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Technical Line

FASB — final guidance

How the new revenue standard affects homebuilders and land developers

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What you need to know

- Homebuilders and land developers apply the revenue recognition standard to revenue from sales of completed homes, residential units and developed land to customers. The standard superseded legacy guidance in ASC 360-20, *Property, Plant, and Equipment — Real Estate Sales*.
- Identifying the promises in a contract, evaluating whether those promises are separate performance obligations and allocating the transaction price to the identified performance obligations have required significant analysis and judgment from homebuilders and land developers.
- This publication has been updated to reflect additional guidance on estimating variable consideration, seller participation in future profit, evaluating repurchase options, and the interaction between the guidance on real estate project costs and the revenue standard.

Overview

The new revenue recognition standard[1] issued by the Financial Accounting Standards Board (FASB or Board) requires homebuilders and land developers to make additional judgments and estimates to home and land sales in its scope, such as identifying the customer in an arrangement and determining how and when revenue should be recognized.

Entities apply Accounting Standards Codification (ASC) 606 to account for sales of real estate to customers. Entities account for sales of real estate (that do not meet the definition of a business) to noncustomers under ASC 610-20, *Other Income — Gains and Losses from the*

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Derecognition of Nonfinancial Assets,[2] which requires the application of certain concepts from ASC 606. For example, a homebuilder may sell a home together with an adjacent land lot. The sale of the home is likely in the scope of ASC 606 while the sale of the land may be in the scope of ASC 610-20, if the sale of land is not part of the homebuilder's ordinary activities. This publication only addresses the application of ASC 606. See our Financial reporting developments (FRD) publication, ***Gains and losses from the derecognition of nonfinancial assets (ASC 610-20),*** for a further discussion of ASC 610-20.

This publication highlights key aspects of applying the FASB's standard to a homebuilder's or land developer's contracts with its customers, addresses significant changes to legacy practice and reflects the latest implementation insights. Homebuilders referenced in this publication include both traditional homebuilders and land developers, unless otherwise specified.

As a reminder, the FASB deferred[3] 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.

Some of the guidance in ASC 970 was amended or eliminated by the revenue standard.

This publication, which contains a summary of the standard in the appendix, supplements our 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.

Homebuilders should also keep in mind that, when they adopt the new credit impairment standard,[4] 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.

Background

Homebuilders generally apply the revenue standard to recognize revenue from home sales and other transactions involving the sale and transfer of real estate, including those in which they act as land developers. Land developers assemble land parcels into a community, subdivide the community into lots and sell the lots to another buyer (e.g., other homebuilders, commercial real estate developers). The land developer also may agree to provide construction or development services to the buyer in connection with, or after, lot sales.

In addition, homebuilders apply the guidance in ASC 970, *Real Estate — General,* which primarily addresses whether costs associated with acquiring, developing, constructing, selling or renting real estate projects (other than real estate projects developed for an entity's own use) should be capitalized or charged to expense as incurred. Some of the guidance in ASC 970 was amended or superseded by the revenue standard, including the guidance to account for "costs incurred to sell real estate" (i.e., certain sales and advertising expenditures related to the sale of real estate projects). Instead, homebuilders need to follow the guidance in ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*, to account for costs incurred to obtain a contract (e.g., sales and advertising expenditures).

Identifying the customer

To apply the standard, an entity must first identify the contract(s) to provide goods or services to customers. The standard defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration."[5] While entities in many cases don't have difficulty identifying the customer, the nature of certain homebuilding arrangements may make this assessment more complex because homebuilders need to consider whether any other activities (e.g., completion of common areas) represent promises to a customer.

Sale of a home or residential unit

When a homebuilder constructs and sells a completed home or residential unit (e.g., condominium), the customer, for purposes of applying the standard, is generally the buyer[6] specified in the home purchase agreement (hereinafter, the buyer or homeowner). The buyer agrees to provide consideration to the homebuilder and, in exchange, typically obtains legal title to the home (subject to the terms of any mortgage encumbrances) and the exclusive right to control its use (subject to applicable laws and the rules and restrictions of any governing property owners' associations).

Transfer of common areas by homebuilders

Homes and residential units constructed and sold to buyers are frequently located within communities also developed by the homebuilder. In addition to completed homes, these communities generally consist of some or all of the following elements (collectively referred to as common areas)[7]:

- Infrastructure (e.g., streets, sidewalks, utility systems, streetlights)
- Facilities (e.g., community clubhouses, pools, playgrounds, parks, trails)
- Enhancements (e.g., entryways, security gates, walls and fences, trees, landscape architecture)
- Off-site improvements (e.g., schools, parks, road improvements, utility systems not located within the physical boundaries of the community)

These common areas are integral to a community and are generally constructed by the homebuilder to (1) provide necessary infrastructure to facilitate long-term use of a community by its homeowners, (2) obtain permits and approval required by local municipalities or governmental agencies and (3) enhance the desirability of a community (i.e., drive increases in home prices and sales pace for the homebuilder). While a community is under development, the homebuilder is frequently able to unilaterally modify the common areas (e.g., add or eliminate common areas, change their nature or design, adjust the timing of their completion). In some cases, municipalities must approve changes to common areas, but consent of the homeowners in the community is generally not necessary.

Common areas are not transferred to a homeowner upon completion. Instead, they are typically transferred to one of the following third parties in exchange for no consideration:

- Homeowners' association (HOA)
- Quasi-governmental agency (e.g., community development district)
- Municipality or local government
- Utility provider
- School district

Homebuilders generally view third-party ownership of common areas as the most practical way to hold, operate and maintain common property for the benefit of the entire community. The third party to which common areas are transferred may vary significantly from community to community, or even for specific elements within the same community, based on a variety of factors. Homebuilders generally decide which common areas to transfer to each third party based on a number of factors (e.g., the municipality's approval process, other state and local regulations). Any remaining common areas are typically transferred to an HOA.

When evaluating the standard, many homebuilders and other stakeholders questioned whether any of the third parties to which common areas are transferred should be considered extensions of the customer (i.e., the homeowner). This question arose because homeowners within a community generally benefit (directly or indirectly) from common areas and expect that common areas will be completed and provided by the homebuilder. If any of these third parties were considered extensions of the customer (e.g., because each homeowner is a member of the HOA), the common areas transferred to them would likely represent implied promises[8] (which may be identified as performance obligations) to the customer, and the homebuilder would be required to allocate revenue from the sale of individual homes to these facilities. That is, the homebuilder would have to wait until it transferred control of the common area to recognize the revenue allocated from a home sale that occurred before control of the common area was transferred.

Third parties to which common areas of a community are transferred by a homebuilder are not considered extensions of the customer.

A homebuilder, when considering each of its arrangements, needs to evaluate whether it has made a promise to deliver an asset or provide a service to a customer and whether the party to which the asset or service is transferred is a customer (or is controlled by a customer). In our view, third parties to which common areas are transferred for no consideration generally should not be considered extensions of the customer in contracts to build homes or residential units because of the following factors:

- A homeowner (i.e., customer) has only limited rights, influence and interactions with the third parties to which common areas are transferred. Individual homeowners do not control any third party to which common areas are transferred, nor do they control the underlying assets that are transferred by a homebuilder. Individual homeowners also do not obtain legal title to any common areas or their underlying assets. An individual homeowner's influence is typically limited to a single vote afforded by membership in an HOA or residency in a municipality.
- A homeowner has no ability to control or influence the party to which common areas are transferred. Homebuilders execute agreements directly with third parties without input from homeowners.
- Although membership of an HOA comprises only a community's homeowners, an HOA's function and purpose align with those of other third parties to which common areas are transferred. For example, each third party is responsible for making decisions about the use and maintenance of the transferred common areas for the common good of the community. In addition, all third parties are governed by a board or council that comprises their constituents, operate in accordance with governing charters or bylaws, hold regular public meetings, establish and enforce community rules or laws, assess mandatory fees or taxes to fund their activities, and can place liens on a resident's property when those fees or taxes go unpaid.
- The transfer of common areas may not occur until several years after the initial sale of homes in a community. In the meantime, a home may be resold to a new owner or owners that were never customers of the homebuilder. Therefore, the common areas are transferred to an entity that, at least partially, does not comprise original customers of the homebuilder.

- The revenue standard did not amend the existing guidance in ASC 970 that prescribes the accounting for costs of amenities and other common areas of a real estate project. This further supports the assertion that common areas should be accounted for as costs of a real estate project (i.e., using the guidance in ASC 970) and not identified as performance obligations in the contract with the customer. Refer to the *Contract costs* section below for further discussion.

How we see it

If a homebuilder concludes that third parties to which common areas of a community are transferred are not considered extensions of the customer, the accounting model for common areas is generally consistent with legacy guidance. Assuming the homebuilder makes no other promises to the buyer (e.g., providing a free health club membership), consideration in a contract within the scope of the model in the standard related to the sale of a home or residential unit is recognized as revenue when control of the home or residential unit transfers to the buyer. Homebuilders need to evaluate the standard's principles for determining when control has transferred to the customer in order to determine the timing of revenue recognition.

Transfer of common areas by land developers

When homebuilders and other real estate entities act as land developers, the buyer is the customer for purposes of applying the standard to lot sales and any construction or development services related to lots sold (i.e., for goods produced or services performed by the homebuilder that will be transferred to the buyer).

These land developments often also include common areas that are constructed by the land developer and transferred to third parties. Consistent with the discussion above regarding the transfer of common areas by homebuilders to third parties, we believe that land developers may also determine that third parties are not extensions of the customer. However, if common areas are transferred to a third party (e.g., an HOA) that is controlled by the buyer of the developed lots, the third party would be an extension of the customer, and the common areas likely would be considered distinct promises (i.e., performance obligations) to the customer.

The *Land development arrangements* section below discusses additional considerations for land developers.

Common areas sold to third parties or retained by a homebuilder as revenue-generating facilities

If a homebuilder transfers (i.e., sells) a common area to a third party in exchange for consideration from that party and determines the transfer is an output of its ordinary activities, the third party is a customer for purposes of applying the standard. The sale of the common area is a contract with a customer, and the homebuilder applies the standard to the transaction.

Further, in certain instances, a homebuilder may construct and then operate common areas (e.g., golf courses) that are made available to community members or the general public in exchange for membership fees or a daily rate. When a homebuilder provides free or discounted membership in a club or other services, the homebuilder must determine whether those goods or services represent a promise to the customer that is distinct from the sale of a home. Promised goods or services that are distinct are performance obligations, and the homebuilder allocates a portion of the selling price of the home to them.

Determining whether (and when) to apply the model in the standard

The determination of whether (and when) an arrangement with a customer is a contract within the scope of the model in the standard affects how it is accounted for. There are five criteria to help an entity make this determination. Step 1 in the appendix to this publication describes these criteria and when and how they should be assessed.

If the criteria are not met, any consideration received from the customer (e.g., a deposit received from the homebuyer at the signing of the purchase contract) is accounted for under the guidance described below in the *Arrangements that do not meet the definition of a contract under the standard* section. Further, an entity may determine that certain disclosures required by the standard (e.g., aggregate amount of transaction price allocated to unsatisfied performance obligations) are not applicable for an arrangement that does not meet the definition of a contract, while other required disclosures (e.g., disaggregation of revenue) may be applicable when the alternative recognition model is applied to contracts that are not in the scope of the model in the standard. The disclosure requirements in the standard are discussed further in the *Disclosure requirements* section below.

Some of the standard's disclosure requirements may not be applicable to a purchase agreement that does not meet the definition of a contract under the standard.

Evaluating the contract criteria

The purchase agreement executed between a homebuilder and a buyer describes the rights and obligations of both parties and the expected payment terms upon closing of the sale. As a result, the following three criteria for identifying a contract are generally satisfied when the purchase agreement is executed:

- The entity can identify each party's rights regarding 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.

Further, when the purchase agreement is executed, the buyer typically provides a deposit that ranges from 1% to 20% of the anticipated sales price. The deposit is generally nonrefundable, but a homebuilder may refund it in certain circumstances or may be legally required to refund it in some jurisdictions. The buyer is generally not obligated to provide any further consideration to the homebuilder until construction of the home is complete and the sale closes. As a result, significant judgment may be required to determine when the remaining two criteria for identifying a contract are satisfied (i.e., (1) the parties to the contract have approved the contract and are committed to perform their respective obligations and (2) 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).

Contract is approved and both parties are committed to perform

In addition to approving the contract, the homebuilder must also be able to conclude that both parties are committed to perform their respective obligations. That is, the homebuilder must be committed to providing the promised goods and services (i.e., completed home), and the buyer must be committed to purchasing those goods and services.

Depending on the contract terms and its usual business practices, the homebuilder will generally conclude it is committed to provide the promised goods and services (i.e., completed home or residential unit) when the purchase agreement is executed or when construction begins. However, the homebuilder's evaluation of the buyer's commitment to purchase the completed home or residential unit will likely involve significant judgment. A homebuilder may need to consider (1) the amount of required initial deposit and (2) the homebuilder's ability to retain the deposit upon the buyer's cancellation of the contract.

For example, when a purchase agreement only requires a deposit that is considered nominal to the buyer (i.e., would not affect the buyer's decision to terminate the contract) or includes terms that allow the deposit to be refunded if the buyer terminates the agreement without cause, a homebuilder may conclude that the buyer is not committed to purchase the completed home when the agreement is executed. After reaching this conclusion, a homebuilder may not be able to assert that the buyer is committed to purchase the completed home until the sale closes.

Collectibility

Under the revenue standard, collectibility refers to the customer's ability and intent to pay substantially all of the amount of consideration to which the entity will be entitled in exchange for the goods and services that will be transferred to the customer. An entity should assess a customer's ability to pay based on the customer's financial capacity and its intention to pay considering all relevant facts and circumstances, including past experiences with that customer or customer class. Step 1 in the appendix to this publication further describes the collectibility guidance in the standard.

Entities need to determine the transaction price before assessing the collectibility of that amount. A homebuilding contract may include variable consideration (e.g., rebates, discounts, price concessions offered explicitly or implicitly to the customer). The standard requires an entity to estimate, at contract inception, the variable consideration it expects to receive and include those amounts in the transaction price unless it is probable that a significant reversal of revenue will occur when the related uncertainties are resolved. Refer to the *Land development arrangements* section below for further discussion on variable consideration.

The standard's collectibility assessment replaced the prescriptive guidance in ASC 360-20 for evaluating a buyer's initial and continuing investment.

Significant judgment is required to determine when an expected partial payment represents a contract with an implied price concession or an impairment loss. In many circumstances, an entity may not be willing to accept less than the contract price (i.e., offer a price concession) but is willing to accept the risk of default by the customer of contractually agreed-upon consideration (i.e., credit risk). In these circumstances, the transaction price would not differ from the contract price, and this amount would be evaluated to determine if collection is probable.

Further, when a homebuilder is evaluating collectibility for a portfolio of contracts, Transition Resource Group for Revenue Recognition (TRG) members generally agreed that if an entity has determined that it's probable that a customer will pay amounts owed under a contract, but the entity historically has not collected consideration from some customers within a portfolio of contracts, it would be appropriate for the entity to record revenue for the contract in full and separately evaluate the corresponding contract asset or receivable for impairment.[9] That is, the entity would not conclude that the arrangement contains an implicit price concession and reduce revenue for the uncollectible amounts.

How we see it

The revenue guidance introduced new judgments that must be made regarding collectibility and eliminated the collectibility guidance in ASC 360-20,[10] including its prescriptive requirements for evaluating whether the composition and size of the buyer's initial and continuing investments were adequate to demonstrate the buyer's commitment to pay for the property. Entities may need new processes and controls to evaluate some arrangements, including those in which the seller provides financing to the buyer.

When seller financing is provided, entities need to consider a variety of factors to evaluate collectibility of the transaction price, including commercially available lending terms for similar transactions, the sufficiency of the down payment, borrower creditworthiness and the entity's historical experience in similar transactions.

A homebuilder's assessment of collectibility throughout the term of the arrangement also may be affected by how the buyer plans to fund the purchase price (i.e., how the transaction is financed), as follows:

- If a purchase is self-funded by the buyer (i.e., the buyer intends to pay cash for 100% of the purchase price to the homebuilder at sale closing), the homebuilder evaluates the buyer's financial position prior to executing the purchase agreement. The homebuilder verifies that the buyer holds the net assets necessary to complete the purchase and determines whether there is any indication of possible deterioration of those net assets prior to sale closing. If the homebuilder is unable to conclude that collectibility is probable when the purchase agreement is executed, that assessment is revisited over the term of the arrangement. Once the sale closes and the homebuilder receives the full purchase price in cash, collection of the transaction price is assured (i.e., the collectibility criterion would be met no later than at sale closing).

- If the purchase is financed by a third-party lender, the homebuilder typically evaluates the buyer's ability to pay using a pre-qualification process prior to executing the purchase agreement. This process, which is similar to the pre-qualification (or preapproval) also performed by the third-party lender, enables the homebuilder to verify the buyer's current net assets, its ability to provide a down payment that meets the requirements of the third-party lender or government sponsored enterprise (GSE) mortgage assistance program, income sources and credit rating. If the homebuilder is unable to conclude that collectibility is probable when the purchase agreement is executed, that assessment is revisited over the term of the arrangement. Once the sale closes and the homebuilder receives the full purchase price in cash, collection of the transaction price is assured (i.e., the collectibility criterion would be met no later than at sale closing).

- If the purchase is financed by the homebuilder's captive lender (i.e., a consolidated entity of the homebuilder that provides financing to buyers), the homebuilder evaluates the buyer's ability to pay using a pre-qualification process similar to the one described above. If the captive lender chooses to retain the note receivable and collect future payments from the buyer, the homebuilder needs to evaluate the buyer's intent and ability to pay the transaction price over the duration of the arrangement. However, once a note receivable is sold to a private investor or GSE and the consideration from that sale is received by the homebuilder, collectibility of the transaction price is assured unless a risk of clawback exists (i.e., the mortgage buyer could require the homebuilder to repurchase the mortgage).

- The standard specifically precludes an entity from evaluating its ability to repossess an asset as part of the collectibility assessment. The FASB noted[11] that the ability to repossess an asset does not mitigate an entity's exposure to credit risk for the consideration promised in the contract. However, that ability may affect the entity's assessment of whether it has transferred control of the asset to the customer.

Arrangements that do not meet the definition of a contract under the standard

If an arrangement does not the meet the criteria to be accounted for as a contract under the standard (and continues not to meet them), an entity should recognize nonrefundable consideration received as revenue only when one of the following events has occurred:

- The entity has fully performed, and substantially all of the consideration has been received.

- The contract has been terminated.

- The entity has transferred control of the goods or services and has stopped transferring (and has no obligation under the contract to transfer) additional goods or services to the customer, if applicable.

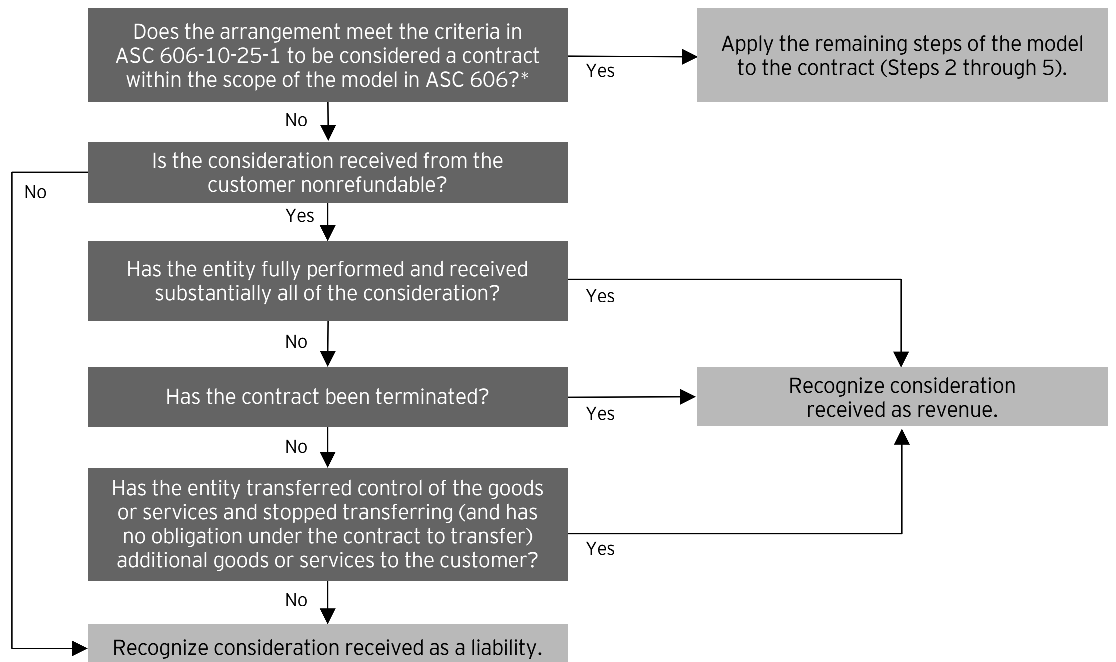
When an arrangement does not meet the criteria to be accounted for as a contract under the standard, homebuilders need to use significant judgment when evaluating the third criterion above (i.e., whether the homebuilder has transferred control of the home to the homebuyer). Once the sale of a home closes, it may be evident that certain of the factors in the standard for evaluating whether control has transferred have been satisfied (e.g., the homebuilder has a present right to payment for the home, physical possession of the home has transferred to the homebuyer). However, the homebuilder may also conclude that other factors have not been met (e.g., significant risks and rewards of ownership of the asset have not transferred to the homebuyer because it made only a nominal down payment at sale closing).

Although it is not specifically addressed in the standard, the evaluation of whether control has transferred affects the timing of derecognition of the related asset. The Board noted[12] that the concept of control in the standard is directly linked to, and intentionally derived from, the concept of control of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*, so there is a direct correlation between when an entity determines it has transferred control of an asset to a customer and when it should derecognize the asset. Once the buyer controls the asset (i.e., it has obtained control of the asset from the selling entity), the entity no longer controls that asset and should no longer recognize that asset (i.e., it should be derecognized by the entity), even when all of the revenue cannot be recognized for other reasons (e.g., the transaction price is not collectible). In these circumstances, it would generally be difficult for the entity to recognize an asset for future amounts it may collect. This could result in a significant up-front loss when the initial nonrefundable consideration received by the selling entity (e.g., the homebuilder) is substantially less than the carrying amount of the asset.

The evaluation of whether control has transferred affects the timing of derecognition of the related asset.

Until one of the events described above occurs, any consideration received from the customer is initially accounted for as a liability (not revenue), and the liability is measured at the amount of consideration received from the customer. The existing guidance in US GAAP (e.g., ASC 360, *Property, Plant, and Equipment*) should be applied to assets related to arrangements that do not meet the criteria to be accounted for as a contract under the standard. In the Background Information and Basis for Conclusions of Accounting Standards Update (ASU) 2014-09,[13] the Board indicated it intended for this accounting to be similar to the "deposit method" that was previously included in US GAAP and applied when there was no consummation of a sale.

The following flowchart illustrates this guidance:



* Entities should continue to assess the criteria throughout the term of the arrangement to determine whether they are subsequently met.

If an entity determines that the contract criteria are subsequently met, revenue should be recognized on a cumulative catch-up basis as of the date a contract exists within the scope of the model (i.e., the contract establishment date) reflecting the performance obligations that are partially or fully satisfied at that time. This accounting is consistent with the discussion in a TRG agenda paper,[14] which states that the cumulative catch-up method "best satisfies the core principle" of recognizing revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Recognizing revenue

Under the revenue standard, an entity recognizes revenue when (or as) it satisfies a performance obligation by transferring control of a promised good or service to a customer. Homebuilders that sell completed homes to buyers generally do not meet any of the three criteria to recognize revenue over time. As a result, revenue is generally recognized at a point in time.

How we see it

Under the revenue standard, control of many real estate properties transfers when the buyer obtains legal title and physical possession of the asset. Although this indicator is not determinative without full consideration of the facts and circumstances of the contract, the title to the real estate typically provides the holder of the title the ability to direct the use of and obtain substantially all of the remaining benefits of the asset to which the title is held. That is, if an entity holds the title to the real estate, it often will have the ability to control the asset.

However, if the transfer of the title to the real estate property doesn't coincide with, or conflicts with, the other indicators of control transfer (e.g., if title transfers but physical possession doesn't), sellers of real estate will have to carefully consider when control of the asset transfers. Sellers of real estate also have to carefully consider any other contract terms that may affect the transfer of control. For example, when an entity has the obligation or right to repurchase an asset (i.e., a forward or call option), this may indicate the buyer has not obtained control of the asset (see the *Repurchase agreements* section below).

In some instances, homebuilders and land developers recognize revenue over time if they determine that either (1) the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced or (2) the asset created by the entity has no alternative use and the entity has an enforceable right (throughout the contract) to payment from the customer for performance completed to date. For example, if a homebuilder constructs a custom home on land owned by the customer and the customer owns the construction in process, the homebuilder may be able to assert that it meets the criterion for revenue recognition over time if the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.

However, real estate sellers generally own the land and/or asset until title is transferred at completion of construction and, therefore, likely do not meet the first criterion described above for over-time recognition. Therefore, they must evaluate whether the asset has no alternative use and the entity has a present right to payment. For example, a real estate developer may determine that an asset has no alternative use because its characteristics (e.g., location, design, technical specifications, materials) would generally result in a contractual and/or practical limitation to redirect its use to another buyer. If, at any time during the contract term, the real estate developer would also be entitled to an amount that at least compensates it for work already performed, it may be able to assert that it meets the second criterion described above for over-time revenue recognition.

Refer to Step 5 in the appendix to this publication for the criteria that must be met to recognize revenue over time.

How we see it

Under the revenue standard, it may be difficult for real estate developers (e.g., developers of residential condominiums) to conclude that their arrangements meet the criteria for revenue recognition over time. In many jurisdictions (e.g., the US), the developer receives an initial deposit from the buyer but is not entitled to further consideration until the sale of the unit closes. As a result, the developer may be unable to assert that it has an enforceable right to payment for performance completed to date at any point in the contract term.

Land development arrangements

As described above, homebuilders and other real estate entities often act as land developers (e.g., entities that construct facilities on the land or provide improvements or amenities, such as roads, sewer lines or parks). Once the land developer identifies the goods and services promised to the customer, it must identify the separate performance obligations in the contract. This may require significant judgment. The criteria for making this determination are included in Step 2 of the appendix to this publication.

Determining whether promises in a land development arrangement are distinct requires significant judgment.

When land developers sell a lot (or lots) to buyers after all development activities are completed, this evaluation is generally straightforward. The developed lots represent distinct promises to the customer (i.e., one or more individual performance obligations), and revenue is recognized when control of the lot(s) and any associated improvements transfers to the buyer (i.e., generally at sale closing).

However, land developers often agree to provide construction or development services for a buyer after closing on the sale of the lot(s). In these cases, the land developer must evaluate which of the following it has agreed to provide the buyer:

- A combined promise of transferring a developed lot or lots and common areas that are transferred to the buyer, if any
- Distinct promises of (1) the sale of a lot or lots, (2) performance of construction or development services on the sold lot(s) and, if applicable, (3) performance of construction or development services related to any common areas that will be transferred to the buyer

When making this assessment, the land developer evaluates the nature of the promise to the customer and considers whether it is providing a significant service of integrating the land and development services into a combined output (i.e., developed lot) specified by the buyer. For example, the developer may determine that the nature of the promise is to deliver a lot in a certain location within a land development that is prepared for construction of a home to be initiated. In many instances, land developers may determine that they do not meet any of the three criteria to recognize revenue over time. As a result, revenue is recognized at a point in time.

If a land developer determines a performance obligation is satisfied over time, it may determine that costs incurred are an appropriate measure of progress toward the transfer of control of a developed lot or the performance of construction or development services. As described in the *Contract costs* section below, ASC 970 requires costs related to common areas be capitalized and allocated as common costs of a real estate project. Homebuilders and land developers need to consider whether costs incurred for common areas transferred to third parties (i.e., common areas that are not transferred to the buyer and, therefore, are not performance obligations) that are allocated as common costs of a real estate project using the guidance in ASC 970 should be included when determining the land developer's progress toward satisfying the respective performance obligations.

How we see it

Under legacy accounting in ASC 360-20, the sale of land when future development is required by the buyer may have been accounted for using the percentage-of-completion method as development and construction proceeded. Under the revenue standard, an entity needs to analyze each of its contracts to determine if that contract includes a single or multiple performance obligations and whether it should recognize revenue over time or at a point in time for performance of construction or development services.

In some instances, this could result in a change in the timing and/or pattern of revenue recognition.

Seller participates in future profit

In many land development arrangements, in addition to receiving fixed consideration from the sale of the property, the land developer participates in revenues or profits generated by the buyer's operation or sale of the property constructed on the land the developer sold. For example, the land developer may sell lots to a homebuilder for fixed consideration and receive a portion of the sales price (e.g., 2%) in the future when the homebuilder sells the completed home to a homebuyer. In these arrangements, the land developer generally has no further obligation or risk of loss.

Amounts from future profit participation represent variable consideration. An entity is required to estimate variable consideration using either the "expected value" method (i.e., the sum of probability-weighted amounts) or the "most likely amount" method (i.e., the single most likely outcome), whichever better predicts the amount of consideration to which it will be entitled. Step 3 in the appendix to this publication provides an overview of this guidance.

Future consideration from a real estate sale may be recognized when control of the property transfers.

The amount of variable consideration may need to be limited (i.e., constrained) and is included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. When an entity is unable to conclude that it is probable that a change in the estimate of variable consideration that *would* result in a significant revenue reversal will not occur, the amount of variable consideration is limited. In addition, when an arrangement includes variable consideration, an entity should update both its estimate of variable consideration and its evaluation of the constraint throughout the term of the contract to depict conditions that exist at each reporting date.

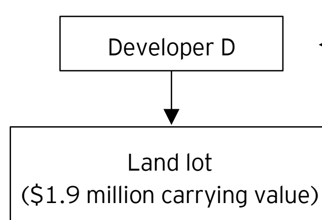
The following illustrates a real estate entity's estimate of variable consideration, including how an entity would apply the constraint resulting from future profit participation from a sale of real estate under the standard.

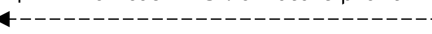
Illustration 1: Determining and reassessing the estimate of variable consideration

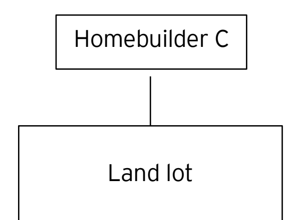
Developer D sells a land lot to Homebuilder C for (1) $2 million and (2) a right to receive 5% of Homebuilder C's future profit from the sale of the residential property (i.e., a home) that will be developed on the lot. Developer D has no ongoing obligations.

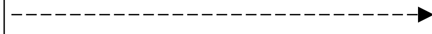
The land lot has a carrying value of $1.9 million.

Before: **After:**









Developer D determines there are a number of possible outcomes of consideration to be received based on the performance of the property (e.g., Homebuilder C's ability to effectively develop the home and secure a homebuyer to purchase the developed property at a favorable sales price).

Analysis

Developer D determines that the "expected value" approach is the better predictor of the variable consideration since multiple outcomes are possible. Developer D estimates the following future profit participation (before considering the constraint):

Developer D's share of profit (a)	Probability of outcome (b)		Expected value amount (a * b)
$ 50,000	10%		$ 5,000
25,000	70%		17,500
–	20%		–
		Total	$ 22,500

Developer D considers the effect of applying the constraint on variable consideration. Developer D considered the factors that could increase the likelihood of a revenue reversal in ASC 606-10-32-12 and observes that the future profit from the sale of the land lot is subject to factors outside its influence and a broad range of outcomes. However, Developer D has significant experience with similar types of contracts, and its experience has predictive value. Considering these factors, Developer D concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur if the entity includes $10,000 of estimated profit participation in the transaction price (i.e., variable consideration is partially constrained at contract inception).

The profit from the sale of the land lot at contract inception is calculated as follows:

Cash proceeds	$ 2,000,000
Variable consideration	10,000
Transaction price	2,010,000
Less: carrying amount of property	1,900,000
Profit on sale	$ 110,000

Developer D updates its estimate of the transaction price at the next reporting date as follows:

Developer D's share of profit (a)	Probability of outcome (b)		Expected value amount (a * b)
$ 50,000	25%		$ 12,500
25,000	50%		12,500
–	25%		–
		Total	$ 25,000

After considering that Homebuilder C now has better pricing information from offers received on the land lot, Developer D concludes that the profit participation estimate is no longer constrained. As a result, Developer D's estimate of variable consideration is updated to $25,000 and $15,000 ($25,000 revised estimated variable consideration less $10,000 previously recognized) is recognized as additional revenue.

Note: The analysis and resulting estimate of variable consideration in a contract with a customer might be different than from this illustration depending on the facts and circumstances, including different terms for the variable consideration. For example, Developer D might have concluded that a lesser amount of, or no, constraint on variable consideration is necessary if the form of the right were to receive a percentage of the sales price of the home instead of a right to receive a percentage of Developer D's profit. Entities should carefully consider all terms and conditions related to variable consideration when they determine the transaction price for their customer contracts.

Repurchase agreements

Certain agreements for the sale of real estate may include provisions that require, or give an option to, the seller to repurchase the property. These provisions are generally structured in one of three ways:

- Forward option — an entity is obligated to repurchase the property
- Call option — an entity has the right to repurchase the property
- Put option — an entity is obligated to repurchase the property at the buyer's request
- ASC 606 addresses the accounting for each of these repurchase provisions.

Forward or call option held by the entity

When an entity has the obligation or right to repurchase a property (i.e., a forward or call option), the standard indicates that the buyer has not obtained control of the property. Instead, the standard requires that an entity account for a transaction that includes a forward or a call option based on the relationship between the repurchase price and the original selling price.

The standard indicates that if the entity has the right or obligation to repurchase the property at a price less than the original sales price (considering the effects of the time value of money), the entity accounts for the transaction as a lease in accordance with ASC 840 (or ASC 842 upon adoption of ASU 2016-02), unless the contract is part of a sale-leaseback transaction.

In contrast, if the entity has the right or obligation to repurchase the property at a price equal to or greater than the original sales price (considering the effects of the time value of money) or if the contract is part of a sale-leaseback transaction, the entity accounts for the arrangement as a financing arrangement.[15]

The following graphic depicts this guidance for transactions that are not sale-leasebacks:

Forward or call option				
Repurchase price	<	Original selling price	=	Lease
Repurchase price	≥	Original selling price	=	Financing

Under the standard, a transaction with a seller option to repurchase the product is treated as a lease or a financing arrangement (i.e., not a sale) because the customer does not have control of the asset and is constrained in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. The Board noted in the Basis for Conclusions of ASU 2014-09[16] that entities would not need to consider the likelihood that a call option will be exercised in determining the accounting for the repurchase provision. However, the Board also stated that non-substantive call options should be ignored and would not affect when a customer obtains control of an asset.

Conditional call options

The standard does not specifically address conditional call options. We believe that if the seller controls the outcome of the condition that causes the call option to become active, then the presence of the call option indicates that control has not transferred because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. That is, the seller would be required to treat the contract as a lease or a financing arrangement as required by the standard.[17]

We also believe that if the seller does not control the condition that causes the call option to become active, then it would be acceptable for the entity to apply judgment to determine whether the call option limits the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. For example, if neither the seller nor the customer controls the outcome of the contingency, the seller could evaluate the nature of the contingency, together with the likelihood of the contingency becoming active, to determine whether it limits the customer's ability to obtain control of the asset.

We further believe that if the customer controls the outcome of the contingency, then the conditional call option may not prevent the customer from obtaining control of the asset if the customer can direct the use of, and obtain substantially all the remaining benefits from, the asset. The guidance in ASC 606-10-55-72 through 55-78 may be helpful for a seller to consider when determining whether the customer obtains control of the asset when a customer controls the outcome of the contingency.

How we see it

The concept of accounting for a forward or call option as a lease or financing arrangement is similar to legacy guidance in ASC 360-20. However, under ASC 360-20, an entity could also apply the profit-sharing method if certain criteria are met. The revenue standard only allows a sale with a corresponding forward or call option to be treated as a lease or a financing arrangement, and the likelihood of exercise is not contemplated in the accounting.

Because the standard treats all forwards and call options the same way and does not consider their likelihood of exercise, some entities may experience a significant change in practice. It is common for land developers to sell land parcels with a right, but not an obligation, to reacquire the property if the buyer fails to comply with provisions of the sales contract. For example, such provisions may include anti-speculation clauses that require the buyer to develop the land in a specific manner or within a stated period of time.

The revenue standard focuses its evaluation on whether the buyer is limited in its ability to direct the use of, or obtain substantially all of the remaining benefits from, the property even though the buyer may have physical possession of the asset. In contrast, under ASC 360-20, the land developer's contingent option did not preclude sales recognition if the probability of the buyer not complying was remote. Land developers applying the guidance in ASC 606 need to apply significant judgment to determine if the buyer has obtained control of the land when the contract contains a conditional call option to repurchase the asset.

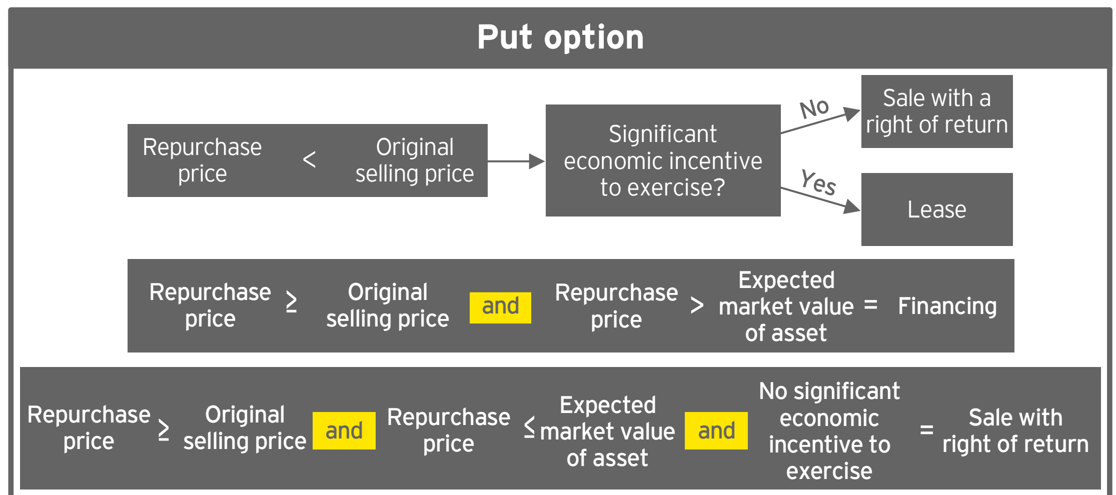
Written put option held by the buyer

A real estate sales contract may give a buyer the ability to require the seller to repurchase the property at a previously agreed-upon price (i.e., a put option). Under ASC 606, a seller accounts for a contract that includes a put option using one of three methods (i.e., lease, sale with a right of return or financing arrangement) depending on the relationship of the exercise price to the original selling price of the property and whether the buyer has a significant economic incentive to exercise its right.

The determination of whether an entity has a significant economic incentive to exercise its right influences whether the buyer truly has control of the property received and determines whether the arrangement is treated as a lease or a sale with the right of return.

- *Lease* — If the repurchase price is less than the original selling price and the buyer has a significant economic incentive to exercise the put option, the seller accounts for the agreement as a lease because the buyer is effectively paying for the right to use the property for a period of time.[18]
- *Sale with a right of return* — If the repurchase price is less than the original selling price and the buyer does not have a significant economic incentive to exercise its right, the seller accounts for the agreement in a manner similar to a sale with a right of return. A repurchase price that is equal to or greater than the original selling price, but less than or equal to its expected market value, is 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.
- *Financing arrangement* — If the buyer has the ability to require the seller to repurchase the property at a price that is equal to or greater than the original selling price and greater than the expected market value of the property, the contract is, in effect, a financing.

The following graphic depicts this guidance:



A seller has to consider many factors to determine whether a buyer has a significant economic incentive to exercise the put option, including the relationship of the repurchase price to the expected market value of the property at the date of repurchase and the amount of time until the option expires. The standard notes that if the repurchase price is expected to significantly exceed the market value of the property, the buyer has a significant economic incentive to exercise the put option.

How we see it

The revenue standard does not provide guidance on determining whether the buyer has "a significant economic incentive" to exercise a put option. We believe entities that sell a property subject to a put option need to estimate the future market price of the property and evaluate other facts and circumstances to determine whether the buyer has a significant economic incentive to exercise the option. This determination may require significant judgment.

Contract costs

Accounting for real estate project costs and costs of common areas

Homebuilders apply the guidance in ASC 970 to account for real estate project costs and allocate costs of common areas (or amenities).

- Project costs are costs that are clearly associated with the acquisition, development and construction of a real estate project and may include the cost of land acquisition, building materials or project plans (among other costs).
- Indirect project costs are costs incurred after the acquisition of the property, such as construction administration, legal fees and various office costs, that clearly relate to projects under development or construction.
- Amenities include golf courses, utility plants, clubhouses, swimming pools, tennis courts, indoor recreational facilities and parking facilities. These are features that enhance the attractiveness or perceived value of the real estate. Promised amenities are amenities that a developer is obligated to construct under the terms of the contracts with purchasers.

Homebuilders apply the guidance in ASC 970 to account for real estate project costs and allocate costs of common areas (or amenities).

The table below summarizes the guidance for capitalizing costs in ASC 970 before and after the adoption of ASC 606:

	ASC 970	
	Before adoption of ASC 606	**After adoption of ASC 606**
Project costs	Project costs clearly associated with the acquisition, development and construction of a real estate project are capitalized as a cost of that project.	After the adoption of ASU 2020-10,[19] no change. That is, project costs, which are costs that are clearly associated with the acquisition, development and construction of a real estate project, are capitalized as a cost of that project. Entities should apply ASC 340-40 for guidance on capitalization of costs that are not within the scope of ASC 970-360 or 970-340. Before the adoption of ASU 2020-10, project costs recognized as an asset in accordance with ASC 340-40 are capitalized as a cost of that project.
Indirect project costs	Indirect project costs that relate to several projects are capitalized and allocated to the projects to which the costs relate.	No change.
Amenities	Costs of amenities are allocated among land parcels benefited and for which development is probable. The accounting for costs of amenities is based on management's plans for the amenities in accordance with ASC 970-340-25-9.[20]	No change.

ASC 340-40 also includes guidance for recognizing costs incurred in fulfilling a contract that are not in the scope of another topic. For most real estate entities, costs incurred in fulfilling a contract (e.g., the costs to construct a home, such as materials and labor) are already in the scope of another topic (e.g., ASC 970 or ASC 360) and, therefore, are excluded from the scope of ASC 340-40. For example:

- ASC 360[21] provides general guidance for capitalizing costs of acquiring property, plant and equipment and includes costs of activities necessarily incurred to bring an asset to the condition and location necessary for its intended use.
- ASC 970-360[22] provides guidance for capitalizing indirect real estate project costs that relate to several real estate projects as project costs.
- ASC 970-340[23] provides guidance for costs related to amenities (i.e., common areas) that are to be sold or transferred in connection with the sale of individual units to customers. Those costs are allocated as common costs of the project among land parcels (e.g., individual lots or units, project phases) for which development is probable and expensed when control of the individual land parcel is transferred.

The revenue standard did not amend the guidance in ASC 970 and ASC 360 above. Refer to our FRD publication, ***Real estate project costs***, for more information.

Accounting for costs incurred to sell real estate projects

The guidance for costs incurred to sell real estate projects in ASC 970 is eliminated.

The revenue standard eliminates the legacy guidance in ASC 970 that prescribes the accounting for costs incurred to sell real estate projects. Homebuilders need to apply the guidance in ASC 340-40 to these costs. Under ASC 340-40, incremental costs of obtaining a contract with a customer (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.

The table below summarizes the key guidance for accounting for costs incurred to sell real estate projects in ASC 970 before and after the adoption of ASC 606:

	ASC 970	
	Before adoption of ASC 606	**After adoption of ASC 606**
Costs incurred to sell real estate projects	Costs incurred to sell real estate are capitalized if the costs are recoverable and incurred for either: ‣ Tangible assets that are used directly throughout the selling period to aid in the sale of the project ‣ Services that have been performed to obtain regulatory approval of sales	Costs incurred to sell real estate projects are capitalized as an asset under ASC 340-40 if the costs are recoverable and would not have been incurred if the contract had not been obtained, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

ASC 340-40 cites sales commissions as a type of an incremental cost that may meet the criteria for capitalization. Any capitalized contract costs are amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates (i.e., the expense is recognized as the entity transfers the related goods or services to the customer). When the timing of revenue recognition (e.g., at a point in time) aligns with the transfer of the goods or services to the buyer, the amortization of the capitalized contract costs in a reporting period will correspond with the revenue recognition in that reporting period.

For example, sales commissions paid for a home sale may represent incremental costs that meet the criteria for capitalization if the costs would not have been incurred if the contract had not been obtained. However, the related amortization expense is recognized when control of the home transfers to the buyer, which will often occur at the same time that the home sale is closed and revenue is recognized.

Costs incurred for model units, advertising and sales overhead are unlikely to qualify for capitalization under ASC 340-40 because they are not incremental costs of obtaining a contract. Costs of furniture and equipment used in sales offices and model units may qualify for capitalization under another ASC topic (e.g., ASC 360).

How we see it

The revenue standard eliminated the legacy guidance in ASC 970 that prescribed the accounting for costs incurred to sell real estate projects. That guidance allowed homebuilders to capitalize selling costs if they were reasonably expected to be recovered from the sale of the project and were used directly to aid in the sale of the project or to obtain regulatory approval of sales. The types of costs that homebuilders can capitalize are limited by the new standard.

Disclosure requirements

The standard significantly increased the volume of required disclosures in homebuilders' interim and annual financial statements. Entities are required to provide a comprehensive set of disclosures about revenue from contracts with customers. For public entities, these disclosures include disaggregated revenues and qualitative and quantitative information about contracts with customers, significant judgments made in applying the standard, and costs to obtain or fulfill a contract. Nonpublic entities can choose to provide the same or streamlined disclosures. The disclosure requirements described below may be particularly relevant to homebuilders.

Disclosure of performance obligations

Homebuilders need to carefully consider the following disclosures about performance obligations in contracts with customers:

- ***When the entity typically satisfies its performance obligations*** **—** For a homebuilder, this may include discussion about the point in time at which control of a completed home is transferred or how control is transferred if an entity meets the criteria to recognize revenue from the sale of a residential unit over time.

- ***The significant payment terms of its contracts*** **—** For a homebuilder, this may include a discussion of any variable consideration included in the transaction price, how the constraint has been considered and the financing terms provided.

- ***The nature of goods or services that the entity has promised to transfer to the customer*** **—** This disclosure should be relatively straightforward for most homebuilders (e.g., the homebuilder generally transfers a completed home or residential unit).

- ***The types of warranties and related obligations*** **—** For a homebuilder, this may include discussion of whether any warranties provided in conjunction with home or residential unit sales are assurance-type or service-type warranties, the length of warranty terms, amounts paid to satisfy warranty claims and any obligations currently recorded.

Disclosure of transaction price allocated to unsatisfied performance obligations

The standard requires disclosure of the following information about transaction price that has been allocated to unsatisfied performance obligations in contracts with customers:

- **The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied or partially satisfied as of the end of the reporting period** — For homebuilders, this would include the transaction price associated with uncompleted homes when the homebuilder determines that the arrangement meets the requirements to be a contract prior to the sale closing.

- **An explanation of when the entity expects to recognize the revenue allocated to unsatisfied or partially satisfied performance obligations** — This disclosure may be made on a quantitative basis using time bands that would be most appropriate for the duration of the remaining performance obligations or by using qualitative information.

The standard provides a practical expedient under which entities can avoid providing the information required by this disclosure for contracts with an original expected duration of less than one year. An entity that uses this practical expedient is required to disclose that fact.

Endnotes:

[1] ASC 606, *Revenue from Contracts with Customers*, as amended, was created by ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and various amendments.

[2] ASC 610-20, as created by ASU 2014-09 and amended by ASU 2017-05, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*.

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

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

[5] ASC 606-10-20.

[6] Homes and residential units are generally purchased by individuals or a single legal entity. However, in circumstances in which multiple individuals agree to collectively purchase a home or residential unit, the collective group of purchasers would constitute a single customer under the revenue standard.

[7] Certain of these community elements are commonly referred to as amenities. We use the broader term "common areas" to include all community elements (not just those that might be considered amenities) that are completed by the homebuilder and transferred to another party.

[8] ASC 606-10-25-16 states that contracts with customers may include "promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer." A performance obligation is a promise to transfer a customer a distinct good or service.

[9] 26 January 2015 TRG meeting; agenda paper no. 13.

[10] ASU 2014-09 superseded the guidance in ASC 360-20 for all sales of real estate except for sale and leaseback transactions involving real estate that are within the scope of ASC 840-40, *Leases — Sale-Leaseback Transactions*. Entities will continue to apply the guidance in ASC 360-20 and ASC 840-40 to sale-leaseback transactions involving real estate until they adopt the new guidance for sale and leaseback transactions in ASC 842, *Leases*.

[11] Paragraph BC15 of ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*.

[12] Paragraph BC28 of ASU 2016-12.

[13] Paragraph BC48 of ASU 2014-09.

[14] 30 March 2015 TRG meeting; agenda paper no. 33.

[15] The financing arrangement is accounted for in accordance with ASC 606-10-55-70.

[16] Paragraph BC427 of ASU 2014-09.

[17] The seller would be required to treat the contract as a lease or a financing arrangement as required by ASC 606-10-55-68.

[18] An exception would be if the contract is part of a sale-leaseback, in which case the contract should be accounted for as a financing arrangement in accordance with ASC 606-10-55-70.

[19] ASU 2020-10, *Codification Improvements,* is effective for annual periods beginning after December 15, 2020, for public business entities. For all other entities, the amendments are effective for annual periods beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early application is permitted for public business entities for any annual or interim period for which financial statements have not been issued. For all other entities, early application of the amendments is permitted for any annual or interim period for which financial statements are available to be issued.

[20] Refer to section 2.4, *Amenities*, of our FRD publication, *Real estate project costs,* for further details.

[21] ASC 360-10-30-1.

[22] ASC 970-360-25-3.

[23] ASC 970-340-25-9 through 25-11.

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

Series guidance

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

Customer options for additional goods or services

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

Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and, therefore, records revenue on a gross basis if it controls the specified good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the specified goods or services. Because it is not always clear whether an

entity controls a specified good or service in some contracts (e.g., those involving intangible goods and/or services), the standard also provides indicators of when an entity may control the specified good or service as follows:

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

Step 3: Determine the transaction price

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

Variable consideration

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

Significant financing component

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

Noncash consideration

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

Consideration paid or payable to the customer

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

Step 4: Allocate the transaction price to the performance obligations in the contract
For contracts that have multiple performance obligations, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). When allocating on a relative standalone selling price basis, any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract. However, there are two exceptions. One exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met: ‣ The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service. ‣ Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the objective of allocating consideration in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer. ‣ The other exception requires an entity to allocate a contract's entire discount to only those goods or services to which it relates if certain criteria are met. To allocate the transaction price on a relative standalone selling price basis, an entity must first determine the standalone selling price of the distinct good or service underlying each performance obligation. The standalone selling price is the price at which an entity would sell a good or service on a standalone (or separate) basis at contract inception. Under the model, the observable price of a good or service sold separately in similar circumstances to similar customers provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity must estimate the standalone selling price by considering all information that is reasonably available to it, maximizing the use of observable inputs and applying estimation methods consistently in similar circumstances. The standard states that suitable estimation methods include, but are not limited to, an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach (if certain conditions are met).
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation
An entity recognizes revenue only when (or as) it satisfies a performance obligation by transferring control of the promised good(s) or service(s) to a customer. The transfer of control can occur over time or at a point in time. A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time: ‣ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. ‣ The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced. ‣ The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date. The transaction price allocated to performance obligations satisfied at a point in time is recognized as revenue when control of the goods or services transfers to the customer. If the performance obligation is satisfied over time, the transaction price allocated to that performance obligation is recognized as revenue as the performance obligation is satisfied. To do this, the standard requires an entity to select a single revenue recognition method (i.e., measure of progress) that faithfully depicts the pattern of the transfer of control over time (i.e., an input method or an output method).

Licenses of intellectual property

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

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

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

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

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

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

Contract costs

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

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

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

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