FINANCIAL ACCOUNTING STANDARDS BOARD

STAFF PAPER

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Project	**FASB Transition Resource Group for Revenue Recognition**
Paper topic	Over Time Revenue Recognition

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Purpose

1. The staff has received questions about the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* (referred to as the "new revenue standard") regarding considerations for over time revenue recognition under the new revenue standard.
2. The Transition Resource Group (TRG) previously discussed questions related to over time revenue recognition on April 18, 2016. See TRG Agenda Ref No. 53—Evaluating How Control Transfers Over Time and TRG Agenda Ref No. 55—April 2016—Summary of Issues Discussed and Next Steps for additional information on that topic. That discussion related to how control transfers when a performance obligation is satisfied over time. The questions in this paper are different from the topics discussed at the April 2016 meeting and relate to evaluating whether an entity has met the criteria in paragraph 606-10-25-27(c) for satisfying a performance obligation over time.

Accounting Guidance

3. Step 5 of the new revenue standard is to recognize revenue when (or as) the entity satisfies a performance obligation. This determination is made for each performance obligation identified in the contract. A performance obligation is satisfied by

transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. The new revenue standard includes criteria to determine whether an entity transfers control over time and, therefore, satisfies a performance obligation and recognizes revenue over time. The following is some of the relevant guidance:

> **606-10-25-27** An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:
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> a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6).
> b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7).
> c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph 606-10-25-28), and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29).
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> **606-10-25-28** An asset created by an entity's performance does not have an alternative use to an entity if the entity is either **restricted contractually** from readily directing the asset for another use during the creation or enhancement of that asset or **limited practically** from readily directing the asset in its **completed state** for another use. The assessment of whether an asset has an alternative use to the entity is made at **contract inception**. After contract inception, an entity **shall not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligatio**n. Paragraphs 606-10-55-8 through 55-10 provide guidance for assessing whether an asset has an alternative use to an entity. (emphasis added)
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> **606-10-25-29** An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 606-10-25-27(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised.

Paragraphs 606-10-55-11 through 55-15 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.

Question 1: Can an entity that recognizes revenue at a point in time under current revenue recognition guidance be required to recognize revenue over time in accordance with the new revenue standard?

4. Under the new revenue standard, an entity determines at contract inception whether it satisfies a performance obligation over time or at a point in time. In Step 5, an entity recognizes revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer, which is when the customer obtains control of that good or service. This means that, depending on the pattern of timing of when a customer obtains control (and hence when a performance obligation is satisfied), revenue is recognized either over time or at a point in time.

5. An entity should assess whether a performance obligation is satisfied over time by evaluating the criteria in paragraph 606-10-25-27 (as well as the other guidance in the new revenue standard about the application of that paragraph). If the performance obligation is satisfied over time, then revenue should be recognized over time as control of the promised good or service transfers to the customer. As explained in paragraph BC124 of Update 2014-09, the Boards developed the criteria in paragraph 606-10-25-27 to provide an entity with an objective basis for assessing when control transfers over time and, in turn, when a performance obligation is satisfied over time. Examples 13 through 17 (paragraphs 606-10-55-159 through 55-182) provide illustrations of performance obligations satisfied over time.

6. If an entity does not satisfy a performance obligation over time (because it does not meet any of the criteria in paragraph 606-10-25-27), then the performance obligation is satisfied at a point in time and the entity should evaluate the guidance in paragraph 606-10-25-30 to determine the point in time when the customer obtains control of the promised good or service and therefore should recognize revenue.

7. The Boards acknowledged in paragraph BC132 of Update 2014-09 that the criteria in paragraph 606-10-25-27(a) and 606-10-25-27(b) could be challenging to apply in some circumstances. To help with an entity's assessment of when control transfers

over time, the Boards developed the criterion in 606-10-25-27(c). The Boards noted that this third criterion about no alternative use and enforceable right to payment may be necessary for services that are specific to a customer (for example, consulting services that ultimately result in a professional opinion for the customer) and also for the creation of tangible (or intangible) goods.

8. The following example, included in TRG Agenda Ref. No. 27—Series of Distinct Goods or Services, illustrates a transaction that might be accounted for at a point in time today but would be accounted for over time under the new revenue standard.

> **Example A:** An entity has contracted with a customer to provide a manufacturing service in which it will produce 1,000 units of a product per month for a 2-year period. The service will be performed evenly over the 2-year period with no breaks in production. The units produced under this service arrangement are substantially the same and are manufactured to the specifications of the customer. The entity does not incur significant up-front costs to develop the production process. Assume that its service of producing each unit is a distinct service in accordance with the criteria in paragraph 606-10-25-19. Additionally, the service is accounted for as a performance obligation satisfied over time in accordance with paragraph 606-10-25-27 because the units are manufactured specific to the customer (such that the entity's performance does not create an asset with alternative use to the entity), and if the contract were to be cancelled, the entity has an enforceable right to payment (cost plus a reasonable profit margin). Therefore, the criteria in paragraph 606-10-25-15 have both been met.

9. In the staff's view, an entity that currently recognizes revenue at a point in time should not presume it will recognize revenue at a point in time under Topic 606. An entity should perform an assessment of its specific facts and circumstances on the basis of the guidance in the new revenue standard. An entity only recognizes revenue at a point in time if it does not meet the over time criteria in the new revenue standard.

10. While the staff's view is that an entity should perform an assessment of its specific facts and circumstances, the staff thinks that for most entities (but not every entity) that assessment will be straightforward and will not be time consuming.

11. The staff is aware from our outreach activities that some entities that recognize revenue at a point in time under current GAAP have concluded that they will

recognize revenue over time under the new revenue standard. An example of a fact pattern described to the staff from a few stakeholders is an entity (for example, a contract manufacturer, as described in Example A) that produces goods designed to a customer's specifications. Because the goods are designed to meet the customer's unique specifications, the entity concludes that its performance does not create an asset with an alternative use to the entity. In addition, the entity has an enforceable right to payment for performance completed to date. Consequently, the entity concludes that it meets the over time criteria in paragraph 606-10-25-27(c) and, therefore, it will recognize revenue over time.

12. The staff is not implying that all entities that produce customized goods should conclude that they will recognize revenue over time under paragraph 606-10-25-27(c). An entity that recognizes revenue at a point in time under current GAAP might conclude that it is should recognize revenue at a point in time under the new revenue standard. This would be the case, for example, if the entity does not have a right to payment. However, an entity will need to perform an assessment of its specific facts and circumstances on the basis of the guidance in the new revenue standard to reach a conclusion about whether revenue should be recognized over time or at a point in time.

13. When an entity is evaluating whether revenue will be recognized over time or at a point in time, it might be an ideal time for the entity to also consider the relevant disclosures. Required disclosures in Topic 606 include (but are not limited to):
    a. When the entity typically satisfies performance obligations (paragraph 606-10-50-12(a))
    b. Judgements, and changes in judgements, used in determining the timing of satisfaction of performance obligations (paragraph 606-10-50-17(a))
    c. For performance obligations satisfied over time, the methods used to recognize revenue (for example, a description of the input or output methods applied) and an explanation of why the methods used provide a faithful depiction of the transfer of goods and services (paragraph 606-10-10-18)
    d. For performance obligations satisfied at a point in time, significant judgements made in evaluating when a customer obtains control of promised goods or services (paragraph 606-10-50-19).

Question 2: In assessing whether an entity's performance creates an asset with no alternative use in accordance with paragraph 606-10-25-27(c), should an entity consider the completed asset or the in-production asset?

14. In accordance with paragraph 606-10-25-27(c), if an 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 entity satisfies its performance obligation, and recognizes revenue, over time. An entity must meet both of the criteria in paragraph 606-10-25-27(c) in order to recognize revenue over time. Question 2 addresses the first criterion about no alternative use and Question 3 addresses the second criteria about enforceable right to payment.

15. Paragraphs 606-10-55-8 through 55-10 provide guidance around the assessment of whether an entity's performance creates an asset with no alternative use. In assessing whether an asset does not have an alternative use to an entity in accordance with paragraph 606-10-25-28, an entity should consider both the effects of contractual restrictions and practical limitations on an entity's ability to readily direct that asset for another use, such as selling it to a different customer. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. A practical limitation exists if an entity would incur a significant economic loss to direct the asset for another use.

16. Stakeholders have raised a question about at which stage in production (or manufacturing) should an entity conclude that the asset has no alternate use. For example, if an asset can be sold to a different customer throughout most of the production process, but the asset that exists at the end of the production process has no alternative use, does the asset have no alternate use when evaluating the over time criteria in paragraph 606-10-25-27(c)? In other words, stakeholders have asked whether the timing of the customization matters when assessing the criteria in paragraph 606-10-25-27(c).

17. Paragraph 606-10-25-28 provides guidance that an entity should consider the completed asset and BC136 of Update 2014-09 provides further clarification of that guidance, as follows:

> **BC136** In assessing whether the asset has an alternative use, the entity would need to consider practical limitations and

> contractual restrictions on directing the asset for another use. In determining whether the entity is limited practically from directing the asset for another use, **the Boards decided that an entity should consider the characteristics of the asset that will ultimately be transferred to the customer**. This is because, for some assets, it is not the period of time for which the asset has no alternative use that is the critical factor in making the assessment but, instead, **whether the asset that is ultimately transferred could be redirected without a significant cost of rework. This may occur in some manufacturing contracts in which the basic design of the asset is the same across all contracts, but the customization is substantial.** Consequently, redirecting the asset in its completed state to another customer would require significant rework. (emphasis added)

18. Paragraph 606-10-25-28 states that the assessment of the no alternative use criterion should be performed at contract inception and that this evaluation should not be reassessed unless the parties to the contract approve a contract modification that substantively changes the performance obligation. In addition, paragraph BC136 of Update 2014-09 states that the no alternative use criterion should be considered in the context of the asset that will ultimately be transferred to the customer.

19. If the asset does not have an alternative use, the entity would not automatically be required to recognize revenue over time. This is because the entity also must meet the second half of the criteria in paragraph 606-10-25-27(c) related to an enforceable right to payment. Paragraph BC141 of Update 2014-09 states that while the notion of no alternative use is a necessary part of the criterion in paragraph 606-10-25-27(c), it is not enough to conclude that a customer controls an asset. Therefore, an entity also must have an enforceable right to payment for performance completed to date for revenue recognition to occur over time.

20. As discussed in paragraph BC142 of Update 2014-09, there is a link between the assessment of control and the factors of no alternative use and a right to payment because if an entity is creating an asset that has no alternative use to the entity, the entity is effectively constructing an asset at the direction of the customer. The

customized asset would have no use to the entity and, therefore, the entity will require economic protection from the risk of the customer terminating the contract by requiring the customer to pay for the entity's performance completed to date if the customer terminates the contract. Because the customer is obligated to pay for the entity's performance and cannot avoid paying for that performance, the customer has obtained the benefits from the entity's performance and the performing entity should recognize revenue over time as performance occurs. Question 3 of this paper addresses the criteria for enforceable right to payment in paragraph 606-10-25-27(c).

21. Consider the following example to illustrate the staff's analysis for Question 2:

> **Example B:** An entity enters into a contract with a customer to build equipment. The entity is in the business of building custom equipment for various customers. The customization of the equipment occurs when the manufacturing process is approximately 75% complete. In other words, for approximately 75% of the manufacturing process, the in-process asset could be redirected to fulfill another customer's equipment order (assuming there is no contractual restriction to do so). However, the equipment cannot be sold in its *completed* state to another customer without incurring a significant economic loss. The design specifications of the equipment are unique to the customer and the entity would only be able to sell the completed equipment at a significant loss.

22. In Example B, the entity would evaluate at contract inception whether there is any contractual restriction or practical limitation on its ability to readily direct the asset in its completed state for another use. Because the entity cannot sell the completed equipment to another customer without incurring a significant economic loss, the entity has a practical limitation on its ability to direct the equipment in its completed state and, therefore, the asset does not have an alternative use. However, before concluding that revenue should be recognized over time, an entity must evaluate whether it has an enforceable right to payment.

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

23. In accordance with paragraph 606-10-25-27(c), if an 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 entity satisfies its performance obligation, and recognizes revenue, over time. An entity must meet both of the criteria in paragraph 606-10-25-27(c) in order to recognize revenue over time. Question 3 addresses the second criterion about enforceable right to payment.

24. Paragraph 606-10-25-29 provides further guidance on the right to payment criterion, as follows:

> **606-10-25-29** An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 606-10-25-27(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Paragraphs 606-10-55-11 through 55-15 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.

25. The assessment of whether the entity has an enforceable right to payment is dependent on whether the termination payment includes a reasonable profit margin on its performance completed to date at all times throughout the duration of the contract if the contract is terminated by the customer for reasons other than the entity's failure to perform as promised, as provided in paragraph 606-10-25-29. That is, if a termination provision only compensates the entity for costs or a portion of costs, the enforceable right to payment criteria would not be met. The payment schedule specified in the contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date.

26. The term *right to payment* is intended to refer to a payment that serves as compensation for an entity's performance completed to date. The criterion in paragraph 606-10-25-27(c) was written with the intention to reinforce the notion of control because an entity would only agree to transfer control of a good or service to a customer if the entity is compensated for the costs associated with fulfilling the contract and it receives a reasonable profit margin that includes a return on those

costs. If an entity concludes that it has entered into a contract with a customer to create an asset that has no alternative use, the entity would recognize revenue over time if there is an enforceable right to payment (including a reasonable profit margin) for performance completed to date.

27. Paragraphs 606-10-55-11 through 55-15 include considerations that an entity should use to assess whether there is an enforceable right to payment for performance completed to date, including whether there is a reasonable profit margin. Paragraph 606-10-55-11 states that an entity does not need to be entitled to the profit margin expected if the contract was fulfilled as promised, but an entity should at least be entitled to either a proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity’s performance under the contract before termination or a reasonable return on the entity’s cost of capital. Paragraph BC144 of Update 2014-09 clarifies this guidance by stating that an entity should focus on the amount that it would be entitled upon termination rather than the amount that the entity may ultimately be willing to settle for in a negotiation.

28. In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. Paragraph 606-10-55-13 provides guidance that if a customer terminates a contract without having the right to terminate the contract at that time, the contract (or laws) gives the entity a right to continue to perform its obligations in accordance with the contract, which would require the customer to perform its obligation of paying the promised consideration and create an enforceable right to payment.

29. An entity should consider the terms of the contract, as well as any legislation or legal precedent that could supplement or override those contractual terms, when assessing the existence and enforceability of a right to payment for performance completed to date. Paragraph 606-10-55-14 explains that an entity needs to consider legislation, administrative practice, or legal precedent that confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer, relevant legal precedent that indicates that similar rights to payment for performance completed to date in similar contracts has no binding legal effect, and an entity’s customary business practice of choosing not to enforce a right to payment that has resulted in the right being rendered unenforceable in that legal environment.

30. Paragraph BC145 of Update 2014-09 points out that the contractual payment terms in the contract might not always align with the entity's enforceable rights to payment for performance completed to date. The right to payment does not need to be a present unconditional right to payment, but rather an entity should consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised. An entity must consider both the terms of the contract and any laws or regulations that could have an impact on the existence and enforceability of right to payment on the contract.
31. The Boards clarified in paragraph BC146 of Update 2014-09 that a non-refundable up-front payment that represents the full transaction price would at least compensate the entity for work completed to date throughout the contract and would provide the entity a right to payment as long as the entity's right to retain the payment is enforceable if the customer terminates the contract in accordance with paragraph 606-10-25-29.
32. As summarized above, Topic 606 provides a framework for evaluating whether an entity has a right to payment. However, application of the guidance sometimes will require judgment. For example, paragraph 606-10-55-11 states that a right to payment should include a reasonable profit margin. This will be a matter of judgment applied to the specific facts and circumstances of the arrangement. Also, application of the guidance on right to payment will be a matter of law. Sometimes an entity's right to payment for performance completed to date might not be explicit in a contract or it might be vague in the contract. In applying the guidance in paragraph 606-10-25-29, an entity should consider contractual provisions as well as any legislation or legal precedent that could supplement or override those contractual terms.
33. Consider the following example to illustrate the staff's analysis for Question 3:

Example C: For each of the last five years, an entity has received an order from a customer for 300 custom ice cream machines. The specifications of the ice cream machines are unique to the customer. In anticipation of the customer's order this year, the entity starts production of the custom ice cream machines before there is a contract between the parties in the current year. The entity is willing to take the risk of beginning to manufacture custom units before there is a contract because (a) the customer has predictable purchasing behavior and (b) the entity has knowledge of the customer's performance in the current year and plans for growth from the customer's public disclosures. The entity and the customer later enter into a contract (that meets all of the criteria in Step 1 of the new revenue standard) for 300 units. The entity has a practical limitation on its ability to direct the equipment in its completed state because it could not do so without incurring a significant economic loss. The entity has an enforceable right to payment beginning when the contract is executed. Assume that each of the machines is distinct.

At the inception of the contract, the entity has completed 50 units (that is, 50 units are in inventory awaiting shipment to the customer), has 10 units in production (that is, 10 units are in various stages of the manufacturing process), and has not begun manufacturing 240 units.

34. In Example C, the entity begins production prior to the existence of a contract under Topic 606. Therefore, the entity cannot recognize revenue (whether at a point in time or over time) until a contract exists (that is, meets all of the criteria for a contract in Step 1 of the new revenue standard).

35. In the staff's view, at contract inception the entity would assess the nature of its promise(s) to the customer and identify the performance obligation(s). Each of the machines is distinct; however, the entity considers whether the arrangement is a series of distinct goods or services in accordance with paragraphs 606-10-25-14(b) through 25-15. One of the two criteria to be a series is that the performance obligation is satisfied over time. There is no alternative use for the machines because of the practical limitation noted in the fact pattern. In addition, there is an enforceable right to payment at the inception of the contract. Therefore, the entity concludes that it will recognize revenue over time in accordance with paragraph 606-10-25-27(c). The second criterion to be a series is that the same method would be used to measure progress toward complete satisfaction to transfer each distinct good or service to the customer. In this fact pattern, the 300 units in the contract are identical so the entity concludes that it would use the same measure of progress for each of the 300 distinct units. Because both of the criteria for a series are met, the entity concludes that the arrangement for 300 machines should be accounted for as a series of goods and services.

36. At contract inception, the entity would record a cumulative catch up adjustment for progress made as of contract inception toward complete satisfaction of the performance obligation (that is, the series comprised of 300 units), considering both the 50 completed units and the 10 in process units. The entity would continue to

recognize revenue over time as progress is made on finishing the 10 units and manufacturing the 240 units.

Question for the TRG Members
1. Do the TRG members agree with the staff's analysis in this paper?