

Annual FASB Update and Review

FUR4/25/V1

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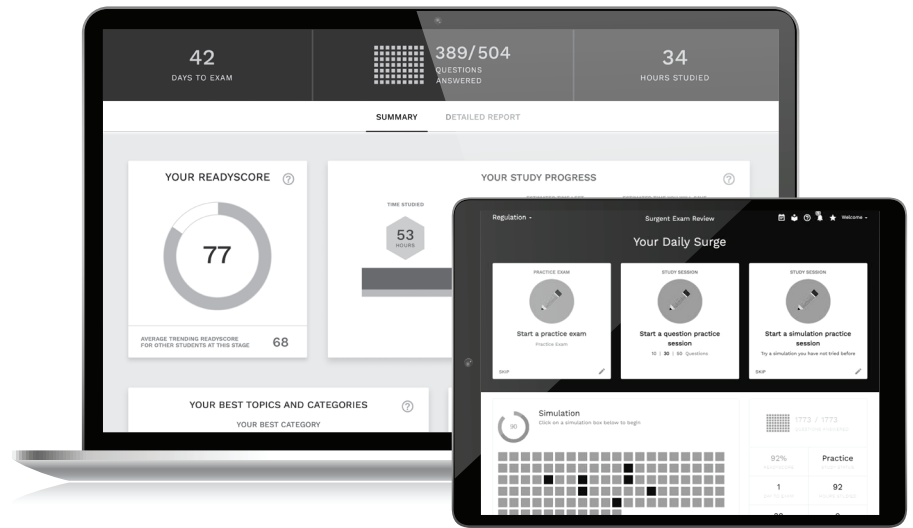
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FASB Accounting Standards Updates, Including the Activities of the PCC

Learning objectives

After completing this chapter, you should be familiar with:

- Recently issued ASUs of greatest significance to smaller and medium-sized entities;
- Recently issued ASUs impacting SEC registrants and other public entities; and
- Items on the FASB's technical agenda.

I. Introduction

Accounting Standards Updates are used by the FASB to amend its Accounting Standards Codification™ (Codification or ASC), which was launched on July 1, 2009, as the single source of authoritative nongovernmental U.S. GAAP. However, ASUs are not authoritative; they are only used to update the FASB Codification.

This chapter will discuss in depth all significant Accounting Standards Updates (ASUs) issued by the FASB in 2025, 2024, and 2023, that are effective in 2025 and beyond. It also covers ASUs issued prior with ongoing significance or application in 2025.

II. Key ASUs issued in 2024 and 2025

A. ASU No. 2025-04, Share-Based Consideration Payable to a Customer

1. Reason for issuance

FASB issued ASU 2025-04 to resolve diversity in practice and improve the clarity and operability of existing guidance related to share-based consideration (e.g., warrants, options, other equity instruments) granted to customers to incentivize them to purchase goods or services. Stakeholders identified uncertainty in distinguishing between service conditions and performance conditions and noted that existing policy elections for forfeiture accounting delayed revenue recognition in ways that reduced decision usefulness. Additionally, there was inconsistency in how the Topic 606 constraint on variable consideration (which is generally a reduction in revenue) was interpreted in conjunction with share-based consideration.

This ASU aims to ensure that revenue recognition reflects the economic substance of customer awards, especially when vesting is tied to purchase volume or value, and better aligns guidance for these awards with the principles of ASC 606 and ASC 718.

2. Entities affected

The ASU contains three main provisions within the update.

The ASU redefines the term “performance condition” in the Master Glossary to include vesting targets based on the volume or monetary amount of purchases as follows:

- a. “For share-based consideration payable to a customer that can result in a reduction of the transaction price in accordance with Topic 606, a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to any of the following:
 - (i) Achieving a specified performance target that is defined solely by reference to the grantor’s own operations (or activities) or by reference to the grantee’s (the customer’s) performance related to the grantor’s own operations (or activities);
 - (ii) The grantee’s purchase (or potential purchase) of the grantor’s goods or services from either the grantor or the grantor’s customers; and/or
 - (iii) A purchase (or potential purchase) of the grantor’s goods or services from either the grantee or the grantee’s customers.

The performance targets listed in this definition for employee and nonemployee awards (for example, a change in control) are also examples of performance conditions for share-based consideration payable to a customer.”

For awards with service conditions, the ASU eliminates the forfeitures-as-they-occur election and instead requires entities to estimate forfeitures.

The amendment further clarifies that the ASC 606 constraint on variable consideration does not apply to share-based customer awards. The grantor is required to only apply Topic 718 to such scenarios.

As a result of the ASU, revenue recognition will no longer be delayed when an entity grants awards that are not expected to vest, allowing a better initial estimate of the transaction price under ASC 606.

3. Main provisions

Applies to all entities, public and private, issuing share-based consideration to customers in the scope of Topic 606.

4. Effective date and transition guidance

The ASU is effective for all entities for annual reporting periods (including interim reporting periods within annual reporting periods) beginning after December 15, 2026. Early adoption is permitted. Modified retrospective (default) or full retrospective adoption is permitted.

“When applying the amendments in this Update on a modified retrospective basis, a grantor should recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the period of adoption and should not recast any financial statement information before the period of adoption. A grantor should apply the amendments as of the date of initial application to all share-based consideration payable to a customer.

When applying the amendments in this Update on a retrospective basis, a grantor should recast comparative periods and recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the earliest period presented. Additionally, an entity that elects to apply the guidance retrospectively should use the actual outcome, if known, of a performance condition or service condition as of the beginning of the annual reporting period of adoption for all prior-period estimates. If

actual outcomes are unknown as of the beginning of the annual reporting period of adoption, an entity should use its estimate of the probability of achieving a service condition or performance condition as of the beginning of the annual reporting period of adoption for all prior-period estimates.”

B. ASU No. 2025-03, *Business Combinations (Topic 805) and Consolidation (Topic 810): Determining the Accounting Acquirer in the Acquisition of a Variable Interest Entity*

1. Reason for issuance

The FASB issued ASU 2025-03 to address inconsistencies in the determination of the accounting acquirer in transactions where a variable interest entity (VIE) is acquired. Under prior guidance, the primary beneficiary of a VIE was always considered the accounting acquirer, even when the transaction was effected by exchanging equity interests. Stakeholders raised concerns about lack of comparability between VIE and non-VIE transactions, especially regarding reverse acquisitions and whether a business combination had occurred. The amendments aim to enhance consistency and comparability by allowing the same accounting acquirer assessment factors that are currently required for determining which entity is the accounting acquirer in other acquisition transactions.

2. Entities affected

This Update affects all entities involved in acquisition transactions effected primarily by exchanging equity interests when the legal acquiree is a VIE that meets the definition of a business.

3. Main provisions

The ASU modifies Topic 805 and Topic 810 to require entities to apply the same set of factors (outlined in ASC 805-10-55-12 through 55-15) to determine the accounting acquirer when:

- a. The legal acquiree is a VIE;
- b. The legal acquiree meets the definition of a business; and
- c. The transaction is effected primarily by exchanging equity interests.

Previously, the primary beneficiary was always the acquirer for VIEs; the ASU removes that automatic designation in the specific case of equity exchange transactions. The factors to consider include relative voting rights, governing body composition, senior management continuity, and size of the entities involved. The ASU does not change the accounting for reverse acquisitions or acquisitions where the legal acquiree is not a business.

4. Effective date and transition guidance

ASU 2025-03 is effective for all entities for annual reporting periods beginning after December 15, 2026, including interim periods within those annual periods. Early adoption is permitted at the beginning of any interim or annual reporting period where financial statements have not yet been issued or made available for issuance. The amendments must be applied prospectively to any qualifying acquisition transactions occurring after the initial application date.

C. ASU No. 2025-02, *Liabilities (Topic 405) – Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 122*

1. Main provision

This Update removed the guidance related to the safeguarding of crypto assets initially issued in SAB 121 that was subsequently repealed by SAB 122.

D. ASU No. 2025-01, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Clarifying the Effective Date*

1. Main provision

The amendment in this Update amends the effective date of Update 2024-03 to clarify that all public business entities are required to adopt the guidance in annual reporting periods beginning after December 15, 2026, and interim periods within annual reporting periods beginning after December 15, 2027. Early adoption of ASU 2024-03 is permitted. This ASU is discussed further in the ASU 2024-03 section.

E. ASU No. 2024-04, *Debt – Debt with Conversion and Other Options (Topic 470-20)*

1. Reason for issuance

ASU 2024-04 was issued to address and improve relevance and consistency in the application of the induced conversion guidance under Subtopic 470-20, with the largest focus being on determining if the conversion should be accounted for as an induced conversion or debt extinguishment. Current guidance was found to be inadequate, particularly after the introduction of cash convertible instruments and changes to accounting for convertible debt instruments with cash conversion features introduced in ASU 2020-06. Current guidance also does not address how the standards should be applied to the settlement of a convertible debt instrument that does not require new equity securities to be issued upon conversion. The Update seeks to clarify the guidance for determining whether a transaction involving the modification of a convertible debt instrument's terms (particularly a cash convertible instrument) at terms that are different from the original conversion terms should be accounted for as an induced conversion or a debt extinguishment.

2. Entities affected

This Update affects entities, public and private, that settle convertible debt instruments where the conversion privileges have been modified to induce conversion.

3. Main provisions

The main provisions of ASU 2024-04 significantly amend the guidance on induced conversions of convertible debt instruments.

The changes include:

- a. **Clarification of inducement offers** – The ASU clarifies that, to account for a settlement of a convertible debt instrument as an induced conversion, the inducement offer must provide the holder with the consideration (in form and amount) that was issuable under the conversion privileges provided in the original terms of the instrument. This clarification addresses ambiguities about whether modifications to terms or the addition of new conversion incentives constitute an induced conversion or a debt extinguishment. The entity must assess this as of the date the conversion offer is accepted by the holder. If, when applying this criterion, the convertible debt instrument had been exchanged or modified (without being deemed substantially different) within the one-year period leading up to the offer acceptance date, an entity should compare the terms provided in the inducement offer with the terms that existed one year before the offer acceptance date.
- b. **Treatment of VWAP modifications** – The ASU specifies that incorporation, elimination, or changes to a volume-weighted average price (VWAP) formula or similar provision do not automatically lead to a debt extinguishment classification. Instead, an entity should assess whether the modified terms preserve the form and amount of the conversion consideration stipulated in the original terms as of the offer acceptance date.
- c. **Applicability to nonconvertible instruments** – The guidance extends to scenarios where a convertible debt instrument is not currently convertible but has a substantive conversion feature at issuance and at the time the inducement offer is accepted.

4. Effective date and transition guidance

ASU 2024-04 is effective for all entities for annual reporting periods beginning after December 15, 2025, and interim periods within those annual periods. Early adoption is permitted for all entities that have adopted ASU 2020-06.

Entities may apply the new guidance on a prospective or retrospective basis:

- a. **Prospective application** – Entities apply the amendments to settlements of convertible debt instruments occurring after the effective date of the guidance.
- b. **Retrospective application** – Entities can recast prior periods and recognize a cumulative-effect adjustment to equity at the later of the beginning of the earliest period presented or the date the entity adopted the amendments in ASU 2020-06.

F. ASU No. 2024-03, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Disaggregation of Income Statement Expenses*

1. Reason for issuance

ASU 2024-03 was issued in response to feedback from investors and other financial statement users who expressed the need for more detailed information about expenses to better understand an entity's performance, forecast future cash flows, and compare performance across entities. Specific feedback highlighted the importance of disaggregating costs of sales and selling, general, and administrative expenses (SG&A) to better understand an entity's cost structure.

2. Entities affected

The amendments in ASU 2024-03 apply to all public business entities.

3. Main provisions

The main provisions require public business entities to disclose more detailed information about their expenses in the notes to their financial statements. Specifically, entities must:

- Disclose the amounts of (a) purchases of inventory, (b) employee compensation, (c) depreciation, (d) intangible asset amortization, and (e) depreciation, depletion, and amortization recognized as part of oil-and gas-producing activities (DD&A) (or other amounts of depletion expense) included in each relevant expense caption. A relevant expense caption is an expense caption presented on the face of the income statement within continuing operations that contains any of the expense categories listed in (a)–(e);
- Include certain amounts that are already required to be disclosed under current generally accepted accounting principles (GAAP) in the same disclosure as the other disaggregation requirements;
- Disclose a qualitative description of the amounts remaining in relevant expense captions that are not separately disaggregated quantitatively; and
- Disclose the total amount of selling expenses and, in annual reporting periods, the entity's definition of selling expenses.

These disclosures are required for both interim and annual reporting periods and aim to enable investors to better understand the components of an entity's expenses, assess performance, and forecast future expenses.

4. Effective date and transition guidance

The FASB removed the initial effective date that was announced in ASU 2024-03. The effective date of ASU 2024-03 was amended shortly after issuance by ASU 2025-01 to correct for a situation where the guidance made it possible for a public business entity to apply the guidance to an interim reporting period prior to applying the guidance to an annual reporting period. Under ASU 2025-01, ASU 2024-03 is effective for public business entities for annual reporting periods beginning after December 15, 2026, and interim reporting periods within annual reporting periods beginning after December 15, 2027.

Early adoption is permitted. Entities have the option to apply the amendments either retrospectively to all prior periods presented or prospectively to new or modified transactions after the effective date.

G. ASU No. 2024-02, *Codification Improvements – Amendments to Remove References to the Concepts Statements*

1. Reason for issuance

ASU 2024-02 introduces amendments to the Codification to remove references to various FASB Concepts Statements. This action is part of the FASB's ongoing project to address suggestions from stakeholders for improvements and technical corrections to the Codification, facilitating updates for clarifications, simplifications, and minor improvements. By removing references to Concepts Statements, which are nonauthoritative, the FASB aims to clarify the Codification, correct any unintended applications of guidance, and draw a clear distinction between authoritative and nonauthoritative literature, ensuring that the Codification reflects current GAAP without implying the authoritativeness of the Concepts Statements, which are now removed.

2. Entities affected

The amendments impact various Topics within the Codification and apply to all reporting entities within the scope of the affected accounting guidance.

3. Main provisions

ASU 2024-02 seeks to refine and clarify the Codification by eliminating unnecessary references to nonauthoritative Concepts Statements, thereby enhancing the clarity and application of GAAP for all reporting entities. The main provisions of ASU 2024-02 involve the removal of references to Concepts Statements across a wide range of Codification Topics. These references are often extraneous and not essential for understanding or applying the guidance. In some cases, the references might imply the authoritativeness of Concepts Statements or refer to superseded documents, potentially leading to diverse interpretations. The amendments aim to simplify the Codification, emphasizing the distinction between authoritative guidance and conceptual frameworks that inform the FASB's standard-setting process. This clarification is expected to streamline the application of GAAP by eliminating potential confusion over the role of Concepts Statements in preparing financial statements.

4. Effective date and transition guidance

For public business entities, the amendments are effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. For all other entities, the amendments apply to fiscal years beginning after December 15, 2025. Early adoption is permitted for entities for any fiscal year or interim period for which financial statements have not yet been issued or made available for issuance. Entities adopting the amendments in an interim period must do so as of the beginning of the fiscal year that includes that interim period. The transition can be applied either prospectively to all new or modified transactions recognized on or after the date of first application or retrospectively to the beginning of the earliest comparative period presented.

H. ASU No. 2024-01, Compensation – Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards

1. Reason for issuance

The Financial Accounting Standards Board (FASB) issued ASU 2024-01 to clarify how entities should apply scope guidance in determining whether profits interest and similar awards should be accounted for under Topic 718, *Compensation – Stock Compensation*. This was in response to complexities and diversity in practice (even for similar fact patterns) identified by the PCC regarding the accounting of profits interest awards, which are used by entities to align compensation with performance and provide participants with future profits and/or equity appreciation. The Update aims to add illustrative examples for clarity and improve consistency in applying GAAP.

2. Entities affected

The amendments affect all reporting entities that account for profits interest awards as compensation to employees or nonemployees in return for goods or services. Additionally, the amendments that clarify the scope and exceptions section of Topic 718 apply to all entities entering into share-based payment transactions.

3. Main provisions

ASU 2024-01 aims to provide clarity and reduce inconsistencies in how entities account for profits interest and similar awards, ensuring a more standardized approach across different entities and situations. ASU

2024-01 introduces an illustrative example with four fact patterns to demonstrate the application of scope guidance for determining whether a profits interest award falls under Topic 718. These examples focus on key considerations such as whether the award grants the right to equity instruments or cash payments based on the entity's share price, among other conditions. This guidance aims to reduce complexity and practice diversity by providing clear criteria for when profits interest awards should be accounted for under Topic 718. The example is comprehensive, covering cases where the awards are share-based payment arrangements and where they are not, based on various conditions like service requirements, participation in distributions, and settlement terms.

4. Effective date and transition guidance

For public business entities (PBEs), the amendments are effective for annual periods beginning after December 15, 2024, including interim periods within those annual periods. For all other entities, they are effective for annual periods beginning after December 15, 2025, and interim periods within those annual periods. Early adoption is permitted for both interim and annual financial statements not yet issued or available for issuance. Entities can apply the amendments retrospectively to all prior periods presented or prospectively to awards granted or modified after the first application date.

III. Key ASUs issued prior to 2024

A. ASU No. 2023-09, *Income Taxes (Topic 740): Improvements to Income Tax Disclosures*

1. Reason for issuance

This ASU was issued to help investors “better understand an entity’s exposure to potential changes in jurisdictional tax legislation and the ensuing risks and opportunities.” It will allow investors to better assess income tax information that relates to cash flow forecasts and capital allocation decisions and will also aid investors in identifying potential opportunities to increase future cash flows.

2. Entities affected

The ASU affects all entities, public and private, subject to ASC Topic 740.

3. Main provisions

The ASU improves transparency and expands what public and private entities must disclose regarding rate reconciliations, income taxes paid, amounts surrounding the disaggregation of foreign and domestic income before taxes, and income tax expense or benefit from continuing operations disaggregated by foreign, federal, and state. Public entities must disclose specific categories in the rate reconciliation and expand disclosures for all reconciling items that meet a quantitative threshold for items that are greater than or equal to 5 percent of pretax income (loss) by the applicable statutory income rate. Private entities require qualitative, not quantitative, disclosure about categories of reconciling items and tax jurisdictions that result in a “significant difference” between the statutory tax rate and the effective tax rate.

All entities must disclose “the amount of income taxes paid (net of refunds received) disaggregated by federal (national), state, and foreign taxes.” They also must disclose “the amount of income taxes paid (net of refunds received) disaggregated by individual jurisdictions in which income taxes paid (net of refunds received) is equal to or greater than 5 percent of total income taxes paid (net of refunds received).” The ASU also provides that entities must disclose (a) income (or loss) from continuing

operations before income tax expense (or benefit), disaggregated between domestic and foreign, and (b) income tax expense (or benefit) from continuing operations disaggregated by federal (national), state, and foreign.

Lastly, the ASU eliminates the requirement for all entities to (a) disclose the nature and estimate of the range of the reasonably possible change in the unrecognized tax benefits balance in the next 12 months or (b) make a statement that an estimate of the range cannot be made.

4. Effective date

ASU No. 2023-09 is effective for public entities for fiscal years beginning after December 15, 2024; for private entities, the effective date is for fiscal years beginning after December 15, 2025. Early adoption and retrospective application are permitted.

B. ASU No. 2023-08, *Intangibles – Goodwill and Other – Crypto Assets (Subtopic 350-60)*

1. Reason for issuance

This ASU was issued to establish balance sheet, income statement, and statement of cash flow reporting requirements for crypto assets and other intangible assets meeting the FASB's revised definition of a crypto asset. Prior to the release of the ASU, the best recommendation was for crypto assets to be classified as intangible assets subject to impairment testing and carried at cost less impairment. Gain recognition was disallowed. The ASU expands disclosure requirements for reporting holdings in crypto assets.

2. Entities affected

The ASU affects all entities holding or transacting in crypto assets.

3. Main provisions

The ASU establishes financial reporting guidelines for crypto assets. A crypto asset is defined in the standard as an asset that meets all of the following criteria to be in scope of the amendment:

- a. Meets the ASC definition of an intangible asset;
- b. Does not provide the asset holder with enforceable rights to or claims on underlying goods, services, or other assets;
- c. Is created or resides on a distributed ledger based on blockchain or similar technology;
- d. Is secured through cryptography;
- e. Is fungible; and
- f. Is not created by the reporting entity or its related parties.

The ASU establishes that intangible assets meeting the definition of a crypto asset must be reported separately from other intangible assets (further disaggregation by crypto asset is permitted). The asset must be measured and reported at fair value on the balance sheet. Changes resulting from remeasurement go directly to the income statement (or statement of activity) as a gain or loss on change in fair value from intangible assets, reported separately from other gains and losses.

The ASU further establishes disclosure requirements for entities subject to the guidance. Entities must disclose the name, cost basis, fair value, and number of units for each significant crypto asset holding and the aggregate fair values and cost bases of the crypto asset holdings that are not individually

significant. For crypto assets that are subject to contractual sale restrictions, the fair value of those crypto assets, the nature and remaining duration of the restriction(s), and the circumstances that could cause the restriction(s) to lapse must be disclosed.

Other disclosures include:

- a. A roll forward, in the aggregate, of activity in the reporting period for crypto asset holdings, including additions (with a description of the activities that resulted in the additions), dispositions, gains, and losses.
- b. For any dispositions of crypto assets in the reporting period, the difference between the disposal price and the cost basis and a description of the activities that resulted in the dispositions.
- c. If gains and losses are not presented separately, the income statement line item in which those gains and losses are recognized.
- d. The method for determining the cost basis of crypto assets.

Annual reconciliation detailing the activity from the opening to the closing balances of crypto assets, separately listing:

- a. Additions;
- b. Dispositions;
- c. Gains included in net income for the period, determined on a crypto-asset-by-crypto-asset basis. Each crypto asset holding that has a net gain from remeasurement as included in net income for the period shall be included in the gains line; and
- d. Losses included in net income for the period, determined on a crypto-asset-by-crypto-asset basis. Each crypto asset holding that has a net loss from remeasurement as included in net income for the period shall be included in the losses line.

4. Effective date

ASU No. 2023-08 is effective for all entities for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. Early adoption is permitted for annual and interim financial statements. Entities are required to make a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the period in which the entity adopts the amendment.

C. ASU No. 2023-07, Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures

1. Reason for issuance

This ASU, which only applies to public entities, was issued in response to the FASB's post-implementation review of Statement No. 131. Prior to the ASU, public entities were required to report segment revenue and profit or loss, with limited expense information disclosed. Investors wanted expanded disclosures about a segment's expenses. The ASU expands such expense disclosure requirements and updates guidance on reportable segments, including disclosure of the title and position of the chief operating decision maker (CODM) and significant expenses reported to them.

2. Entities affected

The ASU only applies to public entities subject to segment disclosure requirements.

3. Main provisions

The main provisions of the ASU focus on mandatory disclosure requirements. The public entity must disclose significant segment expenses that are regularly provided to the CODM and included in segment profit or loss. They are required to disclose and break out other segment items not included in the significant expenses, and the other items should be the difference between segment revenue and segment reported profit or loss.

Entities must continue existing reporting requirements under ASC 280. In addition to reporting segment profit and loss that is most consistent under U.S. GAAP, a public entity may report additional profit and loss measures utilized by the CODM. The entity must disclose the title and position of the CODM and describe how they use the identified segment information.

Note that the ASU applies even if the public entity has only one reportable segment.

4. Effective date

ASU No. 2023-07 is effective for fiscal years beginning after December 15, 2023, and interim periods within fiscal years beginning after December 15, 2024. Early adoption is permitted, and retrospective application is required for all periods presented in the financial statements.

D. ASU No. 2023-05, *Business Combinations – Joint Venture Formations* (Subtopic 805-60)

1. Reason for issuance

This ASU was issued as an amendment to provide clear guidance on accounting for contributions made to a joint venture, upon formation, in a joint venture's separate financial statements. Prior to the ASU, joint ventures took a diverse approach to measuring contributions at the formation date, with some electing to account for net asset contributions at fair value and others electing to account for net asset contributions at the venturer's carrying amount. The Update now provides consistent and decision-useful guidance to investors and reduces diversity in joint venture formation accounting.

2. Entities affected

The ASU applies only to entities that meet the FASB ASC Master Glossary definition of a joint venture or corporate joint venture.

3. Main provisions

The ASU establishes that newly formed joint ventures should initially measure assets and liabilities at fair value as of the formation date (with fair value measurement exceptions that are consistent with business combination guidance). This approach is consistent with the accounting result that would occur if the joint venture was treated as the acquirer of a business and subject to the guidance in FASB ASC Subtopic 850, *Business Combinations*.

Disclosures for joint venture formation should occur in the period in which the formation date occurs. Note that joint venture formation disclosure requirements are different from the requirements for disclosures in a business combination.

4. Effective date

The ASU is effective prospectively for all joint venture formations with a formation date beginning on or after January 1, 2025. Joint ventures formed prior to this date may elect to apply the ASU retrospectively if sufficient information exists. Early adoption is permitted for annual and interim periods for which financial statements have not been issued or made available for issuance, either prospectively or retrospectively.

E. ASU No. 2023-02, *Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*

1. Reason for issuance

This ASU was issued to allow consistent accounting for equity investments made primarily for the purpose of receiving income tax credits and other income tax benefits. Previously, the proportional amortization method was limited to investments in low-income housing tax credit (LIHTC) structures, while equity investments in other tax credit structures were typically accounted for using the equity method or Topic 321. The ASU affects all entities that hold at least one of the following:

- a. Tax equity investments that an entity has elected to account for using the proportional amortization method.
- b. An investment in a LIHTC structure through a limited liability entity that is not accounted for using the proportional amortization method and to which certain LIHTC-specific guidance removed by ASU 2023-02 has been applied.

2. Entities affected

The ASU applies only to entities that meet the FASB ASC Master Glossary definition of a joint venture or corporate joint venture.

3. Main provisions

Entities can elect to account for their tax equity investments utilizing the proportional amortization method if all required conditions are met:

- a. It is probable that the income tax credits allocable to the tax equity investor will be available;
- b. The tax equity investor does not have significant influence over the operating and financial policies of the underlying project;
- c. Substantially all of the projected benefits are from income tax credits and other income tax benefits. Projected benefits include income tax credits, other income tax benefits, and other non-income-tax-related benefits. The projected benefits are determined on a discounted basis using a discount rate consistent with the cash flow assumptions used by the tax equity investor in deciding to invest in the project;
- d. The tax equity investor's projected yield is positive based solely on the cash flows from the income tax credits and other income tax benefits; and
- e. The tax equity investor is a limited liability investor in the limited liability entity for both legal and tax purposes.

Furthermore, when a reporting entity makes the referenced election related to the proportional amortization method on a tax-credit-program-by-tax-credit-program basis, the entity should disclose the following:

- a. The nature of its tax equity investments; and
- b. The effect of its tax equity investments, related income tax credits, and other income tax benefits on its financial position and results of operations.

ASU 2023-02 also removes specialized guidance for LIHTC investments. LIHTC investments may elect the proportional amortization method if all conditions are met. However, if an entity does not elect this method, these investments will follow the appropriate GAAP guidance found in Topic 321 and Subtopic 323-10.

4. Effective date

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted.

F. ASU No. 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*

1. Reason for issuance

This ASU was issued in response to the UK Financial Conduct Authority (FCA) extending the intended cessation date of the USD LIBOR interest rates. ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting* included a sunset provision related to exceptions and optional expedients for contract modifications and hedging relationships. This sunset provision assumed that the LIBOR rates would be discontinued by the end of 2021.

2. Entities affected

The ASU affects all entities that have contracts, hedging relationships, and other transactions that utilize the LIBOR rate or any other reference rate that is expected to be discontinued as a result of reference rate reform.

3. Main provisions

This ASU delays the sunset provision included in ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*. ASU 2022-06 defers the sunset date of Topic 848 from December 31, 2022, to December 31, 2024. This deferment is based on the FCA delaying the intended cessation date of USD LIBOR rates to June 30, 2023. Entities should note that after December 31, 2024, the exceptions and optional expedients for contract modifications and hedging relationships will no longer be permitted.

4. Effective date

ASU No. 2022-06 was effective for all entities upon issuance.

G. ASU No. 2022-05, *Financial Services – Insurance (Topic 944): Transition for Sold Contracts*

1. Reason for issuance

The FASB issued this ASU in response to stakeholders noting certain provisions within ASU 2018-12, *Financial Services – Insurance: Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI)*, were not cost-effective. Practitioner feedback indicated that applying the LDTI guidance to contracts that were derecognized because of a sale or disposal of individual or a group of contracts or legal entities before the LDTI effective date would put an unnecessary burden on insurance entities. This ASU was implemented to reduce costs and complexity related to these transactions.

2. Entities affected

ASU 2022-05 affects insurance entities that have derecognized contracts before the LDTI effective date. Please see further details in the effective date section below.

3. Main provisions

The implementation of ASU 2018-12 requires insurance companies to apply a retrospective transition method from the beginning of the earliest period presented or the prior fiscal year if early application is chosen. This means that the provisions of ASU 2018-12 would apply to contracts that were derecognized prior to the effective date, which would be costly and would not provide useful information.

ASU 2022-05 allows insurance entities to make an accounting policy election on a transaction-by-transaction basis to exclude certain contracts from the application of ASU 2018-12. The derecognized contract must have been sold or disposed of, and the insurance company must have no continuing involvement with the contract to qualify for the accounting policy election.

4. Effective date

The effective dates of the amendments within ASU 2022-05 are consistent with the effective dates of the amendments in ASU 2020-11. ASU 2020-11 extended the effective dates noted in ASU 2018-12 due to the COVID-19 pandemic. Therefore, ASU 2018-12 and ASU 2022-05 are effective for public entities that meet the definition of an SEC filer and are not smaller reporting companies for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. For all other entities, the effective date is fiscal years beginning after December 15, 2024, and interim periods within fiscal years beginning after December 15, 2025. Early adoption is permitted.

H. ASU No. 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*

1. Reason for issuance

This ASU was issued to clarify the guidance in Topic 820, *Fair Value Measurement* when measuring the fair value of an equity security subject to contractual restrictions that prohibit the sale of an equity security. The lack of clarity in the guidance has led to a diversity in practice in the accounting for such instruments.

The ASU also updates the related illustrative example of accounting for such restrictions and adds new disclosure requirements for equity securities subject to contractual sale restrictions that are measured at fair value in accordance with Topic 820.

2. Entities affected

The ASU affects all entities that have investments in equity securities measured at fair value that are subject to a contractual sale restriction.

3. Main provisions

Under this ASU, a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value. Also, an entity cannot, as a separate unit of account, recognize and measure a contractual sale restriction.

The ASU adds the following disclosures related to such securities:

- a. The fair value of equity securities subject to contractual sale restrictions reflected in the balance sheet;
- b. The nature and remaining duration of the restriction(s); and
- c. The circumstances that could cause a lapse in the restriction(s).

4. Effective date

The effective date for ASU No. 2022-03 is as follows:

- a. Public business entities – Fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.
- b. All other entities – Fiscal years beginning after December 15, 2024, and interim periods within those fiscal years.

Early adoption is permitted. ASU No. 2022-03 should be applied on a prospective basis.

Entities that apply ASC 946 should continue to apply their historical accounting to such investments until the contractual restrictions expire.

IV. Other ASUs effective in 2025 or beyond

The following table details ASUs issued by the FASB prior to 2024 that will become effective for public and nonpublic business entities in 2024 or beyond.

ASU	Title	Summary	Effective Date
ASU No. 2023-06	<i>Disclosure Improvements: Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative</i>	Mainly amends requirements surrounding disclosure and presentation of Codification subtopics in an attempt to align SEC mandated disclosures with FASB disclosures. 14 of the SEC's 27 referred disclosures were accepted by the FASB.	The ASU will only become effective if the SEC removes their related disclosure requirements from the regulation by June 30, 2027.
ASU No. 2023-04	<i>Liabilities (Topic 405)</i>	Mainly addresses risks unique to holding customer/client crypto assets, including technological, legal, and regulatory risks. Entities hold these assets on behalf of the users as a part of their platform offering; therefore, the entities are responsible for safeguarding the assets. Such operations present a liability, measured at fair value, to these entities that should be reflected in the financial statements.	Effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years for public business entities. For all other entities, effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years.
ASU No. 2018-12	<i>Financial Services – Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts</i>	Changes the accounting model for long-duration insurance contracts.	Years beginning on or after December 15, 2024.

Details on these previously issued ASUs can be found at the FASB website, www.FASB.org.

Discussion question:

Which of the FASB's new ASUs will have the most significant impact on either your clients or company?

V. FASB's technical agenda

The FASB's technical agenda provides information related to current FASB projects. Projects typically go through a six-step process. These steps include:

1. Topic is added to the agenda;
2. Initial deliberations;
3. Exposure draft;
4. Exposure draft comment period;
5. Exposure draft redeliberation; and
6. Final standard/concept.

The current technical agenda includes the following:

- a. Framework projects (3);
- b. Recognition and measurement: narrow projects (11); and
- c. Presentation and disclosure projects (5).

A. Framework projects

Framework projects do not change the FASB's Accounting Standards Codification (ASC) per se but rather update the theoretical underpinnings of the accounting standards found in the FASB Concepts Statements. These updated concepts are then applied to accounting topics, the changes to which would update the ASC.

Per the FASB website, The FASB Concepts Statements are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts that guide selection of economic phenomena to be recognized and measured for financial reporting and their display in financial statements or related means of communicating information to those who are interested. Concepts Statements guide the Board in developing sound accounting principles and provide the Board and its constituents with an understanding of the appropriate content and inherent limitations of financial reporting. A Statement of Financial Accounting Concepts does not establish generally accepted accounting standards.

There are currently five Concepts Statements.

The objective of this conceptual framework project is to develop an improved conceptual framework that provides a sound foundation for developing future accounting standards. Such a framework is essential to fulfilling the Board's goal of developing standards that are principles-based, internally consistent, and that lead to financial reporting that provides the information capital providers need to make decisions in their capacity as capital providers. The new FASB framework will build on the existing framework.

With the issuance of the updated frameworks related to elements of financial statements and presentation in December 2021, the FASB currently has only one framework project on its agenda: measurement. Its project, dealing with its measurement conceptual framework, is focused on agreeing on the meanings of key terms and what the objectives and qualitative characteristics imply for measurement, identifying appropriate types of measurements, and determining which measurements to use in specific circumstances. This project is currently in initial deliberations, with no exposure documents issued.

The FASB completed its elements framework project in 2021 by updating its Conceptual Statement related to financial statement elements. The updated guidance provides an improved conceptual framework that provides a sound foundation for developing future accounting standards.

The FASB also completed its framework project on presentation in 2021. The new guidance provides the FASB with a framework for developing standards that summarize and communicate information on financial statements in a way that best meets the objective of financial reporting. Ultimately, it will become a basis for the Board when creating presentation requirements in future standards.

Following the issuance of the updated Concepts Statement related to disclosures, the FASB issued final ASUs that updated the disclosures related to the following:

- a. Fair value measurement; and
- b. Defined benefit plans.

B. Recognition and measurement projects: narrow projects

There are 10 active recognition and measurement projects the FASB considers to be narrow projects. New projects added to the technical agenda include:

- a. Accounting for investments in tax credit structures using the proportional amortization method;
- b. Accounting and disclosure of software costs – Exploring ways to narrow the differences between the current internal use and external use models;
- c. Accounting for environmental credit programs – Exploring how to improve the accounting for participants in programs that result in the creation of environmental credits;
- d. Business combination project; and
- e. Implementation issues related to ASC 606 and ASC 842.

Details on the status of all projects can be found on the FASB website.

C. Other presentation and disclosure projects

The FASB is continuing its work on five presentation and disclosure projects. Significant new presentation and disclosure projects include the following:

- a. Disaggregation of income statement expenses;
- b. Statement of cash flows targeted improvements; and
- c. Disaggregation of performance information – Further disaggregation of certain income statement items.

For a complete overview and all of the details of the FASB's current technical agenda, please refer to the FASB's website at www.fasb.org.

VI. Update on the FASB's Private Company Council

Since its creation, the PCC has become the sounding board for feedback from private companies concerning the costs and benefits of both proposed and enacted accounting standards. Additionally, the PCC has both influenced new standard setting with regard to the concerns of private companies as well as advanced several simplification initiatives that have lightened the existing financial reporting burden on private companies. The influence of these simplification initiatives can be seen as the FASB has adopted similar simplifications in the areas of goodwill impairment testing and hedging. Additionally, the influence of the PCC can be seen in the FASB's decision in 2018, through ASU No. 2018-17, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*, to exempt nonpublic business entities from having to apply the variable interest entity (VIE) rules when determining whether to consolidate an entity, in certain situations. This influence can also be seen in the current direction of the FASB's proposed updated guidance on goodwill accounting, which mirrors the amortization election currently available for private companies.

A. Responsibilities

The PCC has two primary responsibilities:

1. To determine whether exceptions or modifications to existing nongovernmental U.S. GAAP are required to address the needs of users of private company financial statements; and
2. To serve as the primary advisory body to the FASB on the appropriate treatment for private companies for items under active consideration on the FASB's technical agenda.

The PCC has completed this first responsibility and is now generally serving in a consulting and advisory role to the FASB as the FASB progresses on its technical agenda.

B. Makeup of the PCC

The PCC consists of between 9 to 12 members, including a chairperson, all of whom will be selected and appointed by the FAF Board of Trustees. The PCC chairperson is affiliated with the FASB and will have had substantial experience with and exposure to private companies during the course of their career. The Chairman works cooperatively with the FASB liaison member, the FASB Chairman, and the FASB Technical Director to accomplish the functions of the PCC and to help facilitate the work of the FASB with respect to private company standard setting activities.

PCC members include users, preparers, and practitioners who have significant experience using, preparing, and auditing (and/or compiling and reviewing) private company financial statements. Members are appointed for a three-year term and may be reappointed for an additional term of two years. Membership tenure may be staggered for some members to establish an orderly rotation. The PCC is still chaired by Jere G. Shawver, the managing partner for assurance and risk with Baker Tilly, a top 10 U.S. public accounting firm. The current members of the PCC can be found on the FASB's website.

As mentioned, the PCC still consults with the FASB on the impact of proposed changes to the accounting codification on smaller and nonpublic entities.

The PCC is currently consulting with the FASB on a number of projects, including the following:

- a. Business combination project;
- b. Consolidation/variable interest entity (VIE) projects;
- c. Definition projects;
- d. Disclosure projects;
- e. Financial instruments projects;
- f. Emerging Issues Taskforce (EITF) projects;
- g. FASB's Agenda consultation; and
- h. Implementation issues related to 842.

Discussion question:

How successful do you feel the PCC has been in attempting to simplify GAAP for nonpublic business entities?

ASC 606, Revenue – A Comprehensive Review and FASB PIR Report Findings

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ASC 606, *Revenue* – A Comprehensive Review and FASB PIR Report Findings

Learning objectives

After completing this chapter, you should be familiar with:

- The results and findings of the FASB's Final (Stage 3) Post-Implementation Review (PIR) Report Topic 606; and
- The FASB's revenue recognition guidance in ASC Topic 606, *Revenue from Contracts with Customers*.

I. Introduction

The FASB has completed Stage 3 of the PIR Process for Topic 606, *Revenue from Contracts with Customers* (Topic 606), the revenue recognition standard originally issued in May 2014 as ASU No. 2014-09, *Revenue from Contracts with Customers*, and subsequently updated through a series of Updates issued by the FASB in 2016. These updates provided further clarification and implementation guidance to the original Update. Even with these updates, the standard remains virtually identical to that issued by the International Accounting Standards Board (IASB), leading to a truly converged, global approach to reporting revenue for all entities.

The standard became effective for public entities for financial reporting periods beginning after December 15, 2017, effectively January 1, 2018, for calendar year reporters, including interim periods. The effective date for nonpublic entities was one year later, with reporting on an interim basis for nonpublic entities effectively beginning for calendar year end entities in the first quarter of 2020.

Topic 606 supersedes the revenue recognition requirements in *Accounting Standards Codification* (Codification or ASC) 605, *Revenue Recognition*, most of the industry-specific guidance throughout the Industry Topics of the Codification, and some of the cost guidance included in ASC 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts*, and affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets, unless those contracts are within the scope of other standards (for example, lease contracts and insurance contracts). So, the standard pretty much impacted everyone.

In this chapter, we will review the five-step model created by Topic 606 for entities to follow when recognizing revenue.

II. Revenue recognition guidance

The core principle of the standard is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration (that is, payment) to which the entity expects to be entitled in exchange for those goods or services.

To achieve this, an entity will apply the following five step, principles-based approach to recognizing revenue:

- Step 1: Identify the contract(s) with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price to the performance obligations in the contract.
- Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

The standard also includes enhanced disclosure requirements intended to provide financial statement users with comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a reporting entity's contracts with customers. In addition, a reporting entity is also required to provide quantitative and/or qualitative information about assets recognized from the costs to obtain or fulfill a contract with a customer.

Topic 606 applies to all contracts with customers (including the transfer of nonfinancial assets) except for the following:

- a. Lease contracts within the scope of ASC 840, *Leases*;
- b. All contracts within the scope of ASC 944, *Financial Services – Insurance*;
- c. Financial instruments and other contractual rights or obligations within the scope of other ASC Topics (e.g., ASC 310, *Receivables*);
- d. Guarantees (other than product or service warranties) within the scope of ASC 460, *Guarantees* (entities should see Topic 815, *Derivatives and Hedging*, for guarantees accounted for as derivatives); and
- e. Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. (For example, ASC 606 would not apply to a contract between two oil companies that agree to an exchange of oil to fulfill demand from their customers in different specified locations on a timely basis.)

For a contract with a customer which falls partially within the scope of ASC 606 and partially within the scope of other Codification Topics, for example, a lease with a service contract, if the other Topics specify how to separate and/or initially measure parts of a contract, an entity should first apply those Topics. In other words, the more specific Topic would take precedence in accounting for a part of a contract, and any residual consideration should be allocated to the part(s) of the contract within the scope of that Topic.

A. Key terms

As a result of creating Topic 606, the FASB added the following terms to the ASC Master Glossary:

- a. **Contract** – An agreement between two or more parties that creates enforceable rights and obligations.
- b. **Contract Asset** – An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).
- c. **Contract Liability** – An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.
- d. **Customer** – 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.

- e. **Performance Obligation** – A promise in a contract with a customer to transfer to the customer either: a good or service (or a bundle of goods or services) that is distinct; or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
- f. **Revenue** – Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
- g. **Standalone Selling Price** – The price at which an entity would sell a promised good or service separately to a customer.
- h. **Transaction Price** – The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

With this as our base of understanding, let us begin our review of the five-step revenue recognition model found in Topic 606.

III. Step 1 – Identify the contract(s) with a customer

The FASB's definition of a contract is based on the common legal definitions of a contract in the United States and emphasizes that a contract exists when an agreement between two or more parties creates enforceable rights and obligations between those parties. Enforceability of the rights and obligations in a contract is a matter of law, and it is important to note that an agreement does not have to be in writing to be a contract. Whether the agreed-upon terms are written, oral, or evidenced otherwise (for example, by electronic assent), a contract exists if the agreement creates rights and obligations that are enforceable against the parties.

Conversely, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties) or the collectability threshold discussed below is not met. A contract is wholly unperformed if the entity has not yet transferred any promised goods or services to the customer and the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

Legalese aside, in accordance with Topic 606, an entity can only apply the revenue recognition model to a contract if all of the following criteria are met:

- a. The parties have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to performing their respective obligations.
- b. The entity can identify each party's rights regarding the goods/services to be transferred.
- c. The entity can identify the payment terms for the goods/services to be transferred.
- d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).
- e. It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods/services that will be transferred to the customer.

If an agreement with a customer meets the above criteria at inception, an entity should not reassess the criteria unless there is an indication of a significant change in facts and circumstances, for example, if a customer's ability to pay the consideration deteriorates significantly. If that were the case, the entity would

reassess whether it is probable that it will collect the consideration to which it will be entitled in exchange for the remaining goods or services that will be transferred to the customer. The word *remaining* here is important because it indicates that a reassessment of the criteria would only be applied to those rights and obligations that have not yet transferred. That is, an entity would not include in the reassessment (and therefore would not reverse) any receivables, revenue or contract assets already recognized.

If an agreement with a customer does not meet the above criteria, an entity should continue to assess the agreement to determine whether the criteria are subsequently met. If an agreement with a customer does not meet the above criteria and an entity receives consideration from the customer, the entity should recognize the consideration received as revenue only when the entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable, or the agreement has been terminated, and the consideration received from the customer is nonrefundable.

An entity should recognize the consideration received from a customer as a liability until either of the above events occurs or until the above criteria are subsequently met. Depending on the facts and circumstances relating to the agreement, the liability recognized represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability should be measured at the amount of consideration received from the customer.

A. Collectability

As entities digested this guidance in Topic 606, the probability of collectability threshold generated many requests for clarification from stakeholders. These requests resulted in the FASB providing further guidance on this concept in ASU No. 2016-12.

Under Topic 606, collectability is not considered in the transaction price, but it is a factor when determining whether a valid contract exists.

The ASC's Master Glossary defines "probable" as a future event or events that are likely to occur. So, using this definition, to have a contract, it must be likely to occur that substantially all of the consideration will be collected. Unlike with the existing guidance, where the portion of the contract revenue that was reasonably assured to be collected could be recognized, under the standard, no revenue could be recognized if there is not a valid contract. Clearly, understanding how to apply this probability threshold is vitally important to remaining compliant with the guidance.

Some stakeholders narrowly interpreted the guidance related to collectability in a manner that would result in more contracts than the Board intended not meeting the collectability criterion. In response to this feedback, the FASB clarified the objective of the collectability criterion in Step 1. This Update states that the objective of the collectability assessment is to determine whether the contract is valid and represents a substantive transaction on the basis of whether a customer has the ability and intention to pay the promised consideration in exchange for the goods or services that will be transferred to the customer.

The FASB also added additional guidance to Topic 606 via this Update that stated that the assessment does not need to consider the customer's ability and intent to pay the entire amount of the consideration for entire duration of the contract, only that which related to the goods or services expected to be transferred.

The entity should look at the contractual terms and its customary business practices to see if its credit risk is less than the entire amount of consideration promised in the contract. For example, the payment terms of the contract may require the customer to pay for the good or service before its delivery; or the entity may have the ability to stop transferring the promised goods or services in the event that the customer fails to pay. Accordingly, in each of these situations, the entity's credit risk would be less than the entire amount of promised consideration in the contract. In the instance of the latter, the entity should assess the collectability of the consideration to which it is entitled only for the goods or services that the customer has the right to receive or that the customer would receive under the entity's customary business practices.

With this clarified guidance, it is clear that the goal of the FASB is to only prevent revenue from being recognized on contracts that lack true substance.

Further, if a contract fails to meet the collectability criterion at contract inception, an entity should continue to assess the contract to determine whether that criterion is subsequently met. If the criterion is not subsequently met, an entity only recognizes any consideration it received as revenue when one of the criteria in paragraph 606-10-25-7 has been met. The two criteria in the original standard are:

- a. When the entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable; or
- b. The agreement has been terminated, and the consideration received from the customer is nonrefundable.

Additionally, some stakeholders expressed the view that it is unclear when these two criteria would be met for certain arrangements.

To help clarify the criteria for recognizing revenue when the collectability threshold is not met at contract inception, the FASB added a third criteria to the two presented above that allows an entity to recognize revenue in the amount of consideration received. When the entity has transferred control of the goods or services to which the consideration that it has received relates, it can recognize that consideration as revenue if all of the following conditions are met:

- a. It has stopped transferring goods or services (if applicable);
- b. It has no obligation under the contract to transfer additional goods or services; and
- c. The consideration received from the customer is nonrefundable.

Essentially, an entity can record revenue on amounts received for already transferred goods if the amount is nonrefundable and it has stopped transferring the good or service and is not required to transfer additional goods or services.

Collectability of the Consideration

In this example, an entity, a service provider, enters into a three-year service contract with a new customer of low credit quality at the beginning of a calendar month. The transaction price of the contract is \$720, and \$20 is due at the end of each month. The standalone selling price of the monthly service is \$20. Both parties are subject to termination penalties if the contract is cancelled.

The entity's history with this class of customer indicates that while the entity cannot conclude it is probable the customer will pay the transaction price of \$720, the customer is expected to make the payments required under the contract for at least nine months. However, if, during the contract term, the customer stops making the required payments, the entity's customary business practice is to limit its credit risk by not transferring further services to the customer and to pursue collection for the unpaid services.

In assessing whether the contract meets the collectability criteria for determining whether a valid contract exists, the entity would assess whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the services that will be transferred to the customer. This includes assessing the entity's history with this class of customer and its business practice of stopping service in response to customer nonpayment. Consequently, as part of this analysis, the entity does not consider the likelihood of payment for services that would not be provided in the event of the customer's nonpayment because the entity is not exposed to credit risk for those services.

It is not probable that the entity will collect the entire transaction price (\$720) because of the customer's low credit rating. However, the entity's exposure to credit risk is mitigated because the entity has the ability and intention (as evidenced by its customary business practice) to stop providing services if the customer does not pay the promised consideration for services provided when it is due. Therefore, the entity concludes that the contract meets the collectability criterion of Step 1 of the model because it is probable that the customer will pay substantially all of the consideration to which the entity is entitled for the services that the entity will transfer to the customer (that is, for the services the entity will provide for as long as the customer continues to pay for the services provided).

Consequently, assuming the other four criteria for a valid contract are met, the entity would apply the remaining guidance in this Topic to recognize revenue and only reassess those criteria if there is an indication of a significant change in facts or circumstances such as the customer not making its required payments.

Topic 606 contains other examples that help to clarify this guidance.

B. Portfolio approach

Although ASC 606 specifies the accounting required for an individual contract, it does include the following practical expedient that allows an entity to use a "portfolio approach" to apply the guidance:

As a practical expedient, an entity may apply this guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity should use estimates and assumptions that reflect the size and composition of the portfolio.

Of course, an entity will need to apply judgment in selecting the size and composition of the portfolio in such a way that the entity reasonably expects that application of the revenue recognition model to the portfolio would not differ materially from the application of the revenue recognition model to the individual contracts or performance obligations in that portfolio.

However, this is not to say that an entity has to quantitatively evaluate each outcome; that is not the FASB's intention, rather, the entity should take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts.

The portfolio approach may be particularly useful in some industries where entities have a large number of similar contracts and applying the revenue recognition model separately for each contract might be impractical. For example, entities in the telecommunications and cable TV industries are characterized as having a high volume of contracts with various potential configurations; providing multiple goods and services in those contracts; including a discount in the contracts; and providing the goods or services at different times. Because of this, implementing an accounting system to determine the standalone selling price for the promised goods or services in each contract and, in turn, allocating the transaction price to the performance obligations identified in that contract would certainly be quite complex and costly.

C. Combining contracts

In accordance with Topic 606, an entity should combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

- a. The contracts are negotiated as a package with a single commercial objective;
- b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract; and/or
- c. The goods or services promised in the contracts (or some of the goods or services promised in each of the contracts) are a single performance obligation.

In determining whether contracts have been entered into "at or near the same time," an entity should apply judgment, keeping in mind that the longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.

D. Contract modifications

A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract (often described as a change order, variation, or amendment to the contract). A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract, and can be approved in writing, by oral agreement, or implied by customary business practices.

If the parties to the contract have not approved a contract modification, an entity should continue to apply the guidance in ASC 606 to the existing contract until the contract modification is approved.

It is important to note that a contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity should consider all relevant facts and circumstances including the terms of the contract and other evidence.

If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity should estimate the change to the transaction

price arising from the modification in accordance with the guidance on estimating variable consideration and on constraining estimates of variable consideration.

An entity should account for a contract modification as a separate contract if:

- a. The scope of the contract increases because of the addition of promised goods or services that are distinct; and
- b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity adjusts the standalone selling price of an additional good or service for a discount the customer receives because the entity does not incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

If a contract modification is not accounted for as a separate contract, an entity should account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable.

1. If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification

The entity should account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract.

The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation) is the sum of:

- a. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue; and
- b. The consideration promised as part of the contract modification.

2. If the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification

The entity should account for the contract modification as if it were a part of the existing contract.

The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue either as an increase in or a reduction of revenue at the date of the contract modification, that is, the adjustment to revenue is made on a cumulative catch-up basis.

3. If the remaining goods or services are a combination of the above two items

The entity should account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of the contract modifications guidance discussed above.

Under Topic 606, the accounting for contract modifications is much more focused on the type of modification and is applicable to all industries.

IV. Step 2 – Identify the performance obligations in the contract

Entities face many different types of obligations in their day-to-day business activities. As such, the FASB decided to specifically define the term *performance obligation* in the revenue recognition guidance as follows.

Performance Obligation	A promise in a contract with a customer to transfer to the customer either: <ul style="list-style-type: none">a. A good or service (or a bundle of goods or services) that is <u>distinct</u>; orb. A <u>series of distinct</u> goods or services that are substantially the same and that have the same pattern of transfer to the customer.
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The notion of a performance obligation is similar to those of deliverables, components, or elements of a contract in existing revenue guidance. Although implicit in the existing guidance, the term *performance obligation* is not formally defined.

A. Implicit promises in contracts with customers

Contracts with customers typically state the goods or services an entity promises to transfer to a customer.

However, performance obligations identified in a contract with a customer may not always be limited to the goods or services explicitly stated in that contract.

Promises implied by an entity's customary business practices, published policies, or specific statements at the time of entering into the contract can also create a valid expectation by the customer that the entity will transfer goods or services to the customer.

B. Distinct

A good or service that is promised to a customer is distinct if both of the following criteria are met:

- a. 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 (that is, the good or service is capable of being distinct). For example, if an entity transferred a machine to the customer but the machine is only capable of providing a benefit to the customer after an installation process that only the entity can provide, the machine would not be distinct; and
- b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

In some cases, even though the individual goods or services promised as a bundle of goods or services might be capable of being distinct, those goods or services should not be accounted for separately because it would not result in a faithful depiction of the entity's performance in that contract. For example, many construction- and production-type contracts involve transferring to the customer various goods and

services that are capable of being distinct, such as building materials, labor, and project management services.

However, identifying all of those individual goods and services as separate performance obligations would be impractical and, more importantly, it would neither faithfully represent the nature of the entity's promise to the customer nor result in a useful depiction of the entity's performance.

This is because it would result in an entity recognizing and measuring revenue when the materials and other inputs to the construction or production process are provided, instead of recognizing and measuring revenue when the entity performs (and uses those inputs) in the construction or production of the item (or items) for which the customer has contracted. So, when identifying whether goods or services are distinct, an entity should not only consider the characteristics of an individual good or service but should also consider whether the promise to transfer the good or service is separately identifiable, that is, distinct within the context of the contract.

ASU No. 2016-10 provided further guidance on the objective of the concept of distinctiveness. Specifically, the guidance now reads that the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs.

The ASU also revised the related factors and examples to align with the improved articulation of the separately identifiable principle. The updated guidance now lists the following factors to aid in this assessment:

- a. 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. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
- b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
- c. 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. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

If a promised good or service is not distinct, an entity should combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

C. A series of distinct goods or services

A promise to transfer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer would be a single performance obligation if both of the following criteria are met:

- a. Each distinct good or service in the series that the entity promises to transfer to the customer meets any of the following criteria and thus considered to be a performance obligation satisfied over time:
 - (i) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (for example, cleaning service).
 - (ii) The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (for example, work in process).
 - (iii) The entity's performance does not create an asset with an alternative use to the entity (For example, an asset with design specifications that are unique to a customer), and the entity has an enforceable right to payment for performance completed to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin).
- b. The same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Examples of such arrangements would represent subscription-based services, where each good or service offered is essentially identical, as well as services frequently offered by software as a service (SaaS) providers and outsourced service providers, such as transaction processors.

Entities must use judgment in determining whether offered goods or services represent an identical good or service, such as a help desk or R&D arrangement, where the promise to the customer is access that is provided daily, or a promise which is distinct. In the former, the above criteria would apply, whereby in the latter, each offering of the good or service would be a distinct promise and a separate performance obligation.

D. Licenses

Given the number of complex arrangements which entities enter into, it may be challenging to identify all performance obligations in a contract, as well as determine when control passes to the customer. One such area relates to licenses.

While providing guidance on accounting for license arrangements in Topic 606, stakeholders nonetheless requested further information in applying this guidance. In response, the FASB, in ASU No. 2016-10, further defined license arrangements as follows:

- a. **Functional intellectual property** – Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality. Revenue for licenses of functional intellectual property would be recognized when access to the license is granted.
- b. **Symbolic intellectual property** – Intellectual property that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities. Revenue for licenses of symbolic intellectual property would be recognized over the period of the license.

Lastly, some licenses contain sale and usage royalty payment provisions. In such instances, the revenue on such licenses would be recognized as the royalty is earned, even if the underlying license is one for functional intellectual property.

E. Options that grant a material right

Entities generally would not account for options until they are exercised. However, certain options that grant a material right to a customer should be considered as separate performance obligations, with a portion of the transaction price allocated to them and recognized when the option is exercised.

Topic 606 defines a material right as an option which provides a material right to the customer that it would not have received without entering into the contract. For example, offering a discount on future purchases over and above one offered to all customers would be considered a material right. Additionally, offering a free item when a customer purchases other products would be another example of an option granting a material right.

Key to accounting for such options is to determine the stand-alone selling price of the option. This may be relatively easy in some instances or more difficult in others, depending on the amount of objective evidence of stand-alone selling price that exists for the good or service. As with all such allocations, you should start with any observable evidence of stand-alone selling price. However, the stand-alone selling price will often need to be estimated. The estimate should reflect both the discount that the customer would obtain when exercising the option, adjusted for any discount that the customer could have received without exercising the option and the likelihood that the option will be exercised.

V. 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, excluding amounts collected on behalf of third parties (for example, sales taxes). An entity should consider the terms of the contract and its customary business practices to determine the transaction price and should assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified.

The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

It is important to note here that the transaction price should only include amounts to which the entity has rights under the current contract; which is to say, the transaction price does not include estimates of consideration from the future exercise of options for additional goods or services or from future change orders. Until the customer exercises the option or agrees to the change order, the entity does not have a right to consideration. In addition, the amounts to which the entity has rights under the current contract can be paid by any party (that is, not only by the customer). For example, in the healthcare industry, an entity may determine the transaction price based on amounts to which it will be entitled to payment from the patient, insurance companies, and/or governmental organizations. This can also occur in other industries in which an entity receives a payment from a manufacturer as a result of the manufacturer issuing coupons or rebates directly to the entity's customer.

At the end of each reporting period, an entity should update the transaction price, including its assessment of whether an estimate of variable consideration is constrained (discussed below), to faithfully represent the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity should account for changes in the transaction price by allocating the change to the performance obligations in the contract on the same basis as at contract inception. Amounts allocated to a satisfied performance obligation should be recognized as revenue or as a reduction of revenue in the period in which the transaction price changes.

When determining the transaction price, an entity should consider the effects of all of the following:

- a. Variable consideration;
- b. Constraining estimates of variable consideration;
- c. The existence of a significant financing component in the contract;
- d. Noncash consideration; and
- e. Consideration payable to a customer.

A. Variable consideration

Oftentimes, an amount of consideration in a contract will vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence (or nonoccurrence) of a future event. For example, an amount of consideration would be variable if a product was sold with either a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone. Variable consideration promised by a customer may be explicitly stated in the contract.

Notwithstanding the terms of a contract, promised consideration is variable if either:

- a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer, this offer may be referred to as a discount, rebate, refund, or credit; or
- b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

An entity should estimate an amount of variable consideration in a contract by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

- a. **The expected value method** – The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
- b. **The most likely amount method** – The most likely amount is the single most likely amount in a range of possible consideration amounts, that is, the single most likely outcome of the contract. The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes; for example, an entity either achieves a performance bonus or does not.

An entity should apply either the expected value method or the most likely amount method consistently throughout the contract, and should consider all of the historical, current, and forecasted information that is reasonably available to identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration would typically be similar to the information that the entity's management would use during a bid and proposal process or in establishing prices for promised goods or services.

1. Refund liability

An entity should recognize a refund liability if it receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received or receivable for which the entity does not expect to be entitled, that is, amounts not included in the transaction price.

The refund liability and corresponding change in the transaction price, and therefore the contract liability, should be updated at the end of each reporting period for changes in circumstances.

Topic 606 includes implementation guidance covering the accounting for a refund liability relating to a sale with a right of return.

B. Constraining estimates of variable consideration

The FASB decided that in order to provide useful information to financial statement users, some estimates of variable consideration should not be included in the transaction price. This would be the case if the estimate is too uncertain and therefore may not faithfully depict the consideration to which the entity will be entitled in exchange for the goods or services transferred to the customer.

What this means is that an entity should only include in the transaction price an amount of variable consideration estimated 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.

Under Topic 606, variable consideration is estimated using either the "expected value" or "most likely amount" method, but only to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty surrounding the variable consideration is resolved. This approach will generally allow more revenue to be recognized sooner than under the existing standards.

C. The existence of a significant financing component in the contract

In determining the transaction price, an entity should adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. Note that the period of time for consideration is not the term of the contract but rather the time between delivery of the good or service and the customer's payment for the good or service.

Notice that the focus here is on whether the payment terms provide the customer or the entity with a significant benefit of financing. That is, an entity should only adjust for financing if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing.

This is because although there may be a significant period of time between the transfer of the goods or services and the payment, the reason for that timing difference may not be related to a financing arrangement between the entity and the customer.

An entity should consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

- a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and
- b. The combined effect of both of the following:
 - (i) The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and
 - (ii) The prevailing interest rates in the relevant market.

On the other hand, a contract with a customer would not have a significant financing component if:

- a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer;
- b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty); and/or
- c. The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference (for example, “protective” payment terms).

In addition, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

If a contract does include a significant financing component, an entity should use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity should not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer’s credit risk).

Interest income or interest expense should be presented separately from revenue from contracts with customers in the statement of comprehensive income and is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer.

D. Noncash consideration

To determine the transaction price for contracts in which the customer promises consideration in a form other than cash, an entity should measure the noncash consideration, or promise of noncash consideration, at fair value, determined at the date of the contract. If the entity cannot reasonably estimate the fair value of the noncash consideration, it should measure the consideration indirectly by reference to the standalone selling price of the goods or services promised to the customer in exchange for the consideration.

If a customer contributes goods or services, for example, materials, equipment, or labor, to facilitate an entity's fulfillment of a contract, the entity should assess whether it obtains control of those contributed goods or services. If it does, the entity should account for the contributed goods or services as noncash consideration received from the customer.

E. Consideration payable to a customer

Consideration payable to a customer includes amounts that an entity pays, or expects to pay, to a customer, or to other parties that purchase the entity's goods or services from the customer, in the form of cash, credit, or other items that the customer can apply against amounts owed to the entity.

An entity should account for consideration payable to a 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 that the customer transfers to the entity, in which case the entity should account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. An example of such an arrangement would be a cooperative advertisement arrangement where the entity contributes to the cost of an advertisement through a reduction of amounts due to it from its customer. An amount equal to the fair value of comparable advertisement if the entity had separately purchased it would be considered advertising expense and not accounted for as a reduction of revenue.

If consideration payable to a customer is a reduction of the transaction price, an entity should recognize the reduction of revenue when (or as) the later of the entity recognizing revenue for the transfer of the related goods or services to the customer, or the entity paying or promising to pay the consideration (even if the payment is conditional on a future event).

VI. Step 4 – Allocate the transaction price to the performance obligations in the contract

Recall the core principle in the revenue recognition guidance is that an entity should recognize 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. What this really means in essence is that an entity should allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation. (Practical application examples provided below.)

A. Standalone selling price is the key

The standalone selling price at contract inception of the goods or services underlying each performance obligation should be used to allocate the transaction price to each of those performance obligations. The standalone selling price is the price at which the entity would sell the promised goods or services separately to a customer.

Akin to a level 1 input in the fair value hierarchy, the best evidence of a standalone selling price is the observable price of goods or services when the entity sells those goods or services separately in similar circumstances and to similar customers. For example, a contractually stated price or a list price for goods or services may be (but not always) the standalone selling price of those goods or services.

If a standalone selling price is not directly observable, an entity should estimate it by considering all reasonably available information, for example, current market conditions, entity-specific factors, and information about the customer.

Examples of suitable estimation methods (which should be applied consistently for similar circumstances) include:

- a. The adjusted market assessment approach, which uses competitors' prices for similar goods or services and adjusts those prices to reflect the entity's costs and margins;
- b. The expected cost plus a margin approach, which forecasts expected costs of satisfying a performance obligation and adds an appropriate margin for those goods or services; and
- c. The residual approach, which estimates a standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract.

B. Discounts

If the sum of the standalone selling prices of the promised goods or services in the contract exceeds the transaction price, that is, the customer receives a discount for purchasing a bundle of goods or services, an entity should allocate the discount to all of the performance obligations on a relative standalone selling price basis. However, an entity should allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

- a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis;
- b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle; and
- c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

If a discount is allocated entirely to one or more performance obligations in the contract in accordance with the above, an entity should allocate the discount before using the residual approach to estimate the standalone selling price of a good or service.

C. Allocation of variable consideration

It may not always be appropriate for an entity to allocate the variable consideration in a transaction price to all of the performance obligations in a contract. For example, an entity may contract to provide two products at different times with a bonus that is contingent on the timely delivery of only the second product. In that case, it might be inappropriate to attribute variable consideration included in the transaction price to both products. Similarly, an entity may contract to provide two products at different times with a fixed amount for the first product that represents that product's standalone selling price and a variable amount that is contingent on the delivery of the second product. That variable amount might be excluded from the estimate of the transaction price because of the requirements for constraining estimates of the transaction price (discussed above). In that case, it might be inappropriate to attribute the fixed consideration included in the transaction price to both products.

As such, an entity should allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation if both of the following criteria are met:

- a. 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 (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service); and
- b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective to depict the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer when considering all of the performance obligations and payment terms in the contract.

D. Changes in the transaction price

After contract inception, the transaction price can change for a variety of reasons, for example, the resolution of uncertain events. When this happens, the entity should allocate the change to the performance obligations in the contract on the same basis as at contract inception. This ensures that changes in the estimate of variable consideration that are included in (or excluded from) the transaction price are allocated to the performance obligation(s) to which the variable consideration relates.

An entity should allocate a change in the transaction price entirely to one or more distinct goods or services if the above criteria are met.

Amounts allocated to a satisfied performance obligation should be recognized as revenue or as a reduction of revenue in the period in which the transaction price changes; and an entity should not reallocate the transaction price to reflect changes in standalone selling prices after contract inception.

VII. Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation

Under the revenue recognition guidance, an entity will recognize revenue when or as it satisfies a performance obligation by transferring promised goods or services to a customer. Transfer occurs when or as the customer obtains *control* of the goods or services, either at a point in time or over time, as applicable.

Control in this context is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from an asset.

Control also includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset (“defensive control”).

When evaluating whether a customer obtains control of an asset, an entity should consider any agreement to repurchase the asset. An entity would need to assess if such an agreement would negate the passage of control necessary for the recognition of revenue.

Lastly, under Topic 606, an entity should consider if revenue should be recognized over time first and, if not, then assess the point in time when control passes. This consideration may result in a change in the timing of revenue recognition for certain entities if their contracts contain certain provisions which require them to recognize revenue over time under Topic 606, whereby they recognized revenue previously at a point in time under existing guidance. An example would be contract manufacturers, which manufacture to customer specifications. Such an arrangement could lead to recognizing revenue over time under Topic 606, whereby most such manufacturers recognize revenue at a point in time currently.

A. Performance obligations satisfied over time

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time if any of the following criteria is met:

- a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;
- b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced; or
- c. 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 right to payment must include some element of profit, though it does not need to be the negotiated profit percentage in the contract.

An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use.

The assessment of whether an asset has an alternative use to the entity is made at contract inception.

After contract inception, an entity should not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation.

Under Topic 606, revenue is recognized only when or as control of the asset is transferred to the customer, meaning an entity must determine whether a performance obligation in the contract has been satisfied before revenue can be recognized.

B. Performance obligations satisfied at a point in time

Performance obligations are satisfied at a point in time when a customer obtains control of a promised asset at a point in time (that is, not over time as discussed below).

To determine the point in time when a customer obtains control of a promised asset and, therefore, the entity satisfies a performance obligation, the entity should consider the definition of control noted above.

In addition, an entity should also consider the following indicators of the transfer of control:

- a. *The entity has a present right to payment for the asset* – If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.
- b. *The customer has legal title to the asset* – Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
- c. *The entity has transferred physical possession of the asset* – The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls.
- d. *The customer has the significant risks and rewards of ownership of the asset* – The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity should exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
- e. *The customer has accepted the asset* – The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

C. Measuring progress toward complete satisfaction of a performance obligation

For each performance obligation that an entity satisfies over time, the entity should recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation.

The objective when measuring progress is to depict the transfer of control of goods or services to the customer, that is, to depict an entity's performance. In this respect, an entity should include in a measure

of progress any goods or services for which the entity transfers control to the customer and exclude any goods or services for which the entity does not transfer control to the customer.

As circumstances change over time, an entity should update its measure of progress to depict the entity's performance completed to date. Such changes should be accounted for as a change in accounting estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*.

For each performance obligation satisfied over time, an entity should apply a single method of measuring progress that is consistent with the above objective and should apply that method consistently to similar performance obligations and in similar circumstances. Appropriate methods of measuring progress include output methods and input methods.

1. Output methods

Output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract and include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered.

If an entity has a right to invoice a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, the entity should recognize revenue in the amount that the entity has a right to invoice. Such an arrangement may occur in professional services, where a customer is billed on a time and material basis, based on agreed-upon rates. An entity could recognize revenue based on the amount it bills even if the amounts billed increased, as long as the amounts represented the value of the services provided to a customer. However, a lump-sum billing, even if meant to approximate the value provided to date to a customer would not qualify for this right to invoice exemption.

2. Input methods

Input methods recognize revenue on the basis of the entity's efforts or inputs in satisfying a performance obligation, for example, costs incurred, relative to the total expected inputs to satisfy that performance obligation.

If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for an entity to recognize revenue on a straight-line basis.

Entities that currently record revenue based on achievement of milestones should assure that such milestones represent actual performance on the contract. If not, the entity would need to change to another input or output method.

D. Reasonable measures of progress

An entity should only recognize revenue for a performance obligation satisfied over time if it can reasonably measure its progress toward complete satisfaction of the performance obligation, which requires the entity to have the reliable information required to apply an appropriate method of measuring progress. In some cases, for example, in the early stages of a contract, an entity may not be able to reasonably measure the outcome of a performance obligation but does expect to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity should recognize

revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

E. Gross vs. net presentation

For each performance obligation within each contract, the entity must determine whether it is a principal in the transaction or whether it is the agent. As a principal, the entity takes control of the good or service which it sells and would record revenue gross, along with related cost of sales. However, if the entity does not take control of the underlying good or service, it is essentially acting as an agent in the transaction. As such, it would record only its agent fee as revenue in the transaction.

Topic 606 contains numerous examples which illustrate characteristics of both principal and agent relationships, along with examples of characteristics which would indicate control of the good or service.

F. Loss contracts

Topic 606 retains the guidance in Topic 605 related to loss contracts that requires an entity to recognize the entire anticipated loss on a contract as soon as the loss becomes evident. A determination that a loss contract exists occurs when the anticipated transaction price of the contract, as determined under Topic 606, is less than the contract costs.

Unless contracts are combined under the guidance in Topic 606, the loss is determined at the contract level. However, per ASU No. 2016-20, an entity may make an accounting policy election to determine the need for a loss provision on a contract at the performance obligation level. If electing this option, the entity should apply this policy in the same manner for similar types of contracts.

VIII. Contract costs

The guidance relating to contract costs can be found in Subtopic, ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.

ASC 340-40 provides accounting guidance for the following costs related to a contract with a customer within the scope of ASC 606:

- a. Incremental costs of obtaining a contract with a customer; and
- b. Costs incurred in fulfilling a contract with a customer that are not within the scope of another Codification Topic.

A. Incremental costs of obtaining a contract with a customer

Incremental costs of obtaining a contract with a customer are costs an entity incurs that would not have been incurred if the contract had not been obtained, for example, a sales commission.

Incremental costs of obtaining a contract with a customer should be recognized as an asset if the entity expects to recover those costs. However, as a practical expedient, such costs may be expensed as incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

B. Costs incurred in fulfilling a contract with a customer

An entity should recognize an asset for the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify, for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved;
- b. 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; and
- c. The costs are expected to be recovered.

For costs incurred in fulfilling a contract with a customer that are within the scope of another Codification Topic, for example, ASC 330, *Inventory*, an entity should account for those costs in accordance with those other Topics (or Subtopics as the case may be).

Costs that relate directly to a contract or a specific anticipated contract include any of the following:

- a. Direct materials, for example, supplies used in providing the promised services to a customer.
- b. Direct labor, for example, salaries and wages of employees who provide the promised services directly to the customer.
- c. Allocations of costs that relate directly to the contract or to contract activities, for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract (overhead).
- d. Costs that are explicitly chargeable to the customer under the contract.
- e. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

On the other hand, an entity should recognize the following costs as expenses when incurred:

- a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity should evaluate those costs in accordance with the above);
- b. Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract;
- c. Costs that relate to satisfied performance obligations or partially satisfied performance obligations in the contract, that is, costs that relate to past performance; and
- d. Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations or partially satisfied performance obligations.

C. Amortization and impairment

An asset capitalized in accordance with the above guidance should be amortized on a basis consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract as well, for example, services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved.

An entity should update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates and should account for the change as a change in accounting estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*.

An entity should recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized exceeds:

- a. The remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less
- b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses.

To determine the amount of consideration that an entity expects to receive, an entity should use the principles for determining the transaction price (except for the guidance on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk. ASU No. 2016-20 clarified that the entity should also consider expected contract renewals and extensions and include both the amount of consideration it has already received but has not recognized as revenue and the amount it expects to receive in the future.

Before an entity recognizes an impairment loss for an asset recognized, the entity should recognize any impairment loss for assets related to the contract that are recognized in accordance with another Codification Topic (for example, ASC 330, *Inventory*). ASU No. 2016-20 clarified the sequence for impairment testing to be, first, assets not within the scope of Topics 340, 350 (Goodwill and Other) or Topic 360 (PP&E), such as inventory; then assets within the scope of Topic 340 and, lastly, asset groups and reporting units within the scope of Topics 360 and 350.

After applying the impairment test above, an entity should include the resulting carrying amount of the asset recognized in the carrying amount of the asset group or reporting unit to which it belongs for the purpose of applying the guidance in ASC 350, *Intangibles – Goodwill and Other*, and ASC 360, *Property, Plant, and Equipment*, to that asset group or reporting unit.

An entity should not recognize a reversal of an impairment loss previously recognized.

IX. FASB Post-Implementation Review Report for ASC 606 – Revenue from Contracts with Customers

A. Overview of the PIR process

The **Post-Implementation Review (PIR)** process is a comprehensive evaluation conducted by the Financial Accounting Standards Board (FASB) to determine whether a new accounting standard, such as ASC 606, meets its intended objectives. These objectives include providing relevant and reliable financial information to users of financial statements in a manner that justifies the costs of implementation and ongoing compliance. The PIR serves as an essential quality control mechanism embedded in the FASB's standard-setting process and is overseen by the Financial Accounting Foundation (FAF) Board of Trustees.

Objectives of the PIR process for ASC 606 include:

- a. **Determining if ASC 606 fulfills its stated purpose**, specifically evaluating whether it resolves the underlying issues that prompted its development, provides decision-useful information, is operational in practice, and has not resulted in significant unintended consequences;
- b. **Evaluating the implementation and compliance costs**, as well as the benefits realized by various stakeholders, including preparers, investors, and regulators; and
- c. **Gathering feedback to refine the standard-setting process**, particularly regarding effective date selection, coordination with other accounting guidance, and considerations for globally converged standards.

B. PIR timeline and objective

In 2014, ASC 606 was officially issued, marking the culmination of a joint project with the IASB. From 2014 to 2021, Stage 1 of the PIR process was undertaken. Stage 1 focused on monitoring the standard's implementation and providing stakeholder support.

During Stage 1, which occurs before the effective date of the standard, the FASB:

- a. Monitors practice as stakeholders prepare for initial implementation of the standard;
- b. Creates and distributes implementation guidance and other educational material; and
- c. Communicates and performs outreach with stakeholder organizations to generate interest in research activities associated with the standard.

From 2018 to 2024, Stage 2 was undertaken. This stage evaluated the actual costs and benefits of the standard post-implementation. During Stage 2, which begins after the effective date of the final standard and continues for approximately three to five years, the FASB undertakes activities to:

- a. Understand the costs that an entity incurred in applying the standard and the costs that investors and other users incurred in analyzing and interpreting the information in the standard;
- b. Understand the benefits of the standard to investors, entities, and other stakeholders; and
- c. Monitor the ongoing application of the standard.

In 2024, the last stage, Stage 3, was finalized with the publication of the summary report, reflecting a decade of data collection and analysis. In Stage 3, the FASB finalized its final report in written fashion and in a public meeting. The PIR process for ASC 606 stands out due to its scope and duration, reflecting the comprehensive changes introduced and the standard's profound impact across a diverse range of industries.

C. PIR key activities and stakeholder engagement

During the PIR process, FASB engaged with over 2,200 stakeholders, representing a broad and diverse group. As the FASB notes in its final report, "stakeholder feedback is critical to ensure timely support for high-quality implementation of the standard."

They requested and analyzed feedback from the following groups:

- a. **Investors** – Including buy-side and sell-side analysts, accounting analysts, credit rating agency professionals, lenders, and private equity firms.
- b. **Preparers** – Public and private companies, as well as not-for-profit entities, across a wide spectrum of industries and sizes.
- c. **Practitioners** – Representatives from audit and consulting firms at the international, national, and regional levels.
- d. **Other stakeholders** – Academics, state CPA societies, trade organizations, regulators, and other standard setters.

The FASB used a multi-faceted approach to gather feedback. The FASB conducted individual interviews and hosted group discussions; organized advisory group meetings, public roundtables, and stakeholder surveys; delivered webcasts and participated in conferences; and solicited and reviewed comment letters in response to exposure drafts.

As a result, the FASB issued 251 public documents, including detailed Board meeting materials, Transition Resource Group (TRG) memoranda, Exposure Drafts, and Accounting Standards Updates (ASUs). The FASB held 56 public Board meetings to deliberate on feedback and PIR updates and responded to more than 500 technical inquiries, aiding stakeholders in the application of ASC 606.

D. Implementation outcomes

Key achievements of ASC 606 as identified by the PIR process include:

- a. Developing a unified, principles-based revenue recognition model that applies broadly across all industries and transactions;
- b. Introducing comprehensive disclosure requirements, improving investor insight through enhanced revenue disaggregation and qualitative descriptions; and
- c. Achieving global convergence by aligning U.S. GAAP with IFRS 15, reducing inconsistencies for multinational organizations.

E. Impact of ASC 606

Most entities experienced minimal impact on the dollar amount of reported revenues but faced significant efforts to revise internal processes and controls. The FASB believes extensive implementation support was crucial and included TRG meetings, ASUs for clarification, and detailed Q&As.

All entities, regardless of the impact on revenue figures, undertook comprehensive reviews of contracts and revenue recognition practices. These reviews and improvements did lead to challenges.

Although overall feedback on ASC 606 was positive, stakeholders identified several areas that posed difficulties due to the increased need for professional judgment and adaptation to new principles.

Top 10 challenging areas:

1. **Licensing of intellectual property** – Determining the timing of revenue recognition and whether licenses are distinct.
2. **Identification of performance obligations** – Assessing whether promises in a contract are distinct and separable.
3. **Standalone selling price determination** – Estimating prices when not directly observable.
4. **Variable consideration constraint** – Estimating and constraining revenue based on expected outcomes.
5. **Sales/usage-based royalties** – Recognizing revenue tied to customer sales or usage metrics.
6. **Principal vs. agent assessments** – Determining control and gross vs. net presentation.
7. **Consideration payable to a customer** – Accounting for payments made to customers or third parties.
8. **Incremental costs of obtaining a contract** – Capitalization and amortization of contract-related costs.
9. **Short-cycle manufacturing revenue recognition** – Recognizing revenue over time for customized, short-cycle products.
10. **Disclosures** – Meeting the expanded requirements effectively and efficiently.

The causes of these challenges were multifaceted. First, given the complexity of revenue recognition, high levels of judgment and estimation were required, particularly in evaluating performance obligations and transaction pricing. The new standard also represented a fundamental departure from previous guidance (Topic 605), and this necessitated process and system overhauls. Additionally, the emergence of complex and hybrid business models, such as SaaS and bundled service arrangements, increased implementation complexity. Despite these challenges, stakeholders did not advocate for revisions to the core model but recommended additional guidance for specific scenarios in the future.

F. Costs vs. benefits

A key goal of the PIR process is to evaluate implementation and compliance costs relative to the benefits accrued from the standard. The FASB completed this step and identified four key benefits that arose as a result of the standard's implementation. First, investors gained deeper insights into contract structures and revenue recognition policies. Second, investors further benefited from enhanced comparability across entities, industries, and global markets, fostering better investment decisions. In short, the income statement has become more comparable. Third, preparers benefited from improved contract analysis and strengthened internal controls over revenue processes. Lastly, global convergence of standards simplified reporting for multinational entities and reduced discrepancies between GAAP and IFRS, making statements across localities more comparable.

The benefits identified came with three key reported costs. Preparers identified significant implementation costs for system upgrades, staff training, and process changes, especially where industry-specific guidance was eliminated. Investors faced initial learning costs, including model updates and analysis changes, though these were generally one-time costs. Many preparers and practitioners identified ongoing costs related to estimating variable consideration, enhanced disclosures, and maintaining robust controls. Despite these costs, "overall, stakeholders agreed that the benefits of the revenue standard outweigh its costs, especially from a long-term perspective."

G. Improvements to the standard-setting process

Key lessons from the PIR include:

- a. The need for realistic effective date planning, factoring in implementation complexity and stakeholder readiness;
- b. The importance of proactively identifying cross-cutting issues, especially those affecting multiple areas of GAAP;
- c. Recognition that early-stage TRGs could enhance guidance clarity and reduce post-issuance amendments; and
- d. Knowledge that, while beneficial, global convergence introduces added time, cost, and complexity that must be weighed carefully.

As a result, FASB instituted enhanced internal procedures to better forecast timelines and coordinate guidance across standards.

X. What is next?

The FASB determined that ASC 606 met its core objectives: delivering a robust, consistent, and principles-based revenue recognition framework. The cost-benefit relationship aligned with initial expectations, with long-term benefits justifying the implementation effort. There is no immediate need for standard-setting changes, as ASC 606 is operational and broadly effective. “The staff has not identified any matters that warrant immediate standard-setting action on Topic 606.”

Going forward, the FASB will maintain ongoing support via the Technical Inquiry Service to address emerging questions. The Board will monitor practice developments and consider future agenda items based on evolving needs. Insights from the PIR will be incorporated into the development of future standards and implementation support strategies.

XI. Practice exercises

A. Exercise 1

Answer the questions following the fact pattern with regard to applying the accounting guidance for recognizing revenue over time.

Facts

The entity, Contractor, has been engaged to replace a bridge over a local river by the local municipality. The contract is for \$3.0 million, which includes all building materials such as steel, concrete, and other materials, all labor and overhead related to the contract. Contractor expects to make a 10 percent profit margin in the contract. Contractor expects that it will take six months to replace the bridge and bills the municipality monthly for the work performed on the bridge, based on the costs which it incurs in building the bridge. The local municipality controls the work in process as the bridge is replaced and can make changes to the bridge design over the period of time that the bridge is being constructed. The municipality can terminate the project at any time, with Contractor entitled to be reimbursed for any costs that it has incurred to date that have not yet been reimbursed by the municipality, plus reasonable profit. However, reimbursements for material purchased by Contractor but not yet used are limited to the cost of the materials.

Questions for Consideration, Using the Guidance in Topic 606

1. How many performance obligations are there in this contract?
2. How would revenue be recognized for this contract? Why?
3. Assume that after five months, Contractor has incurred \$2.4M of costs of the bridge. This includes the cost of the steel and all other materials, which have all been installed by Contractor. Using a cost input method and assuming the same estimated total cost for the bridge as at the beginning of the contract, how much progress has Contractor made on the bridge? How much cumulative revenue and profit would Contractor recognize on the project?

B. Exercise 2

Answer the questions following the fact pattern with regard to applying the accounting guidance for recognizing revenue over time.

Facts

Assume that the entity is a software developer who produces software that customers use to value their investments. The entity provides a license for 12 months to users of the software to access the entity's software at any time in order to use it to assist in valuing the end user's investments. The terms of the license agreement call for an upfront payment by the customer to the entity of \$2,000.

Questions for Consideration, Using the Guidance in Topic 606

1. Would the license meet the definition of a performance obligation?

2. Would the license be classified as a license of functional intellectual property or symbolic intellectual property?

3. Would the revenue be recognized at the point in time that access to the license is granted to the customer or over the license term?

XII. Practice exercises – Suggested solutions

A. Exercise 1

Facts

The entity, Contractor, has been engaged to replace a bridge over a local river by the local municipality. The contract is for \$3.0 million, which includes all building materials such as steel, concrete, and other materials, all labor and overhead related to the contract. Contractor expects to make a 10 percent profit margin in the contract. Contractor expects that it will take six months to replace the bridge and bills the municipality monthly for the work performed on the bridge, based on the costs which it incurs in building the bridge. The local municipality controls the work in process as the bridge is replaced and can make changes to the bridge design over the period of time that the bridge is being constructed. The municipality can terminate the project at any time, with Contractor entitled to be reimbursed for any costs that it has incurred to date that have not yet been reimbursed by the municipality, plus reasonable profit. However, reimbursements for material purchased by Contractor but not yet used are limited to the cost of the materials.

Questions for Consideration, Using the Guidance in Topic 606

1. How many performance obligations are there in this contract?

While the material used to build the bridge would most likely be distinctive in and of themselves, as they would have functionality to the municipality, they are not distinct within the context of the contract, as they are being used as inputs to produce or deliver the combined output specified by the customer, the bridge. As such, Contractor would most likely conclude that the contract has one performance obligation, the building of the bridge.

2. How would revenue be recognized for this contract? Why?

Contractor would recognize revenue for the bridge over time under Topic 606. This is because the municipality controls the work in process as Contractor constructs the bridge.

3. Assume that after five months, Contractor has incurred \$2.4M of costs of the bridge. This includes the cost of the steel and all other materials, which have all been installed by Contractor. Using a cost input method and assuming the same estimated total cost for the bridge as at the beginning of the contract, how much progress has Contractor made on the bridge? How much cumulative revenue and profit would Contractor recognize on the project?

Contractor would estimate its progress on the bridge as follows:

Total costs incurred	\$2.4M
Estimated total costs	2.7M - \$3M contract value less 10 percent estimated profit (\$300K)
Progress percentage	89 percent
Contract price	\$3.0M
Revenue recognized	\$2.667M - \$3M times 89 percent completion

B. Exercise 2

Facts

Assume that the entity is a software developer who produces software that customers use to value their investments. The entity provides a license for 12 months to users of the software to access the entity's software at any time in order to use it to assist in valuing the end user's investments. The terms of the license agreement call for an upfront payment by the customer to the entity of \$2,000.

Questions for Consideration, Using the Guidance in Topic 606

1. Would the license meet the definition of a performance obligation?

As the customer can benefit from the license either on its own or together with other resources that are readily available to the customer (the related IT hardware and software), the license would meet the definition of being distinct and thereby would be a separate performance obligation.

Note that the entity should assess whether its promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract). Given this fact pattern, this does not appear to be the case.

2. Would the license be classified as a license of functional intellectual property or symbolic intellectual property?

Based on the provided fact pattern, the license appears to be intellectual property that has significant standalone functionality, as it performs a function or task. Accordingly, it would be classified as a license of functional intellectual property.

3. Would the revenue be recognized at the point in time that access to the license is granted to the customer or over the license term?

As this contract represents the transfer of a license of functional intellectual property to the customer, revenue would be recognized at the point in time that access to the license is granted to the customer.

However, the entity needs to determine if the exception to this rule exists. It must determine if the functionality of the intellectual property to which the customer has rights is expected to substantively change during the license period as a result of activities of the entity that do not transfer a promised good or service to the customer, and whether the customer is contractually or practically required to use the updated intellectual property resulting from the updates.

In performing this analysis, the entity will need to apply judgment to determine if the updates to the license represent substantive changes to the software. If so, then, it must determine if the customer is contractually or practically required to use the updated software. If it answers yes to both questions, then the entity would recognize the revenue related to the license over the term of the license, or 12 months. As the term of the contract is a year or less, the entity need not consider whether there is a financing element associated with the pricing of the license.

Given the fact pattern, it does not appear that the conditions related to the exception exist. As such, the entity would recognize revenue at the time at which the license is transferred to the customer.

Non-GAAP Financial Measures

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Non-GAAP Financial Measures

Learning objectives

After completing this chapter, you should be familiar with:

- Non-GAAP financial measures; and
- Guidance on presenting non-GAAP measures.

I. Background

Non-GAAP financial measures are reported financial measures and performance metrics that exclude amounts recognized under GAAP. Because they are by definition non-GAAP, they lack formal FASB guidance in the Accounting Standards Codification. To understand their application, we need to look elsewhere for understanding. Fortunately, we have Securities and Exchange Commission Staff Guidance and IFRS 18. IFRS 18 defines management-defined performance measures (MPMs), their classification for non-GAAP measures, as “subtotals of income and expenses that:

- Are used in public communication out of the financial statements (e.g., in management commentary, press releases, or investor presentations);
- Communicate management’s view of an aspect of the financial performance of the entity as a whole; and
- Are a subtotal of income and expenses but are not a required subtotal (i.e., required to be presented or disclosed by IFRS Accounting Standards) or a common income and expenses subtotal listed in IFRS 18 (e.g., gross profit).”

In short, they are metrics presented by management that do not fall under traditional accounting guidance or subtotals within such guidance. Common examples include:

- EBITDA;
- Adjusted EBITDA;
- Adjusted EPS;
- Free cash flow; and
- Adjusted revenue.

An example of non-GAAP measures can be found in Tesla’s 8-K from the first quarter of 2025:

Adjusted EBITDA ^{(1) (2)}	3,384	3,674	4,665	4,333
Adjusted EBITDA margin ^{(1) (2)}	15.9%	14.4%	18.5%	16.9%
Net income attributable to common stockholders (GAAP) ⁽¹⁾	1,390	1,400	2,173	2,128
Net income attributable to common stockholders (non-GAAP) ^{(1) (3)}	1,536	1,812	2,505	2,107
EPS attributable to common stockholders, diluted (GAAP) ⁽¹⁾	0.41	0.40	0.62	0.60
EPS attributable to common stockholders, diluted (non-GAAP) ^{(1) (3)}	0.45	0.52	0.72	0.60
Net cash provided by operating activities	242	3,612	6,255	4,814
Capital expenditures ⁽⁴⁾	(2,777)	(2,272)	(3,513)	(2,780)
Free cash flow ⁽⁴⁾	(2,535)	1,340	2,742	2,034
Cash, cash equivalents and investments	26,863	30,720	33,648	36,563

⁽¹⁾ As a result of the adoption of the new crypto assets standard, the previously reported quarterly periods in 2024 have been recast.

⁽²⁾ Beginning in Q1’25, Adjusted EBITDA (non-GAAP) is presented net of digital assets gains and losses and all prior periods have been adjusted.

⁽³⁾ Beginning in Q1’25, Net income attributable to common stockholders (non-GAAP) is presented net of digital assets gains and losses and all prior periods have been adjusted.

⁽⁴⁾ Beginning in Q1’25, Capital expenditures is presented inclusive of purchases of solar energy systems and all prior periods have been adjusted.

They often appear in earnings releases and MD&A to reflect internal or operational performance views. Regardless of where they appear, they must comply with SEC Regulation G and Item 10(e) of Regulation S-K (for publicly traded entities).

According to Audit Analytics (an audit research database), in Q3 and Q4 of 2015, 88 percent of the S&P 500 companies reported non-GAAP financial measures in their quarterly financial reports. By 2020, that number had increased to 94 percent (Center for Audit Quality). In part due to their proliferation, non-GAAP financial measures have been subject to growing regulatory and investor scrutiny. Common violations of reporting non-GAAP measures include:

- a. Excluding normal/recurring expenses from the metric without explanation;
- b. Emphasizing non-GAAP metrics above and over U.S. GAAP; and
- c. Inconsistent reconciliation practices.

A. Guidance on presenting non-GAAP measures

Currently, no formal FASB guidance governs the disclosure of non-GAAP financial measures. Generally, non-GAAP measures are not audited by auditors. However, auditors are required to verify consistency and ensure measures are not misleading, but the actual measures are left to the presenting company. Practitioners should look to SEC Staff Guidance – Compliance and Disclosure Interpretations, particularly Rule 100(b) of Regulation G and IFRS 18.

SEC guidance can be found at: <https://www.sec.gov/corpfin/non-gAAP-financial-measures.htm>.

We will use this guidance to walk through common questions and responses from the SEC regarding non-GAAP financial measures.

1. SEC question 100.01: General

Question: Can certain adjustments, although not explicitly prohibited, result in a non-GAAP measure that is misleading?

SEC answer: Yes. Certain adjustments may violate Rule 100(b) of Regulation G because they cause the presentation of the non-GAAP measure to be misleading. Whether or not an adjustment results in a misleading non-GAAP measure depends on a company's individual facts and circumstances.

Presenting a non-GAAP performance measure that excludes normal, recurring cash operating expenses necessary to operate a registrant's business is one example of a measure that could be misleading.

When evaluating what is a normal operating expense, the staff considers the nature and effect of the non-GAAP adjustment and how it relates to the company's operations, revenue-generating activities, business strategy, industry, and regulatory environment.

The staff would view an operating expense that occurs repeatedly or occasionally, including at irregular intervals, as recurring.

2. New SEC interpretation: Question 100.05 – Interpretation added in December 2022

Question: Can a non-GAAP measure be misleading if it, and/or any adjustment made to the GAAP measure, is not appropriately labeled and clearly described?

SEC answer: Yes. Non-GAAP measures are not always consistent across or comparable with non-GAAP measures disclosed by other companies. Without an appropriate label and clear description, a non-GAAP measure and/or any adjustment made to arrive at that measure could be misleading to investors.

The following examples would violate Rule 100(b) of Regulation G:

- a. Failure to identify and describe a measure as non-GAAP.
- b. Presenting a non-GAAP measure with a label that does not reflect the nature of the non-GAAP measure, such as:
 - (i) A contribution margin that is calculated as GAAP revenue less certain expenses, labeled “net revenue”;
 - (ii) A non-GAAP measure labeled the same as a GAAP line item or subtotal even though it is calculated differently than the similarly labeled GAAP measure, such as “Gross Profit” or “Sales”; and
 - (iii) A non-GAAP measure labeled “pro forma” that is not calculated in a manner consistent with the pro forma requirements in Article 11 of Regulation S-X.

3. SEC question 102.03: “Nonrecurring” items

Question: Item 10(e) of Regulation S-K prohibits adjusting a non-GAAP financial performance measure to eliminate or smooth items identified as nonrecurring, infrequent, or unusual when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years. Is this prohibition based on the description of the charge or gain, or is it based on the nature of the charge or gain?

SEC answer: The prohibition is based on the description of the charge or gain that is being adjusted. It would **not** be appropriate to state that a charge or gain is nonrecurring, infrequent, or unusual unless it meets the specified criteria. The fact that a registrant cannot describe a charge or gain as nonrecurring, infrequent, or unusual, however, does not mean that the registrant cannot adjust for that charge or gain.

4. SEC question 102.06: Free cash flows

Question: Some companies present a measure of “free cash flow,” which is typically calculated as cash flows from operating activities as presented in the statement of cash flows under GAAP less capital expenditures. Does Item 10(e)(1)(ii) of Regulation S-K prohibit this measure in documents filed with the Commission?

SEC answer: No. The deduction of capital expenditures from the GAAP financial measure of cash flows from operating activities would not violate the prohibitions in Item 10(e)(1)(ii). However, companies should be aware that this measure does not have a uniform definition, and its title does not describe how it is calculated. Accordingly, a clear description of how this measure is calculated, as well as the necessary reconciliation, should accompany the measure where it is used.

The three major categories of the statement of cash flows should be presented when a non-GAAP liquidity measure is presented.

5. SEC question 103.01: EBIT and EBITDA

Question: If EBIT or EBITDA is presented as a performance measure, to which GAAP financial measure should it be reconciled?

SEC answer: If a company presents EBIT or EBITDA as a performance measure, such measures **should be reconciled to net income** as presented in the statement of operations under GAAP. Operating income would **not** be considered the most directly comparable GAAP financial measure because EBIT and EBITDA make adjustments for items that are not included in operating income. In addition, **these measures must not be presented on a per-share basis.**

6. SEC question 103.02: EBIT and EBITDA

Question: Exchange Act Release No. 47226 describes EBIT as “earnings before interest and taxes” and EBITDA as “earnings before interest, taxes, depreciation, and amortization.” What GAAP measure is intended by the term “earnings”?

SEC answer: “Earnings” means net income as presented in the statement of operations under GAAP. Measures that are calculated differently than those described as EBIT and EBITDA in Exchange Act Release No. 47226 should not be characterized as “EBIT” or “EBITDA,” and their titles should be distinguished from “EBIT” or “EBITDA,” such as “Adjusted EBITDA.”

Discussion question:

What are some other non-GAAP measures you have seen companies announce alongside their earnings or other financial results? Do any of those seem inconsistent with U.S. GAAP or appear misleading?