

Technical Line

FASB – final guidance

How the revenue recognition standard affects upstream oil and gas entities

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What you need to know

- ▶ An operator in a joint operating agreement or production sharing contract needs to consider whether it is acting as a principal or an agent for the sale of commodities.
- ▶ Upstream oil and gas entities need to apply judgment when accounting for commodity sales contracts.

When applying the revenue recognition standard,¹ entities in the upstream oil and gas industry need to make judgments and estimates, such as the determination of principal versus agent.

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

Scope and scope exceptions

Risk- and reward-sharing arrangements

An upstream oil and gas entity's contracts with partners in a joint interest operation, production sharing arrangement or similar structure generally are outside the scope of the standard because they typically are not vendor-customer relationships. Instead, these contracts govern relationships in which the parties share the risks and benefits of oil and gas exploration and production.

However, an entity's sales to customers of commodities sourced from a joint operating arrangement (JOA) generally are in the scope of the revenue standard, regardless of the type of ownership interest the entity holds (i.e., operator, non-operator, royalty), because the commodities are outputs of the entity's ordinary activities and are sold to customers.

Mineral rights development agreements in some countries may be governed by a production sharing contract (PSC). While each PSC is unique, the two primary models are concession arrangements and contractual systems. In both types of models, the upstream entity (contractor) typically bears the full risk of exploration and development, though in some cases the host government may participate through a state-owned oil and gas company.

In a concession arrangement, title to the oil or gas produced typically transfers to the contractor, and the government is entitled to a royalty. In a contractual system, title remains with the government, and the contractor is entitled to a share of production as reimbursement of its costs, plus a profit margin.

Depending on the facts and circumstances of a PSC (i.e., a concession arrangement or contractual system), a counterparty in a PSC may not be a customer of the contractor. Instead, the counterparty may be a collaborator or partner that shares in the risks and benefits of developing the oil or gas to be marketed. While arrangements governed by PSCs generally are in the scope of Accounting Standards Codification (ASC) 808 on collaborative arrangements, oil and gas entities need to carefully analyze transactions with their counterparties in these arrangements because some transactions may have a vendor-customer aspect. Therefore, an arrangement or component of an arrangement may be in the scope of ASC 606 if the counterparty meets the definition of a customer in ASC 606 for a distinct good or service (i.e., unit of account under ASC 606).

Conveyances of oil and gas mineral interests

An upstream entity generally accounts for transfers of oil and gas mineral interests, known as conveyances,² under ASC 932, *Extractive Activities – Oil and Gas*. Conveyances of mineral interests generally are not the outputs of an upstream entity's ordinary activities and, therefore, are not considered contracts with customers in the scope of ASC 606.

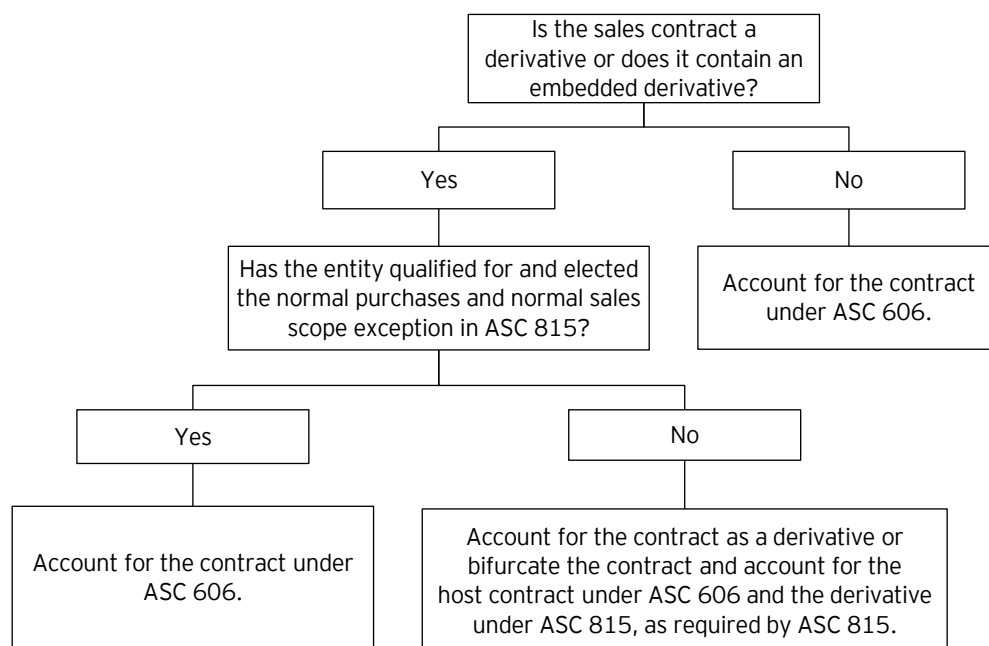
The guidance in ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*, which requires entities to apply principles in ASC 606 to dispositions of nonfinancial assets, also excludes conveyances of oil and gas mineral interests from its scope. Accordingly, conveyance transactions accounted for by ASC 932 are unaffected by either ASC 606 or ASC 610.

Commodity sales contracts

Scope considerations

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

An entity's sales of commodities to a customer that are the output of a JOA generally are in the scope of the revenue standard.



How we see it

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

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

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

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

In assessing whether each unit has the same pattern of transfer, an entity must determine whether each distinct unit meets the criteria to be recognized over time and has the same measure of progress. One of the over-time criteria that upstream entities need to consider for these types of contracts is whether the customer simultaneously receives and consumes the benefits provided by the entity's performance as it transfers control of each barrel or Mcf to the

customer (i.e., whether each of the distinct units meets the criteria to be recognized over time). This over-time criterion would not apply if the entity's performance creates an asset that the customer does not immediately consume upon transfer (e.g., the customer holds an inventory of oil).³ Generally, upstream commodity contracts will have the same measure of progress.

An upstream entity should consider all facts and circumstances when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity.⁴ These facts and circumstances may include the characteristics of the commodity (e.g., whether it can be stored), the contract terms (e.g., whether the entity provides a continuous supply to meet immediate demand) and information about the delivery mechanisms and other infrastructure. The following illustrates how an upstream entity might evaluate performance obligations in a commodity sales contract:

Illustration 1: Sale of crude oil to a customer that will store the product prior to usage

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

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

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

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

How we see it

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

Pricing considerations (Steps 3, 4 and 5)

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

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

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

Fixed pricing

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

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

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

How we see it

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

Upstream oil and gas entities need to carefully evaluate whether they control a specified product prior to its transfer to the customer.

Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, the standard requires an entity to determine whether it is a principal or an agent 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 a promised good or service before transferring that good or service to the customer. An entity is an agent if it does not control the promised good or service before transfer to the customer. If the entity is an agent, it records as revenue the net amount it retains for its agency services (i.e., to arrange for another entity to provide the goods or services).

An entity cannot provide the specified good or service to a customer (and, therefore, be a principal) unless it controls that good or service prior to its transfer. That is control is the determining factor when assessing whether an entity is a principal or an agent.⁵

Because it may not be clear whether an entity controls the specified good or service, the standard provides three indicators of when an entity controls the specified good or service and is therefore a principal. These indicators are meant to support an entity's assessment of control, not to replace it, and each indicator explains how it supports the assessment of control. If an entity reaches different conclusions about whether it controls the specified good or service by applying the standard's definition of control versus the principal indicators, the entity should reconsider its assessment considering the facts and circumstances of its contract. This is because the entity's assessment of control and the principal indicators should align.

Marketing services provided by an operator in a JOA

The operator in a JOA may have a contract with a non-operator to market and sell the non-operator's product to a third party. Both the operator and non-operator need to determine whether the operator is acting as a principal or an agent in the arrangement. The operator will use the assessment to determine the customer and whether to record gross revenue based on total production or net revenue, based on its net working interest. The non-operator will use the assessment to determine the customer and the timing of revenue recognition.

Operators should consider if and when they obtain control of the non-operators' product for sale to the end customer. Non-operators should consider whether they transfer control of the product to the operator through the marketing arrangement. Since there are various ways upstream entities can transfer control (i.e., at the wellhead, inlet, tailgate of the processing plant, or a location where the product is delivered to a third party), they may reach different conclusions for different contracts, depending on the facts and circumstances.

Illustration 3: Crude oil marketing contract when control transfers to the operator

A non-operator (upstream entity) enters into a crude oil contract with the operator, and both entities determine that control of the crude oil passes to the operator at the wellhead. As a result, the non-operator concludes that it has effectively sold crude oil to the operator (i.e., the operator is the customer). The transaction price is the amount the non-operator charges the operator for that commodity. The operator generally would conclude that it is acting as a principal for sales of product it obtains from the non-operator to a third-party customer, and it will record gross revenue for selling both its net interest in the well (i.e., oil it obtained as a result of its interest in the property) as well as the oil it purchased from the non-operator.

Illustration 4: Crude oil marketing contract when control does not transfer to the operator

A non-operator (upstream entity) enters into a crude oil marketing contract and determines that control of the crude oil does not pass to the operator. The upstream entity (non-operator) concludes that it has entered into commodity sales contracts with the end customers and will recognize revenue when control of the crude oil transfers to them. The upstream entity also concludes that it is purchasing marketing services from the operator and will recognize the marketing fee (if any) as a cost of selling the crude oil. The operator has determined it is acting as an agent and accordingly will record revenue for its portion of the production (i.e., oil obtained as a result of its interest in the property) it sells and for the marketing fee it receives for acting as the agent in the non-operator's sales of crude oil to customers.

Complex gas processing arrangements

Upstream entities need to evaluate the facts and circumstances of complex natural gas processing contracts (e.g., percentage of proceeds contracts, percentage of liquids contracts) to determine which party is the principal in the arrangement.⁶ Determining the nature of the promised specified good or service is critical. For example, an upstream entity may sell the unprocessed commodity to a midstream natural gas gathering and processing entity. Alternatively, an upstream entity may sell the processed commodity to an end customer and may purchase processing services from another entity.

Illustration 5: Gas processing contract when control transfers to the processor

An upstream entity enters into a contract with a natural gas processor and determines that it transfers control of unprocessed natural gas to the processor at the inlet of the plant. Assume the upstream entity does not lease the processing facility. As a result, the upstream entity concludes that it has effectively sold unprocessed natural gas to the processor (i.e., the processor is the customer). The transaction price is the net amount the upstream entity charges the processor for that commodity (i.e., the sales price of the processed natural gas net of the processing fee).

Illustration 6: Gas processing contract when control does not transfer to the processor

An upstream entity enters into a natural gas processing contract and determines that control of unprocessed natural gas does not pass to the processor. The upstream entity concludes that it has entered into commodity sales contracts with end customers for the processed natural gas and will recognize revenue when control of the processed natural gas transfers to them. The upstream entity will determine the transaction price based on the consideration paid by the end customers. The upstream entity concludes that it is purchasing processing services from the processor.

Balancing arrangements

Production and sales imbalances arise when entities that are participating in a JOA sell volumes to third-party customers that differ from their proportionate share of production. Upstream entities account for production and sales imbalances that arise from commodity sales to customers under the revenue standard, if applicable. Oil and gas entities should recognize revenue when the entity sells product to customers. Entities need to determine whether arrangements that require entities to periodically settle imbalances create vendor-customer relationships.⁷ Periodic settlement requirements are more common in international contracts.

Disclosure requirements

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

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

- ▶ Entities have to present separately contracts with customers subject to the standard from other sources of revenue on the face of the financial statements or in the notes to the financial statements. This includes both the revenue amounts and the related receivables. For example, entities must separately disclose the revenues and related receivables from commodity sales contracts accounted for under the revenue standard and those accounted for as derivatives under ASC 815 (e.g., index-based contracts entities have not elected to treat as normal purchases and normal sales), even if amounts were generated under the same contract with the same counterparty.
- ▶ The standard requires a comprehensive set of disclosures about revenue from contracts with customers. Entities must evaluate whether separating different types of commodity sales contracts (e.g., by type of commodity, geographical region, type of contract) is appropriate to meet the disaggregation objective. Entities also have to reconcile any differences between this disclosure and segment disclosures. When determining the type of categories to use to disaggregate revenue, entities should consider how information about revenue has been presented for other purposes, including disclosures presented outside the financial statements and information reviewed by the chief operating decision maker for evaluating the performance operating segments.
- ▶ Entities must disclose how much revenue recognized in the current period is associated with previously fulfilled (or partially fulfilled) performance obligations. They may need to consider how this applies to adjustments that may be resolved in subsequent periods (e.g., quality adjustments, volume true-ups, changes in variable consideration associated with volume discounts, changes in estimated breakage).
- ▶ Entities also have to disclose the aggregate amount of the transaction price that is allocated to performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period. For example, if an entity estimates a total transaction price (after applying the constraint on variable consideration) of \$24 million and has recognized \$18 million to date, it discloses that \$6 million of the transaction price is yet to be recognized, along with either quantitative or qualitative information on when the remaining transaction price is expected to be recognized.

Entities can elect to use an optional exemption that allows an entity not to make quantitative disclosures about remaining performance obligations in certain situations, including when contracts have an original expected duration of less than one year and when an estimate of the transaction price is made solely for disclosure purposes. These situations also include: (1) when an entity applies the “right to invoice” practical expedient⁸ and (2) when variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation (i.e., a series of distinct goods or services) when certain criteria are met.

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

Endnotes:

- ¹ ASC 606, *Revenue from Contracts with Customers*.
- ² The American Institute of Certified Public Accountants' Accounting and Auditing Guide for *Entities with Oil and Gas Producing Activities* notes a conveyance is the assignment or transfer of mineral interests, usually a portion of a working interest, to another party. A conveyance may involve a transfer of all or part of the rights and responsibilities of developing and operating a property.
- ³ Paragraph BC128 of Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*.
- ⁴ 13 July 2015 Transition Resource Group (TRG) meeting; agenda paper no. 43.
- ⁵ Paragraph BC31 of ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*.
- ⁶ This discussion assumes that transactions involving the sale of a commodity do not qualify as a derivative under ASC 815 or are accounted for under the normal purchase and normal sales exception to derivative accounting. It also assumes that the processing contract with the midstream entity does not meet the definition of a lease under ASC 842, *Leases*.
- ⁷ Paragraph BC54 of ASU 2014-09.
- ⁸ The Financial Accounting Standards Board (FASB) provided a practical expedient in ASC 606-10-55-18 for using an output method to measure progress toward completion of a performance obligation that is satisfied over time. If an entity demonstrates that the invoiced amount corresponds directly with the value to the customer of the entity's performance completed to date, the practical expedient allows an entity to recognize revenue in the amount for which it has the right to invoice.

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Appendix: The five-step revenue model and contract costs

The standard's core principle is that an entity 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 revenue model and the guidance for contract costs.

Step 1: Identify the contract(s) with the customer
<p>Definition of a contract</p> <p>An entity must first identify the contract, or contracts, to provide goods and services to customers. A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices but must meet the following criteria:</p> <ul style="list-style-type: none"> ▶ The parties to the contract have approved the contract (in writing, orally or based on their customary business practices) and are committed to perform their respective obligations ▶ The entity can identify each party's rights regarding the goods or services to be transferred ▶ The entity can identify the payment terms for the goods or services to be transferred ▶ The contract has commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract) ▶ It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer <p>If these criteria are not met, an entity would not account for the arrangement using the model in the standard and would recognize any nonrefundable consideration received as revenue only when certain events have occurred.</p> <p>Contract combination</p> <p>The standard requires entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if they meet any of the following criteria:</p> <ul style="list-style-type: none"> ▶ The contracts are negotiated as a package with a single commercial objective ▶ The amount of consideration to be paid in one contract depends on the price or performance of another contract ▶ The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation <p>Contract modifications</p> <p>A contract modification is a change in the scope and/or price of a contract. A contract modification is accounted for as a new contract separate from the original contract if the modification adds distinct goods or services at a price that reflects the standalone selling prices of those goods or services. Contract modifications that are not accounted for as separate contracts are considered changes to the original contract and are accounted for as follows:</p> <ul style="list-style-type: none"> ▶ If the goods and services to be transferred after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract ▶ If the goods and services to be transferred after the contract modification are not distinct from the goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract ▶ A combination of the two approaches above: a modification of the existing contract for the partially satisfied performance obligations and the creation of a new contract for the distinct goods and services

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

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

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

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

- ▶ The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct)
- ▶ The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract)

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

- ▶ The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted
- ▶ One or more of the goods or services significantly modify or customize, or are significantly modified or customized by, one or more of the other goods or services promised in the contract
- ▶ The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.

Series guidance

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

Customer options for additional goods or services

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

Principal versus agent considerations

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

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

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

Step 3: Determine the transaction price

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

Variable consideration

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

Significant financing component

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

Noncash consideration

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

Consideration paid or payable to the customer

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

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

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

One exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met:

- ▶ The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service
- ▶ Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the objective of allocating consideration in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer

The other exception requires an entity to allocate a contract's entire discount to only those goods or services to which it relates if certain criteria are met.

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

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

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

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

- ▶ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced
- ▶ The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date

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

Licenses of intellectual property

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

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

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

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

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

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

Contract costs

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

An entity accounts for costs incurred to fulfill a contract with a customer that are within the scope of other authoritative guidance (e.g., inventory, property, plant and equipment, internal-use software) in accordance with that guidance. If the costs are not in the scope of other accounting guidance, an entity 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.