FASB FINANCIAL ACCOUNTING STANDARDS BOARD

STAFF PAPER

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Project	**Transition Resource Group for Revenue Recognition**
Paper topic	Payments to Customers

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Purpose

1. Some stakeholders informed the staff that there is a question about the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606),* about accounting for upfront payments made to customers. The question is about the timing of recognition of the payments in the income statement, such as whether upfront payments should be immediately recognized in the income statement or recognized as assets (and subsequently "amortized"). The question is about whether a payment that is recognized as an asset should be recognized (amortized) in the income statement over the current contract term or whether a longer period is appropriate, such as the current contract term plus certain renewal periods, the period over which the payment is expected to provide benefit, or the customer relationship. Stakeholders have highlighted that there is diversity in practice in this area today and they question whether the guidance in Topic 606 will narrow that diversity and whether the accounting results under Topic 606 could change, compared to outcomes under current GAAP.
2. This paper summarizes the potential implementation issue that was reported to the staff. The staff will seek input from members of the Transition Resource Group for Revenue Recognition (TRG) on the potential implementation issue.

Background

3. Payments to customers are common in many industries. Payments can take the form of cash or other items (for example, a coupon, a credit, or a voucher). The staff understands that scenarios also include the issuance of equity, in lieu of a cash payment. For example, an entity may make a payment to a customer to:
   a. Reimburse the customer for costs associated with entering into a contract (such as costs for setting up a new vendor or costs to shut down operations that will be outsourced to the vendor)
   b. Obtain a customer contract in a competitive environment (pay-to-play or exclusivity)
   c. Provide additional incentives or discounts to customers.
4. The scope of the issue discussed in this paper is about payments to customers (and, arguably, potential customers). The analysis in this paper does not apply to payments that are made to third parties that are not customers (or potential customers). This is because Topic 606 applies to contracts *with customers* and does not provide guidance on payments to other parties (for example, a payment an entity makes to its vendor for services received), as described in paragraph 606-10-32-26.
5. Although this paper applies to payments to customers, sometimes the very challenge with this topic is determining whether the payment is to a customer. An entity will need to apply judgment in some circumstances to determine whether the counterparty to the arrangement is a customer in a revenue contract(s). The following are some examples for which judgment may be needed:
   a. An entity might make a payment to a third party that has never been a customer of the entity, but the payment is made as part of contract negotiations to incentivize the third party to become a customer. The third party is not required to make purchases to receive the payment (for example, purchases are at the option of the third party).
   b. An entity might have conducted business in prior transactions with the counterparty as a customer, but because of the nature of the current arrangement, there is some ambiguity about whether the counterparty is

a customer in the current arrangement. For example, a counterparty might be a longstanding customer in a particular segment, but that same counterparty is a collaborator in another segment (for example, development of a new product).

c. An entity might determine that the counterparty is a collaborator, rather than a customer, if the counterparty has not contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities. (The FASB received an agenda request from a stakeholder about accounting for collaborative arrangements under Topic 808 and the staff has been performing research and outreach to evaluate the matter.)

d. An entity might make a payment to a third party that is expected to be a customer in a future period, but the entity receives an intangible asset in exchange for the payment (for example, the right to be the exclusive provider of a particular component of a key product of the third party).

6. The staff's analysis in this paper does not apply to scenarios in which an entity sells goods or services to a customer at a loss with a strong expectation of profit on future orders from that customer. The staff's analysis on upfront payments to customers should not be applied by analogy to scenarios in which an entity has a loss on the sale of inventory or another asset.

7. Consideration payable to a customer is excluded from the scope of the guidance in Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers. Therefore, the staff's analysis in this paper does not relate to incremental costs of obtaining a contract or costs incurred in fulfilling a contract with a customer, which are within the scope of Subtopic 340-40.

Current Practice

8. Accounting for payments to customers has been a challenging financial reporting issue for many years. Current GAAP on accounting for consideration given from a vendor to a customer is in Subtopic 605-50, Revenue Recognition—Customer Payments and Incentives. The original source of this guidance is EITF 01-9,

Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products). Some of that guidance relates to income statement presentation, and it requires consideration payable to a customer to be presented as a reduction to revenue (not as an expense).

9. During its deliberations of EITF 01-9, the Task Force discussed whether a vendor should recognize consideration given to a customer as an asset in certain circumstances, rather than as an immediate charge in the income statement. The Task Force did not come to a consensus on that issue and discontinued the discussion of that topic. The Task Force observed that if consideration given by a vendor to a reseller initially is recognized as an asset by the vendor, subsequent income statement characterization of that consideration would be determined in accordance with the other issues in EITF 01-9 (that is, generally as a reduction of revenue, except for certain instances described in EITF 01-9 in which negative revenue may be characterized as expense).
10. Because the Task Force did not reach consensus on this issue, no explicit GAAP exists for the accounting for upfront payments to customers today (that is, whether the payment should be recognized as an asset or recognized in the income statement immediately). Accordingly, preparers and auditors evaluate the facts and circumstances of the payment and apply professional judgment to determine the accounting. They consider, among other things, their views of the economics of the arrangement, other guidance (for example, the definition of the term *asset* and accounting for intangible assets), and the views of regulators. The staff understands that there is diversity in practice today. It is difficult to assess the extent to which the diversity results from different (but supportable) judgments about similar fact patterns or results from different fact patterns.
11. During outreach, some stakeholders, particularly those that have addressed issues about consideration payable to a customer for many years, asserted that current practice in this area has evolved over time and has been influenced, in part, by previous SEC staff views on the topic. For example, some stakeholders asserted to the FASB staff that they consider an SEC staff speech given by Paul Kepple, Professional Accounting Fellow, at the December 1998 AICPA National Conference on Current SEC Developments regarding internet loss arrangements.

An excerpt of Mr. Kepple's remarks is included in Appendix A of this paper. In summary, Mr. Kepple stated that the SEC staff objected, in a specific fact pattern, to a registrant recording a one-time nonrecurring loss related to an upfront payment, despite an assertion by the registrant that the payment did not meet the definition of an asset.

12. The FASB staff understands that the speech by Mr. Kepple has been interpreted by some in practice as indicating that upfront payments should be capitalized, depending on the specific facts and circumstances, even if the payment does not meet the definition of an *asset* per the FASB's Conceptual Framework for Financial Accounting. If an asset is recognized, it is assessed for recoverability.

Relevant Prior TRG Discussions

13. At previous meetings, the TRG discussed certain topics related to the issue raised in this paper, such as consideration payable to a customer and options to purchase additional goods and services. The staff notes that those prior discussions do not explicitly answer the question raised in this paper regarding the accounting for upfront payments. However, the prior TRG discussions are included for reference and it may be helpful to consider those prior discussions when considering the issue discussed in this paper. Some of these prior discussions are referenced in the staff analysis in the section below. A summary of those prior TRG discussions is included in Appendix B of this paper.

Question 1: How Should an Entity Account for Upfront Payments to a Customer?

Impact of the Issuance of Topic 606

14. As discussed above, there is diversity in accounting for upfront payments today. Some stakeholders have asked whether this diversity will persist under the new revenue standard or whether the new revenue standard will narrow the diversity. In contemplating that question, it is important to note that during the development of the joint revenue standard, the Boards did not broadly reconsider the accounting for upfront payments to customers, except in the context of certain payments that may

be accounted for as variable consideration. Much of the guidance on consideration payable to a customer is based on existing U.S. GAAP. TRG Agenda Refs No. 28 and 37 describe some key differences between the guidance in Topic 606 and the existing U.S. GAAP. The staff thinks that an entity will need to evaluate the facts and circumstances and make judgments about the nature of the payment. In addition, there are cases in which the answer should be clear under Topic 606, as described below.

15. If the counterparty is a customer, paragraph 606-10-32-25 is clear that the payment should be recorded as a reduction of revenue, unless the payment to the customer is in exchange for a distinct good or service. If that payment relates entirely to the current contract with the customer, Topic 606 is clear on how the payment would be recognized. The consideration paid to a customer is accounted for as a reduction of the transaction price. The practical effect of this accounting is that:

    a. An entity will record an asset for the upfront payment. This asset essentially represents an advance of funds to the customer, which the entity recovers subsequently as related goods or services are performed.

    b. The payment is recognized as a reduction of revenue as the goods or services are transferred to the customer.

16. In the staff's view, an important first step in evaluating the accounting for an upfront payment is understanding the reasons for the payment, the rights and obligations resulting from the payment (if any), the nature of the promise(s) in the contract (if any), and other relevant facts and circumstances. Understanding this rationale can be instructive when determining the accounting and in particular, understanding whether and how the entity expects to obtain future benefits as a result of the payment. In addition, this rationale can be helpful in deciding what information about the arrangement should be disclosed to financial statement users.

17. Consider the following example:

Example 1, Scenario A – IT outsourcing services

Service Provider makes a $1 million payment to a customer as part of the negotiations in a contract to provide IT outsourcing services. The payment to the customer was negotiated because the customer will incur costs to terminate employees and dispose of equipment that is currently utilized in the operations to be outsourced. The contract has a noncancellable term of five years. The entity estimates that the customer will pay a fee of $6 million for five years of services. The payment to the customer is made in connection with a legally enforceable contract (that is, the customer only receives the $1 million when it commits to the outsourcing contract).

18. In the example above, the payment is to compensate the customer for the costs of switching to the entity's service. The payment is consideration payable to the customer, as described in paragraph 606-10-32-25. The payment is not in exchange for a distinct good or service. Therefore, the payment to the customer reduces the transaction price. In this example, the transaction price would be $5 million ($6 million service fee, less $1 million consideration payable to the customer). A $1 million asset would be recorded when the payment is made at contract inception. That asset would be reduced (amortized) over time as the entity provides service to the customer and that "amortization" is reflected in the transaction price (that is, a reduction of revenue).

19. The accounting in that example is clearer than some other circumstances because the payment is made to the customer in the context of the current contract with the customer. The staff is aware of the following circumstances in which the accounting might be less clear than the example above (and undoubtedly there are other circumstances in which the accounting is less clear):

    a. An entity makes an upfront payment to a customer (or a potential customer) and does not have a revenue contract (that is, there is not yet a contract to be accounted for under Topic 606). An entity might make an upfront payment in anticipation of future purchases from the customer.

b. An entity makes an upfront payment to a customer and there is a revenue contract. However, the upfront payment relates to the current contract as well as an anticipated future revenue contracts. For example, a contract might include an agreement to purchases 100 goods and an option to purchase another 400 goods and the entity has an expectation that the customer will purchase a total of about 500 goods.

20. Consider the following examples:

Example 1, Scenario B – IT outsourcing services

Assume the same fact pattern as Example 1, Scenario A, except that the contract is cancellable at the end of any month for no penalty (which results in a month-to-month contract under Topic 606). Although the customer has the right to cancel the contract, Service Provider expects the customer to continue to purchase services for five years because the customer has limited ability to perform the services internally given the customer terminated employees and disposed of equipment. Additionally, the customer has incurred significant set-up costs and will incur the significant set-up costs to change vendors. Finally, Service Provider knows from past experience with entering into similar contracts with other customers that most customers do not cancel contracts. Service Provider has no previous revenue from contracts with this customer.

Example 2 – Supply arrangement

Scenario A

Supplier makes a $1 million payment to a customer as part of the negotiations in a three-year exclusive supply contract to provide specialized parts to a customer that are a component in one of the customer's main products. The payment is made as an incentive and to also reimburse the customer for costs to be incurred to switch from an existing supplier, including termination fees and other costs. The supply contract stipulates a price of $100 per part. The customer provides a non-binding forecast of its supply requirements, which forecasts expected total purchases of 100,000 parts over the contract period (for a total of $10 million). Supplier has no previous revenue from contracts with this customer.

Scenario B

Assume the same facts as Example 2, Scenario A, except that in this scenario Supplier receives a purchase order for 20,000 parts at the time the payment is made. However, consistent with Scenario A, Supplier expects that the customer's purchase volume will be 100,000 parts.

21. In scenarios similar to the three above, a question has arisen about the timing of when the reduction in revenue for an upfront payment should be recorded. Specifically, stakeholders have raised a question about application of the guidance in the following paragraph.

> **606-10-32-27** Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:
>
> a. The entity recognizes revenue for the transfer of the **related goods or services** to the customer.
>
> b. The entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices. **[emphasis added]**

22. The following are two views about the timing of when the reduction in revenue for an upfront payment should be recorded. The difference between the views is the interpretation of the phrase *related goods or services*.
    a. View A: Payments to customers should be recognized as a reduction of revenue as the related goods or services (that is, the expected total purchases resulting from the upfront payment) are transferred to the customer. The payment might be recorded in the income statement over a period that is longer than the current legally enforceable contract. Identification of the related goods or services will require judgment on the basis of the facts and circumstances. The asset would be periodically assessed for recoverability.
    b. View B: Payments to customers should be recognized as a reduction of revenue from the existing contract (that is, existing enforceable rights and obligations). If no revenue contract exists, then the entire payment would be immediately recognized in the income statement.
23. The following is an analysis of how the staff thinks each of the two views would be applied to the examples earlier in this paper.

Example	**View A**	**View B**
Example 1, Scenario A	The upfront payment relates to the noncancelable five-year contract. Therefore, the entity would record an asset for the payment and amortize it as a reduction of revenue as the services are provided to the customer over a five-year period.	Same as View A.
Example 1, Scenario B	The upfront payment relates to the five-year	The current contract term is only one month.

Example	View A	View B
	expected term of the contract. The entity would record an asset for the payment and amortize it as a reduction of revenue over the expected term (that is, considering renewal options the customer is expected to exercise). The asset would be periodically assessed for recoverability.	Therefore, the upfront payment should be offset against the one month of revenue. In this example, the payment exceeds revenue for the first month.
Example 2, Scenario A	The upfront payment relates to the expected 100,000 parts. The entity would record an asset for the payment and amortize it as a reduction of revenue as the anticipated units are provided to the customer. The asset would be periodically assessed for recoverability.	Because the customer is not required to make any purchases, the entity has no revenue contract with the customer. Therefore, the entire upfront payment would be recognized in the income statement when the payment is made.
Example 2, Scenario B	Same as Example 2, Scenario A.	The current contract is for 20,000 units. The upfront payment would

Example	View A	View B
		be recorded as an asset and then would be amortized as a reduction of revenue as the 20,000 units are provided to the customer.

Analysis of View A

24. Proponents of View A point to several areas of GAAP to support their view that the payment can be recorded as an asset (and later as a reduction of revenue) over a period longer than the current contract term, as described below.
25. First, at previous TRG meetings, TRG members discussed the question of which payments to a customer are in the scope of the guidance on consideration payable to a customer. As summarized in Appendix B, TRG members agreed that a reasonable application of both View A (entities should assess all consideration payable to a customer) and View B (entities should assess consideration payable to a customer only within the context of that contract with a customer) as described in TRG Agenda Ref No. 37 could be acceptable approaches, and should result in similar financial reporting outcomes. TRG members also agreed that a reasonable application of either view could be accomplished with processes and internal controls to identify payments to customers that could be related to a revenue contract. During that discussion, some TRG members had concerns that a strict view of only looking at payments within the context of the contract with a customer may not reflect the economics of the transaction (for example, when payments are made to the customer's customer). Although the question in this paper is different from the question previously discussed by the TRG, proponents of View A in this paper note that there are other circumstances in which an entity can look beyond the current contract when accounting for consideration payable to a customer. However, opponents of View A in this paper would point out that the accounting outcomes under View A and View B described on this upfront payment issue could

result in differences in income statement results and, therefore, do not think this prior TRG discussion is relevant.

26. Second, proponents of View A point to the use of the phrase *related goods or services* in paragraph 606-10-32-27 as supporting a view that the payment may relate to the goods or services in anticipated future contracts, which includes anticipated renewals of an existing contract. This guidance is similar to current GAAP which refers to *the related revenue is recognized by the vendor* in paragraph 605-50-25-3. Therefore, those entities that today consider future contracts (or anticipated renewals) when evaluating the period of recognition for upfront payments to customers assert that the adoption of Topic 606 should not impact that previous accounting practice.

27. Third, proponents of this view analogize to the guidance in Subtopic 340-40. That guidance is applied to incremental costs to obtain a contract and costs incurred in fulfilling a contract with a customer. The amortization guidance in paragraph 340-40-35-1 states that the asset may relate to goods or services to be transferred under a specific *anticipated* contract. Therefore, the amortization of the asset is not restricted to the current contract. However, opponents of this view point out that the scope of that guidance in paragraph 340-40-15-2 specifically excludes consideration payable to a customer.

28. Fourth, proponents of View A think that, in the absence of specific GAAP on the topic, an analogy can be made to the subsequent measurement guidance for intangible assets other than goodwill found within paragraphs 350-30-35-1 through 35-3. Specifically, this guidance states that an estimated useful life of a recognized intangible asset is based on its useful life to the reporting entity, and the useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity. Paragraph 350-30-35-3 states that the estimate of the useful life shall be based on an analysis of all pertinent factors, including the entity's own historical experience in renewing or extending similar arrangements, regardless of whether those arrangements have explicit renewal or extension provisions.

29. Finally, in addition to the above technical analysis, some stakeholders assert that in some circumstances the entity is "buying future revenue." In other words, they

assert that the economics of some arrangements are such that the entity has made a payment to a customer in exchange for revenue and, in the absence of specific GAAP on the topic, they think the most faithful representation of the arrangement in the financial statements is to present the payments as a reduction of revenue over the time period in which the related goods or services are expected to be transferred.

Analysis of View B

30. Proponents of View B assert that Topic 606 could result in a change in accounting for payments to customers compared to existing GAAP. This is because the guidance in Topic 606 is based on accounting for *a contract* with a customer. Topic 606 includes new guidance on identifying whether an entity has a contract with a customer. Topic 606 also includes guidance on determining the contract term and has a focus on enforceable rights and obligations. As such, those who subscribe to this view disagree with recording the income statement impact (amortization) over a period longer than the current contract term.
31. Proponents of View B point to TRG Agenda Ref No. 48 on optional purchases. On that topic, TRG members agreed with the staff view that items that as a matter of law are optional from the customer’s perspective (such as the option to renew a contract) are not promised goods or services in the contract. Accordingly, proponents of View B observe it would not be appropriate to consider future goods and services that are not part of the current contract when determining the period of recognition of an upfront payment to a customer.
32. Opponents of View B assert that an entity is essentially buying future revenue by recording the income statement effect up front and that the accounting under View B may not reflect the economics of the transaction. This is because View B may result in recording the income statement effect of the payment immediately in certain scenarios. For example, consider Example 2, Scenario A in which an entity enters into an exclusive supply arrangement. While the supply arrangement does include forecasts, it does not include any contractually guaranteed minimum quantities. If an entity were to subscribe to View B, the entire upfront payment would be recorded in the income statement when the payment is made. The staff understands that there may be some diversity in current GAAP in terms of whether the payment is recorded as an expense or as negative revenue. In either case,

because the income statement effect is recorded up front, the goods or services supplied later under the contract would be recorded at full price (that is, the transaction price for the later contracts would not be reduced by the upfront payment). This results in an entity reflecting higher revenue in later periods compared to earlier periods (all else equal), which some think is not consistent with the economics of the arrangement.

FASB Staff Views

33. The staff's view is that GAAP is not explicit in how to account for scenarios similar to Example 1, Scenario B and Example 2, Scenarios A and B under either existing GAAP or the new revenue standard. This issue has been challenging for many years. In the staff's view, any time an entity is making a payment to a customer (or a potential customer) in expectation of a revenue contract, an entity should carefully evaluate the nature of the payment. The staff thinks aspects of both Views A and B have merit and in some cases, Views A and B result in the same financial reporting outcome (for example, Example 1, Scenario A). The staff does not think that the selection of View A or View B is a policy election. Rather, the staff thinks that an entity should understand the nature of the payment to the customer, understand the rights and obligations in the contract, evaluate the relevant facts and circumstances, apply the guidance in Topic 606 on consideration payable to a customer, consider whether other GAAP is applicable, and apply professional judgment.
34. If an entity applies View A, the staff thinks that an entity should evaluate FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements (CON 6), to determine whether a payment to a customer is an asset. The following are excerpts from CON 6:
    a. **CON 6, paragraph 25:** Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
    b. **CON 6, paragraph 26:** An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to

> future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. Assets commonly have other features that help identify them—for example, assets may be acquired at a cost and they may be tangible, exchangeable, or legally enforceable. However, those features are not essential characteristics of assets…

35. If an entity concludes that a payment to a customer should be recognized as an asset, the entity will need to determine the amortization period and pattern. This will require professional judgment on the basis of the facts and circumstances. Similar judgments are made today when determining the life of many other tangible and intangible assets.
36. If an entity concludes that a payment to a customer should be recognized as an asset, the entity also will need to determine in subsequent periods whether the asset is impaired. While no specific GAAP exists on the subsequent measurement for assets resulting from an upfront payment to a customer, the staff notes that GAAP has various asset impairment models and that those models provide a framework to determine whether an asset is recoverable (or whether the fair value of the asset exceeds its carrying value), and if not, to write down that asset to the appropriate amount. The staff thinks that, in the absence of explicit GAAP, applying the notions behind the impairment tests in GAAP would be a supportable approach.
37. A potential concern with View B is that a company, arguably, could inflate its revenues in future periods by agreeing to make an upfront payment to a customer (for example, in the form of cash or share options) in exchange for the customer agreeing to make higher payments for the goods and services transferred to the customer. However, this same concern exists today and it is something that entities, and their auditors, are cognizant of today.
38. Although the staff thinks that some diversity in practice is likely to persist after the adoption of Topic 606, the staff points out that Topic 606 introduces a comprehensive package of revenue disclosures. For example, an entity is required to disclose significant judgments, and changes in the judgments, about the transaction price (paragraph 606-10-50-17). The staff thinks that the judgments in

deciding whether to capitalize an upfront payment to a customer and the amortization period could be significant judgments (depending on materiality) that impact the transaction price. In addition, other Topics have disclosure requirements that might be applicable depending on the form of the payment and the nature of the payment. For example, if the payment is in the form of equity, disclosure requirements for nonemployee share-based payment (which refer to the disclosure requirements in Topic 718) would be applicable. If the nature of the payment is deemed to be the purchase of an intangible asset for exclusive distribution rights, disclosures for intangible assets would be applicable. Given the wide range of the nature of upfront payments and the significant judgment that sometimes is needed to account for those payments, the staff encourages stakeholders to ensure that sufficient disclosure is made to enable a financial statement user to understand the entity's accounting for upfront payments.

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

Appendix A

Excerpt of Remarks by Paul Kepple, Professional Accounting Fellow, at the December 1998 AICPA National Conference on Current SEC Developments Regarding Internet Loss Arrangements

An internet services provider (Service Co.) entered into an arrangement with an internet access company (Internet Co.). For a fixed up front cash payment, Service Co. became a premier service provider for search and navigation on Internet Co.'s network of internet products and services. Service Co.'s objective in entering into the agreement was to increase user traffic on its system. Internet Co. guaranteed that Service Co. would receive a minimum number of impressions as preferred provider of internet search and navigation. An impression is the listing of Service Co. as a premier search provider on Internet Co.'s webpage(s), providing the user with the ability to click through to Service Co.'s website. Service Co., in turn, would be able to generate revenues through the sales of advertising on its web site. This ability is enhanced by the increased traffic resulting from the agreement with Internet Co. As a result of the fixed cash payment, there was no dispute regarding the fair value of the exchange.

Service Co. recognized a one-time nonrecurring loss upon entering into the above arrangement. The determination of the loss unrecovered costs over the term of the agreement. Specifically, the total up-front cash payment and estimated direct selling costs were deducted from the incremental advertising revenues to arrive at a net loss number. The net loss was then expensed as a one-time nonrecurring charge.

Service Co. did not believe that the upfront payment met the definition of an asset under Concept Statement No. 6 because future economic benefits were not probable and that the arrangement was tantamount to a loss contract. The company also cited SOP 98-5 related to start up activities to further support its position.

The staff objected to the registrant's conclusion. From a conceptual perspective, the staff concluded that the timing of the cash payment should not dictate the accounting conclusion. For instance, if Internet Co. had guaranteed the same number of impressions and Service Co. had agreed to make payments on an "as incurred" basis or as a lump sum upon receipt of the guaranteed impressions, the expense recognition should not change. The staff stated that the amounts paid to maintain and increase user traffic results should be capitalized and amortized over the period the access to the user traffic is received under the agreement. This prepayment was no different from other amounts paid for future service, occupancy, or rights to use. While Service Co. did not believe that it would generate profits during the one year term of the agreement, generally accepted accounting principles do not provide for the write-off of prepaid amounts as losses upon inception of services, lease, and other similar agreements. Instead, the amounts should be amortized systematically over the period that the service, occupancy, or usage occurs. Impairment of the prepayment should be considered in connection with any larger assessment that may be necessary with respect to the assets and the related cash flows of the cash generating activities that will benefit from the consumption of the services or rights.

Other situations reviewed by the staff have been much more complex than the above. Key questions the staff generally asks in these types of arrangements are

1. What is the underlying economic reasons for the transaction? How was it presented for board of director approval? How has it been communicated to the marketplace?
2. What do the contracts state? Are payments for assets such as licenses, rights to use, or prepayments “period costs”? The terms of the contract must be closely scrutinized to understand each element of these bundled arrangements.
3. What is the basis for the nonrecurring one-time loss? If based on SOP 81-1 or SFAS 5, is the arrangement properly appropriately considered within the scope of those documents?

The staff is skeptical of arrangements where the accounting indicates that the company has given away value and encourages registrants to pre-clear unique transactions of this type. The staff also encourages registrants and their auditors to consider taking the accounting issues that are arising in this industry to the EITF on a timely basis.

Appendix B

Prior TRG Discussions

Consideration Payable to a Customer (Agenda Ref No. 37)

Scope

1. The TRG members discussed which payments to a customer are within the scope of the guidance on consideration payable to a customer. TRG members agreed that a reasonable application of either View A (Entities should assess all consideration payable to a customer) or View B (Entities should assess consideration payable to a customer only within the context of that contract with a customer) should result in similar financial reporting outcomes and that reasonable application of either view could be accomplished with processes and internal controls to identify payments to customers that could be related to a revenue contract.
2. In regards to application of View B, some TRG members expressed concern that a strict application of View B might not identify a payment to a customer that is linked to a revenue contract. For example, payments to customers that significantly exceed the fair value of the goods or services received from the customer or payments to an end customer within the distribution chain that are intended to move the entity's products through the distribution chain might not be combined with the contract for the promised goods or services under the contract combination guidance in the new revenue standard if those contracts are not entered into at or near the same time. However, many TRG members thought that a reasonable application of the modification guidance in the new revenue standard when applying View B would identify such payments as a modification of the original transaction (for example, a modification of the transaction price of the type described in paragraph 606-10-32-45 because the two transactions would be economically linked).

Timing

3. TRG members discussed when an entity should recognize consideration payable to a customer as a reduction to revenue. The guidance on consideration payable to a customer in paragraph 606-10-32-27 states that such amounts should be recognized as a reduction of revenue at the *later of* when the related revenue is recognized or

the entity pays or promises to pay such consideration (promises could be implied by customary business practices). This is referred to as the “later of guidance”.

4. Some TRG members highlighted that if an entity intends to provide its customer with a price concession when entering into the contract (regardless of the form of the price concession, for example, cash payment, rebate, account credit, or coupon), then the contract includes variable consideration and it should consider that price concession when estimating variable consideration (subject to the constraint on variable consideration). In determining whether an entity intends to provide the customer with a price concession, the entity should consider the guidance in paragraphs 606-10-32-6 through 32-7. If the contract includes variable consideration because of an expected price concession, then the entity would not wait until it has communicated the price concession to the customer to recognize a reduction in revenue under the later of guidance. Instead, the entity would account for the variable consideration in accordance with paragraph 606-10-32-14. That is, the TRG agreed with the staff view that the *later of* guidance in paragraph 606-10-32-27 only applies to fixed consideration.

Customer options for additional goods and services (Agenda Ref No. 48)

5. Stakeholders had different views about when, if ever, goods or services underlying an option to purchase additional goods or services should be considered promised goods or services when there are no contractual penalties that compensate the other party if the option is not exercised. TRG members agreed with the staff view that items that as a matter of law are optional from the customer’s perspective are not promised goods or services in the contract. The options should instead be assessed to determine whether the customer has a material right. As a result, consideration that would be received for optional goods or services if the customer exercises its right should not be included when determining the transaction price for the initial contract. TRG members discussed scenarios whereby an entity sells goods or services to a customer at a loss with a strong expectation of profit on future orders from that customer. TRG members agreed that if those further purchases are optional, the underlying goods or services would not be considered promised goods or services in the initial contract with the customer, rather any such options would be evaluated for the existence of a material right.