However, an entity could not use this exception to allocate only a portion of the discount to one or more, but not all, performance obligations in the contract. The entity would consider the requirements for allocating a discount only if the discount is not variable consideration (i.e., the dollar amount is fixed and not contingent on future events) or the entity does not meet the criteria to allocate variable consideration to a specific part of the contract.

Repurchase agreements and residual value guarantees

OEMs may have a right or obligation to repurchase vehicles as part of a contract with a customer or may provide residual value guarantees to certain customers. Examples include repurchase options on sales of fleet vehicles or residual value guarantees to fleet customers or third-party purchasers of vehicles (e.g., finance companies). While the economics of a repurchase agreement and a residual value guarantee may be similar, the accounting outcome could be quite different under the standard.

An entity may need to change its accounting for a residual value guarantee.

Repurchase agreements

Some agreements include repurchase provisions, either as part of the original sales contract or as a separate contract that relates to the original sales contract. These provisions affect how an entity applies the guidance on control to affected transactions.

Forward or call option held by the entity

The standard indicates that if the entity has the right or obligation to repurchase the asset at a price less than the original sales price (taking into consideration the effects of the time value of money), the entity would account for the transaction as a lease in accordance with ASC 842, *Leases*, or ASC 840, *Leases*, if an entity hasn't yet adopted ASC 842, unless the contract is part of a sale-leaseback transaction. When an OEM has the obligation or right to repurchase a vehicle, the transaction will most often be accounted for as a lease because the repurchase price is typically less than the original sales price.

Put option held by the customer

If the customer has the ability to require the OEM to repurchase a vehicle (i.e., a put option) at a price lower than the vehicle's original selling price, the standard requires the OEM to consider at contract inception whether the customer has a significant economic incentive to exercise that right. This determination influences whether the customer has control over the asset received and, therefore, whether the contract is treated as a lease or a sale with the right of return.

To determine whether a customer has a significant economic incentive to exercise the repurchase option, OEMs need to consider various factors, including the relationship of the repurchase price to the expected market value (e.g., auction price) of the vehicle at the date of repurchase and the amount of time until the right expires. For example, if the repurchase price is expected to significantly exceed the market value at the time of repurchase, this may indicate that the customer has a significant economic incentive to exercise the repurchase option.

If an OEM determines that its customer has a significant economic incentive to exercise the repurchase option (and therefore, the customer is expected to ultimately return the asset), it should account for the transaction as a lease because the customer is effectively paying the entity for the right to use the asset for a period of time. An exception would be if the contract is part of a sale-leaseback transaction, in which case, the contract should be accounted for as a financing arrangement.

If the customer does not have a significant economic incentive to exercise the right, the OEM should account for the agreement in a manner similar to a sale of a product with a right of return (i.e., treating the right of return, which is a type of variable consideration).

If the repurchase price of the vehicle is equal to or greater than the original selling price but less than or equal to the expected market value of the vehicle, the agreement should also be accounted for as a sale of a product with a right of return, if the customer does not have a significant economic incentive to exercise its right.

If the customer has the ability to require an entity to repurchase the asset at a price equal to or more than the original selling price and the repurchase price is more than the expected market value of the asset, the contract is in effect a financing arrangement.

The Securities and Exchange Commission (SEC) staff has indicated[12] that contractual terms requiring a registrant to repurchase an asset contingent upon a future event would also be an important feature to evaluate. Judgment should be applied to determine whether the contract for the vehicle sale should be accounted for as a lease or a sale with the right of return. For example, an OEM may determine that the vehicle sale should be accounted for as a sale with a right of return because, based on its experience, events that would give the customer the ability to require the OEM to repurchase a particular class or type of vehicle in a specific market or geography rarely occur.

Sales with residual value guarantees

Under certain arrangements, OEMs agree to make customers (typically fleet customers) whole for the difference between the market value of a vehicle and the guaranteed minimum residual value if the resale amount is less than the guaranteed amount at the end of the agreed-upon contract term. If the transaction includes a residual value guarantee that does not include a put option, the OEM will make the customer whole if, for example, the customer receives less than 85% of the initial sale price in a qualifying future sale to a third party, the repurchase agreement guidance in the standard would not apply because the OEM is not repurchasing the asset from the customer. In those situations, OEMs need to assess whether the residual value guarantee is a financial guarantee within the scope of ASC 460, *Guarantees,* and, if it is, they need to account for that portion of the transaction in accordance with that guidance. The remainder of the transaction is accounted for as a sale of the vehicle under the revenue guidance.

The FASB explained in the Basis for Conclusions of ASU 2014-09[13] that it considered whether such arrangements should be accounted for as a lease, which would be consistent with the treatment under legacy GAAP. However, the FASB explained that while the economics of a repurchase agreement and a residual value guarantee may be similar, the customer's ability to control the asset in each case would be different. If the customer holds a put option that it has significant economic incentive to exercise, the customer is effectively restricted in its ability to consume, modify or sell the asset. In contrast, when the entity guarantees that the customer will receive a minimum amount of sales proceeds, the customer is not constrained in its ability to direct the use of, and obtain substantially all of the benefits from, the asset. Accordingly, the Board decided that it was not necessary to expand the guidance on repurchase agreements to consider guaranteed amounts of resale.

Therefore, it is important for OEMs to review all their contracts and make sure that any residual value guarantee is not accomplished through a repurchase provision such as a put within the contract (e.g., the customer has the right to require the entity to repurchase a vehicle two years after the date of purchase at 85% of the original purchase price). If a put option is present, the entity would have to account for such a contract under the repurchase agreement guidance above.

How we see it

Legacy guidance generally required OEMs to account for repurchase agreements and residual value guarantee transactions as leases. Under the new revenue standard, there are circumstances in which OEMs recognize revenue upon shipment of vehicles to customers when there is a repurchase option or residual value guarantee.

Product warranties

Determining whether a warranty should be accounted for as a performance obligation or a cost accrual requires judgment.

The vehicle purchase price set by OEMs typically includes a standard warranty provided by the OEM that the vehicle will operate for a specified period of time or number of miles (e.g., three years or 36,000 miles). In addition, certain OEMs may offer separately priced extended warranties that the retail consumer can purchase through the dealer. The separately priced extended warranty typically provides more comprehensive coverage over a longer period of time (e.g., three to five additional years) than the standard warranty. If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty that is accounted for as a separate performance obligation. Otherwise, it is an assurance-type warranty that is accounted for as a cost accrual because it just provides the customer with assurance that the product complies with agreed-upon specifications.

OEMs may need to exercise significant judgment to determine whether a warranty included in the vehicle purchase price is an assurance-type warranty or a service-type warranty. This evaluation may be affected by several factors, including common warranty practices in the industry and/or geographic location and the entity's business practices related to warranties.

For example, consider an OEM that provides a five-year warranty on a luxury vehicle and a three-year warranty on a standard vehicle. The OEM may conclude that the longer warranty period is not an additional service because it believes the materials used to construct the luxury vehicle are of a higher quality, and latent defects would take longer to appear. In contrast, the OEM might compare the warranty with those offered by competitors and conclude that the five-year warranty period, or some portion of it, is an additional service that should be accounted for as a service-type warranty.

The evaluation of whether a warranty provides a service in addition to the assurance that the product complies with agreed-upon specifications requires judgment and depends on the facts and circumstances. [14] There is no bright line in the standard on what constitutes a service-type warranty beyond the requirement that it be separately priced. However, the standard requires entities to consider factors such as (1) whether the warranty is required by law, (2) the length of the warranty coverage and (3) the nature of the tasks that the entity promises to perform. Entities need to evaluate each type of warranty they offer to determine the appropriate accounting.

OEMs may conclude that some contracts include both an assurance-type warranty and a service-type warranty. When an assurance-type warranty and a service-type warranty are both present in a contract with a customer, an entity is required to accrue for the expected costs associated with the assurance-type warranty and defer the revenue for the service-type warranty. If an OEM promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the OEM should account for both of the warranties together as a single performance obligation.

OEMs also need to carefully consider how and when they offer and sell service-type warranties to their customers. For example, assume a vehicle is sold to a dealer without a service-type warranty but a retail customer subsequently purchases the warranty from the OEM. This likely is considered a separate revenue transaction under the standard, consistent with legacy guidance on separately priced extended warranties. However, if the OEM sells a vehicle to a dealer and the purchase price includes a service-type warranty, the OEM needs to identify the warranty as a separate performance obligation and allocate a portion of the transaction price to it. The OEM also needs to determine the recognition period for revenue from service-type warranties and the appropriate method to measure performance.

How we see it

OEMs need to carefully evaluate their arrangements to determine whether separate performance obligations exist for service-type warranties. Determining whether a warranty is an assurance-type or service-type warranty may require judgment. An OEM may need to change its accounting for product warranties when it adopts the standard.

Significant financing component

For some transactions, the receipt of consideration does not match the timing of the transfer of goods or services to the customer. For example, OEMs may receive consideration in advance for maintenance plans or extended warranties for which the related service is provided over a period of time (typically in excess of one year). Under the standard, OEMs need to assess whether that prepayment provides them with a significant benefit of financing, which likely requires significant judgment.

OEMs are not required to adjust the transaction price for a financing component if, among other things, it is not significant to the contract, the period between the customer's payment and the entity's transfer of the goods or services is less than one year or the difference between the promised consideration and the selling price stems from reasons other than providing financing to either the entity or the customer. In addition, OEMs need to determine whether the timing of the transfer of the goods or services under maintenance plans or extended warranties is at the discretion of the customer. As noted in the Basis for Conclusions of ASU 2014-09,[15] the Board expects that when the timing of using a service is at the discretion of the customer, the purpose of the payment terms is not related to financing, and therefore, the contract does not contain a significant financing component.

Example 30[16] in the standard illustrates how an entity determines whether a contract contains a significant financing component when customer payment is required up front and the primary purpose of the prepayment is not the provision of financing to the entity. In the example, the customers electing to buy a service provided over three years must pay for it up front (that is, a monthly payment option is not available), and the entity determines that providing other payment terms (such as a monthly payment plan) would affect the nature of the risks assumed by the entity to provide the service and may make it uneconomical to provide the service. OEMs need to carefully evaluate their arrangements to determine whether a significant financing component exists.

Other automotive supplier considerations (updated September 2019)

Recognizing revenue

To recognize revenue for a manufactured good (e.g., auto part), an automotive supplier needs to determine when control of the good is transferred to the customer (e.g., an OEM). An entity transfers control of a good (and recognizes revenue) over time (rather than at a point in time) when any of the three criteria described in the standard are met (see Step 5 in the appendix). While two of these criteria are unlikely to be met for automotive supplier contracts, the other criterion, "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,"[17] may be met in certain instances. Automotive suppliers need to thoroughly analyze their contracts to determine whether they meet this criterion.

Alternative use

When the entity's performance creates an asset with an alternative use to the entity (e.g., standard inventory items), the entity can redirect the asset to another customer. In those cases, the entity (not the customer) controls the asset as it is created because the customer does not have the ability to direct the use of the asset or restrict the entity from directing that asset to another customer.

Considering the level of customization of the completed asset may help automotive suppliers assess whether an asset has an alternative use. For example, when an automotive supplier is manufacturing an asset that is highly customized for a particular customer, it is less likely that the entity could use that asset for any other purpose. That is, the automotive supplier would likely need to incur significant rework costs to redirect the asset to another customer or sell the asset at a significantly reduced price. As a result, the asset would not have an alternative use to the automotive supplier, and the customer could be regarded as receiving the benefit of the automotive supplier's performance (i.e., having control of the asset) over time provided that the automotive supplier also has an enforceable right to payment.

Enforceable right to payment for performance completed to date

To evaluate whether an automotive supplier has an enforceable right to payment for performance completed to date, the entity is required to consider the terms of the contract and any laws or regulations that relate to it. The standard states that the right to payment for performance completed to date need not be for a fixed amount. However, at any time during the contract term, an automotive supplier must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer (or another party) for reasons other than the entity's failure to perform as promised. The FASB concluded[18] that a customer's obligation to pay for the entity's performance is an indicator that the customer has obtained benefit from the entity's performance.

The enforceable right to payment criterion has two components that an entity must assess. The first component is what *amount* the customer would be required to pay, and the focus of the analysis should be on the amount to which the entity would be entitled upon termination of the contract. This amount is not the amount the entity would settle for in a negotiation, and it does not need to reflect the full contract margin the entity would earn if the contract were completed. A "reasonable profit margin" would either be a proportion of the entity's expected profit margin that reasonably reflects the entity's performance to date or a reasonable return on the entity's cost of capital. As highlighted in Example 16[19] in the standard, payments from a customer must approximate the selling price of the goods or services transferred to date to be considered a right to payment for performance to date. A fixed payment schedule may not meet this requirement.

The second component to assess is what it means to have the *enforceable right* to payment. Entities should consider any laws, legislation or legal precedent that could supplement or override the contractual terms. Additionally, the standard also states that even when an entity chooses to waive its right to payment in other similar contracts, an entity would continue to have a right to payment for the contract if its right to payment for performance to date remains enforceable. When a contract's written terms do not specify the entity's right to payment upon contract termination, we believe an enforceable right to payment is presumed to not exist.[20]

Automotive suppliers need to carefully review their contractual arrangements for terms relating to an enforceable right to payment.

How we see it

Under legacy guidance, many automotive suppliers recognized revenue when a product was shipped or delivered to an end customer (i.e., at a point in time). An entity that recognized revenue at a point in time under legacy guidance needs to analyze its contracts to determine whether it is required to recognize revenue over time under the new standard and should not presume that it will continue to recognize revenue at a point in time. An automotive supplier needs to assess the facts and circumstances of each of its contracts because it may reach a different conclusion than under legacy guidance about when to recognize revenue.

Entities will likely continue to reach different conclusions about the accounting for pre-production and tooling activities.

Pre-production and tooling activities

Identifying the promised goods and services in the contract

An automotive supplier may incur costs to perform certain services related to the design and development of products it will sell under long-term supply arrangements and may incur costs to design and develop molds, dies and other tools (collectively, tooling) that will be used to produce those parts. A contract may call for the OEM to reimburse the automotive supplier for these costs, or reimbursement may be implicitly guaranteed as part of the price of the product.

Entities that historically accounted for pre-production activities as deliverables under legacy revenue guidance need to evaluate whether the activities are promises in a contract with a customer (and potentially performance obligations) under the standard. When making this evaluation, entities need to determine whether the activity transfers a good or service to their customer. If an entity determines that these activities are promised goods or services, it applies the guidance in the standard to those goods or services.

For example, if an automotive supplier is performing engineering and tooling development to create a new mold for an OEM to use in production and the OEM will own the mold, the automotive supplier would likely conclude that it is transferring control of the mold and that the engineering and tooling development activities are a promised good or service in the contract.

Assessing whether control transfers in such arrangements may be challenging. In some arrangements, legal title of the good or service created by the pre-production activity is transferred to the customer. However, an entity should consider all indicators of control because the transfer of legal title is not a presumptive indicator.[21]

If an entity determines that a pre-production activity is a promised good or service, the entity allocates a portion of the transaction price to that good or service as a performance obligation.

If a pre-production activity does not result in the transfer of control of a good or service to a customer, an entity should consider other guidance that may be applicable (e.g., ASC 340-10 on pre-production costs related to long-term supply arrangements; ASC 340-40 on costs to fulfill a contract with a customer; ASC 360 on property, plant and equipment; ASC 730 on research and development).

How we see it

We believe that an entity that historically accounted for pre-production activities as revenue-generating activities under legacy guidance may conclude that, based on the facts and circumstances, the activities do not represent a promised good or service under the standard. In some cases, an entity needs to apply judgment to determine whether pre-production and tooling activities transfer a good or service to a customer. This view is consistent with that of the SEC staff. [22]

We also believe that entities that didn't historically account for pre-production and tooling activities as revenue-generating activities can continue to apply this conclusion after they adopt the standard if there are no other changes to the facts and circumstances. Many entities concluded under legacy GAAP that pre-production and tooling activities were not revenue-generating activities, either because the activities were not part of ongoing major or central operations (based on the Statement of Financial Accounting Concepts (CON) 6 definition of revenue) or because the activities were considered fulfillment or development activities.

The following table summarizes our views of how entities may appropriately account for pre-production and tooling activities when adopting the standard:

Historical accounting	Our view of appropriate accounting under the standard
An entity concluded that these activities were deliverables that generated revenue under legacy revenue guidance.	We believe that the entity could account for these activities in either of the following ways as long as its conclusions are consistent with the principles in the standard: ▸ A promise in a contract with a customer (and potentially a performance obligation) that generates revenue ▸ Not a promise in a contract with a customer and, therefore, not a revenue-generating activity
An entity concluded that these activities were not in the scope of legacy revenue guidance.	We believe it would be reasonable for the entity to conclude that these activities are not in the scope of the standard. If a public entity concludes that these activities are performance obligations that generate revenue under the standard, we believe the entity should consider discussing this conclusion with the SEC staff.

Costs to fulfill a contract

ASU 2014-09 also added ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*, to codify the guidance on other assets and deferred costs relating to contracts with customers within the scope of ASC 606. This topic provides accounting guidance for incremental costs of obtaining a contract with a customer and costs incurred in fulfilling a contract with a customer related to a contract with a customer in accordance with ASC 606.

For automotive entities, if the conclusion was reached that tooling activities were not in the scope of legacy revenue guidance (and the new standard), they normally accounted for the activities using the guidance for pre-production costs related to long-term supply arrangements subject to ASC 340-10, *Other Assets and Deferred Costs — Overall*. While ASC 340-10 (which was not superseded by ASC 606 or ASC 340-40) provides guidance on capitalizing certain pre-production and tooling costs, diversity in practice exists because ASC 340-10 does not address the accounting for reimbursements received from customers for pre-production and tooling activities.

The following table summarizes our views of appropriate accounting for pre-production and tooling costs:

Historical accounting	Our view of appropriate accounting under the standard
The costs were in the scope of ASC 340-10, and the entity applied that guidance.	We believe it is appropriate for the entity to continue to apply ASC 340-10. Subsequent to the adoption of ASC 606 and ASC 340-40, if the entity determines that a change to this accounting is necessary, it would need to perform a preferability analysis and apply the other requirements of ASC 250.
The entity applied ASC 340-10 by analogy or applied ASC 605-35.	We believe the entity needs to perform a thorough analysis of the facts and circumstances to determine whether ASC 340-40 applies.

How we see it

Because the revenue standard did not amend the guidance in ASC 340-10, we believe that it is appropriate for entities that have historically applied ASC 340-10 because they have concluded that pre-production costs are in the scope of that guidance to continue to apply ASC 340-10 when they adopt the revenue standard and the new cost guidance in ASC 340-40. If an entity later determines that a change to this accounting is necessary, it would need to perform a preferability analysis and apply the other requirements of ASC 250.

However, we believe that entities that have historically applied ASC 340-10 by analogy or applied other guidance (e.g., ASC 605-35, ASC 350-40) should perform a thorough analysis of the facts and circumstances to assess whether the costs are in the scope of the guidance in ASC 340-40. As previously discussed, for an arrangement to be in the scope of ASC 340-40, it must first be in the scope of the revenue standard and not in the scope of other cost guidance. An entity that determines that the costs are in the scope of ASC 340-40 should follow the transition guidance in the standard (i.e., the entity would not be required to establish preferability under ASC 250 when it initially adopts ASC 340-40).

Consideration paid or payable to a customer

Many automotive suppliers make one-time payments to OEMs during the term of the contract to continue to maintain positive relationships with the OEM and to better position themselves in future contract negotiations. Consideration payable to a customer is a reduction of the transaction price and, therefore, revenue, unless the payment is in exchange for a distinct good or service that the customer transfers to the entity. An automotive supplier must first determine whether the payment is in exchange for a distinct good or service from the customer (the OEM) to determine the accounting. If the consideration payable to the customer is a payment for a distinct good or service from the OEM, then the automotive supplier accounts for the purchase of the good or service in the same way that it accounts for other purchases. If the amount payable to the OEM is greater than the fair value of the distinct good or service that the automotive supplier receives from the OEM, then the excess amount is a reduction of the transaction price.

Endnotes:

[1] ASC 606, *Revenue from Contracts with Customers*, created by ASU 2014-09, *Revenue from Contracts with Customers*, and various amendments.

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

[3] ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.

[4] Paragraph BC386 of ASU 2014-09.

[5] ASC 606-10-55-336 through 55-339.

[6] ASC 606-10-55-44 through 45.

[7] Paragraph BC394 of ASU 2014-09.

[8] Paragraph BC92 of ASU 2014-09.

[9] ASC 606-10-55-151 through 55-157A.

[10] 13 July 2015 TRG meeting; agenda paper no. 44.

[11] Paragraph BC280 of ASU 2014-09.

[12] Speech by Sylvia E. Alicea, 8 May 2017. Refer to SEC website at https://www.sec.gov/news/speech/alicea-remarks-bloomburg-bna-conference-revenue-recognition-050817.

[13] Paragraph BC431 of ASU 2014-09.

[14] 30 March 2015 TRG meeting; agenda paper no. 29.

[15] Paragraph BC233 of ASU 2014-09.

[16] ASC 606-10-55-244 through 246.

[17] ASC 606-10-25-27c.

[18] Paragraph BC142 of ASU 2014-09.

[19] ASC 606-10-55-169 through 172.

[20] If the contract with the customer does not specify by its written terms the entity's right to payment upon contract termination and the entity asserts that it has an enforceable right to payment for performance completed to date, please refer to Question 7-7 in the October 2018 edition of the FRD publication, *Revenue from contracts with customers (ASC 606)*.

[21] 9 November 2015 TRG meeting, agenda paper number 46.

[22] Speech by Joseph R. Epstein, 4 December 2017. Refer to the SEC website at https://www.sec.gov/news/speech/epstein-aicpa-2017-conference-sec-pcaob-developments.

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, 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 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 cost 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.